

Improving The Business Environment in East Java

Views from the private sector



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The Asia Foundation

Celebrating Fifty Years

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FOREWORD

As decentralization in Indonesia unfolds and local governments assume increased responsibility for developing their regions, it is encouraging to see positive examples around the country of efforts to promote economic cooperation among local governments and solicit private sector participation in policymaking. East Java Province is one such example.

This report is the product of a series of activities to address trade and investment barriers and facilitate the initiation of East Java Province's long-term development plan called Strategic Infrastructure and Development Reform Program (SIDRP). SIDRP is based on four pillar programs in infrastructure, local economic development, poverty alleviation, and governance. The East Java government, recognizing the importance of improving the business environment for regional development, has initiated SIDRP as an opportunity to engage the private sector. The World Bank and The Asia Foundation support this initiative and we are very pleased to be able to assist the government in this important process. Beyond this initial step, the World Bank is currently working with the Provincial government on identifying infrastructure projects to support, and The Asia Foundation is active in advocating reduced domestic trade barriers and red tape faced by the private sector.

The input of the private sector, from micro entrepreneurs to large businesses, is invaluable in helping the government formulate appropriate economic policy. This report contains numerous illustrations from the private sector perspective on the barriers to growth they face, including what infrastructure hinders growth and access to market, which regulations are obstacles to domestic trade, and how to better target government assistance. The Asia Foundation and the World Bank jointly conducted discussions with around 650 business operators throughout East Java to obtain these views. We trust that these inputs will be incorporated in SIDRP action plans to improve the business climate in East Java. The recommendations are also important for local governments (city/district) in East Java as they work to foster business environments that create jobs and attract investment.

On June 1, 2004, the World Bank and The Asia Foundation, in collaboration with the East Java Provincial Government hosted the East Java Forum for Conducive Investment Climate and Trade. The Forum was opened by Governor Imam Utomo and Coordinating Minister for Economic Affairs, Dorodjatun Kuntjoro-Jakti. Local governments and businesses from 38 cities and regencies, NGOs and other donor agencies were in attendance to discuss the findings in this report, affirm commitment to cooperate among the local governments to reduce domestic trade barriers, and elect private sector representatives who will become members of the working groups in SIDRP.

The World Bank and The Asia Foundation team would like to sincerely thank all private sector participants who took part in the discussions for their time and invaluable insights. We acknowledge that time is of the essence for dynamic businesses, and hope that their continuing contribution in the SIDRP process and other policy dialogue venues yield improved investment climate and the advancement of East Java region.



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Editors: Erin Thébault Weiser (The Asia Foundation) and Megawati Sulistyono (the World Bank).

DISCLAIMER

This volume is a product of the staff of the World Bank and The Asia Foundation, however, the opinions, findings, interpretations, and conclusions here in are those expressed by entrepreneurs in East Java. They do not necessarily represent the views of the World Bank and The Asia Foundation.

LIST OF ABBREVIATIONS

| | |
|----------|---|
| APEKSI | All Indonesia Association of City |
| APKASI | All Indonesia Assciation of Regency Governments |
| APTR | Smallholders Sugar Cane Farmers Associations |
| BAPPENAS | National Planning Body |
| Bakorwil | Regional Coordination Agency |
| BKPM | Investment Coordination Agency |
| BPS | Central Statistical Bureau |
| BPDE | Electronic Management Agency |
| BPP | Directorate General for Guidance of Plantation Production |
| BPN | National Land Agency |
| BUMN | State-owned Companies |
| DAU | General Allocation Fund |
| DLLAJ | Highway Traffic Service |
| DPKK | Manpower Skill Development Fund |
| DPOD | Regional Autonomy Advisory Council |
| DPPM | Capital Investment and Permitting Service |
| FGD | Focus Group Discussion |
| GDP | Gross Domestic Product |
| GPP | Category of Factory Entrepreneur |
| GRDP | Gross Regional Domestic Product |
| HAKI | Intellectual Property Rights |
| HO | Nuisance Permits |
| HPH | Forest Concession Permits |
| ITKA | Expatriate Work Permits |
| IUI | Industrial Business Permits |
| IUT | Permanent Business Permits |
| KPH | Forest Management Unit |
| MoU | Memorandum of Understanding |

LIST OF ABBREVIATIONS

| | |
|----------|---|
| NGO | Non-Government Organization |
| OSS | One Stop Service |
| PAD | Local revenues |
| PBB | Local taxes on land |
| PDRB | Gross Regional Domestic Product |
| PDP | Regional-Owned Plantation Company |
| Perda | Regional Regulation |
| PG | State owned Sugar Plantation Company |
| PLN | State-Owned electricity Company |
| PMA/PMDN | Foreign / Domestic Investment Company |
| PTPN | State Plantation Company |
| P3GI | Indonesian Sugar Plantation Research Center |
| SIDRP | Strategic Infrastructure and Development Reform Program |
| SIPA | Water use permit |
| SIUP | Trading Business Permit |
| SKM | Machine-rolled kretek |
| SKT | Hand-rolled kretek |
| SKSHH | Certificate of Legality of Forest Products |
| SME | Small Medium Enterprises |
| SOE | State Owned Enterprises |
| SPAP | Purchase Allocation Orders |
| SPM | Machine-rolled non- kretek |
| SPT | Hand-rolled non-kretek |
| SPP | Purchase Orders |
| SIP | Purchase Permits |
| UMK | Regional Minimum Wages |
| VAT | Value Added Tax |

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EXECUTIVE SUMMARY

Do local governments have good understanding of the business environment in our regions? This is a question recurrently asked by the private sector, not only in East Java but throughout Indonesia, particularly in recent years as regional autonomy unfolds.

The private sector is the engine of economic growth, and accordingly is the key shareholder and stakeholder in the business environment. East Java has been fortunate to have solid growth provided by its very dynamic private sector. However, for it to produce optimal results in growth and jobs creation, more needs to be done to support a business friendly environment. This support, as our field study has found, varies across regions in East Java.

Rising competition is unavoidable, the challenge is to be competitive. Competitiveness in a business environment has many determining factors from natural resources, infrastructure, government regulations and access to capital, to security. In this limited exercise, we focus on infrastructure conditions (roads, electricity, water) and government regulations (particularly local ones), but other factors - such as access to finance - are also noted. East Java, with population around 35 million people, undoubtedly has the platform to be a very competitive region. A well developed agricultural sector, abundant natural resources such as liquefied petroleum gas in the Madura strait, and access to a deep sea port (Tanjung Perak) are among its comparative advantages. Additionally, the region is also the site of numerous large industries. Nevertheless, East Java is not immune from challenges in the business environment - both from internal and external factors.

Viewpoints from the private sector are the core substance of this report. The team consulted with no less than 650 entrepreneurs across the province ranging from farmers and fishermen to the medium and large businesses. Focus group discussions and in-depth interviews were conducted for several months in various meeting points around the region, and were complemented by research and a survey. We use sectoral approach to give practical illustrations to the issues raised, and value chain analysis is useful to describe various perspectives from upstream to downstream business operators.

Signs of infrastructure bottlenecks have surfaced in many areas. Congested roads, electricity blackouts and water shortages are the main grievances. At present, businesses can still operate, but their future growth would be at risk due to infrastructure constraints. Water, for example, is often in short supply for agriculture businesses in Madiun, Situbondo, Ngawi, Ponorogo, Madura, and polluted water has had detrimental impact to fishery farming, particularly in Tuban. Even the capital city Surabaya has issues with clean water.

Many regulations need to be reviewed. On local regulations, there are two types that raised objections from the private sector. First are regulations subjecting businesses to additional tax and levies. Second are regulations creating unfair competition either among the private sector, or between local government and the private sector. An example of the latter was illustrated by coffee farmers in Jember whereby the local government established a state-owned enterprise PDP (Perusahaan Daerah Perkebunan) and circulated an order (Surat Edaran) to all local government agencies to purchase coffee only from this PDP.

Often, government assistance with good intentions does not result in desired outcomes due to lack of consultation with stakeholders. This case is illustrated time and again in agriculture when government provides assistance to farmers from seeds to equipment which, at the end of the day, are not used by the recipients because they do not meet their needs due to lack of consultations and at times, nepotism in procurement. This is an example that is applicable at larger scale. For instance, private sector gave their views on one of the SIDRP (Strategic Infrastructure and Development Reform Program) proposals on building agriculture terminal. Businesses agreed that it is a good initiative but if located in Sidoarjo as planned, it would be too far from the producers they are trying to assist in the first place.

The issues of illegal levies and security are obvious, but the solutions are not. Since 1998, a shrimp farm in Tuban has lost up to 50% of its produce because of robberies, and coffee farmers are forced to harvest their crops early – tolerating lower quality and prices – to avoid a similar situation. On illegal levies, there are numerous examples given by the private sector in each discussion of the types, methods, amounts and recipients of these payments. Businesses were unified in recommending law enforcement, but they are pessimistic that this is a realistic solution, given that, in too many cases, the problems lie with the authorities.

Improving the coordination function among local governments is important, particularly to enhance domestic trade. Access to market is a basic need for businesses, large and small. In the appendix of this report, we compiled information on existing local government forums in East Java. There are several group forums and some bilateral cooperations, for example between Surabaya and Sidoarjo. These forums should be encouraged to extend issues of interest beyond social problems and politics, to also include investment and trade. Recently, East Java initiated a forum on UPT (one stop service) to share best practices in business licensing.

The East Java Forum for Investment Climate and Trade held on June 1, 2004 should be used as a starting point towards better and more regular public-private dialogue on resolving these issues. This report raises some preliminary issues, and we hope that it gives useful insights, especially to the East Java provincial and local governments in their efforts to improve the business environment in their regions.

1 | BACKGROUND AND AIMS

BACKGROUND AND AIMS

This report presents the results of research undertaken by The World Bank and The Asia Foundation to identify barriers to trade and investment in East Java. This activity was initiated by the World Bank and The Asia Foundation with several important aims: (i) to support private sector participation in the public planning process related to potential World Bank assistance for infrastructure projects; (ii) to provide an opportunity for the private sector to express their concerns to local governments and to make recommendations for improving the business climate; and (iii) to encourage increased coordination between local governments in stimulating trade between regions. The role of the Asia Foundation / World Bank Team was to identify barriers to trade and investment and to facilitate activities to introduce a sustainable and replicable process for how regional governments can best work with the private sector in creating a conducive business climate.

This work was done in collaboration with the Strategic Infrastructure and Development Reform Program (SIDRP) of the East Java Provincial Government. The SIDRP project has 2 stages: first is the establishment of a strategic vision, to be concretely followed up with regional development plans coordinated by the East Java Provincial Government and supported by the 38 local governments in the province. The second is investment projects by donor institutions, such as the World Bank or other donors. The research presented here feeds into the preparatory phase of the SIDRP: establishing a strategic vision and regional development plans. It is very important that the voice of the private sector, as a stakeholder in this project, be represented in the working groups chaired by the government on development of local economies and infrastructure.

In addition, barriers to trade between regions have increased since the introduction of regional autonomy as a result of new local regulations aimed at increasing locally generated revenue. In this work focused on East Java, barriers to domestic trade were found to be a significant obstacle to business growth. The Asia Foundation and World Bank Team raised this issue through this report and in an East Java Forum that was held on June 2004 as part of this project. The forum brought together 400 policy makers and business owners. Proceedings are available in bahasa Indonesia¹. Obstacles to trade and investment highlighted by the research findings were also discussed in radio talk shows and district level workshops sponsored by The Asia Foundation.

¹ East Java Forum for Conducive Trade and Investment Climate and SIDRP Preparation, The World Bank and the Asia Foundation.

Figure 1. Map of East Java

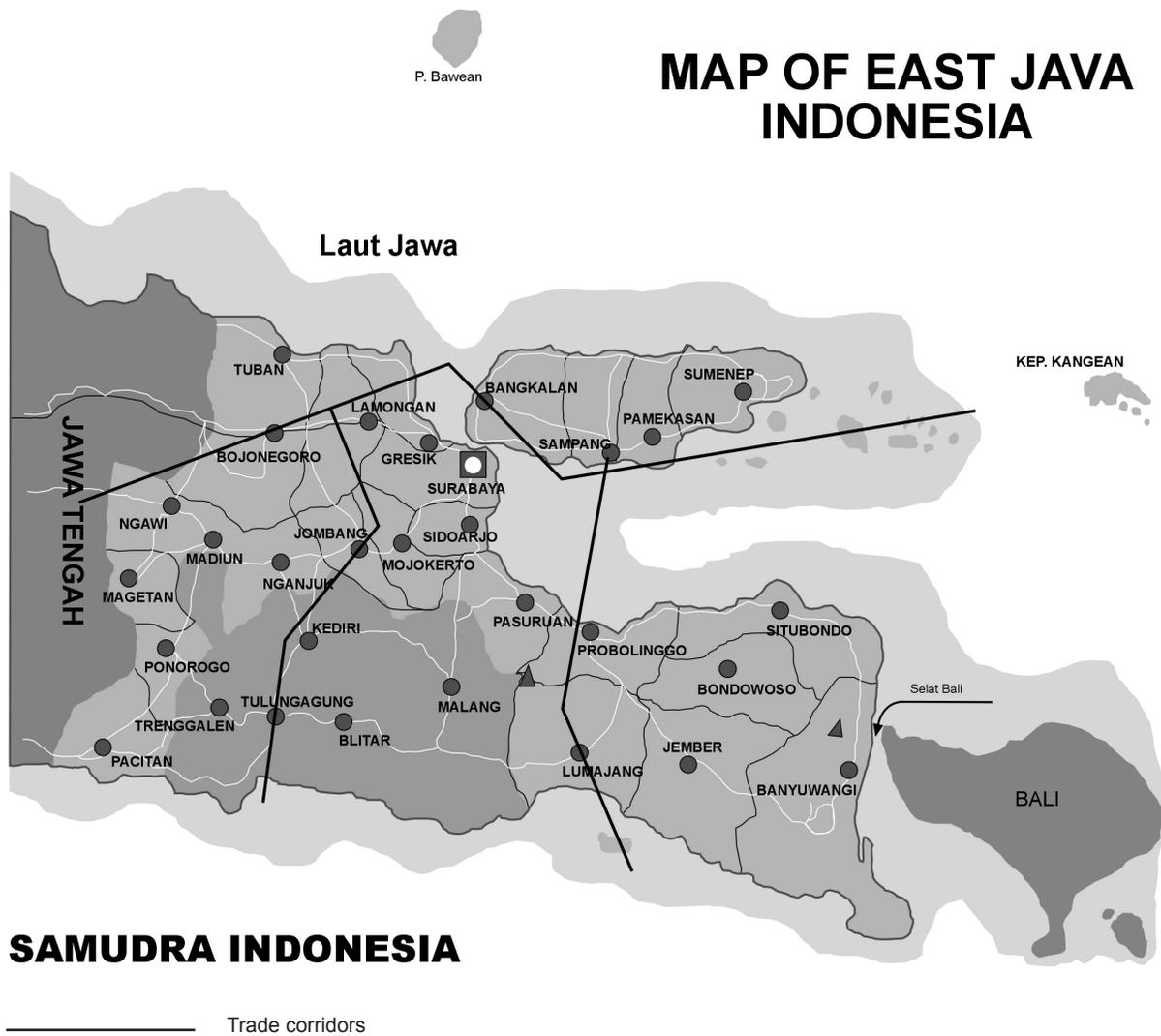


Table 1.1 East Java Development Indicators

| | East Java | Indonesia | Rank (30 Prov) | | East Java c/c to last period | E. Java % change | Indo % change |
|--|-----------|-----------|----------------|---|------------------------------|------------------|---------------|
| ECONOMIC | | | | | | | |
| Gross regional dom. product 2002 (current, billion Rp) | 226,957 | 1,539,579 | 2 | ↑ | 195,762 (2001) | ↑ | 16 |
| GRDP per capita 2002 (current, thousands, Rp) | 6,443 | 7,262 | 14 | ↑ | 5,593 (2001) | ↑ | 15 |
| Growth rate GRDP 2002 (constant 93p) | 3.4 | 4.07 | 21 | ↓ | 3.5 (2001) | ↓ | -2 |
| Growth rate GRDP 2002 per capita (constant) | 2.8 | 2.6 | 13 | = | 2.8 (2001) | ↓ | -3 |
| Total exports 2002 US\$ millions (Tg. Perak, Srbya) | 5,282 | 61,058 | 3 | ↑ | 4,989 (2002) | ↓ | 6 |
| Open unemployment rate 2003 | 8.6 | 9.5 | 14 | ↑ | 6.43 (2002) | ↑ | 35 |
| Poverty rate 2003 | 20.9 | 17.4 | 13 | ↓ | 21.9 (2002) | ↓ | -7 |
| Urban poverty rate 2003 | 16.8 | 13.5 | 11 | ↓ | 18.9 (2002) | ↓ | -11 |
| Rural poverty rate 2003 | 23.7 | 20.2 | 8 | ↓ | 24.1 (2002) | ↑ | -2 |
| SOCIAL | | | | | | | |
| Human development index 2002 | 64.1 | 65.8 | 25 | ↑ | 61.8 (1999) | ↑ | 4 |
| Adult literacy rate 2002 | 83.2 | 89.5 | 28 | ↑ | 81.3 (1999) | ↑ | 2 |
| Life expectancy 2002 (years) | 66.0 | 66.2 | 24 | ↑ | 65.5 (1999) | ↑ | 1 |
| Mean years of schooling 2002 | 6.5 | 7.1 | 25 | ↑ | 5.9 (1999) | = | 10 |
| Population w/o access to health facilities % 2002 | 22.2 | 23.1 | 9 | ↑ | 17.1 (1999) | ↑ | 30 |
| Population w/o access to clean water % 2002 | 36.7 | 44.8 | 4 | ↓ | 43.0 (1999) | ↓ | -15 |
| Population w/o access to sanitation % 2002 | 31.5 | 25.0 | 18 | ↓ | 31.9 (1999) | -- | -1 |
| Infant mortality rate 2002 (per 1,000) | 47.0 | 43.5 | 20 | ↓ | 48.0 (1999) | -- | -2 |
| Households with dirt floors 2002 (%) | 27.5 | 16.7 | 25 | ↓ | 28.3 (1999) | -- | -3 |
| Under-nourished children under five 2002 (%) | 25.5 | 25.8 | 13 | ↓ | 30.7 (1999) | ↓ | -17 |
| DEMOGRAPHIC | | | | | | | |
| Population 2003 (million) | 36.2 | 215.0 | 2 | ↑ | 34.7 (2000) | ↓ | 1 |
| Population growth rate 2000 – 2003 | 1.42 | 1.50 | 12 | ↓ | 1.49 (1990-00) | ↓ | -30 |
| Population density per sq km 2003 | 756 | 114 | 6 | ↑ | 726 (2000) | ↓ | 1 |
| Population Surabaya 2000 (million) | 2.6 | n/a | n/a | ↑ | 2.5 (1990) | -- | 4 |
| Population Surabaya, Sidoarjo, Gresik 2000 (million) | 4.8 | n/a | n/a | ↑ | 4.3 (1990) | -- | 12 |

Source: Statistics Indonesia (BPS 2003), and Indonesian Human Development Report 2004 (BPS, BAPPENAS, UNDP 2004)

2 | METHODOLOGY

Desk Study

Survey

Focus Group Discussions

Case Studies

METHODOLOGY

Data collection activities were conducted from October 2003 through March 2004 and covered all local cities and districts in East Java. The choice of methodology was based on the types of information and data being sought and the information sources available. The types of information sought and the methods used can be seen in the following table.

Table 2.1 Data Gathering Methods and Types and Sources of Information

| Type Of Information | Information Source | Method |
|--|--|---|
| Macro information regarding general situation in East Java, at both provincial and city/ regency levels | Secondary data in the form of research results, statistics, newspaper clippings, and Internet | Desk Study |
| General information regarding business conditions in the regions and mechanisms of coordination among regional governments | Primary data, with respondents being randomly chosen business operators and government representatives from the existing coordination forums | Survey (Total respondents = 103 persons) |
| Information regarding barriers to trade and investment in selected sectors. | Business operators as key informants, intentionally chosen based on being in same sector | Focus Group Discussions (FGD) (Total = 7 FGD with total participants = 527 persons) |
| Case studies | Key informants including business operators and other players who support business activities, such as management of industrial zones or cooperatives, intentionally chosen based on the specific information needed | In-depth Interviews (Total key informants = 59 persons) |

Desk Study

The primary activity in this method was to gather all the secondary data related to the economy of East Java. The secondary data sources collected in this activity were:

- Results of research and seminar papers written by NGOs, research institutions, and foreign donors, about East Java;
- Official data from governments, both central government sources such as the Central Statistical Bureau (BPS) and regional government sources, i.e. cities, regencies, and the province, in the form of figures for PDRB (Gross Regional Domestic Product) for each city and regency, and regional government regulations;
- Information from mass media, both newspapers and electronic media including Internet.

These secondary data were used primarily for mapping the economic conditions in East Java at the macro level.

Survey

The survey was conducted from October 2003 to January 2004. The main information collected through the survey activities was first, about perceptions of business operators regarding various aspects of the business environment including licensing and permitting, infrastructure, levies, and business security; and second, about the effectiveness of the coordination that takes place between city and regency governments and also with the provincial government in East Java (see appendix).

The information on perceptions of business operators was obtained through a questionnaire, while that on effectiveness of coordination was obtained through interviews based on an open-ended list of questions prepared in advance.

A total of 103 respondents from among business operators, in eleven sectors², participated in the survey. The characteristics of the respondents are described in Table 2.2, below.

² These sectors were agribusiness, non-trade services, wood industries, handicrafts, metals, the food industry and industries in other categories, trade, mining, the textile industry, and transportation services

A majority of the respondents (49.8%) in this study had turnover of under 500 million rupiah. Meanwhile, looking at the numbers of personnel, a majority of respondents (79.6%) had fewer than 100 personnel. Thus, considering their business turnover and numbers of personnel, a majority of the respondents in this survey are in the category of small and medium entrepreneurs.

In contrast, the information on the effectiveness of coordination between governments in East Java was obtained from a number of sources representing several coordination forums. These forums can be differentiated into two groups: first, forums under the coordination of the provincial government, and second, forums initiated by the city and regency governments in East Java. There were four forums in the first category: the Regional Coordination Agency (Bakorwil), the Industry and Trade Services, the Cooperation and Legal Bureau, and the Fund and Electronic Management Agency (BPDE). Among the forums in the second category were APEKSI and several bilateral forums.

Focus Group Discussions

Focus group discussions (FGD) were held involving business operators from East Java. A total of 527 business operators ranging from micro to medium participated in seven FGD sessions. In each of these FGD sessions, the participants who attended were business operators from several regions. All participants were business operators from business sectors that were important in terms of contribution towards GRDP in those regions.

Following discussion of general problems in the business environment, participants were divided into groups by sector. In this way they could discuss in-depth the issues faced in developing business in their respective sectors. The discussion for each sector began by analyzing and describing production and distribution chains for the commodity. This was followed by detailing the issues faced by business operators at each stage in the business chain. Based on this breakdown of issues,

Table 2.2 Respondents by Value of Business Turnover/ Year

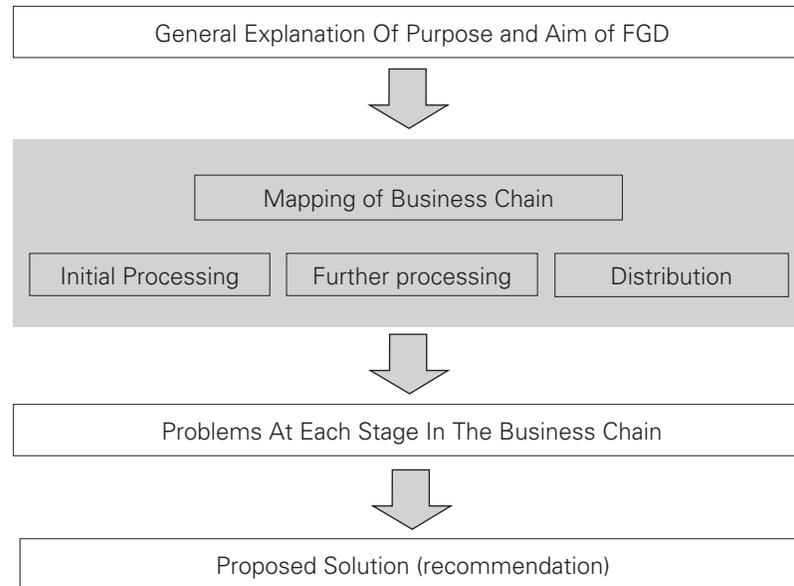
| Business Turnover (RP) | Percentage |
|---------------------------|------------|
| Over 1 billion | 32 % |
| 500 million - 1 billion | 14.6 % |
| 100 million - 500 million | 37.2 % |
| Under 100 million | 12.6 % |
| Total | 100% |

Table 2.3 Numbers of Respondents' Personnel

| Number Of Personnel | Percentage |
|---------------------|------------|
| Over 100 persons | 20.4 % |
| 20 – 99 persons | 44.6 % |
| 5 – 19 persons | 35 % |
| Total | 100% |

a consensus was then reached on the priority issues that most urgently needed to be overcome. The discussions generally ended by collecting ideas from the discussion participants for solutions to their problems, particularly those that had been considered top priorities.

Figure 2.1 Structure of FGD Discussions



This activity of collecting data through the focus group discussion method was conducted in seven locations in East Java. The FGD venues were selected on the basis of (a) regional distribution and (b) accessibility. The coverage area of participants was limited to a maximum of five cities/regencies per FGD, with a maximum land travel time for participants to the FGD of three hours. The seven regional groupings were as follows:

- FGD 1 covered Sidoarjo Regency, Pasuruan Regency and City, and Mojokerto Regency and City³;
- FGD 2 covered the Kediri Regency and City, Tulung Agung Regency, Nganjuk Regency, and Jombang Regency;
- FGD 3 covered Malang Regency and City, Blitar Regency and City, and the City of Batu;
- FGD 4 covered Pamekasan Regency, Sampang Regency, Bangkalan Regency, and Sumenep Regency;
- FGD 5 covered the City of Surabaya, Gresik Regency, and Lamongan Regency;
- FGD 6 covered Jember Regency, Lumajang Regency, Situbondo Regency, Bondowoso Regency, and Banyuwangi Regency;
- FGD 7 covered Madiun Regency and City, Ponorogo Regency, Ngawi Regency, and Magetan Regency.

³City refers to urban area and Regency refers to rural area

Case Studies

It was decided to collect information through in-depth interviews to gather information that would be difficult to obtain through surveys, desk study, or focus group discussions. The information that had not been obtained through these earlier methods was specific information on each sector that was relatively sensitive for the informants.

The in-depth interviews involved between six and ten informants per interview session. A total of 59 key informants were involved in this activity. These in-depth interviews were held in the following regions:

- In-depth interview 1 covered Sidoarjo Regency, Mojokerto Regency, and Pasuruan Regency;
- In-depth interview 2 covered Pacitan Regency;
- In-depth interview 3 covered Trenggalek Regency;
- In-depth interview 4 covered Tuban Regency;
- In-depth interview 5 covered Bojonegoro Regency.

More detailed observation of barriers to trade was also done by having a researcher accompany a goods shipment route. This was done primarily to get a genuine picture of the obstacles faced by business operators on this trade route. The route traversed was from Malang to the port of Tanjung Perak, Surabaya and the good in question was a shipment of wood.



3 | ECONOMIC PROFILE OF EAST JAVA

Growth & Employment

Geographic Breakdown

Sectoral Breakdown

East Java's Exports

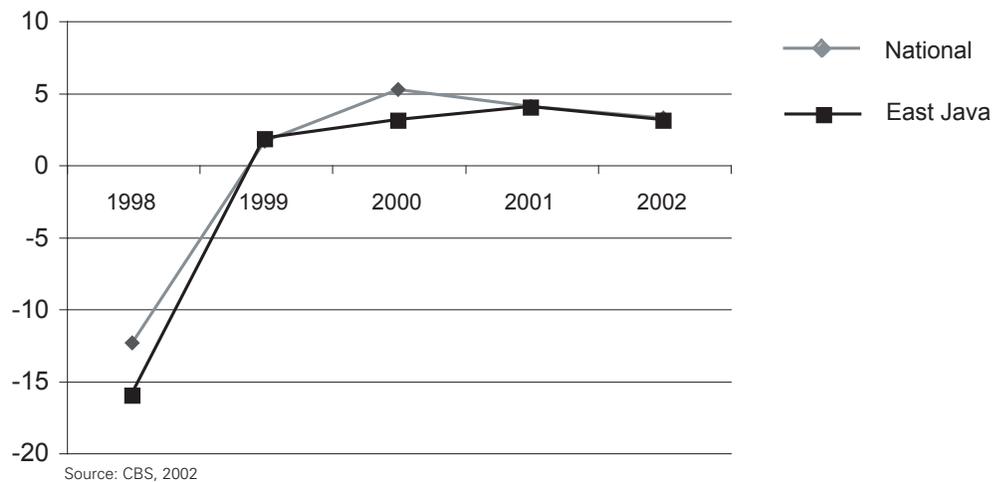
ECONOMIC PROFILE OF EAST JAVA

Growth and Employment

East Java is a key center for growth in the eastern part of Indonesia, as it plays a role as the gateway for trade between the western and eastern parts of Indonesia. With a population of around 35 million (BPS, 2003), the province of East Java is a major contributor to the national GDP, at 196.5 trillion rupiah (current prices for 2001) per year, or more than 13% of the national Gross Domestic Product (GDP).

The rate of economic growth in East Java is very similar to that of the nation as a whole. In 1998, when the impact of the economic crisis was at its peak, Indonesia's economic growth was negative, and so was East Java's; the conditions of economic growth at that time were in fact even worse in East Java. From 1999 onward, growth has shown an increase, and since 2000 it has tended to be stable, even if not very high.

Figure 3.1 Comparison of Rates of Economic Growth, 1998-2002



In terms of contribution by sector to East Java's GRDP, it can be seen that the share from the agricultural sector has declined over the past five years, while the industrial sector share is steadily rising. The service sector has also shown an increase, and is the largest contributor to GRDP.

