





## **National Economic Integrity and the Decentralisation Process: Guidelines for Competition and Domestic Trade Policies**

PAPER PRESENTED AT THE ANNUAL LPEM-FEUI CONFERENCE  
“THE INDONESIAN ECONOMIC RECOVERY IN A CHANGING ENVIRONMENT”  
OCTOBER 4-5, 2000, HOTEL SHANGRILA, JAKARTA

DAVID RAY  
DOMESTIC TRADE ADVISOR  
PEG - MINISTRY OF INDUSTRY AND TRADE<sup>1</sup>  
EMAIL: dray@pegasus.or.id

---

<sup>1</sup> PEG (the Partnership for Economic Growth) is a USAID-funded Project. The views expressed in this report are those of the author and not necessarily those of USAID, the U.S. Government or the Government of Indonesia.



**National Economic Integrity and the Decentralization Process: Guidelines for  
Competition and Domestic Trade Policies**  
David Ray, PEG - MOIT

Abstract

*Internal trade barriers and local discriminations against out-of-region businesses work to undermine the integrity and solidarity of a nation. In decentralising, Indonesia must ensure that increased regional autonomy does not weaken nationhood. To enjoy the efficiency benefits of decentralization Indonesia must continue to have a unified and integrated national economy. This means only minimal barriers to inter-regional trade and business. Domestic trade and competition policy should remain as a matter 'national concern' and therefore not devolved to either Provincial or District level government.*

*This paper identifies two major types of inter-regional trade barriers that may arise out of, or be exacerbated by, the decentralization process. The first relates to tax-type barriers such as taxes, levies, licenses and other charges on domestic trade and business activities. Many of these charges were abolished by Law 18/1997. However this law is under threat of revision. Moreover many local governments are finding ways to sidestep the law, by finding more creative ways of taxing trade, such as forcing businesses to make 'voluntary contributions' to local government coffers, or by simply charging illegal levies. With regional governments pressuring local government offices to find new ways of raising local revenues, there is also concern that business licensing costs will be increased.*

*The second trade barrier type to be considered relates to a range of non-tax barriers which inhibit the regional competition environment. These include price controls, quotas and other quantitative restrictions, required in-region processing of local raw produce, forced sales to monopsonists, regional allocation of markets (rayonisasi), forced partnership programs, anti-competitive behaviour of local government owned enterprises (BUMD) as well as a range of other policies and practices which discriminate against or place undue burden upon out-of-region business*

*This paper draws on empirical data collected by the author during recent fieldtrips to South Sulawesi, West Nusa Tenggara and Central Java and also various field reports prepared by the Persepsi Daerah team at SMERU. The paper also set outs some broad policy guidelines to protect the internal trade and competition environment from the variety of pressures which emerge out of the decentralisation process.*



## **National Economic Integrity and the Decentralisation Process: Guidelines for Competition and Domestic Trade Policies**

David Ray, PEG - MOIT

In 1999 Indonesia embarked on a comprehensive and ambitious decentralisation program. Two laws were passed: Law No. 22 on the devolution of government authority and Law 22 on fiscal decentralisation. These laws are scheduled to become active in January 2001.

The economic and political circumstances within which Indonesia decentralises are clearly unique. There is, nevertheless, a certain universal logic underpinning the decentralisation process. The first, and perhaps most basic argument for decentralisation, is based on the benign principle that moving government closer to the people will result in more efficient government (Musgrave 1983). According to Bahl (1998) this efficiency in government is captured in a number of ways including better provision of public services, better accountability on the part of government officials and more willingness to pay for services. Other potential benefits of decentralisation include improved revenue mobilisation through a general broadening of the tax net and more flexible and responsive regulation of local business (Yusuf 2000, Bahl 1998).

However, as will be emphasised throughout this paper, the effects of decentralization may not always be so propitious. If carried out in a rushed and haphazard manner, decentralization may represent a serious threat to the national economic interest if it undermines efforts to develop integrated, open and competitive domestic markets.

This is arguably the case in Indonesia. Emboldened by the decentralisation process, regional governments are increasingly taking action that undermines Indonesia's national economic integrity<sup>2</sup>.