Figure 3.2 Contribution to GRDP by Sector

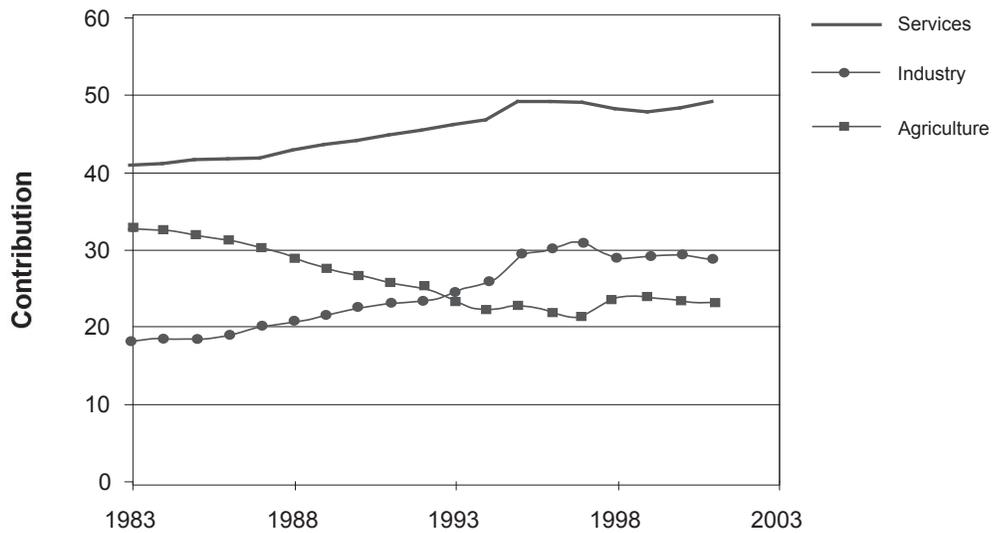
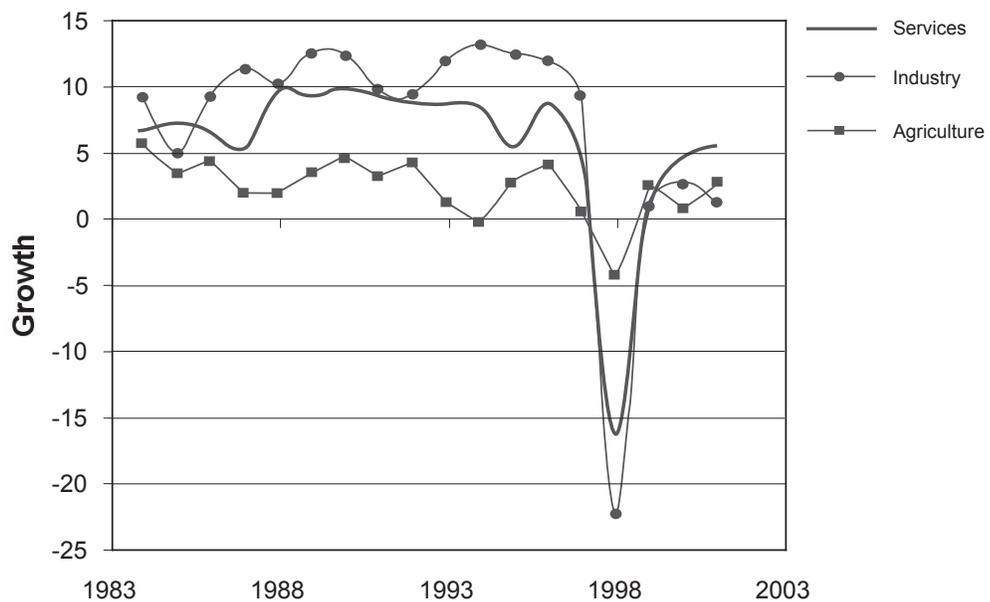


Figure 3.3 Economic Growth by Sector



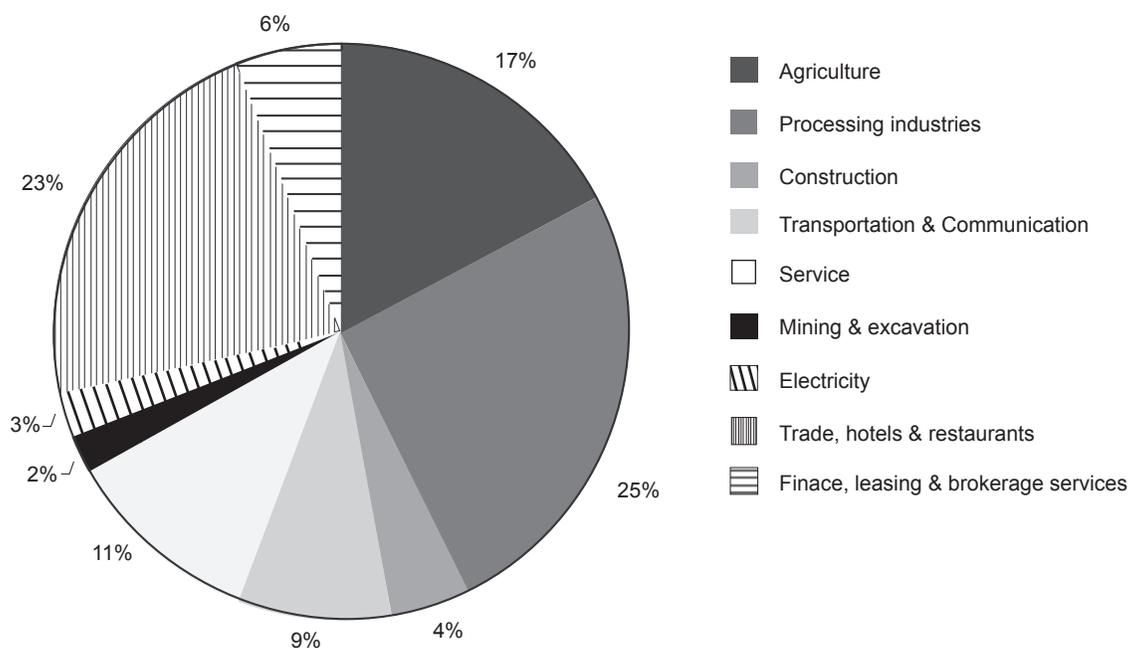
Source: BPS, various editions

The service sector, which groups hotels, restaurants, trade, transportation, and communication, gives East Java an increasingly important role in the eastern part of Indonesia. No fewer than five, five-star hotels are located here, as well as significant numbers of four- and three-star hotels, all of which contribute to the value added of the service sector.

Trade, together with transportation and communication, also plays a very important role in East Java's economy. Around 9% of Indonesia's total value of exports goes through the port of Tanjung Perak, Surabaya (Panggabean, et al., 2003). Similarly, Juanda Airport not only serves domestic flights to the western and eastern parts of Indonesia, but also facilitates at least 35 international flights per week. The airport is also undergoing major expansions.

The three sectors mentioned above show an asymmetry in the numbers of workers they employ. In 1999, out of East Java's total workforce of 17,554,632, 46.18 percent were employed in agriculture, 22.32% in industry, 12.70% in services, and 8.80% in trade⁴.

Figure 3.4 Sectoral Distribution of East Java's GRDP, 2002



Source: Processed from GDRP data, East Java BPS, 2002

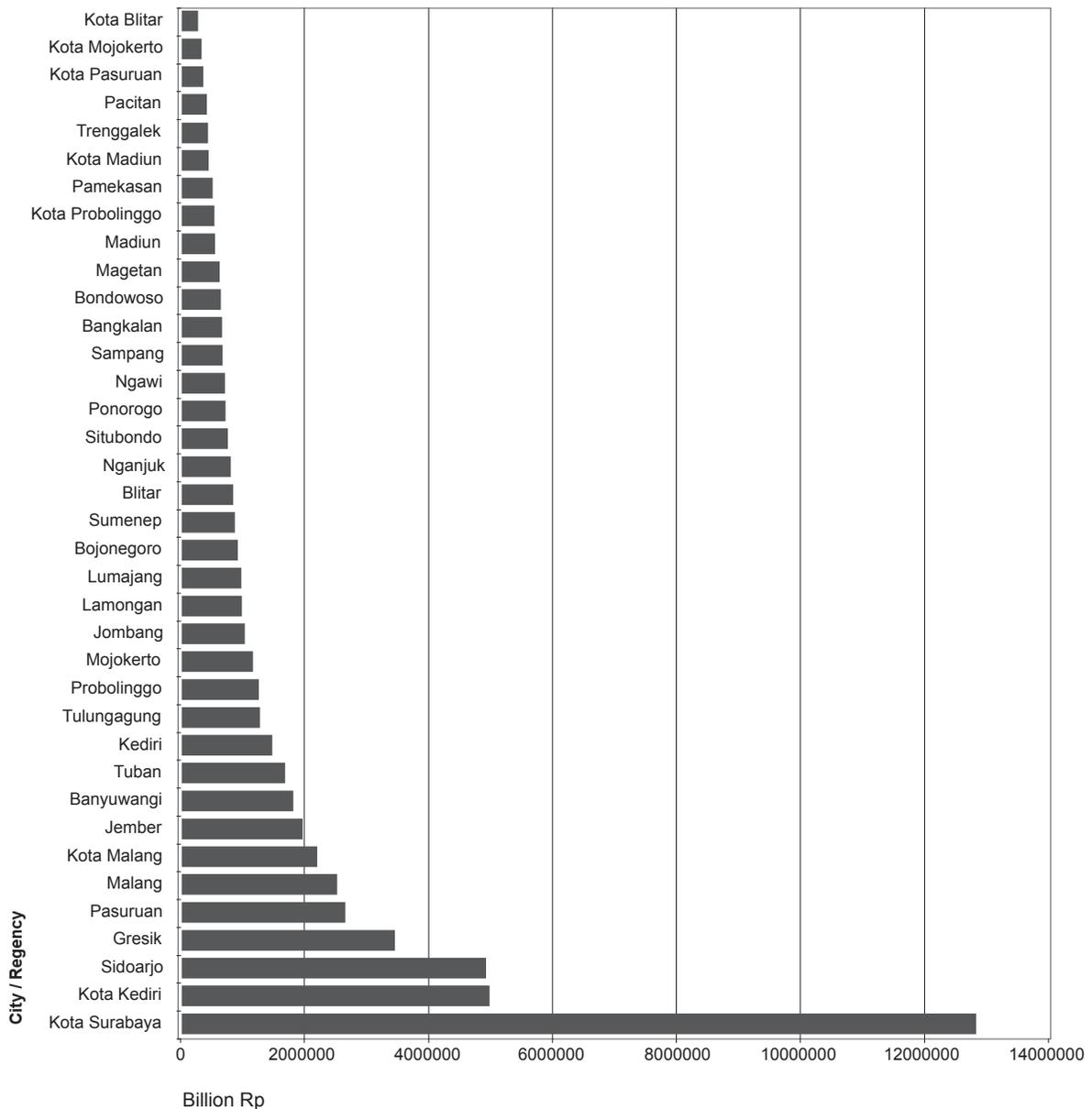
As expected in a developing economy, employment in agriculture is disproportionately high given the sectors low value added.

⁴<http://english.d-infokom-jatim.go.id/eastjava.asp>, downloaded on 1 December 2003

Geographic Breakdown

In spatial terms, too, there are imbalances in economic distribution. More than 20 percent of East Java's economy is concentrated in Surabaya, and if we expand this to include the hinterland of the City of Surabaya, the so-called "Gerbangkertasusila" (Gresik, Bangkalan, Mojokerto, Surabaya, Sidoarjo and Lamongan) region, nearly 40 percent of the province's economy is concentrated in this region.

Figure 3.5 GRDP by Business Sector in Cities and Regencies in East Java



Source: East Java BPS

In spatial-sectoral terms, the economy of East Java can be divided into four corridors, each with different characteristics. These are shown on the map in chapter one. The first corridor comprises the regions of Blitar, City of Blitar, Gresik, Malang, City of Malang, Mojokerto, City of Mojokerto, Pasuruan, City of Pasuruan, Sidoarjo, and City of Surabaya. The second corridor includes Jombang, Kediri, City of Kediri, Madiun, City of Madiun, Magetan, Nganjuk, Pacitan, Trenggalek, Ponorogo, and Tulungagung. The third corridor consists of Banyuwangi, Bondowoso, Lumajang, Jember, Probolinggo, City of Probolinggo, and Situbondo. The fourth corridor includes Bangkalan, Bojonegoro, Lamongan, Ngawi, Pamekasan, Sampang, Sumenep, and Tuban. An analysis using the LQ (location quotient) method conducted by the SIDRP team showed that each corridor has different dynamic economic sectors.

Table 3.1 Economic Sectors in Each Regency and City by Corridor

| REGENCY / CITY | A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R | S | T | U | V | W | X | Y | |
|--------------------|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Corridor I | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1. Blitar | + | + | + | + | | | | | | | | | | | | | | | + | | | | | | + | + |
| 2. Blitar (Mun) | | | + | | | | | | | | + | | | | | | | + | + | + | + | | + | + | + | + |
| 3. Gresik | | | | | + | | | + | | | + | + | + | + | | + | | + | | | | | | | | |
| 4. Malang | + | + | + | | | | | | | | | | + | | | | | | | + | + | + | + | + | + | + |
| 5. Malang (Mun) | | | | | | | | | + | | | | | | | | | + | + | + | + | + | + | + | + | |
| 6. Mojokerto | | + | + | | | | | + | | | + | + | | | | | | + | + | + | | | | | | + |
| 7. Mojokerto (Mun) | | | | | | | | | | + | | | | | | | | + | | + | + | + | + | + | + | + |
| 8. Pasuruan | + | | + | + | | | | + | | + | + | | + | | | | + | | | + | | | | | | |
| 9. Pasuruan (Mun) | | | | | + | | | | | | + | | | | | + | | + | + | + | | | + | + | | + |
| 10. Sidoarjo | | | | | + | | | | | + | + | + | | | | + | + | + | + | + | | + | | | | |
| 11. Surabaya (Mun) | | | | | | | | | | + | | | + | + | + | + | + | + | + | | + | + | + | + | + | |
| Corridor II | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1. Jombang | + | + | + | + | | | | | | | | | | | | | + | | | + | | | | + | + | + |
| 2. Kediri | + | + | + | + | | | | + | | | + | + | | | | | | | | + | | | | | | + |
| 3. Kediri (Mun) | | | | | | | | | + | | | | | | | | | | | | | | | | | |
| 4. Madiun | + | + | + | + | | | | | | | | | | | | | | | | | | | | | + | + |
| 5. Madiun (Mun) | | | | | | | | | | | | | | | | + | | + | | + | + | + | + | + | + | + |
| 6. Magetan | + | + | + | + | | | | | | | | | | | | | | + | | | | | | | | + |
| 7. Nganjuk | + | + | + | + | | | | | | | | | | | | | | | | + | | | | | + | + |
| 8. Pacitan | + | + | + | | | | | + | | | | | | | | | | | | + | | | | | + | + |
| 9. Trenggalek | + | + | + | | | | | + | | | | | | | | | | | | + | | | | | + | + |
| 10. Ponorogo | + | + | + | | | | | + | | | | | | | | | | | | + | | | | | | + |
| 11. Tulungagung | | | + | | | | | + | | + | | | | | + | | | | | | + | | | | | + |

| REGENCY / CITY | A | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R | S | T | U | V | W | X | Y | |
|----------------------|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Corridor III | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1. Banyuwangi | + | + | | + | + | | + | + | | | | | | | | | | | | + | | + | + | + | + | |
| 2. Bondowoso | + | + | + | + | | | | | | | | | | | | | | | | | | | + | + | + | |
| 3. Jember | + | + | + | + | | | | | | | | | | | | | | | + | + | | | + | + | + | |
| 4. Lumajang | + | + | + | | | | | + | | | | | | | | | | | | + | | | | + | + | |
| 5. Probolinggo | + | + | | + | + | | | | | | | + | | | | | | | | + | | | | | + | |
| 6. Probolinggo (Mun) | | | | | | | | | | | + | | + | | | | | | + | + | | + | + | + | | |
| 7. Situbondo | + | + | | | + | | | | | | | | | | | | | | | + | | | + | | + | |
| Corridor IV | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 1. Bangkalan | + | | + | + | + | | | | | | | | | | | | | | | + | | + | | | + | |
| 2. Bojonegoro | + | + | + | + | | | | | | | + | | | | | | | | | | | | | | + | + |
| 3. Lamongan | + | | + | + | + | | | | | | | | | | | | | | | | | | | | + | |
| 4. Ngawi | + | + | | + | | | | | | | | | | | | | | | | | | | | | + | + |
| 5. Pamekasan | + | + | + | | + | | | | | | | | | | | | | | | + | | | | + | + | |
| 6. Sampang | + | | + | | + | | | | | | | | | | | | | | | + | | | | | + | |
| 7. Sumenep | + | + | + | | + | + | | | | | | | | | | | | | | + | | | | + | + | |
| 8. Tuban | + | | | + | + | | | + | | | | | | + | | | | | | + | + | | | | | |

| | | | | | | | | | |
|---|-------------------|---|-----------------|---|-----------------|---|----------------------------|---|--------------------|
| A | Food Plants | F | Oil and Gas | K | Wood processing | P | Machinery | U | Hotels-Restaurants |
| B | Plantation Plants | G | Non Oil and Gas | L | Paper | Q | Other Industries | V | Transportation |
| C | Livestock | H | Minerals | M | Chemicals | R | Electricity, Gas and Water | W | Communication |
| D | Forest Products | I | Food Processing | N | Cement | S | Construction | X | Financial Services |
| E | Fisheries | J | Textiles | O | Metals | T | Trade | Y | Other Services |

Source: SIDRP

Sectoral Breakdown

Agricultural sector

Both the growth rate and the contribution of the agricultural sector are low. Nevertheless, East Java remains one of the nation's major granaries. This is possible because much of the agricultural land in the province is used for food crops, especially rice.

Apart from food crops, the fisheries subsector is also quite important. East Java has potential in sea fisheries (catches) and in cultivated fisheries, both in marshes and on drier land. The significant length of seashore in three of the four corridors indicates the prosperous natural sea resources. This poten-

tial is also supported by the presence of large-scale fish auction sites (TPI), at Brondong (Lamongan) and Muncar (Banyuwangi). Intensive brackish water cultivation, particularly of shrimp, grouper, and bandeng, is done mostly along the north coast (between Tuban and Banyuwangi), though there is also a small amount of intensive shrimp cultivation in the South Malang region. Fisheries along the south coast are not fully exploited due to lack of development in the area.

Industrial sector

Although growth in the processing industry sector shows a declining trend, this sector remains very important in contributing to East Java's GRP. The prominent role of the processing industry sector is due to the great number of large industries in East Java, such as the metal and machinery industry, the cigarette industry, the food processing industry, and the chemical industry. Most of the large-scale processing industries in East Java are either State-Owned Companies (BUMN) or Foreign/Domestic Investment companies (PMA/PMDN).

These large industries are distributed through many locations in East Java, though majority of them are located near Surabaya (Gresik, Pasuruan, Mojokerto, and Sidoarjo). Given the stronger infrastructure available to support such activities.

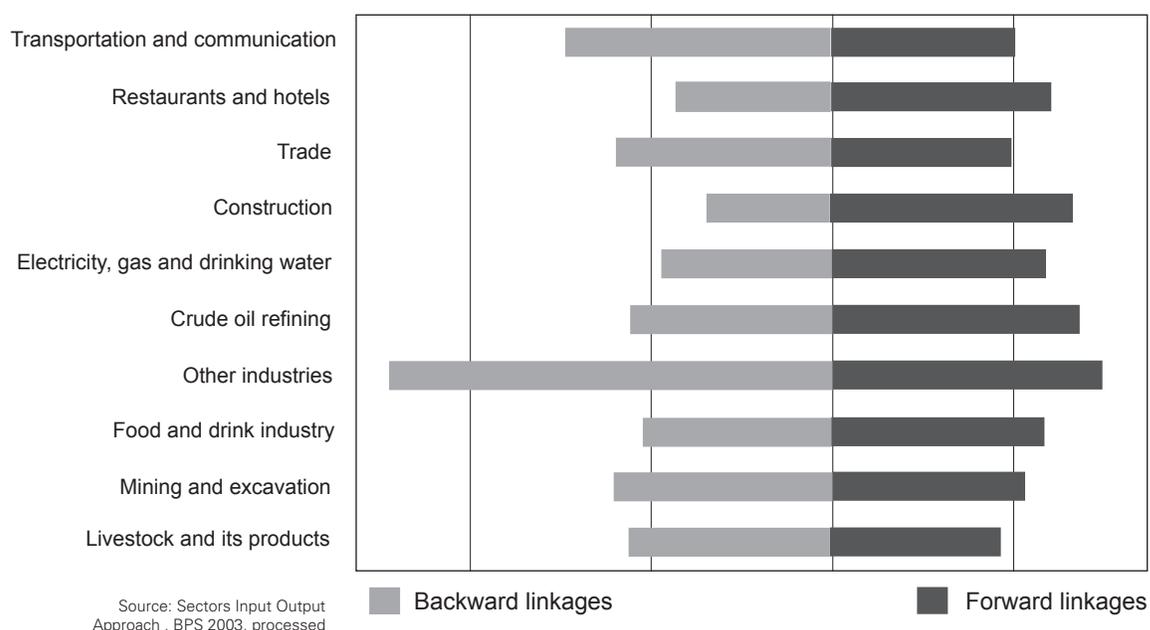
The strategic role of the processing industry sector is its ability to spur broader growth in East Java's economy and to create jobs. This potential is possible because the processing industry sector's backward and forward linkages are relatively stronger than those of other sectors. Results of an input-output (I-O) analysis show that several categories of processing industries have quite high backward and forward linkages.

Table 3.2 Levels of Backward and Forward Linkages

| Sector Code | Sector | Linkages To Upstream Sectors | Linkages To Downstream Sectors |
|--------------------|-------------------------------------|-------------------------------------|---------------------------------------|
| 1 | Rice | 0.76 | 0.81 |
| 2 | Food plants | 0.85 | 0.79 |
| 3 | Other agricultural plants | 0.79 | 0.85 |
| 4 | Livestock and its products | 1.11 | 0.92 |
| 5 | Forestry | 0.89 | 0.73 |
| 6 | Fisheries | 0.74 | 0.80 |
| 7 | Mining and excavation | 1.19 | 1.073 |
| 8 | Food and drink industry | 1.03 | 1.18 |
| 9 | Other industries | 2.43 | 1.5 |
| 10 | Crude oil refining | 1.10 | 1.38 |
| 11 | Electricity, gas and drinking water | 0.93 | 1.18 |
| 12 | Construction | 0.68 | 1.33 |
| 13 | Trade | 1.18 | 0.98 |
| 14 | Restaurants and hotels | 0.85 | 1.21 |
| 15 | Transportation and communication | 1.46 | 1.01 |
| 16 | Financial and service institutions | 0.86 | 0.91 |
| 17 | General government | 0.67 | 0.68 |
| 18 | Services | 0.79 | 0.98 |

Source: Sectors Input Output Approach, BPS 2003, processed

The industrial sector in East Java has relatively stronger backward (upstream) and forward (downstream) linkages than the other sectors. This indicates that changes in the processing industry sector will significantly affect the development of other sectors. That is, growth in the industrial sector will provide positive spillover effects, as it will be followed by growth in other sectors, as can be seen in Figure 3.6

Figure 3.6 Economic Sectors In East Java With Relatively Strong Forward And Backward Linkages

An analysis using the LQ index shows that development of the industrial sector is continuing to occur in centers of growth such as Surabaya, Sidoarjo, Pasuruan, Mojokerto, and Gresik. This can be expected to play an important role in stimulating the economic growth of the region more broadly.

Service Sector

Since the 1998 economic crisis, the trade, hotel and restaurant sector has shown the highest rate of growth in East Java. The greatest added value in this sector derives from the trade subsector. The rapid growth in this sector is due to relatively low entry barriers into this subsector, as it is less capital-intensive than the manufacturing sector. Much of the growth in the trade sector is located in urban areas. Over the past several years, construction of shopping centers and shop-houses (ruko), as a trade venue, has been very rapid. In Surabaya, the past three years have seen the establishment of several hypermarkets and supermalls, such as Indogrosir, Tunjungan Plaza IV, Giant, Pakuwon Supermal and Trade City Mal, as well as Carrefour.

In spatial terms, regions with city status dominate the trade sector: the cities of Surabaya, Malang, Kediri, Madiun, Mojokerto, Pasuruan and Probolinggo. In these regions, the construction of shopping centers and shop-houses is also quite rapid. This indicates that business operators have positive expectations regarding the prospects of the trading sector.

The trade sector in those cities is mainly conducted by small and medium enterprises. The business environment in cities seems to support SMEs in three ways: demand is high given the concentration of population, infrastructure facilities are better than in periurban or rural areas, access to (formal) financial resources is better, and barriers to entry to the informal sector are low.

The role of the trade sector is very important, particularly in attracting development of other sectors. This is evident from the input-output analysis, which shows that linkages with the upstream sectors are relatively high. This sector plays an important role in the process of distributing the goods produced by other sectors.

East Java's Exports

After experiencing a trade deficit in 1997, East Java's exports started to rise again in 1998. However, in 2002 the value of East Java's exports again declined by 6.71% from US\$ 5.77 billion in 2001 to US\$ 5.38 billion in 2002. According to BPS data for 2002, the value of East Java's exports came to 9.4% of the total national exports of US\$ 57.16 billion. During the period 1999-2002, the average contribution of East Java's exports to the national total was 9.58%.

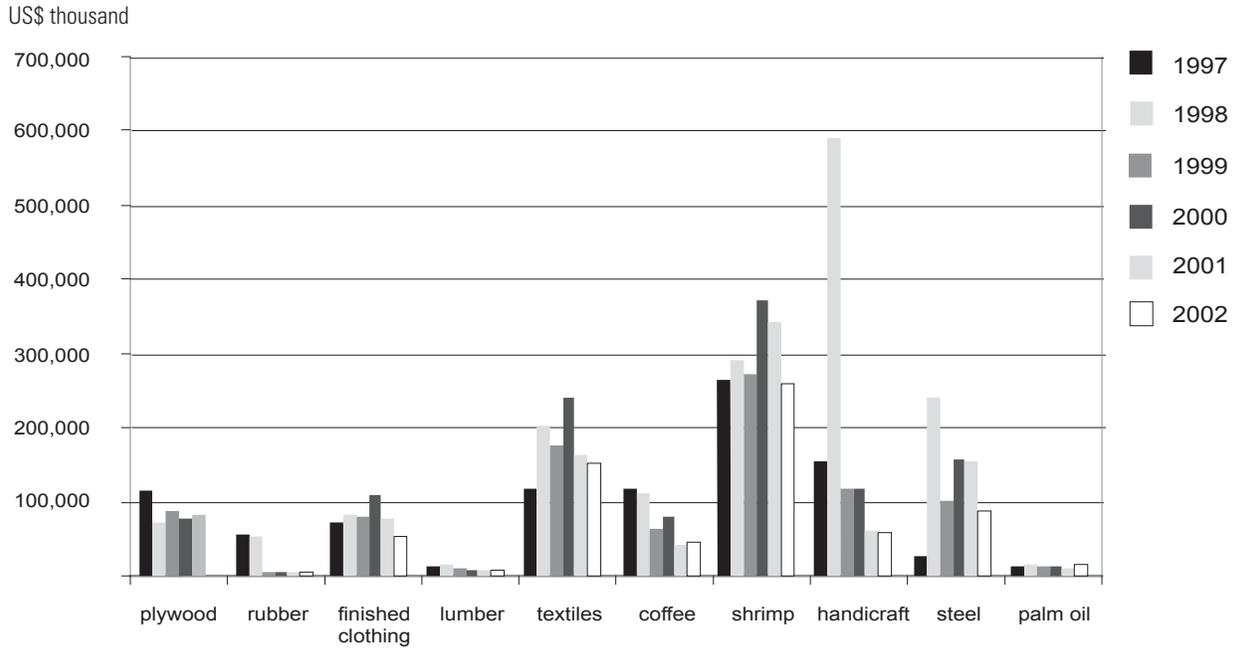
Table 3.3 Value of East Java's Exports and Imports, 1997-2002

| YEAR | EXPORTS (USD) | CHANGE (%) | IMPORTS (USD) | CHANGE (%) |
|------|---------------|------------|---------------|------------|
| 1997 | 4,236,613,055 | 6.47 | 7,334,143,528 | 28.58 |
| 1998 | 5,335,308,251 | 25.93 | 3,761,954,797 | -48.71 |
| 1999 | 4,655,601,739 | -12.74 | 3,655,786,735 | -2.82 |
| 2000 | 5,766,242,301 | 23.86 | 4,862,534,635 | 33.01 |
| 2001 | 5,770,579,896 | 0.08 | 4,542,947,899 | -6.57 |
| 2002 | 5,383,203,943 | -6.71 | 5,046,115,459 | 11.08 |

Source: East Java BPS

The commodities that make the greatest contribution to exports from East Java are pulp, paper, furniture and processed wood products, and electrical equipment. Although the contribution of furniture and processed wood products to East Java's exports remains quite high, growth in these products has declined relative to earlier years. In fact, according to data from the Surabaya office of Bank Indonesia, plywood contracted by 6.70% in the third quarter of 2003 compared with the same period of the previous year.

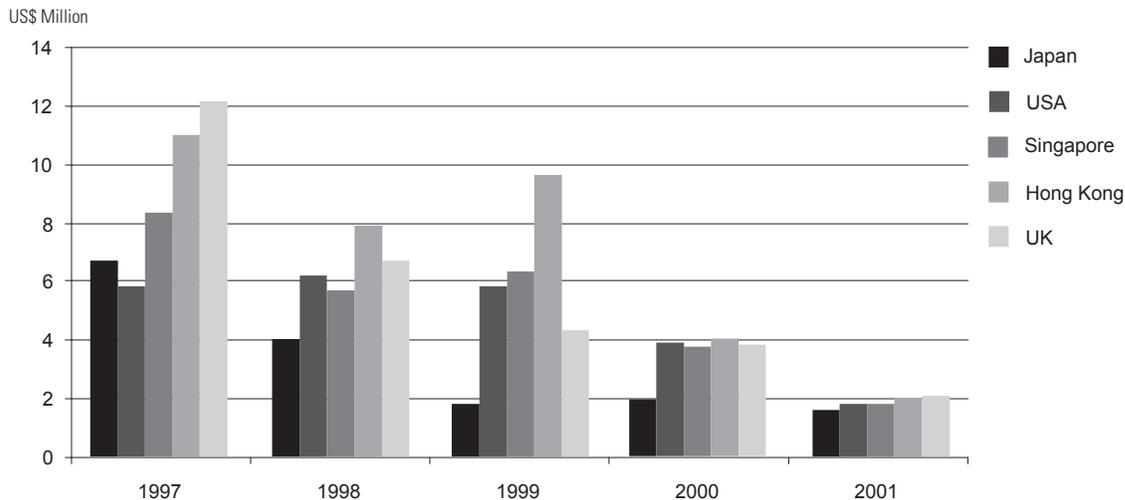
Figure 3.7 Export Value of East Java's Main Non Oil and Gas Commodities



Source: Economic and Financial Statistics of the Province of East Java, Surabaya Office, Bank Indonesia

The main destinations of East Java's exports are Indonesia's major trading partners: Japan, the United States, Singapore, Hong Kong, and the European Community. Based on the existing production capacity and market opportunities, the potential of East Java's exports can still be developed, particularly to the Europe, Africa, Latin America, and the countries of the Middle East. However, these are not easy markets for East Java's products to enter, due to certain international trade standards that are difficult for local producers to meet, such as quality standards and prohibitions on the use of certain chemicals in agricultural products.

Figure 3.8 Value of East Java's Export to 5 Main Trading Partner Nations, 1997-2001



Source: Economic and Financial Statistics of the Province of East Java, Surabaya Office, Bank Indonesia 2003

4 | INVESTMENT AND INTERREGIONAL TRADE CONDITIONS IN EAST JAVA

Investment Performance
in East Java
Licensing and Permitting
Physical Infrastructure
Levies
Security
Labor

INVESTMENT AND INTERREGIONAL TRADE CONDITIONS IN EAST JAVA

When decentralization began, many local governments started to issue new regulations to increase their locally generated revenues (*Penerimaan Asli Daerah - PAD*). These regulations, increased the cost of doing business and provoked protest by the public, particularly the private sector. Consequently, as decentralization proceeded, many local government regulations were revoked. This means that although decentralization should ultimately support stronger business growth based on a system of healthy competition between districts, in the early stages of its implementation, many issues need to be watched very carefully.