Consider the case of Lampung. In response to decentralisation pressures to increase locally sourced taxation revenues (PAD), Lampung has recently created a long list of

---

<sup>2</sup> In recent months there has been an increasing number of reports of local government officials exploiting the regional autonomy process to impose a variety of new illegal taxes and levies on business and trade activities. This has prompted appeals from central government politicians and bureaucrats for greater discipline within regional governments. See for example 'Pemda mulai 'unjuk gigi' di sector kehutanan' (*Bisnis Indonesia*, 19<sup>th</sup> September 2000), 'Mendagri: Retribusi komoditas oleh pemda melanggar aturan' (*Bisnis Indonesia* 20<sup>th</sup> September 2000), 'Menhutbun: Pemda agar tak tarik pungutan di luar DR' (*Bisnis Indonesia*, 10<sup>th</sup> July 2000), 'Regional autonomy abused to take levies, says Ryaas' (*Jakarta Post*, June 20 2000), Kadin: Investasi baru sebatas perizinan (*Kompas* 11<sup>th</sup> July 2000) and 'Kejar PAD tanpa hambat investasi' (*Bisnis Indonesia*, 18<sup>th</sup> August 2000).

tariffs on local products destined for other parts of Indonesia. The regional regulation from the Provincial government, *Peraturan Pemerintah Nomor 6 Tahun 2000 - Retribusi Izin Komodoti Keluar Propinsi Lampung*, imposes a tax or 'license fee', of between Rp2/kg and Rp150,000/kg on 180 commodities exported from the province. The regulation also requires that products not of Lampung origin to be taxed as long as there is no proof of origin<sup>3</sup>.

The provincial government's justification of this new trade tax is that the decentralisation law (i.e. Law 22 1999) provides the authority for local governments to fund the regional autonomy process via the imposition of *retribusi* (levies) on government services<sup>4</sup>. This is clearly not the case. According to article 82 of the decentralisation law all local taxes and *retribusi* can only be established via national legislation (*undang-undang*)<sup>5</sup>. As will be discussed later, the relevant national legislation, Law No. 18/1997 currently prohibits all forms of taxation on inter-regional trade (although this law is now under review).

The case of Lampung sets a dangerous precedent. If all provincial governments imposed similar barriers on inter-regional trade then a situation may arise where the same commodity is taxed at multiple locations/instances by a variety of local governments. This would seriously impede economic development in Indonesia. Inter-regional trade would be hampered if not destroyed as the cumulative taxation burden imposed by the respective regions may exceed the value of the commodity traded, or at least render it unprofitable for it to be transported and traded internally. Consumer prices would rise and consumer choice would be limited. Declining demand would restrict production opportunities, and ultimately increase unemployment<sup>6</sup>. Moreover, higher costs associated with internal trade and transport would hamper export growth and regions with international port facilities may find it cheaper to import than to buy domestically<sup>7</sup>.

Whilst local government officials may see imposition of trade taxes and charges as serving (at least some) local interests in the form of higher locally sourced government revenues (PAD), the imposition of multiple trade distorting taxes at the local level are obviously not in the national interest.

It is for this reason that it is important to clearly define between matters of national and

---

<sup>3</sup> Given the difficulties of proving where agricultural commodities are actually produced, this proof of origin requirement should be interpreted as imposing a tariff on virtually all trade passing through Lampung.

<sup>4</sup> In this case the service provided by the government is the issuance of licenses to transport commodities outside of the province

<sup>5</sup> Pasal 82, UU 22/1999 (1) Pajak dan retribusi Daerah ditetapkan dengan undang-undang. (2) Penentuan tarif dan tata cara pemungutan pajak dan retribusi Daerah ditetapkan dengan Peraturan Daerah sesuai dengan peraturan perundangan-undangan.

<sup>6</sup> Standard arguments for free trade such as those emphasising specialisation, economies of scale and comparative advantage are equally relevant in the domestic arena.

<sup>7</sup> An interesting article in *Bisnis Indonesia* 22<sup>nd</sup> September 2000 ('Batam impor sapi dari Australia') notes that Batam has begun to import cattle from Australia as the domestic price is too high. As will be discussed later, an important factor driving up the domestic price of cattle is the inter-island export quota imposed by the provinces of South Sulawesi and NTB.

local interest. Policy makers in Indonesia have already done this to a certain, but limited extent. Law No. 22/1999 for example has provisions defining what authority is to be given to regional authorities and what is to be retained by the central government. Articles 7 (1) and 7 (2) of Law 22/1999, for example, outlines which areas are to remain as matters of 'national concern' and therefore not to be devolved to the regions. These include international politics, defence, justice, monetary and fiscal policy, religion, national planning, national macroeconomic development, national administration, human resource development, exploitation of natural resources, strategic high technology, conservation and national standards. Unfortunately, internal trade (and even foreign trade) is not explicitly mentioned in either of these articles

Internal trade should be regarded as a matter of national concern, and the national government needs to establish a set of guidelines within which the regional autonomy program can progress without threatening national economic integrity<sup>8</sup>. As yet, the national government has not articulated such policies. In the absence of central government rules or guidelines, there are signs that some local governments are taking the autonomy initiative and are undertaking actions inimical to trade and other national interests that may be later difficult to undo.

The following sections of this paper will provide an overview of the various inter-regional trade distortions commonly imposed by local government. Also considered are some broad policy guidelines to help ensure that the devolution of authority from the centre to the regions does not inhibit the domestic trade and competition environment. .

Following Persepsi Daerah (1999) two broad categories of domestic trade distortions are considered: 1) tax type barriers and 2) non-tax barriers to trade<sup>9</sup>. The former includes, amongst others, taxes, fees, retributions and other charges on the movement of agricultural produce, business licenses and permits and other collections, both legal and illegal.<sup>10</sup> Non-tax barriers are more difficult to quantify and clearly more intractable when it comes to reforms to eradicate them. They can be in the form of price controls, quotas as well as a range of other governmentally imposed distortions that restrict the domestic competition environment.

As will be discussed in the next sections, both types of market distortions can be injurious

---

<sup>8</sup> A potentially important policy instrument to protect the internal trade and competition environment from decentralisation pressures is the government regulation (peraturan pemerintah) 25/1000 which delineates the responsibilities between central and local government. At the time of writing DEPPERINDAG was working to ensure that the ministry's relevant section in this regulation has the necessary detail to provide that protection.

<sup>9</sup> A similar delineation was used by Quizon, Rahma and Tomayah (1997) in their categorisation of inter-regional trade barriers into revenue and non-revenue raising distortions.

<sup>10</sup> A number of authors have noted that tax type distortions were particularly evident during the latter years of the Suharto period and was a key factor behind the general complaint of a 'high cost economy' See for example the various reports produced by Persepsi Daerah (1999), Tomayah (1997), Juanita (1997), Garcia (1997), Andari, Hunga and Sandee 1997), Rahma (1997), Darma (2000), Quizon, Rahma and Tomayah (1997) and the various commodity studies produced by the TIP-USAID project at the Ministry of Industry and Trade in 1996.

to local business interests. More importantly the national interest can also be compromised when local government driven market distortions are used to discriminate against outsiders. Under decentralization, without some check, localities are likely to discriminate against domestic trade from other regions, or to favor local traders over outsiders. It is perhaps only natural that local interests will pressure local authorities to provide protection from non-local competition. Moreover, as they are not accountable to outsiders, local governments are more likely to impose greater taxes and costs on non-local businesses.

For this reason it is critical that during and after the decentralisation process clear guidelines are articulated by the central government to prevent the emergence of both internal trade barriers and local discriminations against out-of-region business. In this way the internal integrity of Indonesian markets can be better maintained and the efficiency gains of decentralisation (discussed earlier) will not be lost.

### ***Tax Barriers in Inter-regional Trade***

Ensuring free flows of goods and services within the domestic economy represents an important component of a healthy trade and competition environment. This is particularly the case for archipelagic and essentially agrarian country such as Indonesia. The imposition of local taxes, charges, levies and other barriers on the movement of agricultural produce seriously undermines the competitiveness of farmers and other small scale agricultural producers, particularly those who transport their produce over long distances. Long distances imply more exactions, and in order to attempt to remain competitive, framers and small-scale producers will have to absorb these additional costs.

Prior to enactment of Law 18/1997, which removed many tax distortions to domestic trade, farmers and traders were forced to pay various charges and fees on the side of the road or at key access points during transport. Those travelling longer distances lost a greater percentage of the wholesale price. With passage of Law 18/1997, provincial and Kabupaten authorities were no longer permitted to tax agricultural products involved in inter-regional trade. As a result, the wedge between farmgate and market prices was reduced, and farmers were able to command a greater share of final wholesale prices (Syaikhu et. al. 1999). This raised farmer incomes and stimulated regional trade and production activities (see box 1 for an explanation of Law 18/1997 and its impact upon the rural agricultural economy).