Ray⁵, for example, notes four issues under decentralization that tend to weaken healthy business competition. The first of these is problems in formulating regulations, consisting of weakness in identifying problems, inadequate development of alternatives, ineffective review of local regulations, and lack of participation. The second is that there are still many problems with the local regulations themselves, such as weaknesses in the utilization of fees collected, and fees charged for permits for small businesses. The third is the trade distortions that occur, and the fourth is weakness in maintaining neutrality in competition.

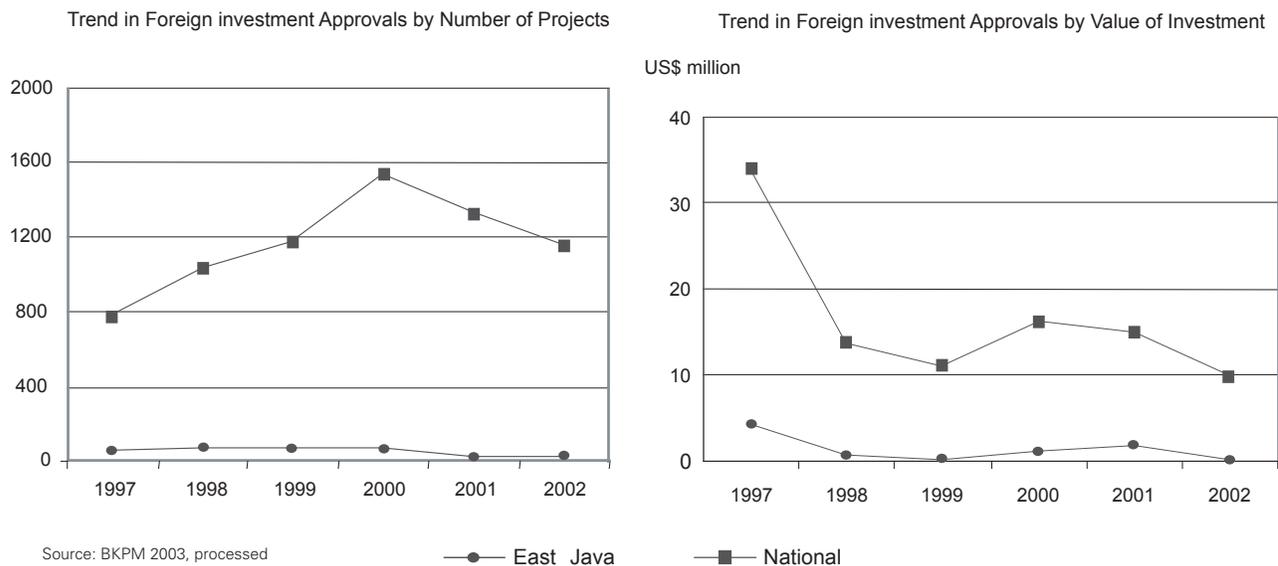
East Java faces these same issues in developing a healthy business climate. The centralization that prevailed until recently weakened the initiative of regional governments, such that they tended to act only as operators of development that simply carried out orders, in this case from the central government. In the centralization era, there were many constraints faced by businessmen caused by government regulation. In this era of decentralization, in which regional initiatives are now permitted, improvements are needed to remove pre-existing barriers, but these changes are still proceeding very slowly. At the same time, the demands of the public are developing very rapidly.

⁵David Ray, Proceeding of a conference entitled "Decentralization, Regulatory Reform and The Bussiness Climate," pp.3-17, PEG-USAID, Jakarta, August 2003

Investment Performance in East Java

Investment trends in East Java have been relatively consistent with Indonesia as a whole for post crisis approvals for foreign investment (PMA) and domestic investment (PMDN)), except for 2000.

Figure 4.1 Foreign Investment Approval in East Java, 1997-2002

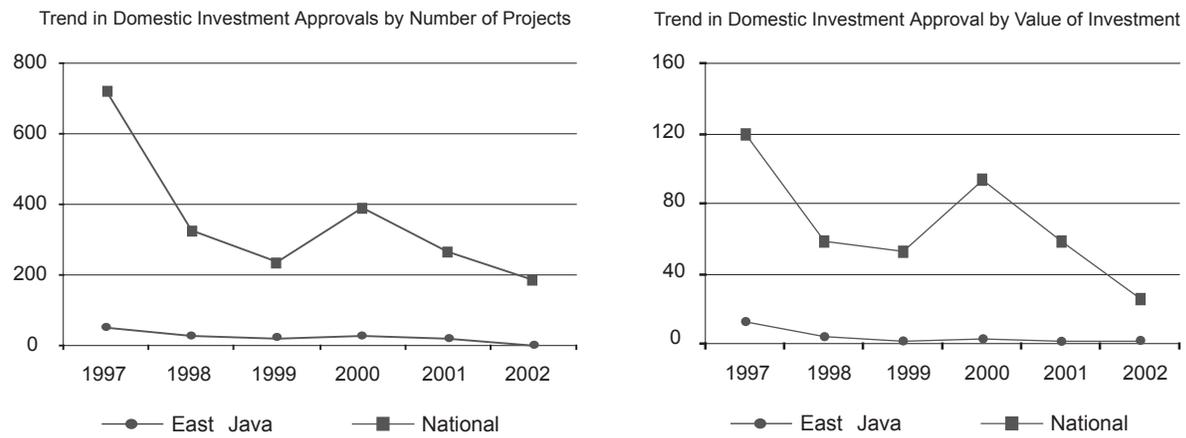


In 2000, foreign and domestic investment showed very different trends in terms of numbers of projects. There was a sharp rise in the amount of foreign and domestic investment in the Jakarta Capital District and in West Java. But this trend was not reflected in the value of investment as projects were smaller on average.

Another aspect that deserves attention in these investment approval data is that both the numbers of projects and the value of investment, for both foreign and domestic investment, need to be compared with actual investments. Data from Bappenas (National Planning Body)⁶ state that nationwide between 2000 and 2003 the percentage of actual investment relative to approvals showed a decline, for both foreign and domestic investment. This decline was quite drastic: from 94% in 2000 to 58.8% in 2001, 25.2% in 2002, and 21% in 2003.

⁶ *Bisnis Indonesia*, 5 February 2004

Figure 4.2 Domestic Investment Approvals in East Java 1997-2002



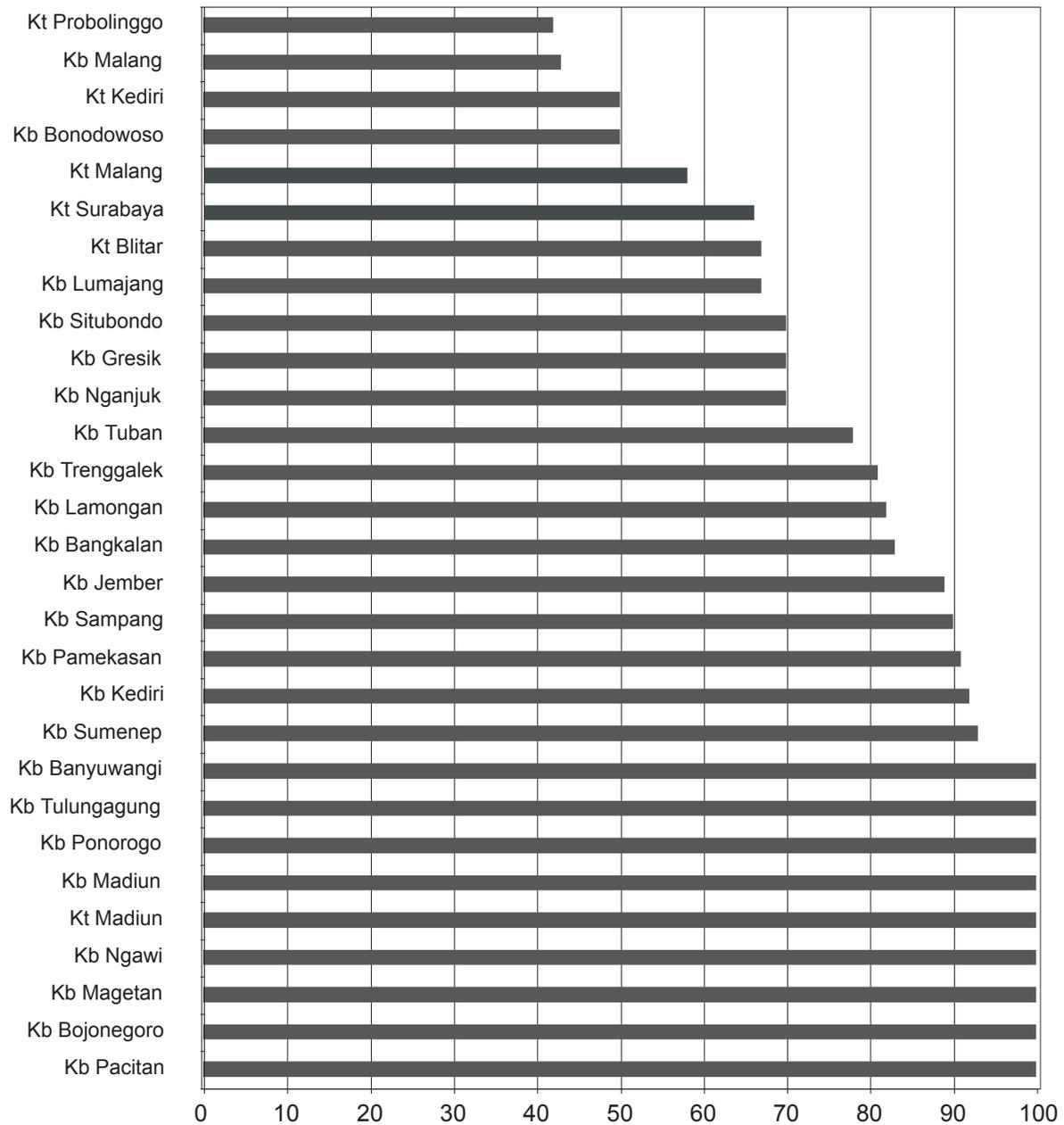
Source: BKPM 2003, processed

There are differing perceptions among business operators regarding the business climate in the various regions within East Java. For example, around 70% of respondents in Surabaya stated that the business climate in their area was reasonably supportive, while only 45% of business operators in Malang Regency expressed the same view⁷. KPPOD's⁸ study shows that Gresik Regency and Sidoarjo Regency were rated number 17 and 21 respectively in their 2003 ranking of 200 cities /regencies.

⁷Survey by PSD Team in cooperation with the World Bank and The Asia Foundation.

⁸Regional Investment Attractiveness: A Survey of Business Perception, Komite Pemantau Pelaksanaan Otonomi Daerah (Regional Autonomy Watch), 2003.

Figure 4.3 Business Operator Agreeing that the Business Climate in Their City/Regency is Supportive (%)



Kt : kota, or city
 Kb : kabupaten, or regency

Source: Survey by PSD Team, 2004

Licensing and Permitting

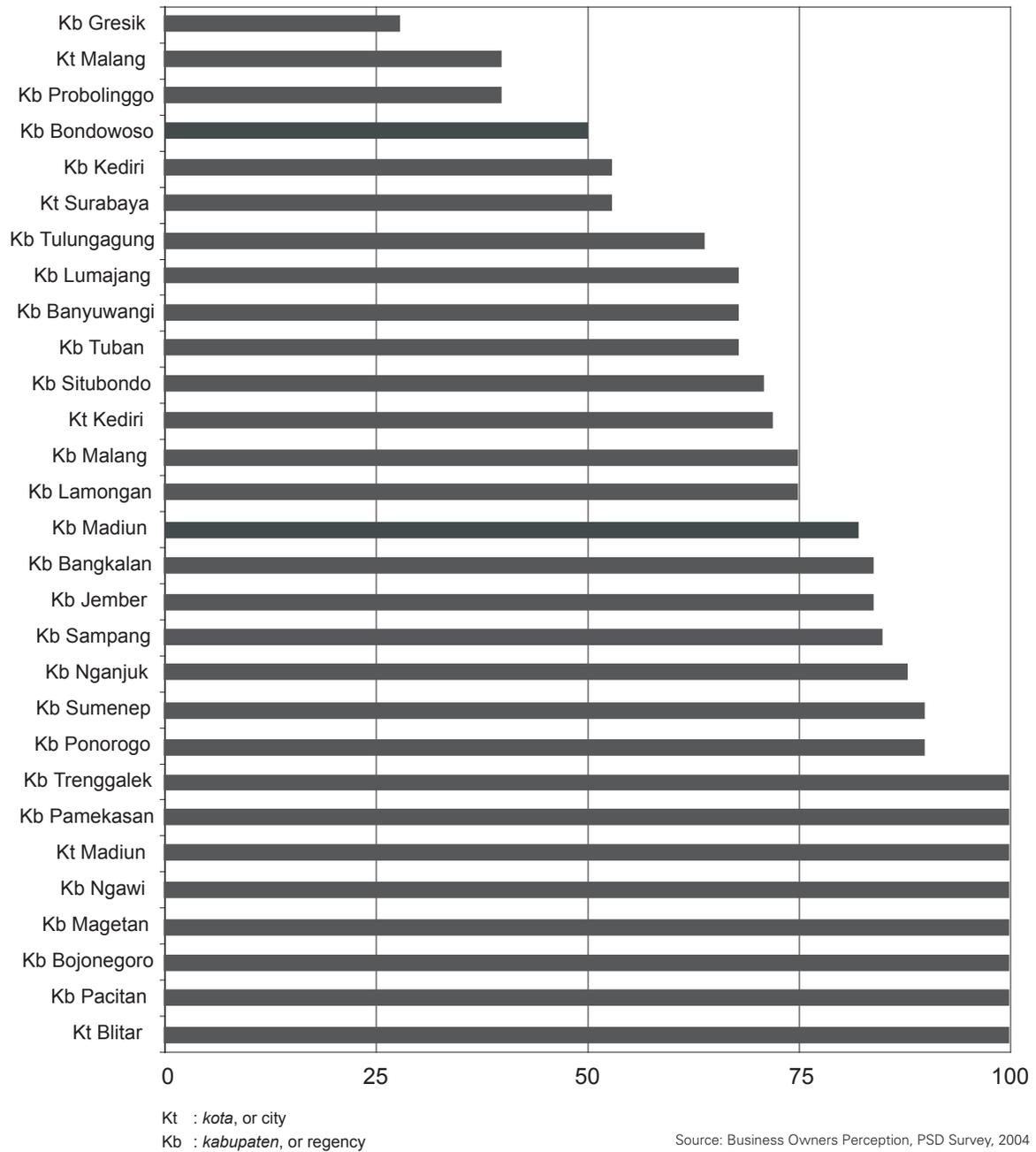
Permitting essentially involves two closely interrelated aspects. The first has to do with the policies and regulations on permits, and the second with the institutions that issue the permits. In terms of policies and regulations, it is evident that before and after decentralization, permitting policy in Indonesia has not changed much. Several studies, both by the PSD team and by other institutions, show fairly consistent conclusions. Although in principle the regulations on permitting have been transferred from the central government to the regional governments, in actual practice most local governments continue to use the old regulations from the central government, rather than making changes in line with the needs of local business operators. The only significant change in permitting is that local governments have begun charging fees for permits that were free under the centralized system. Unfortunately, this change is not a positive one, but rather tends to impose even greater burdens on the public.

Yet a quite significant change has recently taken place in terms of the permitting institutions. One Stop Service (OSS) permitting service units have been established in many regions in East Java. Provided for by a Ministerial circular issued in 1999, OSS are physical offices that can centralize the application, processing, or approval of permits depending on their degree of authority. Among these are Sidoarjo⁹ Regency, the City of Malang, Banyuwangi Regency, Magetan Regency, and the City and the Regency of Kediri. Although these institutions do not consistently provide efficient services, the public is starting to feel some increased convenience. An evaluation of OSS in 6 districts shows that the number of businesses formalizing has increased since the development of OSS and that processing times and informal fees have improved in OSS receiving external technical assistance¹⁰. This may be why the perceptions of business operators toward these services have improved somewhat.

⁹ In Sidoarjo, the OSS has reduced processing time by 40% and cost by 30%.

¹⁰Conducted by Institute of Technology Transfer for SMEs, funded by The Asia Foundation

Figure 4.4 Business Operator Agreeing that their Local Government Facilities Business Permitting (%)



One of the OSS institutions with the most impressive performance is that in Sidoarjo Regency. This permit service institution, the Capital Investment and Permitting Service (DPPM), is at present the only OSS in Indonesia with ISO 9000 certification. This reflects the fact that their services are standardized and accountable. This is clearly advantageous, both for business operators arranging ordinary business permits and for investors.

Another way of reducing regulatory barriers is the establishment of industrial zones. Several industrial zones in East Java, such as SIER, PIER and NIP, have autonomous institutions that provide investment permit services to business operators in the zones. Thus, the business operators no longer need to go to Jakarta or Surabaya to arrange their investment permits.

The survey, while not representative, showed that in all seven cities covered, the rate of Trading Business Permit (SIUP) holding was over 50%. This is significantly higher than the average rate of permit holding nationwide of 14.8%¹¹.

Nevertheless, unnecessarily bureaucratic and corrupt practices in the form of illegal levies continue to haunt permitting services. Business operators must still pay many additional costs to obtain certain permits. Generally, it is impossible for business operators to escape this illegal levy trap when they are applying for permits, because without paying the extra fees it will be difficult or even impossible to get the required permits. Table 4.1 shows informal fees paid for a number of required permits that are nominally issued free of charge.

Table 4.1 Costs for Obtaining Permits (in Rp thousand)

| REGENCY | SIUP | TDP | SP/MD | ETPIK |
|---------------------|-----------|-----|----------|-------|
| Gresik Regency | 100 - 250 | 75 | 25 - 100 | - |
| Jember Regency | 50 - 350 | 60 | - | - |
| Pamekasan Regency | 20 - 250 | 25 | 100 | - |
| Pasuruan Regency | 25 - 100 | - | - | 1.500 |
| City of Surabaya | 100 - 750 | 150 | - | - |
| Tulungagung Regency | - | 500 | - | - |

Source: REDI Survey, 2004

Note: SIUP = Trading Business Permit, TDP = Company Registration Certificate, ETPIK = Registered Exporter of Forestry Industry Products, SP/MD = Certificate/License for Food Industry

However, a new central government policy has recently been issued through Presidential Decree (Keppres) No. 29 of 2004 on organization of investment permit services for both foreign and domestic investors. This policy basically rescinds the authority that the central government had granted to the regional governments in permitting services for investment activities. The central government, in this case the Investment Coordination Agency (BKPM), will provide investment permit services

¹¹Small Industry Statistics, BPS, 2002

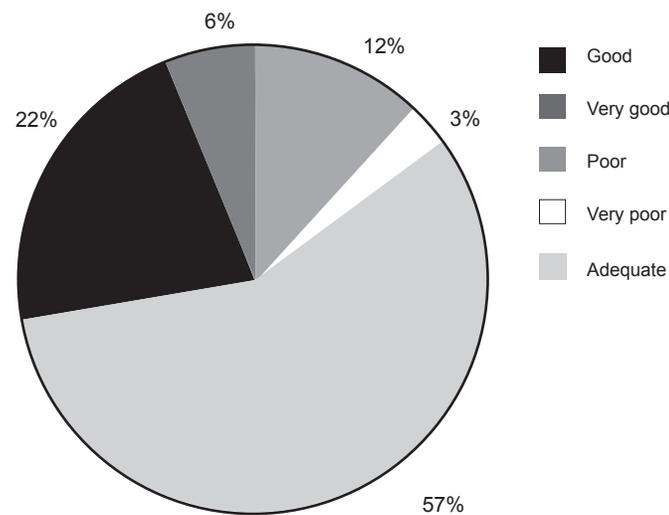
under one roof. This policy was issued because so many investors were complaining about the difficulties faced in arranging investment permits. However, it will not affect SMEs which represent the bulk of domestic businesses.

In the Focus Group Discussions held by the PSD Team in various regions in East Java, the issue of permitting came up most prominently in the wood sector. These complaints relate to wood source permits and occurred consistency throughout East Java. It can therefore be concluded that the permitting for the commodity of wood urgently needs fundamental reforms. A more detailed explanation can be seen in the description of the wood business chain in the next chapter.

Physical Infrastructure

Infrastructure needs in East Java vary across sectors, regions, and between urban and rural areas, both in terms of their quality and quantity. Businesses were asked their views on the availability and conditions of roads, telecommunications, electricity, water, and transportation affecting their operations. General observation in response to a short questionnaire reflects that existing infrastructure was deemed only adequate, and further discussions with the focus groups revealed serious gaps in infrastructure that pose looming constraints to the growth of businesses and development in East Java as a whole.

Figure 4.5 Perceptions of Business Operators toward Infrastructure
(Roads, Telecommunications, Electricity, Water, Transportation)



Source: PSD Survey, 2004

Specific constraints expressed by business operators are summarized as follows.

Roads: Construction of road infrastructure remains concentrated around urban areas and barely reaches the villages or rural areas, where many production centers are located. This is emphasized in the sectoral studies of wood and fisheries in the following chapter. Official records show 27,232.27 km of roads in East Java, consisting of 1,899.21 km of state roads, 1,439.18 km of provincial roads, 21,935.45 km of city/regency roads, 931.45 km of district roads, and 63.07 km of toll roads. The largest proportion, therefore, is roads maintained by the cities and regencies. Poor road conditions are increasing the cost and time it takes to get produce to market, and for perishable goods the delay reduces quality and consequently, their selling price. The construction of Jalur Lintas Selatan (Southern coast road) and Suramadu bridge (to link Surabaya and Madura) are eagerly anticipated by businesses, particularly those from Madura and the southern part of East Java. In relation to the Suramadu bridge, there are concerns that the construction of the bridge will not be supported by sufficient road infrastructure, connecting north and south Madura.

Clean water: In several cities and regencies in East Java, including the City of Surabaya, water infrastructure is a very serious problem and has a negative impact on the private sector. It is said that East Java will soon be experiencing a clean water crisis. This is due to severe deforestation and widespread extraction of ground water, particularly for industrial activity. Statistics show that the use of ground water for industry in Mojokerto rose 53% compared with the previous year. This water crisis poses such a threat that more than 30,000 hectares of irrigated rice fields cannot be harvested as they should be¹². The areas around Madura and the southern part of East Java are regions that require serious attention, as these are the areas suffering the most serious consequences of water crisis. Poor irrigation networks and water supply were identified as key issues by tobacco farmers in Madura, and coffee and sugar cane planters throughout East Java. Increased pollution and shallow rivers were blamed for poor water quality which has become problematic for fish and shrimp farmers. Businesses proposed immediate steps for reforestation efforts, river dredging, and legal actions against industrial polluters.

Electricity: Although supply and quality of power had been reasonably adequate, businesses are feeling that the optimum level has been reached and new investment is needed. Blackouts are now a common occurrence, including for the industrial sector. Electricity shortages are not unique to East Java, but considering the province's prominence in production, increasing power blackouts in the past three years have been particularly harmful. Another issue with power cuts is that they often occur without any prior notice. Many larger businesses invest in their own power generators to compensate, but smaller businesses cannot afford this costly option. Small industries located in rural areas also cited poor network access as a problem and they feel the electricity rates are too high.

¹²Jakarta Post, 26 April 2004

Ports: The presence of ports in East Java is crucial for economic activity. The second largest port in Indonesia, Tanjung Perak in Surabaya, strategically serves as the gateway for trading activity to and from East Java. The other harbors on the coast of East Java, particularly in the southern part, are also quite significant for economic development, especially in the fisheries sector. However, utilization of harbors on the coasts of East Java other than Tanjung Perak is less than optimal because of the limited facilities available, or have become overcrowded such as the case in Banyuwangi where there is a lack of sufficient berthing space and supporting processing facilities. Other shortcomings include the capacity of cold storages, fuel depots, warehouses and road access.

Levies

Creating competitive conditions for interregional trade requires serious attention from local governments. The facts show that 80.66% of business operators in East Java in the survey bring in raw materials, either from within East Java itself or from outside the province. The same is true for output. A total of 83.3% of business operators responding to the survey said that their markets are located outside the cities or regencies where they live¹³. The importance of interregional trade is thus obvious.

The obstacles to trade between regions take a number of forms. For example, excessive inspections of goods and (illegal) levies are practices commonly faced by business operators when they ship goods into or out of their regions. This situation not only increases costs but also increases the time spent on the road. Crimes, such as looting and robbery, also frequently occur. Below is an excerpt from the field notes of the PSD Team member who accompanied the journey of a shipment of goods from Malang to the Port of Tanjung Perak, Surabaya.

The entrepreneur can request police escort services from the Polda (Police Region) or Polres (Police Subregion). This escort is officially free of charge, but usually the business operator provides compensation by paying a sum of money, either set or not. Escort services are also provided by legal escort service providers such as Securicor.

Other escort services, referred to as “unofficial” escort services, include Gajah Oling (Ga-Ol), Ikatan Payung Madura (IPAMA), Aremania, RST and others. Gajah Oling is the largest escort service in East Java. Ga-Ol is an escort service organization that issues membership cards to truck drivers. These membership cards show that Ga-Ol was established by the Supply and Transport Cooperative of Regional

¹³REDI Survey, 2004: 21-23

Military Command V, Brawijaya (Bek-ang Dam V/Brawijaya) with its address at Kalisosok, Surabaya. Membership in Ga-Ol requires payment of a membership fee of Rp. 30,000 to Rp 35,000 per month.

Other unofficial costs observed directly in the field were for transport of vegetables to the seaport. Once the truck enters the gateway of the port at Tanjung Perak, the driver must pay a policeman an unofficial levy of Rp. 10,000 after paying for the official entry ticket. Once through the gate, the truck must stop briefly at the KP3 or KPLP post and hand over another Rp. 10,000 to the official there. The writer even witnessed a KP3 official chasing a truck to collect his fee because the truck driver was hurrying to buy a ticket for the boat, which was about to leave.

(Source: PSD Team's field notes, 2004)

Levies are a significant issue as elsewhere in Indonesia for all sectors and are commonly experienced by business operators in East Java. Illegal levies are a manifestation of corrupt practices that have long haunted economic activity in the country. Even though the central government has issued a Parliamentary Decree on conduct of the state free from corruption, collusion, and nepotism (KKN), there is very little accountability on the part of government officials. Corruption in all branches of the judiciary responsible for prosecuting cases makes this practice difficult to root out.

Second, these levies have been formalized through decrees, usually in the form of fees and taxes, using the excuse of low regional revenues. These new formal levies on the public have become the most popular fund-raising alternative for local governments. Ironically, these levies occur not only at the city and regency level, but even at the village level as local governments copy the higher levels of government in creating new regulations requiring payment of levies.

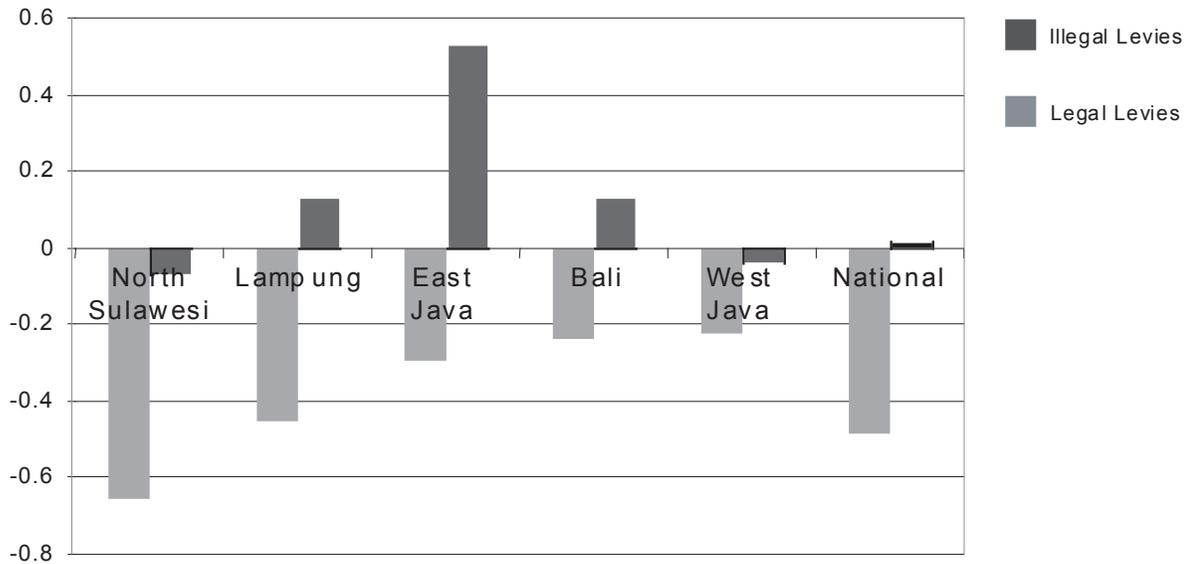
Examples of Village Government Levies:

Case (1): *Transporting wood from the source at Rejo to Kamolan, passing through three villages. If the wood is transported in a pick-up truck, it is subject to a levy of Rp. 2,500 per run; using an L300, Rp 5,000 per run; and using a truck, Rp 10,000 per truck per run.*

Case (2): *Transporting wood from Karang Rejo – Munggaran – Mendo Agung, assessed Rp 2,000 per 5 kilometers per pick-up per run. (Source: PSD Team's field notes, 2004)*

Third, poor governance practices mean that official levies are commonly accompanied by unofficial levies due to high levels of discretion and low levels of accountability on the part of government officials. Consequently, the creation of new official levies can also lead to more unofficial levies.

Figure 4.6 Perceptions of Business Operators on Levies (Scale -2 : getting worse and 2 getting better)



Source: REDI (2003) in Ray, Decentralization, Regulatory Reform and the Business Climate, PEG, USAID, 2003 processed

The survey above shows the perceptions of business operators in several regions. Business operators in North Sulawesi state that official levies are becoming worse than before. Likewise, business operators in East Java feel that official levies now are worse than before. However, East Java has a much higher ranking than other regions for public perceptions that unofficial levies are declining. This is consistent with the findings of this report.

Even though the perception is that the situation with unofficial levies is improving, the handling of these levies still requires attention, because although their frequency may be declining, their intensity appears to be increasing. Two prominent forms of illegal levies in East Java are levies on the highways or in the shipment of goods, and “contributions” to third parties, which are enforced in a repressive way, sometimes by people in military uniforms.

Case studies of levies on roads:

Transporting wood from Trenggalek to Surabaya using trailer truck; unofficial levies along the roads total around Rp 50,000 per truck per run. In addition to these daily levies, there are also monthly levies that must be paid of between Rp 2.5 million and Rp 4 million for four posts (those mentioned were Polsek (police sector), Polres (police resort, sub-area), and Sabhara [riot police] units).

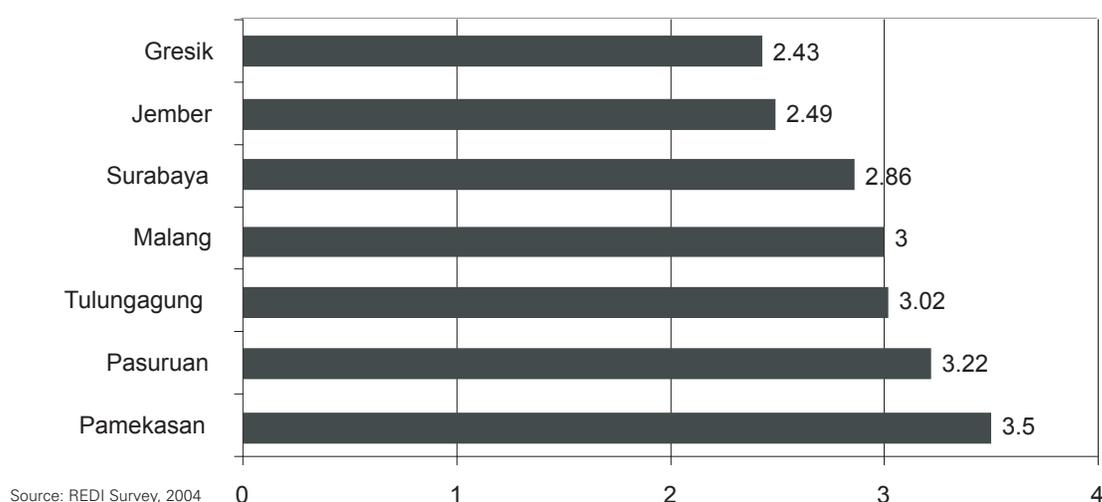
Case (2): *Shipping wood from Dongko district to Probolinggo; had to spend around Rp. 100,000. Posts where it is known that payments must be made are Polsek Dongko, Perhutani in Krangan, and other posts along the way from Blitar to Malang. Source: PSD Team's field notes, 2004*

Another study states that levies on entrepreneurs in East Java reach an average of Rp 4.93 million per year¹⁴. This figure is much higher than the average levies in the same year in South Sulawesi, which came to Rp 949,000. But it is far lower than in North Sumatra and West Java, where the averages came to over Rp 7.5 million per year. According to this study, of these total levies the greatest percentages are paid for two types of levies: hoodlums and for social/community activities. The second type of levies is very common in Indonesia. Community groups ask the company to provide money for social or community activities, such as Independence Day celebrations.

Security

East Java does not experience as many political disturbances as in Jakarta. The large-scale riots or demonstrations that occur in Jakarta - as a reference for the political situation in Indonesia - have had little impact on the situation in East Java, except for Surabaya. Succession of the Governor of East Java in mid-2003 was not accompanied by mass demonstrations, as usually is the case. However, security issues disrupting the business community do exist, and only 57.3% of respondents in the survey felt that the existing level of security was conducive to business.

¹⁴Medium Size Study, Discussion Paper, Center For Economic And Social Studies (CESS), 2003;17

Figure 4.7 Security Conduciveness Index

The PSD Team found that many cases of theft were reported in the fishery sector and in the agriculture sectors, especially in forestry. Thefts in the pond fishery sector, mostly in shrimp ponds, can be categorized as robberies, as they are always accompanied by violence. One shrimp pond operator from the Mojokerto region reported that his losses to robberies reached over 30%, or equivalent to Rp 25 million, for each harvest.

Thefts in the offshore fisheries sector are mostly committed by foreign fishermen. Several factors make this possible. First, the maritime police (coast guard) are ineffective because the number of officers is not adequate for the area that must be guarded, and they are also ill-equipped. Also, local fishermen cannot sail very far out to sea, as they generally use small fishing boats, and so their fishing grounds are limited to a relatively small area, only four to six miles offshore, or only three to five hours each time they go to sea.

For the commodity of wood, the theft that occurs is more complex and tends to be systemic, involving various formal institutions, thus making it harder to eradicate. The direct impact of these thefts is that wood traders in the downstream sector have difficulty in obtaining raw material. It is estimated that entrepreneurs lose US\$ 200 to 300 million because they are unable to fill orders from the export market¹⁵.

¹⁵Agence France Press, 16 March 2004

Security problems, especially in industrial zones and fishponds, have forced business operators to seek special assistance from the security forces, in this case the police. The business operators who have asked the police for extra protection say that technically it has had a positive impact, in that the levels of theft and robberies have declined. However, this security assistance entails considerable additional costs. One shrimp pond operator said that he has to spend up to Rp 5 million each harvest for police protection. An entrepreneur at PIER, the industrial zone, said that he pays out between Rp 1 million and Rp 3 million every month.

Labor

Labor conditions in East Java vary from region to region. The PSD Team observed that labor disturbances mostly occur in industrialized areas such as Sidoarjo Regency, the City of Surabaya, Mojokerto Regency, and Pasuruan Regency. Labor disturbances have caused a number of companies to reduce or postpone their activities, and some have chosen to move their activities out of Indonesia¹⁶. In general, business operators complain of the difficulty of obtaining labor in line with their needs, while there are also strong demands from surrounding communities for jobs for local workers. On the other hand, workers generally see inadequate minimum wage rates and the failure to involve workers in formulating company policy as the sources of labor problems.

Workers are dissatisfied as they feel that the sizes of the increase in the minimum wage are still too low. Business operators, on the other hand, feel that increases in labor costs significantly threaten their ability to be competitive. The Regional Minimum Wages (UMK) for 2004 came into force as of 1 January 2004 through Decree of the Governor of East Java No. 188/273/KPTS/013/2003. The City of Surabaya has the highest UMK, followed by the nearby cities and regencies of Gresik, Sidoarjo, Mojokerto and Pasuruan. Bondowoso Regency has the lowest UMK. The increase in UMK from 2003 to 2004 was around 2 to 6 percent, still below the inflation figures for the respective cities/regencies.

¹⁶Report of the private sector team, Surabaya, World Bank 2003

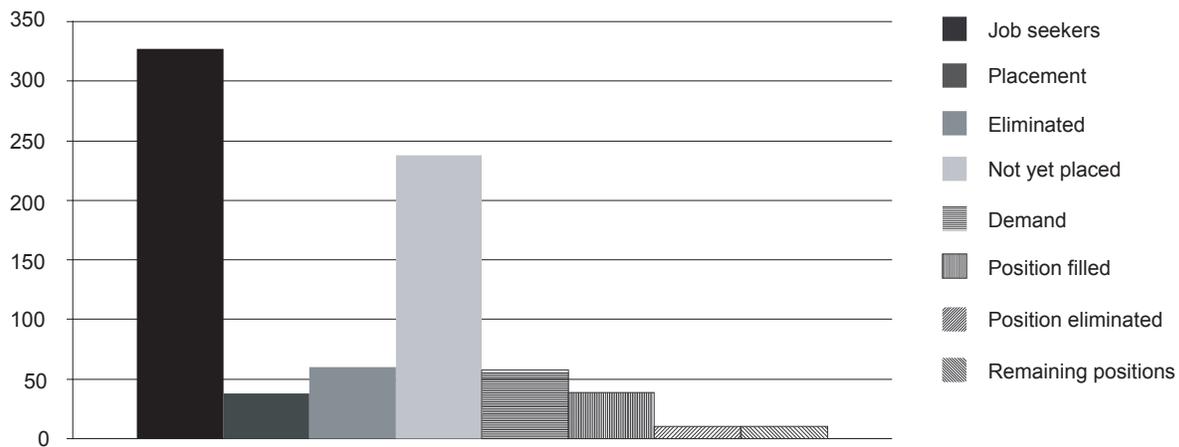
Table 4.3 Regional Minimum Wage (UMK) in East Java, 2003 and 2004 (Rp/month)

| No. | City (Kota) / Regency | 2003 | 2004 | No. | City (Kota) / Regency | 2003 | 2004 |
|-----|-----------------------|---------|---------|-----|-----------------------|---------|---------|
| 1 | Kota Surabaya | 516.750 | 550.700 | 20 | Kab Madiun | 281.000 | 320.000 |
| 2 | Kab Gresik | 516.500 | 550.550 | 21 | Kab Magetan | 292.500 | 321.530 |
| 3 | Kab Sidoarjo | 516.500 | 550.550 | 22 | Kab Ngawi | 288.700 | 323.600 |
| 4 | Kota Mojokerto | 478.500 | 488.000 | 23 | Kab Ponorogo | 282.000 | 315.000 |
| 5 | Kab Mojokerto | 516.500 | 550.550 | 24 | Kab Pacitan | 289.000 | 320.975 |
| 6 | Kota Malang | 497.100 | 548.000 | 25 | Kota Blitar | 301.100 | 331.210 |
| 7 | Kab Malang | 497.100 | 548.000 | 26 | Kab Blitar | 295.000 | 317.200 |
| 8 | Kota Batu | 497.100 | 548.000 | 27 | Kab Trenggalek | 274.000 | 316.500 |
| 9 | Kota Pasuruan | 430.000 | 450.000 | 28 | Kab Tulungagung | 332.500 | 349.000 |
| 10 | Kab Pasuruan | 513.000 | 550.550 | 29 | Kab Bojonegoro | 287.500 | 331.000 |
| 11 | Kota Probolinggo | 445.000 | 461.000 | 30 | Kab Banyuwangi | 319.400 | 356.000 |
| 12 | Kab Probolinggo | 443.750 | 456.000 | 31 | Kab Sampang | 300.700 | 330.000 |
| 13 | Kab Jombang | 398.000 | 426.500 | 32 | Kab Lumajang | 292.700 | 321.000 |
| 14 | Kota Kediri | 415.000 | 480.000 | 33 | Kab Jember | 384.000 | 397.606 |
| 15 | Kab Kediri | 415.000 | 480.000 | 34 | Kab Bondowoso | 300.000 | 310.000 |
| 16 | Kab Nganjuk | 335.000 | 354.000 | 35 | Kab Situbondo | 311.000 | 348.500 |
| 17 | Kab Lamongan | 328.450 | 380.743 | 36 | Kab Pamekasan | 400.000 | 430.000 |
| 18 | Kab Tuban | 322.500 | 345.000 | 37 | Kab Sumenep | 360.000 | 400.000 |
| 19 | Kota Madiun | 305.000 | 325.000 | 38 | Kab Bangkalan | 390.000 | 440.000 |

Source: Office of East Java Manpower and Transmigration Service

The dynamic that occurs between economic growth and regulation of personnel matters has a significant impact on labor conditions in East Java. In 2000, the unemployment figures, which cover job seekers, those not yet placed, and those who have been laid off, were still very high. The increases in the UMK have had some impact on the labor situation in East Java, as shown in the following figure:

Figure 4.8 Labor Market Conditions, 2000



Source: East Java Manpower Service

Businesses that have linkages with tourism in Bali fared better. For example, the textile industries in Central Java, West Java and Yogya are the largest suppliers of textile products to Bali. When the economic crisis seriously disrupted economic activity in most regions in Indonesia, Bali (until the October 2002 bombings) continued to reap significant profits from the increased flow of tourists and from the circulation of dollars, which were worth more than before. This situation had a direct impact on other industries in Java and the surrounding area that support the tourism industry in Bali and Lombok.



5 | COMMODITY VALUE CHAINS

Teak

Tobacco

Sugar cane and Sugar

Coffee

Salt

Shrimp

Beef Cattle

Textiles

COMMODITY VALUE CHAINS

The problems described in the previous chapters are faced by business operators generally. In this chapter we will examine several commodity value chains, with the aim of showing more specifically the kinds of problems that business operators face at each stage along the production and distribution chain. These commodities were chosen for in-depth examination on the basis of two main criteria: their importance to the regional economy and the greater complexity of their problems compared with those of other commodities.

A number of these commodities, due to their historical and perceived strategic importance to the economy, are marked by significant state intervention. State-owned enterprises, price controls for inputs and outputs, and monopolies/monopsonies continue to affect the business environment for commodities such as sugar, tobacco, and salt. In addition, Indonesia retains a policy of self-sufficiency for a number of basic foodstuffs that has resulted in trade barriers. Distortions created by these policies constitute a significant barrier to growth and need to be addressed in policy reform efforts. However, they are not reviewed in detail here. Information below is from the perspective of the business owners rather than providing a policy overview for each sector.

TEAK

Respondents consulted for this sector came from the following regions: Bojonegoro, Tuban, Ngawi, Kediri, Kabupaten Malang, Banyuwangi, Jember, Bondowoso, Probolinggo, Situbondo.

The production capacity of Indonesia's wood and forest products industry is among the highest in the world. In 1996, Indonesia was in eleventh place in wood industry production capacity. However, as the domestic wood supply has declined this capacity is reduced (see table 6.1). This is closely related to the recent high levels of deforestation and log smuggling for export, which are very difficult to control. Loebis and Schmitz¹⁷ in their study found that the rate of forest loss in Indonesia has accelerated; in 1998 it was reported that from 1 million hectares per year, it has risen to 2 million hectares per year since 1996.

¹⁷Lienda Loebis and Hubert Schmitz, in "Java Furniture Makers: Winners or Losers from Globalization", IDS, Sussex, Sept 2003.

Table 5.1 Capacity of Wood and Other Forest Products Processing Industry and its Utilization

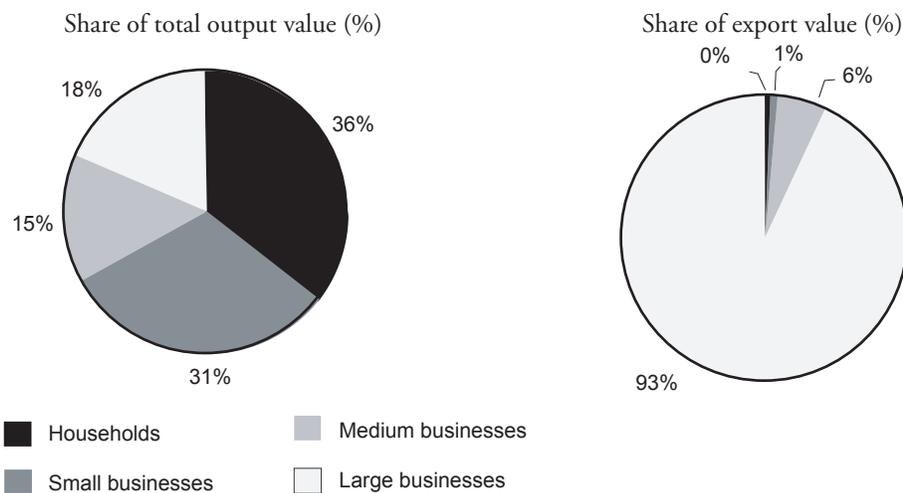
| | Capacity (Thousand M3) | Utilization (%) |
|------|------------------------|-----------------|
| 1996 | 1,363 | 50 |
| 1997 | 1,371 | 57.4 |
| 1998 | 1,373 | 45.4 |
| 1999 | 1,373 | 47 |

Source: BPS, processed

Since 1997, wood from outside Java, including imported wood, has started to enter East Java’s wood market, and the amount of wood from outside Java is steadily increasing. In nearly all the FGD that have been conducted, the participants, especially those downstream in the commodity chain, state that they are using more and more wood from outside Java, including imports. This is felt mostly by business operators in the northern part of East Java. Since there are very few forests left in East Java, aside from protected ones, businesses need to source wood from outside the province.

The output value and export value of wood and other forest product goods, by source of wood, are as shown in the figure below. Basically, the wood produced in Indonesia comes from sources in four categories: households, small, medium and large businesses. In terms of output value, households are in the highest position, but large businesses dominate export activities. This indicates that the domestic market demand for the wood industry is met by household and small and medium-scale businesses.

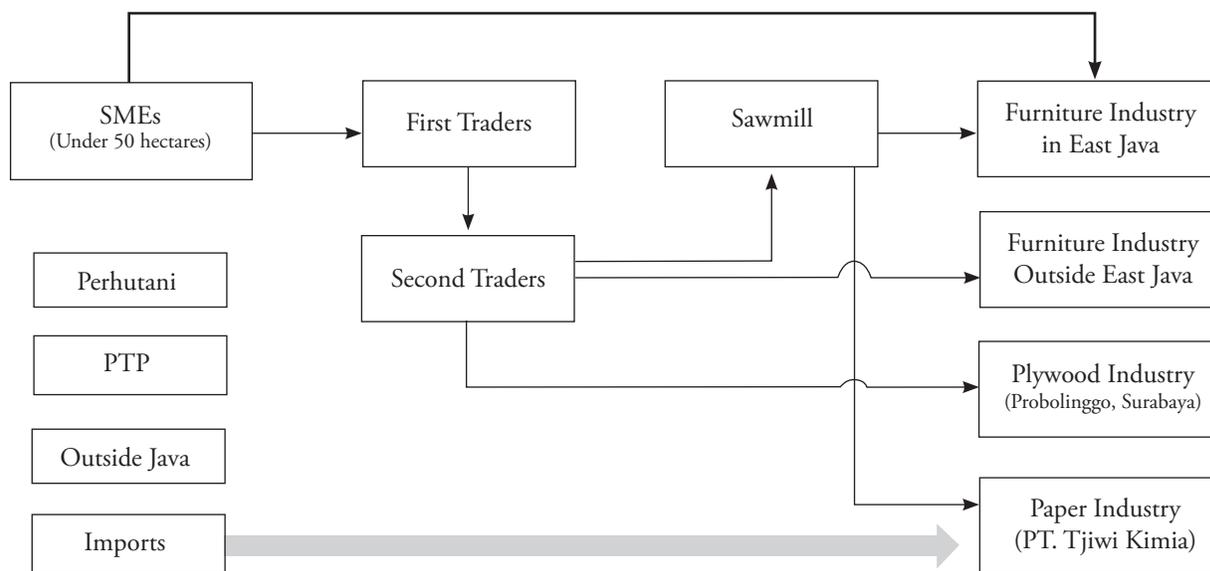
Figure 5.1 Comparison of Industrial Output Value and Value of Exports
(Wood and Other Forest Product Goods)



Source: Industry Statistics, BPS, 2000, processed

The main sources of wood in East Java are smallholders' forests, Perhutani (a state-owned company), wood from outside Java, and foreign imported wood. The definition of smallholders' forests is wood that is planted on individually owned land, usually using a small area. The owners of smallholders' forests are generally household businesses and small businesses. The wood from outside Java generally comes from the large business operator category. Below is an illustration of the wood commodity distribution chain in East Java.

Figure 5.2 Distribution Chain of the Wood Business in East Java



The following are some of the problems faced by business operators in the wood industry sector.

ISSUES

WOOD THEFT AND DEFORESTATION

The steadily shrinking supply of wood raw material, especially teak, dominated the discussions in several regions. This declining availability of wood raw materials is due mostly to uncontrolled wood theft and forest looting. The government and security forces are no longer able to handle the problem of wood theft and looting, which is done through illegal logging. This high level of wood theft, as mentioned earlier, is made possible by the alleged involvement of “insiders” or even the military. Especially since the start of the “reform” era, people seem to be in a race to cut the forests, claiming that this is in compensation for the earlier seizure of their land. Illegal logging in the forests has clearly increased very sharply.

There are two common methods of wood theft. The first is direct cutting and then smuggling to other regions through the available middlemen. In this case, the wood that is traded falls into the category of illegal trade. The second method is to illegally fell the trees and then produce permits for the logs; in this way, the logs become “legal,” and when they are traded the transaction is also legal.

This situation is closely tied to the process of granting permits, both for cutting and for transport of logs, which is highly susceptible to corruption, making it possible for permits to be issued that should not in fact be issued. This second method could be overcome if the local government were firm about eradicating corruption.

This wood theft and looting results in rapid deforestation, but the government’s ability to replant the forests is very limited and far behind the rate of deforestation.

The area of forest under the management of Perhutani Bojonegoro is 50,145 hectares (including protected forest). This represents 95% of the total forest area in Bojonegoro Regency. Of this area, around 20%, or 11,000 ha, was reforested in 2001. It is believed that the amount of forest destruction is steadily increasing. The capability of the regional government, through Perhutani, to reforest these areas is very slow, only around 1,017 hectares per year on average (2003). But the annual rate of deforestation is estimated to far exceed this figure. (FGD, PSD Team, 2004)

Another problem that has caused limited reforestation is the low level of active community participation in public control.

PERMITTING

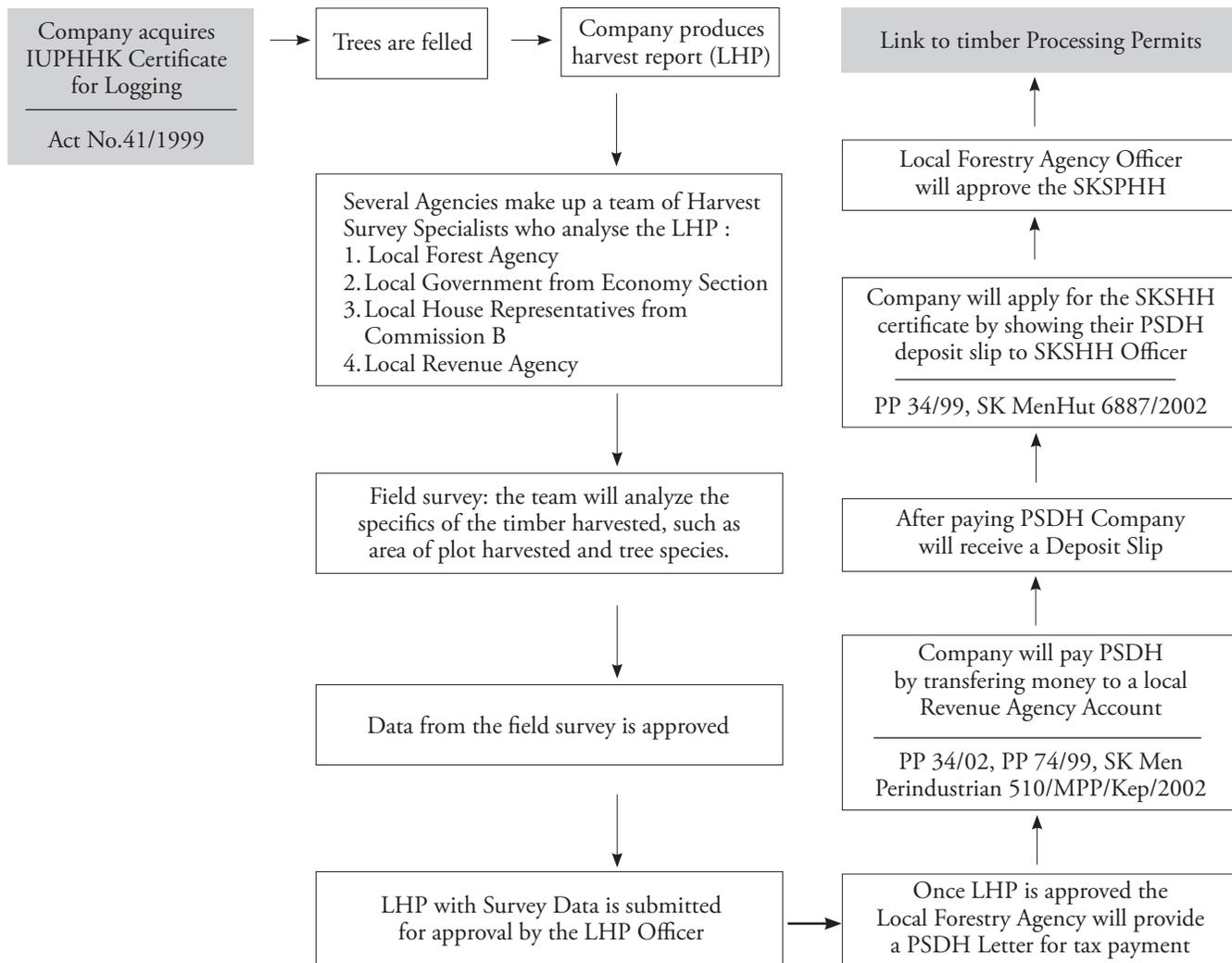
Permitting in the wood sector is a very complex issue. The two types of permits most often complained about by wood entrepreneurs are the Certificate of Legality of Forest Products (*Surat Keterangan Sahnya Hasil Hutan, SKSHH*)¹⁸ and licenses in the form of Purchase Allocation Orders (*Surat Perintah Alokasi Pembelian, SPAP*), Purchase Orders (*Surat Perintah Pembelian, SPP*) and Purchase Permits (*Surat Ijin Pembelian, SIP*)¹⁹.

¹⁸Decree of the Minister of Forestry and Plantations No 132/Kpts-II/2000 on Imposition of the Certificate of Legality of Forest Products (SKSHH) as replacement for the Log Transport Document (SAKB), the Loaned Wood Transport Document (SAKO) and the Non-Wood Forest Product Transport Document (SAHHBK).

¹⁹These licenses are differentiated on the basis of the volume of wood purchases per year, and can be described in detail as follows: (a) SPAP: this permit is issued by the Head Office of Perhutani for annual wood purchases of over 2000 cubic meters (m³); (b) SPP: this permit is issued by the Provincial Perhutani for annual purchases of wood between 600 and 900 m³; (c) SIP: this permit is issued by the regency-level Perhutani for annual wood purchases of not more than 700 m³.

SKSHH provides a legal assurance that the wood is of legal origin. The agency that has the authority to issue SKSHH is the regional government, through the local Plantations and Forestry Services. However, as noted above, in reality these certificates are often used to provide legality for stolen goods. In other words, a great deal of wood that has in fact been stolen very easily obtains SKSHH. This means that with this certificate, the wood becomes legal in the market. The consequence of this is that business operators who obtain their wood legally feel disadvantaged, as they must compete with others who have obtained their wood illegally (but “legalized”) at far lower prices, making competition very tight indeed. In Bojonegoro, it is estimated that the amount of illegal wood that managed to obtain SKSHH I 2003 came to 14,000 m³ (FGD, PSD Team, 2004).

Figure 5.3 SKSHH VALIDATION PROCESS
National Timber Trade/Transport Permit Decree of Director General for the
Forest Production Development no.82/KPTS VI-EDAR/2002



Notes:
 PSDH (Forest Resource Royalty Provision/Provisi Sumber Daya Hutan) is a levy substitute of the intrinsic value for the produce

The implementation standards of the Forestry Law on SKSHH pose a dilemma. On the one hand, the regulation is done in such detail that it should close off all opportunities for fraud, while on the other hand the high detail of the standards creates such complexity in the implementation that it actually creates opportunities for corruption. For example, with regard to the dimensions and weight of logs, the SKSHH specifies the weight and dimensions of the logs that may be transported and traded; however, because there is no standard technology for wood cutting, it is difficult to exactly meet the weight and dimensions that are specified in the SKSHH. This difference between the weight and dimensions specified in the SKSHH and the amounts actually transported means that transporting wood from one place to another is subject to many levies, both from the police and from the Highway Traffic Service (DLLAJ).

Another weakness in this policy on permitting through SKSHH is that it does not differentiate between wood produced by PT Perhutani or large-scale companies that hold Forest Concession Permits (HPH) and wood that is cut from smallholders' forests. This lack of distinction between wood sources applies to fees, transportation requirements, and the like. Even though it is planted on their own land, when individuals, as the landowners, want to cut their own wood it is very difficult for them because the regulations on the origin of the wood treat it the same as wood from state land.

The second type of permits, the SPAP/SPP/SIP, are permits that are issued regarding the method of obtaining or purchasing wood. At present, there are two methods for obtaining or purchasing wood from Perhutani: through tender or through licenses. The tender process applies only for large-scale purchases, while smaller purchases are made using licenses. Consequently, most business operators, particularly small-scale entrepreneurs, purchase wood from Perhutani using licenses. The types of licenses are the SPAP, issued by the central authority, the SPP, issued by the units at the provincial level, and the SIP, issued by the Forest Management Unit (KPH) at the regency level. The difference between the SPAP, SPP, and SIP lies in the amount of wood purchased.

As with the SKSHH, these licenses are susceptible to corrupt practices, which make arranging these documents difficult and expensive; they can only be obtained quickly if a bribe is paid to the issuer.

A participant from Bojonegoro said, "...If you're willing to pay Rp 1.5 million to arrange your license, it will be ready before 12 o'clock, but if you pay only Rp 25.000, it won't be ready until 2.00 or later, or even the next day..." (FGD, PSD Team, 2004)

Another permitting policy that limits the wood supply is the moratorium policy²⁰ which prevents logging. Basically, this policy is intended to ensure the continued existence of wood in the forests,

²⁰Decree of the Minister of Forestry No. 127/Kpts-V/2001 on temporary suspension (moratorium) on activities of cutting and trade in ramin (*gonytylus spp*)

particularly ramin wood, so that it is not depleted in a short time. On the other hand, this policy has also caused restrictions on PT Perhutani in its own logging. In implementation, this policy has not been very effective due to weak control.

Another type of permit that affects wood transactions, and especially wood exports, is the policy on export permits for several types of forest products, such as plywood and rattan. As specified in the Decree of the Minister of Industry and Trade provisions regarding exports, there are certain permits required for export of forest products, as follows :

Decree of the Minister of Industry and Trade No. 28/MPP/Kep/1/1998: On Provisions for Export of Plywood

Article 2

Clause 1:

Exports of plywood, blockboard and veneer as mentioned in Article 1 may only be done by Companies that have been recognized as Registered Plywood Exporters (ETKL) by the Director General of International Trade on behalf of the Minister of Industry and Trade.

Clause 2:

- (a) Companies that have plywood industries and have obtained Industry Business Permits (IUI), or
- (b) Companies that do not have plywood industries but have marketing contract with plywood industries that have obtained IUI and have not been recognized as ETKL.

Article 3

The procedure and requirements to be recognized as ETKL are as follows:

1. Submit a request to the Director General of International Trade, in this case the Director for Exports, through the local office of the Department of Industry and Trade to obtain a recommendation.
2. Attach supporting documents in the form of:
 - An Industry Business Permit issued by the Department of Industry and Trade or the Investment Coordination Agency (BKPM)
Companies that do not have plywood industries are required to attach a marketing cooperation contract with a company that has a plywood industry and has not been recognized as an ETKL, which has been legalized by the local Office of the Department of Industry and Trade, and a Trading Business Permit (SIUP)
 - TDP [Trade License]
 - NPWP [Taxpayer Number]
 - Notarial Deed of Company Establishment

Similar provisions also apply for exports of sawn wood or processed wood, which are contained in separate ministerial decrees.

In the downstream sector, Intellectual Property Rights (HAKI) for wood crafts persons are quite important, as they protect them from imitation and falsification. However, business operators say that it is very difficult to obtain such HAKI; not only is it expensive and time-consuming, but it is not entirely clear to them where to arrange this. The consequence is that many designs are copied by others, especially other furniture and handicraft producers. And even if the HAKI are obtained, it is still difficult to obtain protection against counterfeiting of one's products because enforcement is weak.

Another type of permit that is also expensive and difficult to obtain is the Wood Land Location Permit, which is felt to be quite expensive in interior regions as its price is the same as that for land located near major roads. These location permits have undergone quite significant increases, not to mention the informal levies that are imposed. Here is the experience of a teak farmer who canceled his plans because things became too expensive:

Farmer in Kediri Regency owned 4 hectares of land. He planned to plant this land with gold teak seedlings. The capital needed to raise the seedlings was around Rp 25 million per hectare, so the total cost to develop the four hectares would be Rp 100 million. When he tried to arrange a location permit, he was asked to pay Rp 50 million per hectare, totaling Rp 200 million. This figure was the result of bargaining, as the price initially asked was Rp 350 million for the four hectares. (FGD, PSD Team, 2004)

INFRASTRUCTURE

The types of infrastructure that have a significant impact on forestry related business activities in East Java are as follows:

Telephone network: The telephone network is quite limited, and seldom reaches the villages, though most of the smallholders' forests are located in village areas. This means that the process of selling this wood is often not efficient as communication between traders/buyers and suppliers requires physical visits.