Recent reports from Persepsi Daerah (1999), Ray and Darma (2000) and CESS/TAF (2000) suggest that there remain various forms of taxes on domestic trade. Further, the same studies show that regional government commitment to the implementation, enforcement and socialization of Law 18/1997 varies significantly from province to province and Kabupaten to Kabupaten. Tax type distortions to trade continue to be more prevalent in the outer regions and at the more disaggregated levels of government (see table 1 below for a sample of continuing tax type distortions in domestic trade).

**BOX 1****LAW 18/1997 AND THE RURAL AGRICULTURAL ECONOMY**

In 1995 the rural sector paid some of the highest tax rates in the country. This heavy tax burden was in large part caused by the frequent imposition of taxes, levies and other more informal charges upon the physical quantities of agricultural goods, often during transport. In a number of cases the market price of agricultural products were many times higher than the farm gate (producer) price. The net result of these price distortions was lower farmer incomes and higher consumer prices.

A number of factors have been put forward as contributing to the high rate of tax and other distortions on domestic agricultural trade:

- The restrictions on local authorities to tax income and assets, thus leaving trade as an obvious and natural target.
- The lack of an effective review process of relevant laws and regulations within local parliaments
- Relatively low and/or declining rural agricultural incomes providing fertile ground for the emergence of opportunistic rent seeking activities

Law 18/1997 significantly reduced the number of trade distorting taxes and levies. Most importantly, provincial and Kabupaten authorities were no longer permitted to tax agricultural products involved in inter-regional trade. To offset the loss in fiscal revenue for the regions, the central government allowed the collection of land transfer taxes, gasoline taxes, category C mining taxes and use of underground water charges.

Evidence to date suggests that Law 18/1997 was quite successful (although not in all areas) in reducing the wedge between farm gate and consumer prices. A comprehensive series of studies were carried out by a World Bank funded NGO (SMERU - *Persepsi Daerah*) over 1998/99. These studies essentially monitored the impact of Law 18/1997 upon local trade and production activities and also the impact upon local government finances. Using their primary data from 14 provinces for 23 commodities, the following summary table can be constructed

**Proportion of final wholesale price received by farmers (crude average)**

Prior to Law 18/1997 became effective (pre May 1998)	After Law 18/1997 became effective (mid-late 1999)	Change (in percentage points)	Implied change in farmer's gross revenue (assuming constant quantity)
74%	83%	9%	12%

Source: *Persepsi Daerah* (1999)

Prior to Law 18/1997 becoming effective (May 1998), farmers and small-scale producers received approximately 74 % of final wholesale price for their produce, increasing to 83%<sup>11</sup> after deregulation. The difference in these two figures represents the loss to local authorities from the various taxes, charges and levies that were later banned by Law 18/1997. If we assume that farmers continued to produce at constant levels, this change in the percentage of wholesale price received translates into a 12 % increase in gross revenues. The reality confronting many rural agricultural producers is that they operate on very slim margins, and often at a loss when market conditions are not favorable. Thus an increase of 9 % in the share of the final wholesale price delivered to farmers could well imply a dramatic increase in profit margins and real incomes.

<sup>11</sup> It should be emphasised that these figures are only averages. For some areas there were considerable variation in the pre and post deregulation figures.

Local governments are also becoming inventive in finding ways to tax trade. The 'third party contributions' facility (or SPK), for example, is rapidly becoming a de facto tax on trade in a number of outer provinces. This facility requires local business to provide 'voluntary' payments to local government. The SPK operates as a tax, but it is not recorded as such within government accounts. This is because it is meant to be a 'contribution' or 'gift' from the community to local authorities. Third party contributions are classed as 'other sources of income', and are therefore not affected by the reform measures contained in Law no. 18 /1997.

Since the implementation of Law no. 18/1997, provincial and Kabupaten governments have used third party contributions to increase revenues, or at least to offset the expected fiscal losses associated with the removal of the various kinds of trade taxes and levies. Various approaches are used to collect this levy ranging from subtle pressure to explicit threats of punitive action. However in virtually all cases, the basis for the measurement of the levy is unclear and the method of collection non-transparent. Examples of the misuse of SPK facility can be found, amongst other places, in the province of Nusa Tenggara Barat, where tobacco producers are obliged to 'volunteer' Rp. 80 to local coffers for every kilogram produced. Similarly, in the cattle market in Mataram, Lombok, traders must pay SPK Rp 2000 for each head of cattle traded<sup>12</sup>.