Village road networks: Forest areas or wood production centers are generally in village areas. Consequently, the condition of village roads, particularly those from the forests to the regency and provincial roads, has a great impact on the wood business. At present, many village roads are in poor condition, which means that the transport process takes a long time and transport costs become higher. Furthermore, in the Bojonegoro area, where many wood handicraft and furniture producers

are located, most of the roads are quite narrow. This makes it difficult for trucks to enter the handi-craft production centers, which means that entrepreneurs must spend more on transport costs.

Ten cubic meters of wood could be transported by truck in one trip, at a cost of Rp 100,000. But because the condition of the roads makes this impossible, the only vehicles that can reach the interior of the forest are pickups. A pickup can only carry around 3 m³, and therefore has to make three or four trips. The pickup charges between Rp 40,000 and Rp 60,000 per trip. Thus, the total cost for transporting 10 m³ of wood by pickup is around Rp 200,000, or twice the price, and it also takes three times as long. (FGD, PSD Team, 2004)

Limited electricity network, especially to the villages: Even when the electric power network does reach the villages, there is still a problem with equitable distribution. Allocation of electric connections is subject to embezzlement by village authorities, whereby members of the public pay for electric connections, but PLN says that it never received their deposits and so the connections are not provided.

LAND MANAGEMENT

In the southern part of East Java, the limited wood supply is due mostly to the limited forest area. Participants said that many wood orders are placed with farmers, traders, and sawmill operators, but there is no more land available to be converted into wood production forests. In fact, there is a great deal of state-owned land that is not being well managed, but access to it is not available.

TAXES AND FEES

The fees for SKSHH are felt to be quite high; for example, in Surabaya the SKSHH rate is Rp 5000/m³. Multi-layered taxes are still found in many regions, and are felt to be a great burden. In Trenggalek, for example, the following taxes – Vehicle Tax, VAT, Income Tax, and Tax on Retained Earnings – are all applied on the same object, an automobile. In one FGD, a sawmill business operator said that he spent Rp 500 million in one year to arrange all these documents.

ILLEGAL LEVIES

Illegal levies were brought up in nearly every FGD that was conducted. For the commodity of wood, the illegal levies that discussion participants complained about included the following:

- Levies from the village, RT [neighborhood association], RW [higher level neighborhood association], hansip [civilian defense patrol], and “contributions” to other parties such as the local police department, etc.

Case examples of levies by Village Government:

Case (1): Transporting wood from Sumber Rejo to Kamolan, passing through three villages. If the wood is transported by pickup, it is subjected to a levy of Rp. 2,500 per trip, if using an L300 the levy is Rp 5,000 per trip, and using a truck the levy is Rp 10,000 per truck per trip.

Case (2): Transporting wood from Karang Rejo Village – Mungguran – Mendo Agung: assessed Rp 2,000 per 5 kilometers per pickup per trip.

- Levies at seaports
- Illegal levies in arrangement of SKSHH; can reach 20% of the price of the wood
- Levies on the roads, especially from the police

Case examples of levies on the roads:

Case (1): Transporting wood from Trenggalek to Surabaya using a trailer truck, the costs per trip per truck for unofficial levies during the entire journey came to around Rp 50,000. In addition to these “daily” levies, there are other expenses of a monthly nature, around Rp 2.5 million to Rp 4 million for four posts (Police Sector, Police Resort, and police sabhara unit were mentioned).

Case (2): In a shipment of wood from Dongko district to Probolinggo, around Rp. 100,000 had to be spent. Posts where it is known that payments must be made include Dongko Police Sector, Perhutani in Krangan, and other posts between Blitar and Malang.

- “Door to door” levies: Many groups collect such levies, including village officials, the police, the military, and so on. A furniture business operator, for example, must allocate around Rp 250,000 to 300,000 per month for such levies. The amounts usually rise in the run-up to major holidays such as Lebaran, Christmas and New Year’s.

TOBACCO

Respondents consulted for this sector came from the following regions: Bojonegoro, Sumenep, Kediri, Malang, Banyuwangi, Jember.

Tobacco is a commodity primarily used in producing cigarettes, but nationwide this industry provides jobs for millions of people, with a multiplier effect in the business chain of tobacco cultivation, processing, printing, advertising, trade, transportation, and research²¹.

²¹Kompas, 31 August 2000

This industry also makes quite a large contribution to state revenues. Excise duties on tobacco products in 1998 provided revenues of Rp. 7.5 trillion, or 4.47 percent of total state revenues; five years later, in 2003, this had risen to Rp. 27.9 trillion, or 7.54 percent of total state revenues²².

Tobacco is a plantation crop that was first developed by the Dutch colonial government in the nineteenth century. The industry began to grow in the early twentieth century, with Europe and America as its main markets. Tobacco then became a traditional plantation crop in East Java, with the Virginia and Besuki Na Oogst (BNO) tobacco varieties used as raw material for *kretek* cigarettes and cigars²³.

The tobacco and cigarette industry is one of East Java's chief industries. According to data from the East Java Central Statistical Agency (BPS), 2002, out of the total 807 tobacco companies in Indonesia, 435 companies are located in East Java, and four of them are foreign owned. No fewer than five regencies in East Java – Bojonegoro, Jember, Probolinggo, Pamekasan and Sumenep – are tobacco producers, both for the domestic cigarette industry and for export.

Table 5.2 Plantation Area and Tobacco Production of the Five Largest Producing Regions in East Java, 2000 – 2002

| | 2000 | | 2001 | | 2002 | |
|-------------|-----------|-------------------|-----------|-------------------|-----------|-------------------|
| | Area (ha) | Production (tons) | Area (ha) | Production (tons) | Area (ha) | Production (tons) |
| Bojonegoro | 14,603 | 12,022 | 12,713 | 11,367 | 13,093 | 11,768 |
| Jember | 17,070 | 12,655 | 18,806 | 17,801 | 11,893 | 13,080 |
| Probolinggo | 9,556 | 11,219 | 11,228 | 13,455 | 12,569 | 14,813 |
| Sumenep | 19,381 | 12,617 | 23,784 | 15,389 | 23,790 | 15,564 |
| Pamekasan | 30,488 | 18,347 | 39,565 | 18,174 | 39,570 | 18,400 |
| East Java | 125,996 | 98,381 | 149,538 | 107,361 | 149,409 | 108,515 |

Processed from "East Java in Figures, 2002"

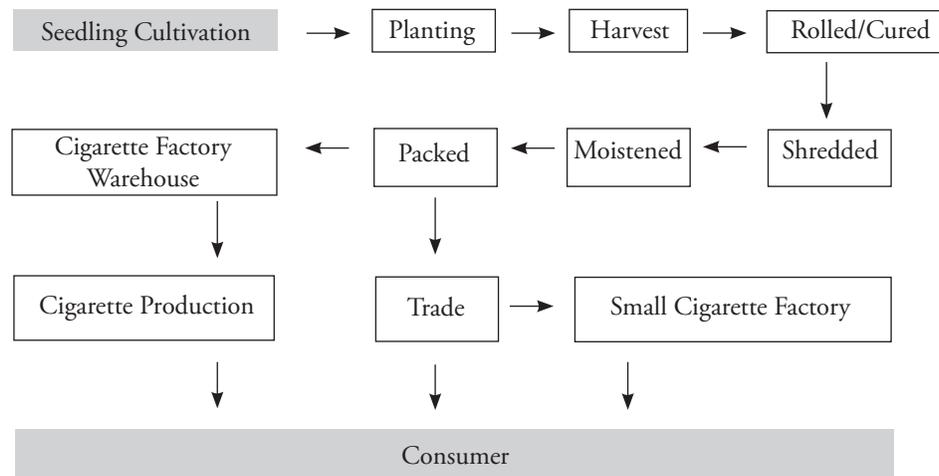
The tobacco produced from these regions becomes the primary raw material for the cigarette industry, which is spread throughout East Java. The major cigarette companies, such as Gudang Garam in Kediri, Sampoerna in Surabaya, and Bentoel Prima, Philip Morris and Rothmans of Pall Mall Indonesia in Malang, are headquartered in East Java and have tremendous buying power.

²² Analysis of Macro and Micro Bases for Tobacco Excise Policies in Indonesia, Directorate General of Customs and Excise and Fiscal Analysis Agency (BAF), Department of Finance, 2004.

²³ Kretek are local, unfiltered cigarettes, and referred to as clove cigarettes in the international market.

In general, the business chain of the tobacco product industry is as follows:

Figure 5.4 Production of Tobacco



In the business chain shown above, the tobacco business itself involves farmers, landowners, traders, and cigarette factories. And after the processing stage, the tobacco products industry involves other players as well, such as the paper and packaging industries, trade and distribution, advertising, and even the entertainment and sports industries.

Farmers are particularly susceptible to policy changes and changes in the prevailing business environment, as the production companies are better able to cushion losses. Factors affecting the price to farmers include costs of inputs (fertilizers, seeds and other inputs which are largely obtained from state-owned companies), and level of demand, which is affected among other things by cigarette excise duty policies. Results of a survey of tobacco farmers showed that they have rather negative perceptions of the tobacco excise policy set by the government²⁴.

²⁴ Brahmantio et al., in the Department of Finance PSPK-BAF study, stated that the continually rising tobacco excise duties will be a burden on farmers, in that the increases will be borne by farmers/ eat into the farmers' prices (52.8%), increased excise rates not accompanied by policy on the tobacco price will depress the tobacco price (36.3%), and the remainder stated that the increased tobacco excise has reduced demand for tobacco.

ISSUES

COST COMPONENTS AND PRICE ISSUES

As discussed above, farmers face high production risks. Any changes in the components of production costs will affect the farmers' income. The cost components in the tobacco farming business include the following: (1) land rental costs, (2) labor costs, (3) land preparation costs, (4) fertilizer costs, (5) seedlings and chemicals, (6) maintenance costs, (7) harvest costs, (8) processing costs, and (9) marketing costs²⁵.

The results of the FGD noted that farmers do not have direct access to the cigarette manufacturers' warehouses. The farmers sell the tobacco that they produce to small-scale brokers, who buy in bulk before it is harvested. These small brokers often sell the bulk tobacco to larger traders, who then carry out the process of drying the tobacco leaves. The dry tobacco that is produced is then sold to warehouses, most of which are owned by (or related to) the cigarette factories.

The traders or small brokers receive sub delivery orders (DO) from the big traders/brokers, who receive DO from the cigarette warehouses or factories. The brokers holding the sub-DO, in order to get better prices, often deal directly with the warehouses. Various illegal levies occur at this stage, such as at the tobacco receiving gate, weighing, and tobacco quality inspection. The fact that some traders have special access to representatives of the cigarette factories, with the various facilities that they provide, creates imbalanced competition among the tobacco traders²⁶.

Another type of price fluctuation occurs when the supply of tobacco from the farmers exceeds the demand from the cigarette factory warehouses. In fact, both the cigarette factories and the agriculture/plantation services in the regions play a role in informing farmers about the demand for tobacco in the coming periods. This is intended to prevent the tobacco price from collapsing at the farmers' level. But often the information on the expected demand for tobacco, which presents attractive estimated prices for certain types and qualities, encourages farmers to plant tobacco. Consequently, when harvest time comes the supply of tobacco is overabundant, in excess of the warehouses' demand, and the tobacco price at the level of the farmers therefore falls.

In terms of long-term competitiveness, Indonesian tobacco growers face stiff competition in the international market. China is one of the primary potential competitors. Tobacco from China has a lower price and producers have ten times greater productivity. Tobacco production in China could reach 2000 kilograms per hectare²⁷, compared to 200 kilograms per hectare in Indonesia.

²⁵ Final Report of Study on Tobacco Excise Alternatives, 2004, FE-UNDIP, 2003

²⁶ The facilities that are provided include information on the prices and qualities of tobacco desired by the cigarette factory warehouses. Some warehouses, or businessmen who act on behalf of the cigarette manufacturers, even provide loans to traders for the purpose of buying tobacco from the farmers. (REDI, 2003)

²⁷ Kompas, 12 August 2002

Table 5.3 Exports and Imports of Tobacco in Indonesia, 1990- 2000

| YEAR | EXPORTS | | IMPORTS | |
|--------|--------------|-----------------|--------------|-----------------|
| | Volume(Tons) | Value(US\$ 000) | Volume(Tons) | Value(US\$ 000) |
| 1990 | 17,401 | 58,612 | 26,546 | 41,963 |
| 1991 | 22,403 | 57,862 | 28,542 | 58,430 |
| 1992 | 32,365 | 80,949 | 25,108 | 64,547 |
| 1993 | 37,259 | 66,014 | 30,226 | 76,995 |
| 1994 | 30,926 | 53,261 | 40,321 | 100,217 |
| 1995 | 21,989 | 61,456 | 47,953 | 104,474 |
| 1996 | 33,240 | 85,623 | 45,060 | 134,153 |
| 1997 | 42,281 | 104,743 | 47,108 | 157,767 |
| 1998 | 49,960 | 147,552 | 23,219 | 108,464 |
| 1999* | 37,096 | 91,833 | 37,345 | 128,021 |
| 2000** | 29,050 | 77,708 | 27,283 | 85,844 |

Source: Directorate General for Guidance of Plantation Production

Note: *) Provisional Data **) Estimated Data

QUALITY STANDARDS

The cigarette manufacturers determine the standards for tobacco products, with substandard product being sold at reduced prices. The same is true with the determination of standards of tobacco for export. Quality standards are determined greatly by the choice of tobacco variety, processing technique, and tar and nicotine levels.

Large cigarette factories, which have their own warehouses, usually employ a certain treatment when they store the tobacco in their warehouses, in order to control the quality of the tobacco. The tobacco is usually aged from three to five years, as it is believed that this aging provides a more enjoyable taste. Having tobacco in stock cushions the large companies to some extent from external price shocks caused by fluctuations in tobacco prices or excise taxes.

Another standard relates to the health requirements set by the World Health Organization (WHO). Through Government Regulation No. 81 of 1999, the government has specified that tar and nicotine levels for cigarettes bought and sold in Indonesia may not exceed 1.5 mg of nicotine and 20 mg

of tar per cigarette. However, to date the average nicotine and tar contents for hand-rolled kretek (SKT) are 3 mg and 60 mg, and for machine-rolled *kretek* (KM) 2.5 mg and 50 mg. Enforcement of the regulations regarding nicotine and tar levels in cigarettes would have a tremendous impact on tobacco farmers. This is because kretek (including both hand- and machine-rolled) account for 87 percent of total cigarette production, while non-kretek with lower nicotine and tar levels, account for the remaining 13 percent. To meet these standards, a long-term program by the Department of Agriculture is needed, together with technical guidance to reduce nicotine and tar content, accompanied by adjustment of the tobacco processing technology to achieve the desired quality standards.

EXCISE DUTIES

Any increase in the excise duties on tobacco products always affects cigarette factories, tobacco farmers, tobacco traders, cigarette retailers, and consumers. The excise rates that are assessed on tobacco products follow a very complex formula, containing components of Category of Factory Entrepreneur (GPP) and Type of Tobacco Product, including machine-rolled kretek, (SKM), hand-rolled *kretek* (SKT), machine-rolled non-kretek (SPM), traditional varieties such as kelemek and klobot, hand-rolled non-kretek (SPT), cigars, shredded tobacco, and so on. The excise assessment then serves as the basis for the government in setting the retail selling price (HJE) in Rupiah per cigarette.

The problem of counterfeiting of cigarette excise duty stamps not only affects the state, as the East Java Regional Office of Customs and Excise has complained, but also affects competition among cigarette products. Medium-scale cigarette producers in Malang complain about counterfeiting of cigarette duty stamps, as this situation means that these producers' products have to compete on an unlevel playing field against cigarette producers who counterfeit cigarette duty stamps or who buy counterfeit duty stamps.

In Tulungagung, the cigarette factories complain about difficulties in obtaining cigarette duty stamps during certain months (such as before Lebaran). Without the duty stamps, the factories cannot sell the cigarettes they have produced, and they pile up in the warehouses. (FGD, PSD Team, 2004)

INFRASTRUCTURE

Tobacco farmers and cigarette business operators are deeply concerned about the quality of roads and other basic infrastructure, which strongly affect their business. Farmers on the island of Madura feel that the physical infrastructure there is not very supportive. The main road from north to south is considered too narrow, and there are no alternative routes. The road is also in generally bad condition.

Farmers and business operators in Madura have responded positively to the construction of the Suramadu (Surabaya-Madura) Bridge, as this will facilitate business transportation to and from Madura. However, one consequence of the construction of the bridge will be that the increased flow of business will result in traffic congestion on the main east-west route in the south of the island. This congestion must be anticipated by widening the existing road and opening another route on the north side, to be followed by north-south connecting routes.

As a plantation crop planted on large tracts of land, tobacco plants need adequate availability of water. For tobacco farmers on Madura, the availability of water for their tobacco plants has declined, as there are so few sources of water on the island. According to the farmers, in addition to water for plantation irrigation, the quantity of clean water for household purposes is still inadequate.

Another type of infrastructure that tobacco farmers need is bureaus or units for testing and standardizing the quality of tobacco. The existence of such infrastructure will provide clearer information on the types and qualities of seedlings and on standardization of tobacco processing.

PERMITS

At the level of the farmers, very little of the land that is used for tobacco cultivation has proper certificates. Farmers would like greater ease in arranging land certificates. Arranging land certificates is quite a complex matter at present; unfortunately it is crucial since farmers need the certificates as collateral if they want to apply for bank loans. Tobacco traders, meanwhile, complain about lack of clarity in the requirements for obtaining business permits (SIUP).

LEVIES

Cigarette factories depend greatly on the excise duty stamps as a requirement to market their products, and often have trouble in obtaining duty stamps in the quantities needed. In order to obtain duty stamps, sometimes entrepreneurs even have to pay illegal levies; cigarette business operators in Tulungagung and Malang have had this experience.

Business operators also face the burden of mandatory contributions that are generally collected at certain times and events. These levies, in the form of fees, are incurred by cigarette business operators when they are delivering and marketing their products in delivery trucks labeled with their products' logos or images. This advertising tax on delivery vehicles is assessed in Blitar and Nganjuk.

Meanwhile, farmers in Pamekasan and Sumenep have long complained of the practice of levies in the form of free samples of tobacco taken by certain middlemen or cigarette factory warehouse officials, in large quantities. The farmers in these two regencies have proposed to the Regency govern-

ment that Regional Regulations be issued to regulate the tobacco trade in these regions, which would include a provision on the collection of tobacco samples that would not be detrimental to farmers. Farmers in Madura also complain about levies that are assessed on tobacco farmers as a flat rate.

SUGAR CANE AND SUGAR

Respondents consulted for this sector came from the following regions: Malang, Sidoarjo, Magetan, Kediri, Tulungagung.

Sugar cane is, along with tobacco, one of the largest plantation crops in East Java. This crop was first introduced during the Dutch colonial period. At first, sugar cane was planted in the valleys of the major rivers in Java; cultivation then spread to high plateau regions as well. In the early twentieth century, the Indies were the world's second largest sugar exporter, after Cuba. Since it was an important commodity, the colonial government even established a sugar plantation research station in Pasuruan, which is now known as the Indonesian Sugar Plantation Research Center (P3GI). The state-owned Sugar Plantation Company (PG) largely finances this institution.

Nationally, domestic sugar production has declined, compared with production levels in 1930, which reached three million tons. With total national production currently at 1.7 million tons, Indonesia's sugar demand must be met with sugar imports of up to 1.5 million tons per year²⁸. Of the total national sugar production, the 33 sugar refineries in East Java produce approximately 41% of the total, or around 700 thousand tons of sugar²⁹.

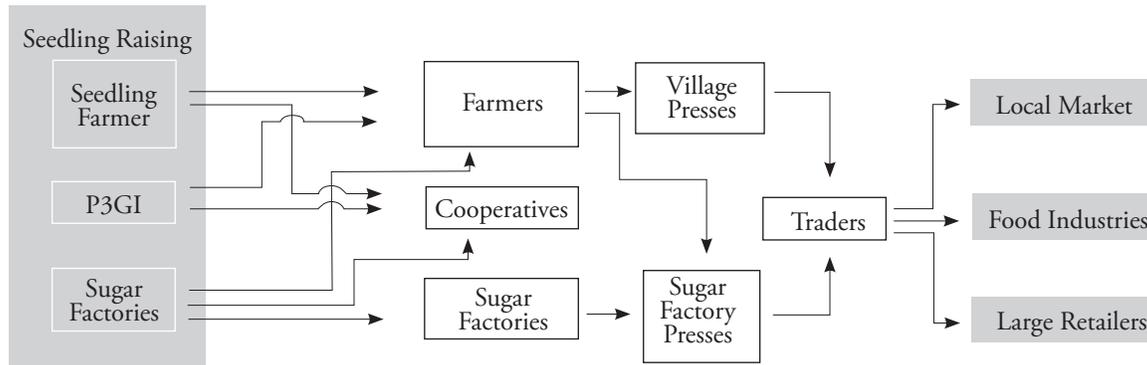
Sugar production in East Java rose steadily between 1999 and 2002. This increase, according to data from the Directorate General for Guidance of Plantation Production (BPP) of the Department of Agriculture, resulted from an increase in the area of land planted with sugar cane, accompanied by improved productivity of the sugar cane plants, reaching five tons per hectare.

²⁸Kompas, 25 July 2003

²⁹Kompas, 25 July 2003

In general terms, the domestic sugar production and distribution chain is as follows:

Figure 5.5 Production Chain of Sugar



Most of the seedling supply comes from the seedlings raised by PG and P3GI, with small amounts produced by seedling farmers. The seedlings from P3GI and seedling farmers are planted on farmers' land, while the seedlings produced by PG are planted in land owned by PG and by farmers in PG's operation areas. According to the Smallholders Sugar Cane Farmers Association (APTR) in the region of [State Plantation Company] PTPN XI East Java, the sugar cane plantation land owned by farmers ranges between 35 and 60 percent of the total sugar cane land within PG's operation areas. Only a small amount of the sugar cane harvest is pressed by business operators to produce brown sugar; most of it is pressed at PG.

In the profit and loss sharing of the farmers' production cane crop that is pressed by PG, the farmers receive 66 percent of the sugar and PG gets the remaining 34 percent. Of the farmers' share, one tenth, or around 6.6 percent is given by PG in kind in the form of sugar, while the remaining 59.4 percent is auctioned by APTR's auction team.

In East Java, farmers supply around 75 to 90 percent of the raw material for sugar factories. Therefore, the productivity of the sugar factories' installed production machinery depends greatly on adequate supply from the farmers. According to the factory operators, to be able to compete with imported sugar, farmers must be able to increase the productivity of their cane fields to at least 8.5 tons per hectare³⁰.

³⁰Kompas, 23 May 2003

ISSUES

FARMER'S PRODUCTIVITY

According to data from the Directorate General of BPP, the productivity of sugar cane plants in East Java is at present second only to that of cane plants in Lampung, which produce on average 7.8 tons of sugar per hectare. The productivity of the sugar cane fields in East Java could in fact be raised if the farmers employed proper management in planting the cane.

Seedling selection, land preparation, fertilization, cutting techniques, and irrigation systems are all factors that can affect the productivity of sugar cane. One factor that most affects the productivity and sucrose content of the cane is the method of pruning the cane shoots (ratoons), which in Indonesia is done up to twelve times in the productive life of the plant. In fact, to produce internationally competitive quality sugar cane with high sucrose content, each cane should be pruned a maximum of only two times then discarded.

One cause of excessive pruning is that preparation of new plantings is still done by traditional, labor-intensive methods. The costs of proper land preparation are very high, around Rp 15-16 million per hectare³¹. Many farmers state that tractors are too expensive for them. Numerous prunings are therefore done because preparing a new planting is not financially feasible. The small size of plots, which average less than 0.25 hectares per farmer, also increases the production costs for each field³². These factors lead many farmers to choose to plant crops other than sugar cane, contributing to a shortfall in raw materials experienced by the sugar factories.

EFFICIENCY OF THE SUGAR FACTORIES

Improvements in productivity need to be made from upstream to downstream in the commodity of sugar cane, from the technology that is used in the sugar cane plantations to the processing of the cane in the sugar factories. The sugar factories in Java, including East Java, are in general highly inefficient. The machinery used at PG is the same that has been used for the past 80 years. To meet the government's target that by 2007 the national sugar industry must produce at least three million tons of sugar, thorough restructuring of the sugar factories is needed, including major capital investment to replace the existing machinery.

³¹Kompas, 3 June 2003

³²Kompas, 26 May 2003

Around 70 to 75 percent of the installed capacity of machinery in the sugar factories in East Java is actually in use; the rest is idle capacity. With this level of capacity utilization, according to the plant operators, the efficiency of the production process reaches 80 to 90 percent. According to PG managers, the idle capacity in PG's machinery occurs because the supply of sugar cane from the farmers does not meet the maximum needs of the factories in line with their installed capacity. However, according to the farmers, the insufficient supply to the factories is caused not only by harvest sizes that are less than maximum but also by the inefficient production management in the sugar factories. The system of long queues for pressing, which can reach 30 hours after cutting the cane, is detrimental to the farmers, because this can reduce the cane's sucrose content by as much as 50 percent. To avoid this continuous reduction in sucrose content resulting from overlong waits, many farmers choose to move to other sugar factories where they can have their cane pressed immediately.

PG as it exists today is known to be inefficient in its production. This results not only from its antiquated mill machinery but also from its management structure which is too "fat" and lacks flexibility as decisions are made centrally by PTPN's central management. PG's inefficiency has encouraged the idea of mini sugar mills (PGM). PGM are small mills that can press sugar independently of PTPN. They have been opened on a pilot basis by the Malang local government. PGM have been tested by sugar cane farmers in Malang Regency. The principle of PGM is to increase the productivity of the sugar cane plants, increase the efficiency of the farmers' sugar production, and reduce the waiting time for pressing farmers' sugar cane, so as not to lose the cane's sucrose content. Farmers hope that these PGM schemes will attract the government or private enterprises to build these factories and that banks will help with the financing. (FGD, PSD Team, 2004)

SUGAR IMPORTS AND SMUGGLED SUGAR

The sugar import policy is regulated in Decree of the Minister of Industry and Trade No. 643 of 2002 on Sugar Import Trade Procedures. This policy protects Indonesian sugar cane farmers from foreign competitors who have higher efficiency and lower prices. Import licenses are issued as long as domestic prices for sugar are considered to be high enough. For example, with basic production cost for sugar of Rp. 3,100 per kg, farmers sell to traders in the range of Rp. 3,400 – Rp. 3,450 per kg. At this price, the government can open imports of white crystal sugar. But when the price at the farmer's level is below Rp. 3,100 per kg, the government does not permit imports of white crystal sugar.

Sugar must be imported because domestic production cannot meet the total national demand. As explained above, Indonesia imports around 1.5 million tons of sugar every year to meet the needs of domestic consumption and industry. However, the amount of imported sugar that enters the country often exceeds the national need. These excessive imports occur both through legal import procurement and through smuggling.

Ministerial Decree 643/2002 grants import licenses to the sugar factories (who mill domestically produced sugar), registered sugar traders (who distribute domestically produced sugar as well), and a trading company, PT. PPI. Sugar cane farmers question the decision of the Ministry of Industry and Trade to appoint PT. PPI as a sugar importer, as it is not connected to the farmers. They fear that the company will therefore not protect their interests to uphold the import barriers.

Sugar cane farmers feel that the coordination of the Customs and Excise officials and the police in the implementation of the Trading Procedure Policy for imported sugar is not yet optimum. They would like much tighter monitoring of gates for sugar smuggling such as Madura and other ports in the northern part of East Java.

TAXES AND LEVIES

The wide range of levies that sugar cane farmers face is felt to be a great burden. Levies occur at harvest, transport, milling and finished product stages. The levies at harvest time are in the form of plantation crop fees. Together with this fee, sugar cane farmers in the Madiun area are also subjected to parking fees while waiting for milling. Farmers were also subjected to village road tolls of Rp. 25,000/trip by the village government. In cases in Jember and Situbondo, sugar cane farmers are even subjected to village levies for village road maintenance and levies on their crops. Because most farmers mill their sugar at the state-owned factory, payment of these levies is sometimes made directly to the state-owned company.

In Madiun, sugar cane farmers pay directly to PG through deductions from the sugar cane crop and DO of Rp 275 per ton, which consists of (a) Rp. 100/ton for road fees to the regional government, (b) Rp. 75/ton for police security protection, and (c) Rp. 100/ton for APTR dues (FGD, PSD Team, 2004)

Meanwhile, PG complains about the assessment of the national VAT on land rental and rental of transport for cut cane. This VAT assessment increases the costs PG must bear by 10%.

LACK OF WATER RESOURCES

One aspect of infrastructure that is of great concern to sugar cane farmers is water sources and channels. The irrigation channels to farmers' fields are not very good at present, as they are not well maintained. To obtain enough water, farmers get water from wells, which is then pumped to irrigate their sugar cane fields.

In the case of difficulties with water availability in the former residency of Madiun, farmers or farmers' associations have had to obtain water by pumping it from depths of 80 to 300 meters for each

100 hectares. This is also due to a change in the priority for the use of water from springs, which was previously allocated to plantations but has been shifted to drinking water. Sugar cane farmers in Situbondo also mentioned the need for field irrigation infrastructure. Water is presently provided with the help of water pumps, but it is hoped that the planned Samir Reservoir will be developed in the very near future.

Difficulties in meeting water needs for production are also experienced by the sugar factory (PG). At present, the water supply to PG for production is obtained from the river and from pumping of ground water, which is flowed through the factory's pipelines. Because of this utilization of surface water and ground water, PG is assessed water Exploration and Maintenance (EP) fees of Rp 50 million per month by Jasa Tirta [water service]. However, PG must still carry out maintenance by itself, and even repairs whenever damage to the water pipelines occur. (FGD, PSD Team, 2004)

SECURITY

Whenever the harvest season approaches, farmers are always prepared for the possibility of fires in their sugar cane fields. Fires destroy between 5 to 10 percent of the sugar cane fields. Farmers acknowledge that as well as fires resulting from natural causes, sometimes they result from business competition or criminal acts. The farmers can only anticipate cases of fires and other security disturbances in the sugar cane fields by increasing their surveillance and monitoring together with other farmers.

Another security case is the practice of levies packaged in the form of security costs for sugar distribution. Sugar traders in Madiun say they must pay Rp. 300,000 per month to a certain group that operates in the distribution of basic goods. (FGD, PSD Team, 2004)

COFFEE

Respondents consulted for this sector came from the following regions: Kediri, Malang, Blitar, Surabaya, Gresik, Jember, Bondowoso, Probolinggo, Situbondo.

Coffee plants have long been cultivated, both in smallholders' plots and in large plantations. However, coffee plantation area in Indonesia has been declining. While in 1992 the area planted came to 1,333,898 hectares, as early as 1997 this had declined by 154,005 hectares to only 1,179,843 hectares³³. At the same time, despite the reduction in area under cultivation, the production volume remained relatively stable, at between 27.5 thousand tons and 30 thousand tons per year.

³³ www.bi.go.id

Table 5.4 Production and Export Value of Indonesia's Coffee Plants, 1996 – 2001

| Year | Level Of Production (In Tons) | Export Value (In Thousand Us\$) |
|--------|----------------------------------|------------------------------------|
| 1996 | 28,500 | 17,059 |
| 1997 | 30,600 | 26,133 |
| 1998 | 28,500 | 36,453 |
| 1999 | 27,493 | 24,189 |
| 2000 | 29,500 | 22,773 |
| 2001*) | 28,681 | n.a. |

Sources: www.bi.go.id and www.dprin.go.id

*) = Estimate as of September 2001

From the data above it can be seen that although the level of production was roughly stable, the export value of coffee experienced declines in 1999 and 2000. In contrast, in 1998 the export value rose significantly even though the level of production was down from the previous year. This was related to the decline in the value of the Rupiah against the US dollar. The selling prices for coffee received by all players in the coffee market have been shown to fluctuate in the long term, due to conditions of supply and demand in the international market. Specifically for Indonesia, at present the prices received by producers are greatly influenced by the depreciation of the Rupiah against the US dollar.

Table 5.5 Export Price of Coffee (FOB³⁴ in US \$/kg)

| No | Type Of Coffee | 1993 | 1994 | 1995 | 1996 | 1997 |
|----|----------------|------|------|------|------|------|
| 1. | Arabica | 2.19 | 3.73 | 3.31 | 2.58 | 4.18 |
| 2. | Robusta | 1.04 | 2.15 | 3.06 | 2.07 | 1.64 |

Source: www.bi.go.id and www.dprin.go.id *) = Estimate as of September 2001

The dynamics of trade in the commodity of coffee at the national level against world coffee prices also affect the conditions of this commodity in East Java. Coffee is grown in 26 regencies/cities out of the total 38 regencies/cities in East Java.

³⁴ Freight On Board. The value of exports when they are placed on a ship, lorry or aeroplane to leave a country. FOB thus includes cost of production and of transport to the port of embarkation, but does not include the cost of freight and insurance in getting them to their foreign destination. Free on Board is contrasted with cost, insurance and freight (cif), the value of goods on arrival at a foreign port, which includes freight and insurance (Black, Dictionary of Economics, Oxford, 2002)

Table 5.6 Distribution of Coffee by Region in East Java, 1998

| Regency / City | Area (Hectares) | Volume (Tons) |
|----------------|-----------------|---------------|
| Jember | 24,375 | 14,294.5 |
| Malang | 19,516 | 7,971.6 |
| Bondowoso | 15,560 | 7,288.0 |
| Banyuwangi | 14,366 | 9,721.8 |
| Blitar | 8,197 | 2,970.2 |
| Lumajang | 4,867 | 1,391.8 |
| Pasuruan | 3,610 | 784.8 |
| Probolinggo | 2,783 | 580.0 |
| Kediri | 2,491 | 3,720.3 |
| Situbondo | 2,021 | 743.2 |
| Pacitan | 1,736 | 293.2 |
| Jombang | 1,515 | 456.0 |
| Madiun | 1,445 | 387.7 |
| Trenggalek | 729 | 145.3 |
| Tulung Agung | 656 | 417.0 |
| Ponorogo | 631 | 118.6 |
| Magetan | 462 | 94.9 |
| Ngawi | 382 | 48.3 |
| Nganjuk | 217 | 58.7 |
| Mojokerto | 62 | 17.7 |
| Pamekasan | 56 | 17 |
| Gresik | 38 | 13.3 |
| Sumenep | 13 | 2.4 |
| City of Malang | 13 | 2.6 |
| City of Madiun | 3 | 0.4 |
| City of Kediri | 3 | 0.7 |

Source: www.bi.go.id

From the table above it can be seen that the largest contribution to the commodity of coffee in East Java comes from five regencies: Jember, the largest contributor, followed by the regencies of Banyuwangi, Malang, Bondowoso, and Kediri.

Coffee in East Java is grown and developed through smallholder plantations, large government-owned plantations (managed by PT. Perkebunan Nusantara/PTPN and owned by the central government and by local government), and large plantations owned by the private sector, both national and foreign. Smallholder plantations are generally small scale businesses managed in traditional ways, and therefore have low productivity. In contrast, the large plantations are managed with more modern practices and high technology.

The coffee produced from smallholders' plantations in many areas of East Java is traded to various parties, but most often to middlemen (pengepul). These middlemen are usually local traders, or traders from other regions, who come to the farmers in the villages. They usually purchase the crops directly from the farmers.

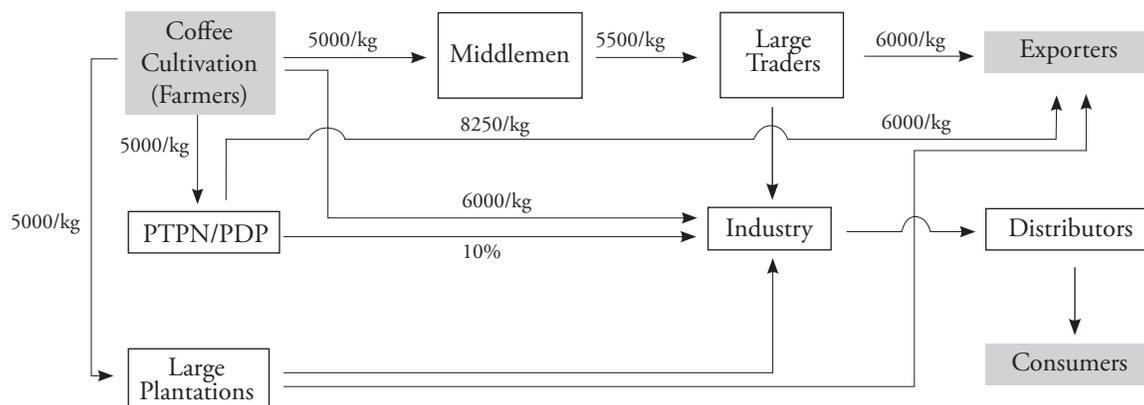
A survey conducted by the Java Coffee Exporters Association obtained data showing that farmers usually sell their crops as follows:

- 69% to middleman traders (who usually travel from village to village)
- 27% to local middleman traders (usually located in the district)
- 3% to industry (in this case because these coffee farmers are under the guidance of exporters or companies), and
- 1% to exporters

As well as selling their coffee crops to middlemen, some farmers also sell to PTPN or to the Regionally-Owned Plantation Company (PDP), particularly farmers in Jember. Farmers in other regions sell to the large plantations. This means that although PTPN and the large plantations have coffee under cultivation on land under their own ownership and management, they also often absorb the coffee crops of smaller farmers.

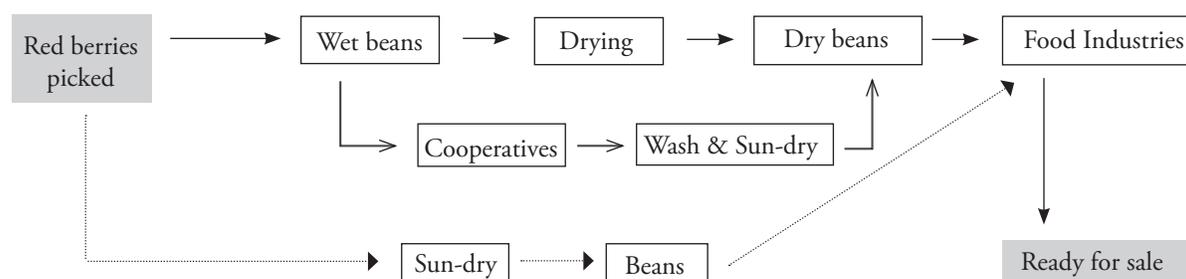
The range of price is Rp 500 to Rp 1,000 at each link in the distribution chain from the farmers to the exporters, except for the trading price from PTPN to the industry, as shown in the figure below:

Figure 5.6 Production Chain of Coffee



Large traders and the government-owned plantations usually perform the role of reprocessing the coffee beans that come from farmers. This reprocessing is aimed at reducing the water content and sorting the coffee. The process by the farmers, from picking to sorting the coffee beans, is very important as it strongly affects the price. This can be seen in the case faced by coffee farmers in Madiun, Ngawi and Ponorogo.

Figure 5.7 Process from Picking To Sorting Of Coffee Beans



Note:

There are three processes commonly used by farmers to sell their coffee beans:

- = The process usually used
- = Alternative process 1
- .-> = Alternative process 2

Even when farmers plant coffee of the Arabica and Robusta varieties of the highest quality and with high selling prices, if the picking and sorting process is done using alternatives 1 and 2, the selling price will be lower. The price for quality I Arabica ranges from Rp. 7,000 to Rp. 8,000 and for quality II, from Rp 6,000 to Rp. 7,000. For Robusta, farmers mostly sell quality I at between Rp. 7,000 and Rp. 8,000.

ISSUES

INFRASTRUCTURE

There are two infrastructure issues that pose serious problems for coffee farmers. The first of these is the many roads in bad condition. Farmers in Jember, Madiun, Ngawi and Bondowoso say that the village roads leading to the districts are in very bad shape. In their view, the government is not concerned about the condition of the roads leading to the production centers. In fact, the roads to the districts are an important factor in the distribution of their products.

In Banyuwangi, the public has undertaken a self-help effort to upgrade bad roads. The farmers say that repairing the roads has been a great benefit to them because operational costs have fallen by as much as 20%. (FGD, PSD Team, 2004)

The second issue is availability of water. This problem frequently arises in Madiun, Ngawi, and Ponorogo, especially during the dry season. Farmers in Madiun and Ponorogo complain that the irrigation is inadequate.

COMPETITION FROM THE GOVERNMENT

Under decentralization, local governments, faced with new pressures to raise local revenue, are in some cases turning to the creation of new state-owned enterprises (SOEs). These SOEs, owned by the local government, are in this case competing with the private sector. One example that was discussed during the research is in Jember. The Jember local government has established a local government-owned plantation company (PDP) that grows coffee and produces it as ground coffee. Based on information provided by farmers in Jember, it is suspected that the local government engaged in “unhealthy business competition” by issuing a circular letter to government officials and offices (from the subdistrict level to the services) instructing them to consume coffee from the PDP. Because of this circular letter, it is difficult for ground coffee producers to market their products to government offices.

INADEQUATE GOVERNMENT SERVICES

The FGD participants felt that the support services provided to coffee farmers by the local government are not very helpful. Concerns included the low frequency of agricultural extension information campaigns, and the qualifications of extension officers, who are felt to lack technical capabilities regarding eradication of coffee pests. In Jember, the farmers’ groups actually had to teach the extension officer about pest control. It is also felt that local governments do not want to coordinate with the technical agencies that do understand about coffee issues. Although there is a Coffee and Chocolate Research Center in the region, run by the central government, the local governments have never involved this Research Center in programs for handling coffee.

A second problem for the farmers is the policy on provision of top-grade seedlings. The provision of these seedlings by the government is usually done through vendors without involving the farmers in the process. There is no dialogue regarding the seedling provision program. Consequently, the top-grade seedling provision program is often not in line with the actual conditions in the field. Seedlings are even provided with no details given on how to eradicate the pests that may attack them.

“...the top-grade seedling program is often provided by the local government without any discussion with the farmers. The government usually uses contracted vendors who do not understand about agriculture. Often the seedlings that are provided are not even the top-grade seedlings, but of completely unknown types...” (FGD, PSD Team, 2004)

The other obstacle is provision of appropriate technology, particularly for spraying. Cases experienced by farmers in Jember showed that the technological assistance provided by the local government was not actually what the farmers needed. An FGD participant related that the Ponorogo local government once offered assistance with a coffee bean hulling machine adapted from a rice-polishing machine. However, this rice-hulling machine did not provide good results when used on coffee, and when the farmers used the machine the coffee beans were broken. In another instance, farmers in Ngawi needed information on coffee bean peeling machinery. To date, the local government has not provided adequate information on technology for processing coffee beans.

PRICING IRREGULARITIES

Another issue related to government services is the service provided by state-owned companies such as Perhutani. Farmers in Bondowoso have often experienced cases of manipulation of crop weighing scales by Perhutani. Many farmers in Bondowoso use Perhutani land to plant coffee. The pattern employed is profit sharing between the farmers and the land manager, with one third for Perhutani and two thirds for the managers. To determine the value of its third, Perhutani usually estimates it first before the harvest, and so when the farmers deposit the one-third share of their crops, they have prepared the number of kilos of coffee to be deposited in line with Perhutani's earlier estimate. But when they get to Perhutani, the farmers feel that the results of the weighing are never the same as those of their own scales at home. Not just one farmer, but nearly all of them have experienced this. Because of the shortfall in the value of the coffee deposited, the farmers are asked to make up the difference in cash to the Perhutani weighing officer, adjusted to the prevailing coffee price.

CAPITAL

Another group of farmers from Jember, Madiun, Ngawi, Banyuwangi, Ponorogo and Bondowoso said that they experience difficulty in obtaining bank loans due to the requirement for a land certificate as collateral. Farmers generally have only a “*pethok D*”³⁵. It is difficult for the farmers to get their *pethok D* converted into a land certificate from the National Land Agency (BPN), as the process is rife with corruption. The farmers say that to facilitate the process of certificate issuance, they must pay bribes of at least Rp. 50,000 at each desk. If they do not pay these bribes, the process will take a very long time, three months at the very least. As it is difficult to access formal finance, farmers use other means of obtaining credit:

³⁵ A letter issued by the head of the village, which states the ownership of land. *Pethok D* is one of the requirements to get a land certificate.

Farmers employ many methods to overcome their financial problems. Most often they sell their crops to middlemen long before the harvest. Under this system, the farmers receive only 50% to 70% of the market price. Another method is to borrow from a “little miss,” that is, to borrow a certain amount of cash from someone (usually a woman, hence the term). When harvest comes, it is repaid from the produce, but the selling price of the produce is determined by the lender. (FGD, PSD Team, 2004)

SECURITY

The crimes of greatest concern to farmers are thefts of the coffee right before harvest. Because they are so worried about these situations, many farmers prefer to pick their coffee when the beans are still green, because if they are not picked, the farmers could lose their crops entirely. But the consequence of this “green picking” is that the selling price is low because the quality is poor. This problem appears to be widespread with only participants from Banyuwangi saying that theft and looting almost never occur there.

SALT

Respondents consulted for this sector came from: Sampang, Pamekasan and Sumenep.

The salt sector is synonymous with Madura and East Java in general as the largest national producer of salt. It plays an important part in their community life. Even though the sector has existed for a long time, production techniques are still based on low productivity, traditional methods.

Under Dutch colonial rule, salt production was regulated by a policy, “*Zoutmonopolie-Ordonnantie 1941*”, that designated certain regions in Indonesia, including Java and Madura, as regions with a government monopoly on salt production. This meant that production of salt by the people was an illegal act. Only state-owned companies could produce salt in these regions. These companies, the State Salt Company and State Soda Company were unable to produce sufficient quantities to meet the national demand. To overcome the inadequate production of salt, the post-independence government issued Emergency Law No. 25 of 1957 on Elimination of the Salt Monopoly and Production of Salt by the People³⁶. This Emergency Law was intended to increase national salt production. In 1959, this Emergency Law was confirmed as Law Number 13.

³⁶State Dazette for 1957 No. 82

At present, Indonesia has 25,383 hectares of salt fields, with official total production of 1.7 million tons. This is insufficient to meet national demand, which in 2002 came to 2.8 million tons, with growth in demand of 8.4%³⁷. It is estimated that by 2004 the national salt demand will reach 3.3 million tons. The largest salt production company in Indonesia is the state-owned enterprise PT. Garam. PT. Garam's production is only around 250,000 to 300,000 tons/year, on an area of around 5,000 hectares.

There are 22 provinces in Indonesia producing salt. The province of East Java is the largest national producer of salt. It is estimated that the province contributes 70% of the raw material salt produced in Indonesia, and for iodized salt, the province contributes 45% of total national production. The remaining 30% of salt production is distributed among 21 other provinces, as seen in the following table:

Table 5.7 Salt Production in Indonesia

| No | Province | Capacity Of Iodized Salt (Tons/year) | Capacity Of Raw Material Salt (Tons/year) |
|----|--------------------|--------------------------------------|---|
| 1 | East Java | 596,772 | 1,100,000 |
| 2 | West Java | 209,744 | 130,000 |
| 3 | Central Java | 148,032 | 220,000 |
| 4 | North Sumatra | 72,000 | --- |
| 5 | South Sumatra | 56,000 | --- |
| 6 | West Nusa Tenggara | 52,700 | 61,000 |
| 7 | West Sumatra | 51,000 | --- |
| 8 | South Sulawesi | 47,448 | 70,000 |
| 9 | Lampung | 25,640 | --- |
| 10 | Jambi | 24,000 | --- |
| 11 | Riau | 20,000 | --- |
| 12 | West Kalimantan | 14,200 | --- |
| 13 | North Sulawesi | 10,850 | --- |
| 14 | Aceh | 9,000 | 10,000 |
| 15 | Bengkulu | 8,200 | --- |
| 16 | Central Sulawesi | 7,000 | 18,000 |
| 17 | DKI | 5,123 | --- |
| 18 | South Kalimantan | 5,000 | --- |
| 19 | Central Kalimantan | 3,000 | --- |
| 20 | East Kalimantan | 2,500 | --- |
| 21 | Bali | 864 | 2,200 |
| 22 | East Nusa Tenggara | 440 | 10,000 |
| | Total | 1,350,013 | 1,621,200 |

Source: Sampang Regency Industry, Trade and Mining Service

³⁷Kompas, 19 March 2003, "Government Studies Stimuli for Salt Industry

Of total salt demand 40% is absorbed as salt for consumption and the remaining 60% as salt for industry. Industrial salt is used in several industries: 76% for the soda industry, 15% for oil drilling, and 9% for other types of industry such as leather, cosmetics, soap and ice. Of the salt demand for consumption, 72% is used as food, while the rest is used as an auxiliary material in the food industry³⁸.

In East Java, local production by household or informal sector producers is abundant. According to data from the Industry, Trade and Mining Service of Sampang Regency, salt in East Java is more than sufficient to meet local demand. They estimate salt consumption demand in East Java at approximately 172,754 tons per year, while the level of production comes to 1,100,000 tons per year.

Table 5.8 Salt Areas and Salt Production in East Java, 2003

| Field | Location | Area | Production Capacity |
|--------------------|---|-----------------------|---------------------|
| PT. Garam | Sumenep, Pamekasan, Sampang | 5,116 Ha | 400,000 tons / year |
| Smallholders' Salt | Sumenep, Pamekasan, Tuban, Lamongan, Gresik, Sidoarjo, Pasuruan | 14,007 Ha | 700,000 tons / year |
| Total | 19,123 Ha | 1,100,000 tons / year | |

Source: Sampang Regency Industry, Trade and Mining Service

Of the total production of 1,100,000 tons in East Java, only 55% is further processed into iodized salt. The remaining 45% is raw material salt that is normally used in industry. The greatest contribution to production of iodized salt comes from Surabaya and Pamekasan. Surabaya only processes raw salt into iodized salt. East Java's raw salt production comes mostly from the regencies on the island of Madura specifically in Sampang, Pamekasan and Sumenep. The contribution of Madura to East Java's raw salt production is estimated at 70% of East Java's total production.

³⁸<http://suharJavanasuria.tripod.com>

Table 5.9 The Iodized Salt Industry in East Java

| Regency / City | Number Of Companies In Production | Production Capacity (Tons) |
|------------------|-----------------------------------|----------------------------|
| City of Surabaya | 5 | 280 |
| Kab. Pamekasan | 3 | 220 |
| Kab. Sidoarjo | 3 | 36.5 |
| Kab. Gresik | 5 | 32.2 |
| City of Pasuruan | 9 | 14.75 |
| Kab. Pasuruan | 4 | 5.862 |
| Kab. Malang | 5 | 4.26 |
| Kab. Probolinggo | 2 | 2 |
| Kab. Lumajang | 1 | 1.2 |
| Kab. Sampang | 2 | 0 |
| Total | 39 | 596.772 |

Source: Sampang Regency Industry, Trade and Mining Service

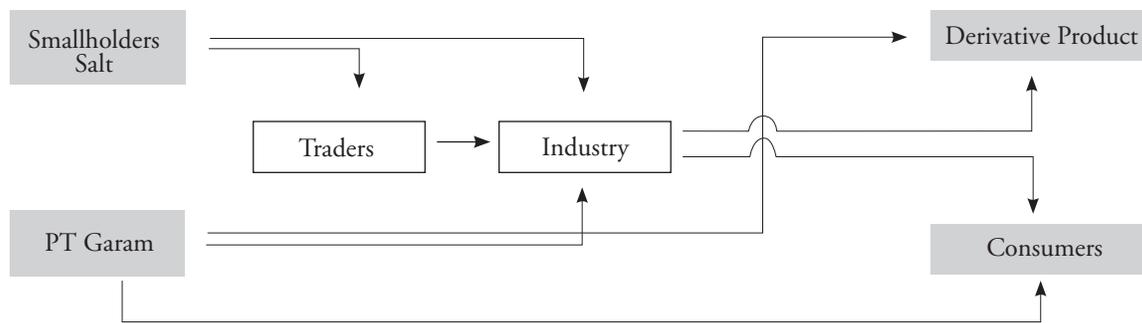
According to FGDs held in Madura, salt producers are of two types: smallholders, that is, salt managed and produced by the public on an individual basis, and PT. Garam. PT. Garam both produces and markets salt.

Processing of smallholders' salt is generally done using very simple technology. This salt production process is done by evaporating seawater in small plots. The stages are first, to drain the area, followed by irrigation (with sea water) and then sun drying. The sea water that is evaporated contains seven types of minerals in each liter: CaSO_4 , MgSO_4 , MgCl_2 , KCl , NaBr , NaCl , and water. The process of evaporation used to dry the salt affects the quality of smallholders' salt. The existing processes produce three-quality grade of smallholders' salt: first, K1 (quality 1) for salt of the best quality. For this grade, the process from irrigation to sun drying takes at least 30 days. The second grade is K2 (quality 2), for salt of medium quality. This grade requires 15 days for the process from irrigation to sun drying. Finally, K3 (quality 3) is for salt of the lowest quality, production of which takes only seven days. The production process for smallholders' salt is as follows:

Figure 5.8 Salt Production

The salt products produced by smallholders are not immediately distributed to the public, but require complex further processing to meet the quality standards for salt for consumption. The most important aspect of this is the level of iodine content for consumption salt. The further processing of salt to ensure required iodine content is managed by PT. Garam and other salt processing industries, as this activity requires higher technology. Thus, the distribution chain for smallholders' salt is channeled to only three groups: PT. Garam, traders, and industry.

Figure 5.9 Production Chain of Salt



The “traders” category in this chain consists generally of companies that trade in smallholders’ salt to be channeled to other processing industries. These companies usually do not process smallholders’ salt into consumption salt. Meanwhile, the “industry” category, which receives supplies from the traders and from PT. Garam, operates in various types of products, including soda, leather, soap, oil, and cosmetic industries. The derivative products include salt cake.

ISSUES

IMPORTED SALT

Salt is another commodity that is considered to be of strategic importance and is therefore subject to a protective trade policy. According to the available data, national salt production has never sufficed to meet the national need. The government has therefore undertaken various means to meet the national salt need. One of these is importing salt from other countries. At present, salt is imported from three countries: India, Australia, and Jordan. The largest amount is imported from India. However, this salt import policy creates a range of problems for salt farmers, particularly in East Java. The existing production data show that the province of East Java has abundant salt production, and yet the government applies its import policy without conducting dialogue with the farmers.

“....Even now there are still tons of salt here (in Pamekasan – ed.) that we haven’t been able to sell, and then the government suddenly introduces this import policy. But we have abundant stocks here. Doesn’t the government know that? ...” (FGD, PSD Team, 2004)

The problem of salt imports as mentioned above became quite a serious issue in 2002 and 2003. As mentioned earlier, the salt market consists of the markets for consumption salt and for industrial salt. Salt for industry requires a NaCl content of 99%, while salt for consumption requires a minimum NaCl content of 95%. Salt farmers are usually only able to produce salt with a NaCl content of 95% to 97%. Consequently, to meet the industrial demand for salt, the government still needs imports from other countries, especially Australia and Jordan. However, in 2002-2003 the Indonesian government was also importing salt from India, even though its quality was the same as that of local salt. This put domestic salt at a disadvantage as the market price of local salt is Rp. 55,000,- to Rp. 75,000,- but Indian salt is Rp. 40,000,- In 2003 the Indonesian government recommended a halt to imports of salt from India given sufficient domestic stocks. Imports from Australia, however, continued.

PRICING OF SMALLHOLDERS’ SALT

In addition to the still-unresolved problems with the import policy, there is also concern over a recent Memorandum of Understanding (MoU) between the regencies of Sampang, Pamekasan and Sumenep and nine salt companies in Madura to regulate the base price for smallholders’ salt. As explained above, most of the salt produced by smallholders is absorbed and reprocessed by industrial companies. At present there are nine salt industry company groups in East Java, three of which dominate the industry. These nine companies effectively represent a cartel and are known as the “group of 9”.

The matter of price has always been closely related to the relationship between the salt farmers and the processing industry companies. According to the salt farmers, there has never been a base price agreed among the government, the farmers, and the industry companies. At present, the prices are determined by the industry companies³⁹. The initiative by the three regional governments in Madura to draft an MoU is seen by smallholders as inappropriate because they were not represented in the negotiations to set the price under the regulation. Even though the draft MoU contained names of three representatives of farmers’ groups, according to the farmers their bargaining position was very low, as in this opinion from one FGD participant:

“...How can we engage in a dialogue if the only dominant partners are the government and the group of 9? The farmers were simply presented with the finished MoU, with no prior dialogue. We don’t even know how they chose the representatives of the farmers’ groups ...” (FGD, PSD Team, 2004)

³⁹The current base market prices of salt are Rp. 75,000 per ton for K-1 grade, Rp. 65,000/ton for K-2, and Rp 55,000/ton for K-3.

INFRASTRUCTURE

Inadequate port facilities: Ports are a vital part of infrastructure for salt distribution, particularly for farmers from Pamekasan and Sumenep. Farmers in these two regions distribute much of their salt to outside Java, including to Sumatra and Kalimantan. In contrast, farmers in Sampang distribute most of their salt within Java, so ports are not a problem for them, as they use land transport routes and the harbors between Madura and Surabaya, which are quite adequate.

The port that is identified in the FGD as an obstacle is the port of Pamekasan. This regency port has a very shallow draft. Consequently, many farmers in Pamekasan ship their salt through the port in Kalianget, Sumenep. But this increases their costs by Rp 25 per kg, due to the land transport costs to ship the salt from Pamekasan to Sumenep.

There is in fact a shorter way that salt farmers could use to market their product to other islands which would be through the Sejati port owned by PT. Garam. Shipping costs to reach this port are only Rp 15 per kg. Unfortunately, there are bureaucratic obstacles to using PT. Garam's port, as expressed by one business operator:

"... We have tried several times, together with the Industry and Trade Service, to apply to PT. Garam to use their port, but have been repeatedly refused, even though we were having trouble with sales distribution. So we are forced to use the dock at Kalianget, even though the distance affects our transport costs..." (FGD, PSD Team, 2004)

In October 2003⁴⁰, the farmers, through the Sampang Regency Industry, Trade and Mining Service, once obtained approval from PT. Garam to use its dock. But the approval letter was actually an obstacle to the existing trade. The letter stated the following matters, among others:

- "...In principle we have no objections to your using the Port, with the following provisions:*
- 1. Salt may not be loaded for shipment to North Sumatra.*
 - 2. In case of any damage to the port resulting from this use, the cost of the repairs will be charged to you.*
 - 3. A loading cost charge will be applied to every shipment of salt."*

Among the requirements above, the prohibition on shipping salt to North Sumatra was problematic. The salt farmers in Madura prefer to sell their product to North Sumatra because the prices are higher, ranging between Rp. 225,000 and Rp. 300,000 per ton. According to farmers, no clear reasons were given by PT. Garam for prohibiting these shipments. Presumably, PT Garam seeks to protect access to this preferential market for themselves.

⁴⁰Letter of the Managing Director of PT. Garam to the Head of the Sampang Regency Industry, Trade and Mining Service, 8 October 2003

On the other hand, the existing port at Sumenep itself is considered inadequate, as it is not deep enough. Capacity in the port is limited to 3,000 tons. If the capacity exceeds this, the ship that is being loaded must be docked offshore, thus increasing the transport costs as smaller boats must be used to carry the cargo out to the ship. This can increase costs by Rp. 25 per kg.

Insufficient roads: networks are also a problem, specifically the roads from the salt fields to the main, public roads. In three regions (Pamekasan, Sampang, and Sumenep) there are no roads from the salt fields to the main roads. This means that the farmers must spend more on labor to transport their salt from the fields to the main roads. These transport costs are quite high, up to Rp. 50,000/ton. This high cost cuts sharply into the farmers' already low profits. The selling price is only Rp. 55,000 to Rp. 75,000 per ton.

PERMITTING AND LABELING

Participants in these three regions said that permitting is not a problem. A business operator in Sumenep, for example, received his business permit (SIUP) in only one day, and it also took only one day to obtain a Travel Letter from the Department of Industry and Trade to ship salt to other islands. The problem that does arise is with labeling and packaging of salt being shipped to other regions, especially North Sumatra. Generally, the salt packages that farmers use for shipping are simply blank sacks with no labels or trademarks. In September 2003, 1,738 tons of salt belonging to farmers in Sumenep was confiscated by the East Java Police. The reason given was that this salt did not meet government quality standards and violated the Consumer Protection Law as there were no labels on the packages⁴¹. The farmers, on the other hand, held that the Consumer Protection Law applied only to finished products, or end products to be purchased by end consumers, whereas the product that they were distributing was a half-finished product that was going to be reprocessed by companies in North Sumatra. Therefore, not having labels or trademarks was not a violation of the Consumer Protection Law. This issue points to a possible lack of clarity in the regulation.

POLICY MAKING PROCESS

The government almost never engages in a process of public consultation with the farmers when creating new policies. For example, although the local governments are preparing a draft MoU between the Sampang, Pamekasan and Sumenep regency governments, as discussed above, the farmers have never felt involved in the process of formulating this draft. A further problem is that the people invited by the government to represent farmers in the drafting of the MoU are in fact not farmers but rather traders.

⁴¹Harian Surya, 7 November 2003

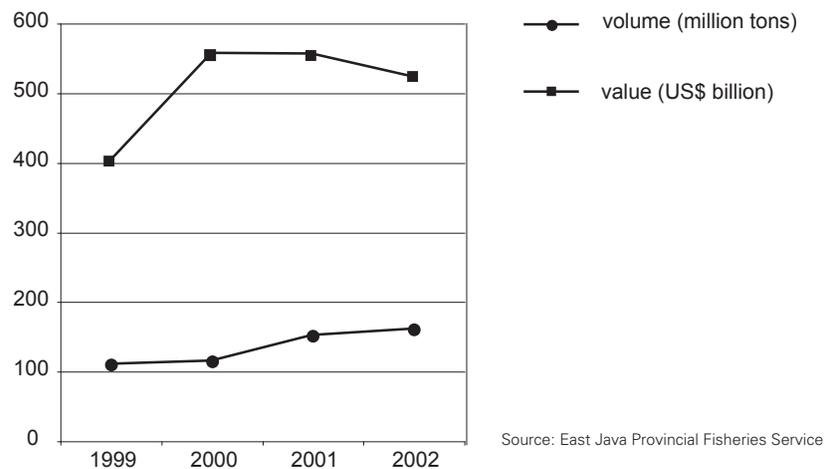
The second problem relates to the salt import policy. Farmers feel that preparation of this policy did not go through sufficient examination or monitoring of national salt production. For these reasons, the farmers feel that government policy, at both the central and local levels, fails to involve the private sector, and especially SMEs, in planning, decision making, monitoring and supervision.

SHRIMP

Respondents consulted for this sector come from the following regions: Sampang, Pamekasan, Sumenep, Tuban, Lamongan, Gresik, Malang, Banyuwangi.

East Java's fisheries exports are quite stable on the whole. Up to 2002, the data below showed a steady increase in volume of sales compared with the previous years.

Figure 5.10 Exports Of East Java's Fishery Produce, 1999-2002

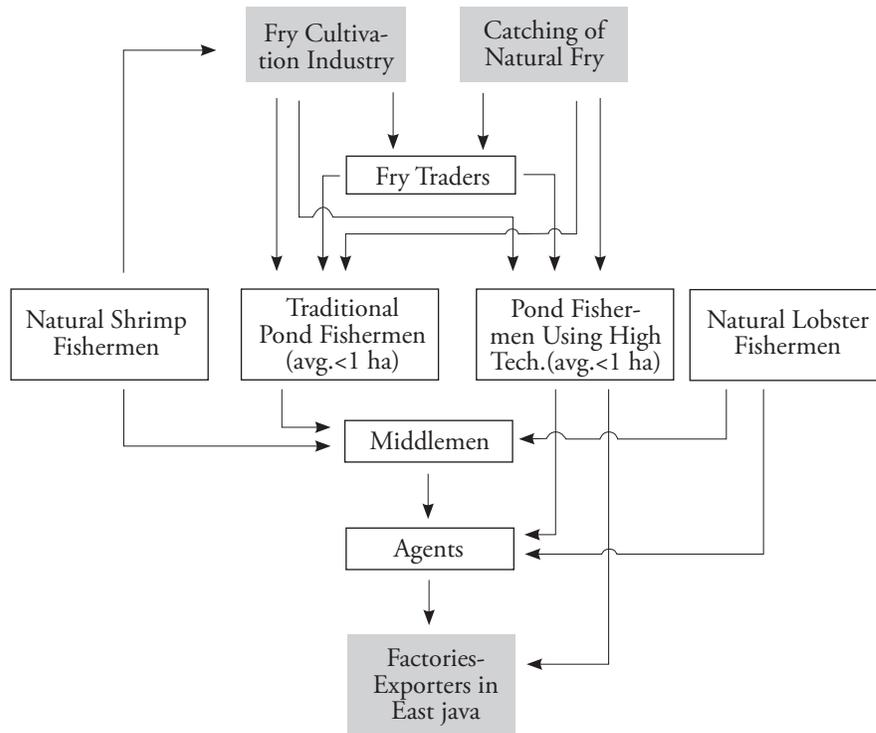


The fisheries sector continues to make a significant contribution to East Java's economy. At the end of 2002, this sector contributed Rp. 820 billion, or around 1.35% of East Java's GRDP. The regions contributing the largest fish production in that year were Lamongan, Gresik and Trenggalek, at 70,000 tons, 58,000 tons, and 57,000 tons respectively.

There are four categories of businesses in the distribution chain for the commodity of shrimp:

- Business operators who deal in shrimp fry, whether by catching fry in the open sea or through artificial cultivation in ponds;
- Shrimp cultivators, those involved in growing the shrimp;
- Shrimp traders, from middlemen to exporters;
- Shrimp cultivation support businesses, such as the feed and chemical industries.

Figure 5.11 Production Chain of Shrimp



What differentiates traditional farmers from intensive pond farmers is the shrimp raising technology, particularly in the use of feed and medicines. Traditional farmers are generally small businesses that do not use much specialized technology in raising their shrimp.

ISSUES

PRICE FLUCTUATION IN EXPORTS

Shrimp cultivators often face very sharp price fluctuations. The ones who feel the negative impacts of this price instability most strongly are the pond farmers, who are both the initial shrimp producers and the end consumers of the fish feed industry. Pond farmers state that the decline in their revenues can be as much as 50%. Exporters, too, feel the negative impacts of these price fluctuations, though not as harshly as the pond farmers. It is difficult for them to avoid this situation, as they must directly deal with several matters in the international market⁴²:

⁴²Result of Focus Group Discussion , PSD Team, 2004

1. International standards on prohibition of use of chemicals and antibiotics, requirements for the use of specific labeling, and other aspects make competition in the international market increasingly difficult.
2. New products are appearing from other countries, with better quality and lower prices.
3. Much of the shrimp supplied by Indonesian fishermen is of a quality that does not meet international standards.

In Tuban, around five years ago one exporter could ship around 60 containers of fish per month, but now it's only 20 to 25 containers. (FGD, PSD Team, 2004)

4. Specifically for lobster, the international business network is highly restricted, and so traders in Madura are extremely dependent on exporters in Surabaya. Fishermen and traders in Madura have not been able to make direct contact with buyers. Fish traders from Madura must therefore follow the prices set by the large traders or exporters in Surabaya.

PERMITTING

One complaint expressed by shrimp exporters was multiple levies on the same object namely water. In Tuban, there is a water fee collected by the provincial government and also a Water Use Permit (SIPA) from the local government. In Bojonegoro and Pacitan, multiple permitting with the issuance of Product Worthiness Certificates (SKP) and Fish Processing Permits (SPI) act as levies on fish processing.

SECURITY

Looting of fish ponds by the local community occurs at every harvest. This has been going on since the financial crisis of 1998. The losses suffered at every harvest can run as high as 50%. Business operators therefore try to overcome this problem by requesting assistance from the police.

In Tuban, for security assistance during the seven to ten days of the harvest period, a pond owner must pay out around Rp 50,000 per person per day, which could add up to Rp. 3,000,000 during the harvest (FGD, PSD Team, 2004)

Security in delivering goods from East Java to Jakarta is also quite a problem, particularly with illegal levies collected by the police on the roads. One middleman said that for each shrimp delivery trip he had to have ready at least Rp. 50,000 to pay illegal levies. One shrimp exporter related that he has to pay escort costs for his trucks of Rp. 3,000,000 per month.

Meanwhile, the availability of both adult shrimp and shrimp fry in the open sea is at threat from large-scale theft by foreign fishing ships. Such thefts occur quite often, and local fishermen know about this as they can see the foreign ships. But efforts to handle fish theft in the open seas remain very limited, and in some regions non-existent.

INFRASTRUCTURE

Shrimp are extremely perishable, and so the condition of infrastructure has a tremendous impact on the quality of the shrimp. The following situations illustrate the importance of infrastructure for this commodity.

Water resources. For shrimp pond cultivators, both fry producers and shrimp raisers, water has mostly been obtained from the rivers and canals in the Tuban area. Now, however, these rivers and canals no longer provide water in adequate quantity or quality. Business operators say that there are probably two reasons for this:

1. The rivers and canals are becoming shallower, all the way from upstream to downstream.
2. Water pollution is getting steadily worse, from both industrial effluent and household waste, causing high failure rates in the shrimp harvests. This water pollution occurs even upstream.

Damage to the physical environment also has a tremendous impact on shrimp cultivation, which is deeply affected by water quality. Among the causes of deteriorating water quality revealed in the FGDs were:

- Offshore oil drilling activities. For example, two oil drilling companies are operating around two miles offshore from Bangkalan, which is within the fish catching area of the fishermen in this region. The drilling activities have caused quite serious water pollution over the past five years. Farmers and fishermen say that their production has declined by as much as 30%.
- Much fishing is still done using bombs or even formalin. The fishermen usually get the formalin from their suppliers or buyers in Surabaya. This not only kills or damages a lot of fish eggs and fry, but also damages the coral reefs that are so important as a place for fish to breed.
- Environmental damage is also felt in the shrinkage of the mangrove forests, less than half of which remain. Yet these forests play an important role in providing good water quality for shrimp in the nearby waters.

Road and Inter-Island Transportation. Traders in the downstream shrimp sector often complain about road transportation. For example, the three-kilometer stretch of road from Tuban and Babat

to Surabaya is narrow and heavily rutted, causing serious traffic jams at certain times of day. Discussion participants said that on average there are around twelve traffic accidents a week on this stretch of road. It takes two to three hours to get from Tuban to Surabaya, while with a good road it would take no more than one and a half hours.

For shrimp farmers in Pacitan, the road infrastructure most urgently in need of repair is the village roads, especially those to the coasts, which are not asphalted. This makes it impossible for vehicles to enter the port area, and so the fish must be hand-carried to the main road. This increases transport costs and also the time involved, thus also increasing the risk of deterioration in the quality of the fish.

For traders from Madura, much of the fry and the end product are produced in the small islands surrounding Madura. Unfortunately, the transport from these small islands, both to Madura itself and to places outside Madura such as Surabaya and Bali, is quite limited. There are only small sailing boats that cannot sail very far. This limitation causes losses at the level of the farmers, because not only are the goods often damaged due to long journeys, but sometimes they cannot be transported at all. For example, it takes nine hours to get from Sepeken to Bali, while fresh fish should ideally be transported in under four hours.

Port Capacity. In Pacitan, Tuban, Bojonegoro and Banyuwangi, only small boats can land at the existing harbors. Large ships cannot dock with the existing capacity. Fish middlemen and traders believe that if larger ships could dock, this would stimulate their local economies by significantly increasing the volume of fish traded through these ports.

Other problems with limited facilities perceived by the port users include lack of warehouses, especially for fish and ice, and places to store fuel. In Pacitan, for example, when fishermen need diesel fuel they have to go to the nearest filling station, which is five kilometers away, and the amount of fuel available is limited to just a few tanks. These difficulties in obtaining diesel fuel are exacerbated around major holidays.

It was once proposed to invite an investor to build a fuel filling station at the fish auction market, but it is unlikely that any investor would want to do this as there are so many regulatory requirements that would have to be filled⁴³. In addition to a filling station, fishermen would like to have other fuel storage facilities near the harbor.

⁴³The fuel needs of fishermen could be met by opening a special Fuel Filling Station for Fishermen (SPBBN), which sells only diesel fuel. Among the provisions for opening an SPBBN are (1) one SPBBN requires investment of between Rp 300 million and 500 million, aside from the land costs; (2) The location must be near the shore; (3) It will be given a certain allocation [of fuel] in line with the fishermen's actual needs; (4) It must have an "ownership rights" land certificate with a minimum area of 800 m² and frontage of 40 meters; (5) It must have a recommendation from the office of the Minister of Fisheries and Maritime Affairs; and (6) The owner may be a limited liability company (PT), an individual, or a cooperative.

TECHNOLOGY

Research and Development. Farmers feel that there are many problems (such as disease, appropriate salt content, after-harvest technology) that are steadily getting worse and that require technical solutions. Participants said that these problems are getting worse because there is no institution to conduct research and develop fishing technology, which could serve as a reference for the farmers. Related to this is the lack of technical officers or consultants in the field who could provide information on how to handle the various problems related to fish. Shrimp diseases, particularly for pond farmers, are a problem for which special efforts to find a solution are badly needed. Technological developments in this area are also requested.

Limited Cold Storage Capacity. At present, most middlemen and exporters have cold storage capacity of between 10 and 15 tons. This capacity is not adequate compared with the demand for shrimp, which reaches 20 to 30 tons per month, especially as this cold storage is used not only for shrimp but also for storage of other fishery products.

Use of Small Boats. The productivity of farmers in East Java is low. There are two likely reasons for this:

1. The use of small boats with small capacities limits fishermen's fishing grounds. They cannot go very far from shore, generally no longer than six hours.
2. The use of kerosene mixed with oil as a replacement for diesel fuel, which fishermen feel is too expensive, results in increasing levels of fuel residue dumped into the sea, causing an increase in pollution and shortening the lives of boat engines.

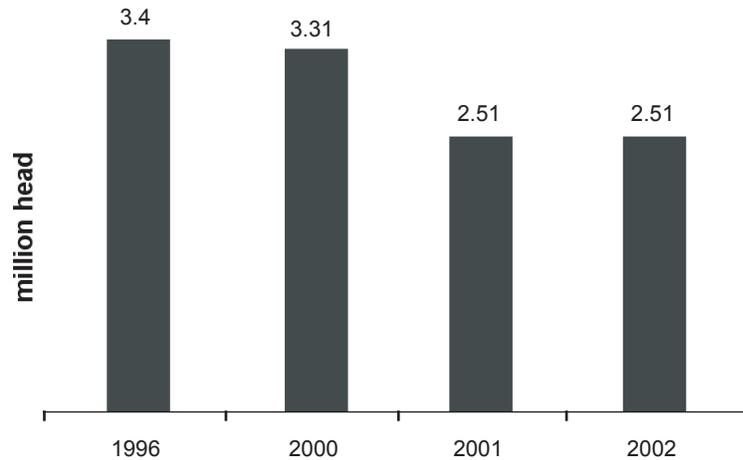
BEEF CATTLE

Respondents consulted for this sector come from the following regions: Bojonegoro, Sumenep, Kediri, Malang, Banyuwangi, Jember, Trenggalek, Pacitan, Tuban

In 2002, there were around 2.51 million cattle in East Java⁴⁴, spread throughout various areas but mostly in certain pockets of production: Trenggalek, Jember, the South coast of East Java, Bojonegoro, Pacitan, Tuban, and Malang (for dairy cattle) and the surrounding areas. The change in numbers of beef cattle since 1996 has been as follows:

⁴⁴East Java in Figures, 2002

Figure 5.12 Change in Beef Cattle Population of East Java Source: East Java in Figures, 1997 and 2002

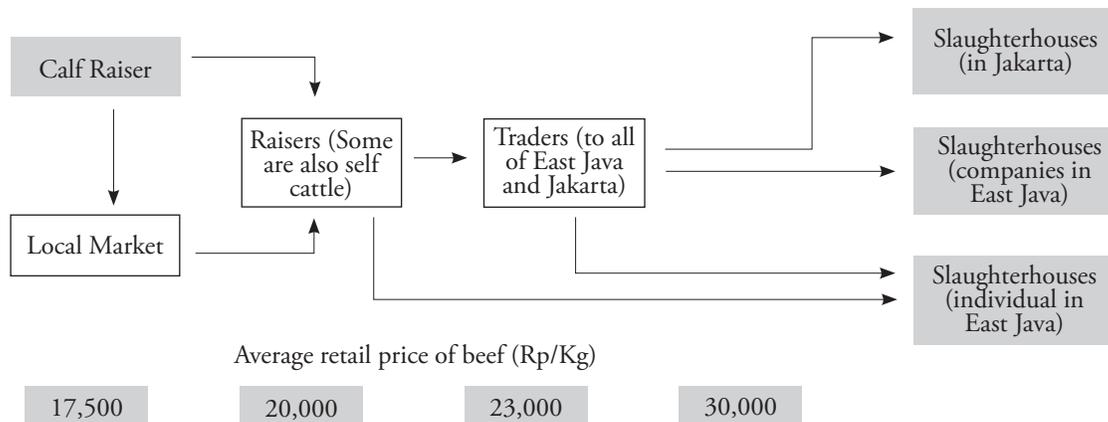


Source: East Java in Figures, 1997 and 2002

The overall number of beef cattle in East Java showed a decline between 1996 and 2002. As of 2002, with around 2,515,439 head of cattle and assuming an average weight of 300 kg per head, the total beef production in East Java is around 0.7 million tons. Meanwhile national meat imports in 2002⁴⁵ were around 4.4 million tons. Thus, the ratio of East Java’s beef production to national beef imports in 2002 was 1:6.3.

The value chain for beef cattle in East Java, as shown in the following figure, involves at least four categories of business operators: calf raisers (who produce calves for fattening), cattle raisers/ fatteners, traders, and the slaughterhouse industry. Each of these different categories faces its own business challenges and opportunities.

Figure 5.13 Production Chain of Beef Cattle



⁴⁵ Source: http://www.bi.go.id/sipuk/lm/ind/sapi_potong/aspek_pemasaran.htm

In general, both calf breeders and cattle raisers are farming households. The average cattle ownership per household in Jember, Lumajang, Bojonegoro, and the surrounding area is two to three head. However, because cattle raising in this area employs a profit-sharing system, meaning that people raise cattle for other owners, the average cattle raiser handles three to five head of cattle.

Cattle raisers under this profit sharing system fall into two categories: *penggaduh*, who raise cattle belonging to others, and sometimes their own as well, and livestock entrepreneurs, who farm out their cattle to be raised by other people and who generally own five to ten head for medium-scale entrepreneurs and ten to twenty head for large-scale entrepreneurs. The following discussion will examine the problems of the cattle industry in East Java based on the categories mentioned above.

ISSUES

LACK OF SUPPORT SERVICES

In the first stage of the cattle industry, the quality of the calves is a crucial point that determines the success of the later product, both during the fattening/raising stage and in trade. The support of research and development institutions at this stage is clearly very weak; consequently it is difficult for cattle raisers to obtain calves of good quality. Cattle raisers buy calves from the local market, where there are no set standards or technology to measure their health. Cattle raisers therefore choose their calves based on physical appearance and guesswork. As a result, according to FGD participants in Jember, Bojonegoro, and Malang, the cattle achieve only around 80% of their predicted weight.

Another problem faced by cattle raisers is the difficulty in predicting and planning their cows' pregnancies. This means that raisers have trouble making business calculations. Two types of officers are urgently needed in this preparatory business: artificial insemination officers and health officers. Artificial insemination officers essentially provide insemination service to farmers to promote cow pregnancies. But there are very few such officers, and so many cattle are impregnated naturally. In addition, existing insemination services are felt to be low quality.

The Bojonegoro Livestock Service provided frozen sperm for artificial insemination from high quality cattle from Australia, the United States, and New Zealand. The cows were inseminated by a livestock officer in the village/ district for a fee of Rp. 25,000 per dose. In Jember, each district has an average of 2000 head of cattle, with around 300 of them being cows. There needs to be at least one artificial insemination officer per district to handle these numbers, but at present there is only one for every three or four districts. (FGD, PSD Team, 2004)

Some other problems with regard to artificial insemination include:

- The supplies for artificial insemination are scarce and only available in a few cities such as Jember;
- Artificial insemination is reasonably affordable at around Rp. 50,000, but there is no guarantee that the cow will become pregnant.

Veterinary health officers are also important for cattle raising. As with the artificial insemination officers, there are not enough health officers. The implications of this are as follows:

- Distribution of cattle vaccines is limited, even though raisers can afford to buy it;
- They cannot handle cattle that get sick;
- They cannot assist with birthing, particularly with difficult births;
- The health of breeding cattle is not ensured; as a result, it is difficult to obtain good calves.

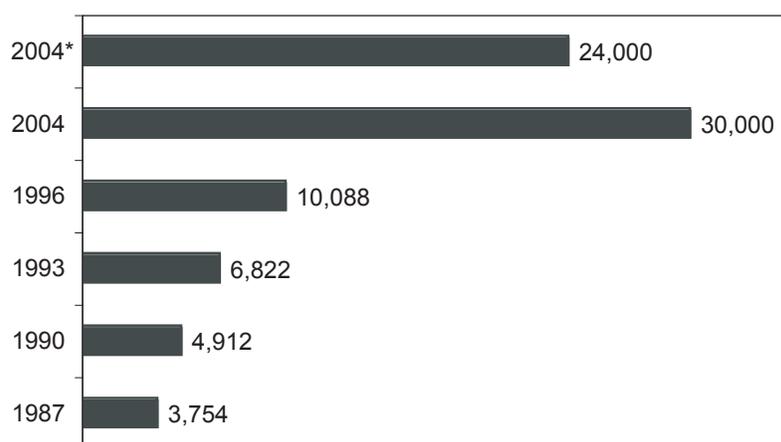
Among the efforts farmers have undertaken to overcome these problems by themselves are:

- When cattle fall ill, many raisers try using traditional medicines or going to traditional healers. If this does not work, they sell the cattle cheaply;
- When no artificial insemination officers are available, natural impregnation is attempted by borrowing a stud bull from another farmer and paying a stud fee in the event of a resultant pregnancy.

PAYMENT AND PRICING

After four to six months of fattening their cattle, business operators start to sell them, either on the local market or to slaughterhouses in Jakarta. The selling price for cattle at this age is around Rp. 4.5 to 5 million per head. Before the cattle are sold, traders are required to have them inspected at a cost of Rp. 8,000 per head.

Figure 5.14 Average Retail Prices of Beef in Rural Areas of East Java (Rp/kg)



Source: Information System for Small Business Development, BI, 2004 and FGD

* Retail Price of Imported Beef

The number of imported cattle in Java as a whole has significantly decreased the demand for cattle from East Java. One participant in an FGD in Bojonegoro estimated that the quantitative decline in demand had been around 70% over the past three years, and prices had fallen by 30-50%. In the markets throughout Java, the price of beef is Rp. 30,000 per kg for local beef and Rp. 23,000 - Rp. 24,000 for imported beef, particularly from Australia, or around 20% cheaper.

Payments in the cattle trade are not usually made in cash; the cattle are taken away first, and payment is made once they are sold. This system ties farmers to certain traders, because their working capital is held up by the buyers. This situation makes it difficult for cattle raisers to obtain fresh capital to maintain their herds.

The cattle traders say that they must do things this way because the slaughterhouses to which they sell the cattle apply the same system, i.e. not paying on the spot. This is why the cattle traders must do the same to the cattle raisers. Slaughterhouse operators, located especially in Cakung, East Jakarta, confirmed this. They say that slaughterhouses are not allowed not to pay on the spot, as they must first check the health conditions of the cattle being sold.

INFRASTRUCTURE

In general, business operators say that the condition of the road infrastructure is reasonably adequate, though there are some stretches in rather poor condition, such as Semboro-Kencong Padang Rejo in Jember, and Bombongsari-Sumber Gedog in Banyuwangi.

The infrastructure that is still urgently needed for business development is telephone lines. According to operators of cattle businesses, telephones are a great help to farmers for contacting health and artificial insemination officers, ordering medicine, and seeking price information and information on medicines. At present, neither the regular telephone network nor the cellular (hand phone) system reaches the cattle production center regions.

PERMITTING AND LEVIES

A number of permits that are required in the cattle business are considered to be a burden, e.g.:

- Cattle raisers are required to have Building Permits for their pens;
- Cattle raisers must also have nuisance permits (izin HO) valid for five years;
- Cattle raisers must have Livestock Business Permits;
- Operators complain of levies from village officials for the pens that are erected, in the amount of Rp. 75,000/unit/year

- Operators are subjected to levies by village officials for livestock transport using village roads. A double truck is charged Rp. 5,000 per trip, a single truck Rp. 2,500 per trip, and a pick-up Rp. 1,000 per trip.
- Livestock operators are required to pay cattle inspection fees to Officers from the East Java Provincial Government on duty at the border post with Central Java, in the amount of Rp. 5,000 to 8,000 per head.

The types of levies that were cancelled in Malang Regency through Local Regulation No. 11 of 1998 but then include reintroduced⁴⁹:

- The livestock slaughtering tax was cancelled in 1998 but reintroduced in 2002;
- Livestock card fees of Rp 500 per head per year;
- Livestock health inspections in the livestock market; levies continue in the field for fees of this kind, at Rp 400 per head.

Transportation of cattle on the roads is also susceptible to illegal levies. Business operators complain of levies by police on their open-back cattle trucks. Cattle shipments along the southern route, i.e. via Ngawi, often fall victim to levies in the Mantingan area (Ngawi, on the border with Central Java) and at least one levy during the journey through Central Java before entering the Cikampek toll road. On the northern route, cattle transport trucks have to pay levies in Sarang (Rembang, Central Java), Kandanghaur-Indramayu, and before entering the Cikampek toll road.

SLAUGHTERHOUSES

The problem at the final link in the supply/distribution chain is the limited capacity of the existing slaughterhouses in East Java. In Jember, there are at present 14 slaughterhouses (capacity per day not known). In Lumajang there are around seven slaughterhouses, with a capacity of two to three head per day per slaughterhouse.

Through field monitoring, the team found that there are at least three types of slaughterhouses: individually owned slaughterhouses, medium-sized slaughterhouses, most of which belong to local governments, and the large Cakung slaughterhouse in Jakarta. Individual slaughterhouses usually have very limited capacity, less than five head per day. These individual slaughterhouses have only existed since around 2000. Previously, slaughterhouses of this type were not permitted, or in other words, the government did not issue permits to them, on considerations of product safety. Slaughterhouses must have certain hygiene standards and meet requirements for livestock slaughtering. Recently, many individual slaughterhouses have started to open because the local governments, in order to raise locally generated revenue, have started to issue business permits. But there are indications that supervision of these business activities remains very weak.

⁴⁶SMERU Study, 1999

The next type is a medium-sized slaughterhouse, with a capacity of ten to twenty head per day. Only one such slaughterhouse was found that was individually owned, located in Surabaya with a capacity of 40 head per day. This company, PT Abatoir, was established around fifteen years ago. Ten years ago, it only dealt with local cattle from East Java, Bali and NTB, but since 1998 it has been handling more imported cattle than local: 60% imported and 40% local. This is because imported cattle are not only of better quality but also cheaper.

Matters perceived as obstacles to this type of slaughterhouse business include:

- 10% VAT, which has been imposed since 2000;
- Slaughtering fees of Rp 6,000 per head of live cattle;
- Illegal levies.

Until 2000, all beef cattle sold in the Jakarta market had to come through the large slaughterhouse, RPH Dharma Jaya, better known as the Cakung slaughterhouse. This slaughterhouse is a state-owned enterprise, with a majority of shares held by the Jakarta Provincial Government. The Cakung slaughterhouse is equipped with cold storage, chilling room, and packing facilities and its own trading unit. The installed capacity of the Cakung slaughterhouse is 1,000 head per day. In 1994, average production per day reached 850 head per day, but over the past two years, production has fallen to around 250 head per day. This is because so many privately owned slaughterhouses have opened up in areas surrounding Jakarta such as Tangerang, Bekasi and Bogor. According to the Cakung slaughterhouse management, the decline is not because the supply of cattle has fallen, but because of competition from these privately owned slaughterhouses.

TEXTILES

Respondents consulted for this sector come from the following regions: Surabaya, Sidoarjo, Pasuruan, Mojokerto, Kediri, Jombang.

The textile industry is a labor-intensive industry where low wages had been Indonesia's comparative advantage in attracting investment. From around 1975 to 1993, the textile industry provided jobs for up to 33% of the industrial sector work force in Indonesia. With average increase in added value of 17%, the ability of the textile industry to absorb manpower during that period demonstrated that this sector was very dynamic for two decades⁴⁷. Growth in the textile industry, particularly in the garment industry, arose from the sector's export orientation. Exports were supported by several factors, such as slow domestic demand with the end of the oil boom era, the comparative advantage

⁴⁷ Aswicahyono and Maidir, Indonesian's textiles and Apparels Industry : Taking a Stand in the New International Competition, CSIS, 2003

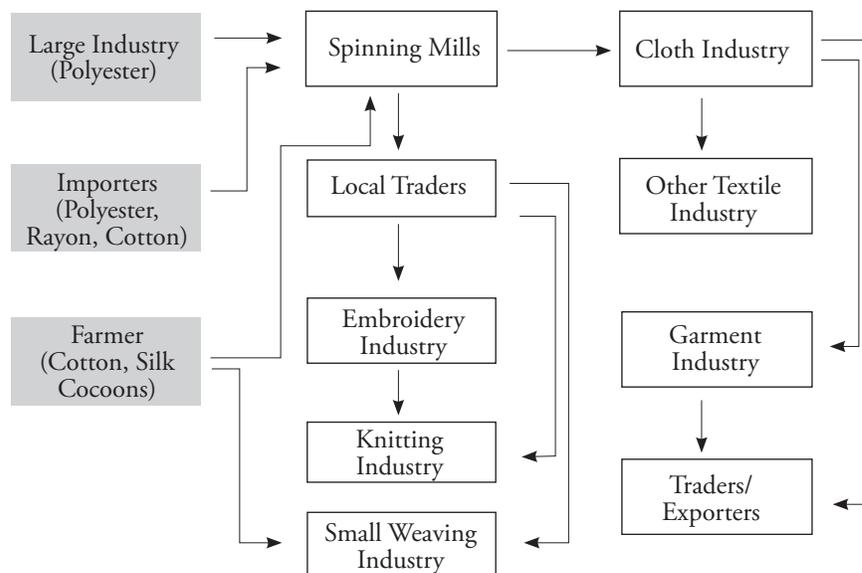
of low wages, the lack of export quotas, and incentives in the form of export subsidies and subsidies on interest rates for export credits.

However, the high growth of the garment industry ended in 1993. This was due to the emergence of regional competitors and a decline in Indonesian's competitiveness due to an increase in minimum wage that was not accompanied by an increase in the workers' productivity.

According to an industry survey, the textile and textile product (TPT) industry provides added value at each step in the chain. The TPT value chain includes fibers that are used as the raw material for thread, textile materials (fabric), and garments. According to BPS data, among the four TPT categories above, garments are the product that provides the greatest contribution in Indonesia's TPT exports – 52.2% of total TPT exports – and absorbs around 10.6% of the total work force in the manufacturing sector⁴⁸.

In general, the value chain for textiles is as follows:

Figure 5.15 Production Chain of Textile



⁴⁸BPS Industry Survey, 2000

In 2002, the average production of the textile industry in East Java reached 1.1 million meters. Competition from China dealt Indonesian's textile industry a heavy blow in both the domestic textile market and in textile exports. Nationally, according to data from the Department of Industry and Trade, Indonesia's textile exports declined by 9% from around US\$ 7.8 billion in 2001 to US\$ 7.1 billion in 2002⁴⁹.

In an effort to protect domestic textile producers, the Minister of Industry and Trade issued Decree No. 732/MPP/Kep/10/2002 on Trade Procedures for Textile Imports (October 22, 2002), stipulating that textiles could only be imported by textile producer importers (IP). The textiles imported by textile IP were only to be used as raw materials or supplementary materials in the production process of industries owned by the textile IP, and were not allowed to be bought and sold or transferred. Decree No. 732 of 2002 stated that distribution of illegal imported textiles in the Indonesian market had created unfair trade and caused losses to the domestic textile producers. Then, to support control over the country of origin of textile products entering the country and the treatment of textile products in their countries of origin, the Minister of Industry and Trade issued Decree Number 276/MPP/Kep/4/2003 on verification or technical tracing of textile imports and textile products.

ISSUES

INFRASTRUCTURE

As an industry that operates virtually non-stop, the textile industry is highly dependent on the electricity supply. Business operators fear that there could be an electricity crisis as a result of the decline in electricity supply from power plants and the poor maintenance and management at PLN's substations. These fears are well founded, as textile business operators experience five to eight power cuts power month, often with no prior notice. Business operators feel at a serious disadvantage from these power cuts.

According to BPS data for 2001, the total input costs of 179 medium and large scale textile industries in East Java from electricity and gas came to over Rp. 97 billion, or 8% of the total input costs of these industries.

To stay in continuous operation, some operators provide their own power generation sets to add electrical capacity and/or to provide substitute electrical current during power cuts. However, the use of these generator sets is subjected to the non-PLN Public Street Lighting Tax by the local government. This was said to be unfair on two accounts : not only is the private sector taxed for solving their power shortage, the street lighting is not in fact provided in industrial areas, which invites security problems.

⁴⁹Kompas, 18 February 2003

The use of electric power for industry is increasingly expensive, and the supply is increasingly inadequate. To overcome shortfalls in energy from outside PLN's electricity, gas installations to industry should be increased. Business operators feel that the use of gas would lead to lower production costs.

Another aspect of infrastructure that business operators are concerned about is loading/unloading facilities and the services of the Terminal Handling Charge that supports loading/unloading at the port of Tanjung Perak, Surabaya. There are six loading facilities available, but only two of these facilities serve container shipments. Inadequate facilities are an obstacle to business operators because they lead to additional costs for warehousing, for the "closing time" charges for bringing goods into the port, and for increased costs due to goods being damaged by being held up in the port⁵⁰.

PERMITTING

Textile industry operators complain about the lack of transparency in the permitting bureaucracy with regard to requirements, time, and cost to arrange permits. Several foreign investment textile industries in Pasuruan and Mojokerto had bad experiences with the lack of transparency in the permitting bureaucracy. Authority to extend the Industrial Business Permits (IUI), Permanent Business Permits (IUT) and extension of Expatriate Work Permits (ITKA), has been transferred to the local governments through local regulations. Unfortunately, the local governments themselves are unprepared for this, and arrangement of these permits must still be done at the Investment Coordination Agency at the provincial level. Consequently, business operators spend extra time and expense because they must still go to regency and provincial offices.

Double burdens due to overlapping permits also occur in procurement of industrial equipment. Textile business operators in Malang complain about multiple permits for procurement of industrial equipment (diesel, forklifts, and fire extinguishers). The burden occurs because the business operator must arrange multiple permits for the same equipment from different government departments, and this is often accompanied by additional levies for the permits. In contrast, in Gresik and Mojokerto business operators say they are not subjected to permit fees, but do have to pay inspection fees for their equipment. Operators mentioned that the cost for fire extinguisher inspections is Rp. 3,000 to 5,000 per unit.

Law No. 34/2000 on Regional Fees and Taxes permitted the assessment of fees on issuance of special permits. Permits for use of ground water are among the special permits for which fees may be assessed. But lack of clarity on the rates for this permit means that business operators have to bear greater costs. In Mojokerto, to obtain ground water, the business operator must first obtain a ground water use permit (SIPA) for three wells with a discharge rate of 860 liters each per minute.

⁵⁰ Isdijoso, Tambunan and Ubaidillah, Prospects for Free Domestic Trade in the Era of Decentralization and Its Impact on Growth of Regional Economies, CESS, PRISM Project – The Asia Foundation, 2001.

To obtain this permit, the operator was charged Rp. 40 million. This cost did not include the costs of accommodation for the inspectors from the agency concerned. In addition to the costs that must be paid to obtain permits, the operator still must pay fees for the use of the ground water each month, based on the amount used.

TAX, LEVIES AND FEES

In discussions with textile business operators, several types of levies were identified that operators feel to be serious burdens. For example there is a lack of clarity about rates in the calibration tests conducted by the East Java Provincial Industry and Trade Service. One business operator from Sidoarjo was charged Rp 40 million for testing of 150 units of calibration equipment.

Another problematic levy is the Manpower Skill Development Fund (DPKK) imposed on placement of Foreign Workers in the amount of US\$ 100 per month. This fee is aimed at raising the skills of local workers through transfer of skills from foreign workers to local workers. But business operators complain that there is in fact no training provided, which is the stated aim of the fee.

Business operators must pay levies in the form of fees for services even when they do not in fact receive the services. For example, the garbage collection fee is imposed even on industries that process their own waste. Many industries have incinerators to burn the waste from their industries; the heat from this is used to fire their boilers.

As the textile industry has such a long value chain in the production process, industries at each step in the chain obtain raw materials that are subjected to VAT (Incoming Tax), while the products they sell may be subjected to VAT (Outgoing Tax). Business operators may file for reimbursement of the VAT they have paid, but as they feel that the procedures to obtain this restitution of tax are so complicated, some operators are enticed to use non-VAT (black market) raw materials. Business operators, as taxpayers, expect clean services from the tax officials. Business operators feel that the difficulties in dealing with tax matters, including tax reimbursement, occur because some tax officials are not “clean.”

Business operators also complain about administrative audits in customs. This occurs because of the customs administration of the types, specifications, and volume of goods entering through customs. In the case of one FGD participant's company, the company was required to pay export duty owed on cotton imports two months after shipping. This invoice was based on the fact that the price of the cotton imported by the company was lower than the price for the same type of cotton listed with the Department of Industry and Trade. (FGD, PSD Team, 2004)

Since implementation of the decentralization policy, taxes on land and property have become less consistent for investors to gauge. Control over land matters was transferred from central to local government in 2001. The local government then developed local institutions and regulations on land use, including real property taxes. Unfortunately, in some regencies, local taxes (PBB) on land were introduced that were up to ten times higher than previous rates. Rates were raised particularly dramatically for those located in industrial zones. As a consequence, many companies closed or re-located out of the industrial zones.

“Almost 13% of the companies closed or relocated during 2002 because the cost of production here were too high after the increase of PBB” (PIER management)

With the repercussions for business and investment being so dramatic, the central government moved to rescind the authority to raise taxes on real property in the middle of 2003.

SECURITY

The most important security problem perceived by textile business operators is the smuggling of textile products. The competition from legal imports has already caused East Java’s textile industry to decline by 26%⁵¹. Business operators have voiced their objections about the rampant smuggling of textile products, but they feel that the response from the security forces is not serious.

Another important security issue is worker strikes. As a labor-intensive industry, this industry often faces industrial relations problems. Business operators complain that the labor regulations and the handling of labor disputes are often one-sided. Many labor disputes have resulted in strikes, and when these cases are taken to the dispute resolution team, the workers always win. It is hoped that the government will be fairer in settling labor disputes in the future.

⁵¹Kompas, 5 May 2003

6 | CONCLUSION AND RECOMMENDATION

Conclusion

General Recommendations

Sectoral Recommendations

CONCLUSION AND RECOMMENDATIONS

Conclusions

The contribution of East Java's economy to the overall national economy is significant at nearly 14% of GDP. The provincial economy is dominated by the service sector in terms of contribution to GRDP, although agriculture continues to employ nearly 50% of the population. Consistent with the overall conditions in Indonesia, investment in East Java's economy is stagnant, or even declining. With poverty incidence in the province at over 20% according to national statistics, this is a serious cause for concern.

Among the factors contributing to the slow rate of growth in East Java's economy are:

- **INFRASTRUCTURE:** Investment in infrastructure has declined nationwide since the financial crisis. Deterioration of roads, electricity, and ports are beginning to impact businesses in East Java. The survey found that the majority of business operators still rate the existing infrastructure as adequate, but in the sectoral data we find many problems with poor availability of roads leading to production centers and outside urban areas, poor water supply for industry, and limited port facilities.
- **POLICY:** Many current policies impede the trade of goods and services or even create distortions in market mechanisms. Examples include the establishment of new state-owned enterprises by local governments, price setting by governments, and double taxation in some sectors. The private sector continues to feel excluded from the policy making process. In addition, it is felt that the lack of transparency and accountability in government services means that even well-intentioned policies are likely to be badly implemented.
- **LEVIES:** Since the introduction of regional autonomy, pressures on local governments to raise revenue have resulted in a proliferation of local taxes and levies. From the perspective of the private sector, these levies are resulting in a high cost economy that exacerbates their already tenuous position in global markets. Overlapping and multiple fees and taxes for the same goods/services are considered particularly onerous. Formal charges also give rise to informal fees because of weak governance practices. Perhaps surprisingly, however, respondents felt that informal fees were dropping at the same time formal fees were increasing dramatically.

- **SECURITY:** It was found that there are a number of security issues marking the business environment in East Java. Larger manufacturers reported difficulties related to labor strikes and disturbances, particularly in the main growth area (Gerbangkertasusila). In the agricultural sector, theft was a consistent problem, with crops being stolen just prior to harvest. In addition, transport of goods is disturbed by illegal tolls and demands for protection money from armed forces. Finally, illegal logging and fishing are impacting businesses in the wood and fishery sectors, respectively.

Many of these issues cross the administrative boundaries of the local governments that now have the power to make most policy. One very important issue for economic development in East Java is therefore the ability of local governments to coordinate and cooperate in promoting a healthy business climate, at both the local and the provincial levels. It is essential for business operators that policies and programs be formulated for interregional cooperation to promote a positive investment climate. As will be discussed in the appendix, the role that could be played by the provincial government in coordinating and facilitating cooperation between local administrations is not yet being fully explored.

General Recommendations

The private sector had the opportunity to offer their recommendations to resolve issues they see as most urgent at the end of focus group discussions and in-depth interviews. These recommendations are grouped into a general set of recommendations applicable to all sectors and that were consistently raised by businesses and, secondly, sector-specific recommendations.

Infrastructure

Several broad areas for improvement were proposed to address looming constraints for East Java development:

Roads

- The completion of Jalan Lintas Selatan (Southern toll road) and Suramadu bridge (to link Surabaya and Madura) are eagerly anticipated by businesses, particularly those from Madura and the southern part of East Java. Additionally, in relation to building the Suramadu bridge, it was suggested that roads connecting north and south Madura should also be developed.
- Road access to production centers in remote locations such as villages, shores and mountains needs to be improved.

Telecommunications

Telephone connectivity needs to be enhanced around production centers, particularly to reach the rural regions to assist farmers and small entrepreneurs in getting better access to vital information such as prices, raw materials, medicines, fertilizers and others.

Electricity

New investment in the electricity sector is crucial for businesses, large and small. Electricity shortages are not unique to East Java, but as the province is a site of many production facilities, the increasing power blackouts in the past three years have been particularly harmful.

Water

Businesses, especially in fishery and agriculture sectors, suffer from the poor quantity and quality of available water. Deforestation, shallow rivers and industrial pollution were cited as the main culprits. Businesses proposed immediate steps for continuous reforestation efforts, river dredging and legal actions against industrial polluters.

Ports

Economic activities along East Java shoreline are quite dynamic, but not supported by adequate port facilities, especially around the eastern and southern coasts. Businesses in these areas recommend widening and deepening of ports to accommodate larger boats and provision of supporting facilities such as cold storage.

Regulations

Businesses perceive two types of problems regarding regulations. First, there are new regulations that have emerged at the local government level after the implementation of decentralization that create a high cost economy and increase uncertainty. The regulations can be levies imposed to business without sound reasons, non-transparent licensing procedures and tariffs, shortening of a license validity, or tax on goods or products leaving, entering or passing through an area. *Local governments should initiate regulatory (perda) review on the various present regulations and be more cautious in introducing new ones. The review could be done by implementing Regulatory Impact Assessment (RIA) or by involving citizens, including business owners, in the writing of regulations.*

There are also cases where local regulation conflict with national regulation. Business owners recommend that *the East Java provincial government take a more active role in bridging local governments and the central government should problems arise as a result of the introduction of conflicting regulations.*

Security

Many business owners complain that they feel unsafe in conducting business. The types of disturbance can be in the form of thugs (*preman*), youth groups, or security apparatus offering security protection, loading and unloading services, or other services that business owners do not need. Sometimes these offers are accompanied by threats, blocking of roads leading to factory, or acts of vandalism. The monetary amount that businesses currently must set aside to secure their production sites, plantations, or transported goods is considerable. The repeated message from the private sector is they want *local government, through the law and security apparatus, to impose increased accountability for those who create disturbances.*

Access to Capital

The private sector feels inadequate support from banks and other formal financial institutions, particularly for agriculture and small businesses. Even when collateral requirements are fulfilled, credit is often still not approved, or given at much lower than the requested amount. Lack of trust was said to be the key constraint. The private sector proposed that banks train staff to assess business feasibility as determining factor for credit approval.

Credit schemes from the government are well intended to assist micro and small businesses, but the implementation is often untimely and not well targeted. *A more effective control mechanism in enforcing government schemes was suggested*⁵².

Competitiveness

The trend of declining competitiveness is apparent in almost all commodities due to product quality and the shortcoming of local producers in creating added value or product innovation. To improve the quality of local products, businesses across sectors emphasized the need to have more R&D institutions to develop better technology that can improve production efficiency and innovation.

Sectoral Recommendations

Livestock Sector

Developing supporting industries and facilities at upstream (animal feed, medicines) and downstream (processed food) levels is necessary. Better equipped and trained field staff to assist with disease prevention and treatment was also mentioned even prior to the bird flu occurrence.

⁵²More information on access to credit in East Java can be obtained from a study by Don Johnson for JBIC titled “*Access to Credit and Small Firm Growth : Result From a Survey in East Java*”.

Fishery Sector

- Improving the quality and quantity of government-run R&D institutes to develop technology specific for this sector. Additionally, fishermen and micro entrepreneurs proposed comparative studies to other regions to assist them to improve their processing techniques and find buyers in wider markets.
- Building cold storage facilities that accommodate production volumes in the regions would greatly assist fishermen to manage market price fluctuations.

Forestry

- Entrepreneurs strongly proposed a review to be done on Law no. 41/99 that stipulates same treatment – in terms of retribution, taxes, and required documentations – applies for community and industrial forests. In practice, this is burdensome for small businesses operating on community forests. For instance, it was suggested that the license to cut woods in community forests can perhaps be provided at village or sub-district level instead of district level.
- Businesses also strongly suggested dialogue between the government and police to resolve the illegal levies problem rampant in this sector which is mainly due to discrepancies in the implementation of licenses.
- Improve public participation in the efforts to control illegal logging.
- To manage shortages in raw materials, the government was asked to take steps to eradicate illegal logging practices, and in parallel, carry out reforestation with good monitoring system.
- Utilize idle state forests, and partner with the local community in opening these new areas.

Plantation

- Farmers in this sector, specifically tobacco, urged information transparency in determining prices and the tobacco needs of cigarette factories.
- Revitalizing the sugar processing industry by replacing old machinery, as well as improving cultivation techniques at the upstream level are key to improving its productivity.

- Land certification program, with simpler procedure and lower cost, was proposed by coffee entrepreneurs as they would like to pledge collateral to access bank credit.
- The police force should provide improved security in plantations.

Manufacturing Sector

Respondents from this sector mainly consist of medium to large companies. Their three main recommendations are:

- Serious sanctions from the government to discourage smuggling activities which bear damaging consequences to several industries such as textile and wood.
- Consistency in labor policies and impartiality in resolving labor disputes would be vital since East Java is the host of numerous labor intensive industries.
- Simplifying VAT reimbursement and ‘cleaning’ tax officials would increase tax revenues for the government in addition to making it easier for business to fulfill their tax obligations.



APPENDIX 1 | Conditions Of Coordination Between
Local Governments Within East Java

APPENDIX

The issues presented in the recommendations and conclusions make it clear that mechanisms for coordination between local governments and sharing of best practice are needed. The information below provides an overview of fora that exist currently for such cooperation. Some of these are coordination forums between the provincial government and the regency/city governments, others coordinate between local (regency and city) governments.

The Regional Coordination Agencies (*Bakorwil*)

With the implementation of decentralization, the authorities of the regency and city governments have greatly increased authority. In this context, one of the roles of the provincial government is to perform the function of coordination, particularly with regard to issues that cross local government boundaries. In an effort to perform this function, the East Java provincial government, through Regional Regulation (*Perda*) No. 5 of 2001, has established four Regional Coordination Agencies (*Badan Koordinasi Wilayah, Bakorwil*). Each of these *Bakorwil* covers a separate coordination area, as shown below.

Tabel 6.1 Division of Regional Coordination Agencies (Bakorwil) in East Java

| Bakorwil I | Bakorwil II | Bakorwil III | Bakorwil IV |
|--------------------|---------------------|---------------------|--------------------|
| Bojonegoro Regency | Madiun Regency | Malang Regency | Pamekasan Regency |
| Tuban Regency | City of Madiun | City of Malang | Sumenep Regency |
| Lamongan Regency | Ponorogo Regency | Pasuruan Regency | Sampang Regency |
| Jombang Regency | Ngawi Regency | City of Pasuruan | Bangkalan Regency |
| Mojokerto Regency | Magetan Regency | Probolinggo Regency | Gresik Regency |
| City of Mojokerto | Pacitan Regency | City of Probolinggo | Sidoarjo Regency |
| Kediri Regency | Trenggalek Regency | Lumajang Regency | City of Surabaya |
| City of Kediri | Tulungagung Regency | City of Batu | |
| | Blitar Regency | Banyuwangi Regency | |
| | City of Blitar | Jember Regency | |
| | Nganjuk Regency | Situbondo Regency | |
| | | Bondowoso Regency | |

The East Java Provincial Government set up these four *Bakorwil* with the aim of providing coordination with the regency/city governments, facilitating autonomy activities, coordinating the potential of the regions, and providing material for the Governor in policy making. The basic duties of the *Bakorwil* can be seen in greater detail in Regional Regulation of the Province of East Java No. 5 of 2001 on the Regional Coordination Agencies (*Bakorwil*) and its operational basis in the form of Gubernatorial Decree No. 50 of 2001. The regulation clarifies that the *Bakorwil* have as their main duties assisting the Governor in coordination, guidance, and supervision of the conduct of provincial autonomy and regency/city autonomy in the region.

To carry out these basic duties, the *Bakorwil* have the following functions:

- Coordination, guidance, and supervision of the conduct of provincial autonomy in their regions.
- Coordination, guidance, and supervision of the conduct of duties of deconcentration.
- Coordination, guidance, and supervision of the conduct of regency/ city autonomy in their regions.
- Coordination, guidance, and supervision of the conduct of duties of assisting the regencies/cities.
- Establishing integration between provincial autonomy and regency/ city autonomy in their regions.
- Monitoring and evaluating developments in the conduct of provincial autonomy and the conduct of regency/city autonomy in their regions.
- Monitoring and evaluating developments in the conduct of duties of assisting the province and duties of assisting the regencies/ cities.
- Preparing reports on activities of the regional coordination agencies as input for the Governor in policy making.

In addition to the *Bakorwil*, coordination functions are also exercised by the technical services of the East Java Provincial Government. The coordination functions of each technical service depend on the basic duties and functions of these services. The results of a study on coordination conducted by the Regional Economic Development Institute (REDI) show that no coordination has ever been done related to trade barriers between cities/regencies and problems with investment policy. The coordination provided by the *Bakorwil* is mostly coordination in physical development and coordination in anticipating social, political, and environmental problems.

The All-Indonesia Association of City Governments (*Asosiasi Pemerintahan Kota Seluruh Indonesia*, APEKSI), Regional Commissariat IV

In addition to the coordination forum under the East Java Provincial Government, there was a need for associations of local governments, which consist of city governments and regency governments. In East Java, this coordination forum is part of the All-Indonesia Association of City Governments (APEKSI), chaired by the Mayor of Surabaya. Meetings of this forum may either be official or take the form of informal forums to discuss specific issues.

Formally, the aim of APEKSI is to represent the interests of its members in the implementation of regional autonomy, and to promote the role of the public and of the business community in line with regional potential and diversity. Specifically, APEKSI's aims are:

- To represent the view and interests of cities in Indonesia to the central government and to other organizations or institutions.
- To efficiently and effectively manage and implement the association's working sections in order to bring about an improvement in the quality of services and activities for residents of cities in Indonesia.
- To assist the strengthening and development of capacities of local governments through consultation, advice, and development of decentralized structures.
- To provide information to the public and to promote a positive image of the contributions of city governments.
- To develop proactive responses for development of issues and management of change in strengthening the management of cities through cooperation between city governments.
- To serve as intermediary and facilitator for conferences, discussions, meetings, and other learning/study activities to increase knowledge and share experiences.
- To develop relations with other associations and professional groups in Indonesia and abroad in order to channel the aspirations and interests of APEKSI's members in development programs.
- To cooperate with donor institutions and other institutions to obtain support in the framework of developing the capacities of cities.

In its existing coordination forum, APEKSI has several specific topics for discussion, particularly with regard to issues of city government administration. In APEKSI's view, the issue of autonomy is inseparable from three specific issues: the division of powers, regional revenues, and regional administration systems. In implementation, this is clearest in the system of devolution of authority to the regencies and cities, accompanied by the reallocation of personnel and assets and upgrading of the regions' financial capabilities.

Taking these assumptions as the point of departure, the topics and issues most often discussed in APEKSI are the following:

- With regard to the hierarchy of laws, one issue that is often discussed is the conflict between different legal regulations that regulate the same authorities; an example of this is Presidential Decree No. 10 of 2001 on Implementation of Autonomy in the Agrarian Sector, which is not in line with legal regulations of a higher order (Law No. 22 of 1999 and Government Regulation No. 25 of 2000).
- There are still many standards of a technical nature that the central government has not yet produced, resulting in confusion for the local governments. One consequence is cases of authorities that have not been transferred to the cities, such as the authority over land matters, forestry, and communications, which a number of cities have not yet received.
- Some provincial governments tend to be reluctant to delegate their authorities to the regencies and cities.
- Certain localities have refused the authority that has been transferred to them as this would be a burden on their city budgets.
- In personnel management, the most significant problem is the civil service hierarchy (grades) for officials, which creates problems when formerly central government officials are placed in the structure of local governments.
- In asset management, the problem most often discussed is the lack of implementation instructions from the central government to city governments on arrangements for assets.
- With regard to regional finances, the hot issue that is currently being discussed is problems with the General Allocation Fund (Dana Alokasi Umum, DAU). City governments feel that the indicators used are inadequate. As a tool to determine the weight of the DAU that a re-

gion will receive, these indicators do not pay enough attention to the conditions of cities. For example, the functions of city management are not included as an indicator. As a consequence, many cities were only able to finance routine expenditures [and no development projects] in 2001.

- Aside from the DAU, in connection with the issue of increasing regional revenues, new standards are needed for a wide range of technical matters, such as arrangements for meaningful contributions for city development from national companies located in the regions, and management of certain units to provide revenues for the regions (e.g. management of drivers' licenses and car registrations).

The All-Indonesia Association of Regency Governments (*Asosiasi Pemerintah Kabupaten Seluruh Indonesia*, APKASI), East Java Regional Coordinator

The purpose of the All-Indonesia Association of Regency Governments (APKASI), formed on 30 May 2000, is to create a conducive climate for the conduct of regency government in order to achieve regional self-sufficiency and to improve public welfare, and also maintain the unity and integrity of the nation with the aim of realizing national aims, as mandated in the Preamble to the 1945 Constitution.

The establishment of APKASI was also based on Decree of the Minister of the Interior No. 16 of 2000 on Guidelines for Establishment of Associations of Local Governments. The declaration, in Jakarta, was attended by 26 regents representing their respective provinces, and produced the decision on Establishment of the Management and Officers of APKASI. To realize its aims, the Association of Regency Governments has the right and the obligation to appoint its representatives as members of the Regional Autonomy Advisory Council (*Dewan Pertimbangan Otonomi Daerah*, DPOD) to represent the interests of the regencies. As a basis for achieving these aims, APKASI established the Constitution of the All-Indonesia Association of Regency Governments at its First National Conference, held on 3-4 August 2001 in Tenggarong, Kutai Regency, East Kalimantan.

The aims of the Association are:

- To designate its members to represent the Association as members of the Regional Autonomy Advisory Council;
- To proactively provide input and considered opinions on all policies of the Central Government and/or other parties that affect the interests of the regencies.
- To provide services (research, training, public information, consultation, etc.) in order to upgrade the capabilities of regency governments.
- To provide sample models of legislation for regency governments.
- To facilitate cooperation between regencies, between regencies and cities, between regencies and third parties (private sector), and between regencies and foreign countries/institutions/agency.
- To facilitate exchanges of information between regency governments and/or other party;
- To mediate resolution of disputes between regencies or between regencies and cities;
- To publicize information on the conduct of regency government.

East Java's representative of APKASI is the East Java Regional Coordinator. Presently serving as coordinator for APKASI's East Java region is the Regent of Jember. In the area of trade, APKASI's East Java Coordination Unit conducted a coordination meeting on the issues faced by tobacco farmers in East Java on 18 September 2003. Twenty tobacco-producing regencies were involved in this meeting. In this meeting, the twenty tobacco-producing regencies of East Java agreed on cooperation in the tobacco sector. This agreement was reached in APKASI's East Java Coordination Meeting, which discussed tobacco issues at the Jember Regency Pendopo.

This cooperation was undertaken after the price of tobacco had fallen over the previous three years. According to the Regent of Jember, the tobacco price collapsed because of a lack of unity in handling tobacco matters. Up to now, each region has acted independently, and this is why the farmers' negotiating position is weak. On the other hand, this meeting did not actually provide much positive hope for the tobacco farmers themselves in the view of an officer from the Rajang Rengganis Tobacco Farmers Association (APTRR).

To date, no further information has been obtained on efforts toward cooperation or coordination by APKASI in other trade or investment sectors.

Bilateral Coordination between local governments

Bilateral coordination between local governments is also occurring since decentralization. One example is the memorandum of understanding between the Sidoarjo Regency Government and the Surabaya City Government on Interregional Development Cooperation.

This cooperation is aimed at increasing integration in the management of various development programs and efficiency in the utilization and development of interrelated potentials in which each party needs the other's resources, and also in connection with geographical location. This inter-regional development cooperation between these two parties is aimed at stimulating the regional economy and improving public welfare.

Among the aspects of this bilateral cooperation are:

- Synchronization of development planning along the border areas, such as planning the construction of roads in the area of Rungkut (Surabaya) and Berbek (Sidoarjo).
- Coordination in handling social and public order issues (street children, homeless people, beggars, and general security) around the Bungurasih Terminal.
- Cooperation in the arrangement of investment regions; any capital intensive investment will be directed to Surabaya, while labor intensive investment will be directed to Sidoarjo.

The Effectiveness of the Coordination Forums

Each of the existing coordination forums in East Java focuses on activities related to the economy of its respective region. Through these various program activities, the coordination forums have achieved certain targets, both programmed and incidental. The coordination forums under the *Bakorwil*, for example, have proposed to the provincial government that it issue regional regulations regarding the assets of the provincial government in the localities.

The *Bakorwil* have also coordinated between local governments, for example in efforts to anticipate or calm conflicts between political party supporters. The *Bakorwil* have also recommended to the fisheries services in the regions that they provide cold storage so that the quality of the fish caught by fishermen can be maintained. As an apparatus of the provincial government, *Bakorwil* has tried to settle the conflict on boundary markers on Mount Kelud between the governments of Kediri Regency and Blitar Regency, and recommended cancellation of Bojonegoro Regency Regulation No. 17 of 2001 as it conflicted with a provincial regulation.

Among the various recommendations made by the *Bakorwil* coordination forums, only a few have in fact been realized. One of these was the cancellation of Bojonegoro Regency Regulation No. 17 of 2001, which conflicted with Decree of the Governor of East Java No. 44 of 2001. The conflict laid in the rates set by Bojonegoro Regency, which were lower than those set by the East Java provincial government. Chapter VII article 8, stipulates the structure and amounts of the rates, as follows:

- a. Processed Wood for Domestic Use, Rp 5,000 (five thousand Rupiah) per cubic meter (m³);
- b. Processed Wood for Export, Rp 10,000 (ten thousand rupiah) per m³;
- c. Wood from TPK [Wood Storage Depots]:
 - A1/C1, Rp 2,500 (two thousand five hundred rupiah) per m³;
 - A2/C2, Rp 5,000 (five thousand rupiah) per m³;
 - A3/C3, Rp 7,500 (seven thousand five hundred rupiah) per m³;
- d. Wood from demolition of houses or bridges, Rp 15.000 (fifteen thousand rupiah) per m³.

These rates set in the Bojonegoro Regency Regulation conflicted with those set by the provincial government. For this reason, Bojonegoro Regency Regulation No. 17 of 2001 was revoked.

The coordination forums under the East Java Provincial Industry and Trade Service (Disperindag) generally conduct coordination in the run-up to major national holidays such as Idul Fitri, Christmas, and New Year's. As these holidays approach, Disperindag coordinates with the technical services at the local levels to ensure the distribution of goods. But when Disperindag has tried to touch on matters of policy at the local level that are detrimental to the business climate, this has not been effective, as the local governments always claim their authority under regional autonomy to legitimize their policies.

The Provincial Legal Bureau has also tried to provide coordination regarding problematic local regulations, which many business operators have complained about in various sectors in East Java. But the Legal Bureau faces the constraint that the authority to oversee local regulations on taxes and fees that are a burden on the public lies with the central government, not the provincial government.

This standard can be seen in Government Regulation (PP) No. 20 of 2001 and Ministerial Decree No. 41 of 2001, which state that supervision of local regulations shall be done directly by the Minister and is not delegated to the governors. However, it is difficult for the Minister of the Interior to carry this out, as there are so many problematic local regulations in Indonesia. The consequence is that the disposition of many of these local regulations remains uncertain, i.e. whether they can be implemented or will be revoked.

Facing this situation, the Provincial Legal Bureau has undertaken several strategies. Steps taken by the Legal Bureau to handle problem local regulations include the following:

- Supervising city and regency regulations and urging that problematic ones be revoked.
- If the local government is unwilling to revoke the regulation, it is exposed in the mass media so that the public knows about it.
- Urging the Minister to revoke problematic local regulations, as the Provincial Legal Bureau does not have a hierarchical relationship with the local governments.

Yet these steps have not been effective. The Legal Bureau has not exposed many of the numerous problematic local regulations in East Java through the mass media. Consequently, the function of coordinating legislation in the regions is not yet running effectively. Similarly, steps by the Minister of the Interior ordering the revocation of local regulations have also been ineffective, because the localities, both executives and legislatures, stand their ground and refuse to cancel these regulations, claiming that Law No. 22 of 1999 grants wide authority to the localities.

As one example, we can examine the case when Interior Minister Hari Sabarno, through four letters and two ministerial decrees, urged the Gresik Regency legislature (DPRD) and executive to cancel or revise six local regulations that they had already ratified. The Central Government held that these six local regulations conflicted not only with the public interest but also with national Laws. But the Gresik Regency Government rejected this pressure, as it declared that these local regulations had been prepared based on careful consideration and had a sound legal basis.

These six local regulations were Perda No. 39 of 2000 on third party contributions, which the Minister said must be nullified as it conflicted with the public interest; Perda No. 8 of 2002 on manpower services, Perda No. 5 of 2000 on Nuisance Permit Fees, and Perda No. 10 of 2001 on parking taxes, all of which conflicted with Law No. 34 of 2000 on taxes and fees; and Perda No. 3 of 2001 on Land Use Planning and Perda No. 19 of 2001 on Harbors, both of which conflicted with Law No. 21 of 1992 on shipping. The local government firmly refused to cancel these regulations. In its view, the Minister must honor the existence of Law No. 22 of 1999 on Regional Autonomy.

The effectiveness of bilateral coordination forums, such as that between the governments of Sidoarjo Regency and the City of Surabaya, also remains limited. One positive outcome of this coordination forum has been construction of a major road in the bordering area, which was discussed first so that it would have the same width on both sides of the border. There has also been cooperation in handling social problems, such as homeless people and beggars at Bungurasih Terminal, also on the border between the two jurisdictions.

The effectiveness of the coordination forum within APEKSI has also been relatively limited. This forum tends mostly to discuss problems of limited city government budgets. Consequently, discussion in this coordination forum is focused mostly on how to restore the sources of regional revenue controlled by the central government to the regions. For example, there is an idea that the income from Pelindo (Port Corporation) should be returned to the local governments.

In conclusion, it can fairly be said that there are as yet no coordination forums that have been able to effectively increase the conduciveness of the business climate in East Java. The main factor is the negative excesses of regional autonomy, particularly in connection with the abolition of the hierarchical relationship between the provincial government and the regency/city governments. This allows the localities to become egoistic, as seen from the numerous local regulations that distort East Java's business climate.



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