Just as there are fears that the third party contributions facility will become a new tax barrier on domestic trade, there are also mounting concerns about the impact of decentralisation on the business licensing process. It has been well documented that business licensing currently represents a major impediment to SME development in Indonesia<sup>13</sup>. To set up a trading company for example, a host of licenses must be first produced, each requiring substantial paperwork and multiple approvals from various levels and departments of local government. The process tends to be time consuming, very confusing not to mention expensive. As more and more authority to regulate business is devolved to the regions there are signs that some local governments intend to use their business licensing facilities to increase local taxation revenues

### Taxation and trade

As noted earlier, Law 18/1997 significantly reduced the number of trade distorting taxes and levies. Despite the essentially positive impact this measure had upon the rural agricultural economy there is now growing pressure to repeal or at least substantially

---

<sup>12</sup> Field research carried out by David Ray and Lukman Muslimin in West Nusa Tenggara June 2000.

<sup>13</sup> See for example Dwipayana (1998), Chotim (1998) and all the articles contained in the November 1997 issue of the *Jurnal Analisis Sosial*. Note also that in recent months there have been mounting appeals in the media for the government to simplify and standardise the business licensing process: see for example *Bisnis Indonesia* 25<sup>th</sup> August 2000 'Rizal agar permudah UKM peroleh modal dan tinjau regulasi'; *Bisnis Indonesia* 28<sup>th</sup> April 2000 'Asia Foundation nilai birokrasi berbelit hambat UKM'; *Bisnis Indonesia* 25<sup>th</sup> August 2000 'Pemerintah agar tinjau izin yang hambat UKM'; *Bisnis Indonesia* 11<sup>th</sup> May 2000 'Perizinan jadi kendala UKM' and *Bisnis Indonesia* 15<sup>th</sup> August 2000 'UKM tak berkembang akibat arogansi aparat'.

modify the law<sup>14</sup>. The general argument used against Law 18/1997 is that in the spirit of decentralization, the authority to impose taxes and levies (*retribusi*) on domestic trade and business activities should be made by local, rather than central government. Law 18/1997 is considered by many to be too restrictive and does not provide enough flexibility for local governments to raise funds from local sources. Moreover Law 18/1997 is perceived to be inconsistent with Law 25/1999 on the devolution of fiscal authority to the regions.

Whatever taxation structure emerges out of the decentralization process, it should not be heavily dependent upon the taxation of inter-regional trade. As is the case for many countries, there needs to be the necessary legislation and supporting institutions to prevent tax distortions on domestic trade. A country's constitution perhaps provides the most fundamental means for protecting free trade. In Australia for example, section 92 of the constitution prohibits any forms of duties on internal trade:

*On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free (Australian Constitution section 92).*

The Indonesian constitution has no such stipulation that ensures free and open internal trade. As the decentralisation process continues and more and more authority is devolved to the regions, we are likely to see local governments become increasingly emboldened to unilaterally impose taxes on domestic trade (recall the Lampung case noted earlier). For this reason it is imperative that consideration be given to amending the Indonesian constitution such that it explicitly mentions that all internal trade in goods and services must be entirely free.

The view that local government should be prevented from interfering in domestic trade is in no way inconsistent with the argument that local governments need to be able to expand their taxation revenue raising capacity. An important reason why local governments in Indonesia are so prone to tax trade activities is because of the present taxation system that is very restrictive and centralistic. As noted earlier, local governments are in most part unable to draw local revenues from taxes on assets, incomes and value added, leaving trade as a residual and obvious target. Another reason is that it is very simple to tax trade. This can be done by simply positioning officials at key strategic locations, such as at city and district boundaries, weigh stations, ports, bridges and crossroads. It should also be remembered that the more contact local officials have with businesses, traders and farmers the more opportunity there is to extract informal or illegal charges (*pungli*). For these reasons it may be appropriate to consider devolving other taxation powers (such as property or value added tax) from the center to the regions.

---

<sup>14</sup> 'PP Otonomi Daerah diluncurkan 7 Mei 2000' *Bisnis Indonesia*, April 28 2000; 'UU Pajak & Retribusi daerah perlu diubah', *Bisnis Indonesia* April 11 2000; 'UU Pajak perlu diubah agar Pemda leluasa', *Bisnis Indonesia* April 18 2000; 'Daerah tunggu PP implementasi UU Otonomi & Perimbangan Keuangan', *Bisnis Indonesia* May 8 2000. The Indonesia Forum has recently weighed into the debate by arguing that UU 18/1997 must be revised or 'perfected' to ensure greater flexibility in revenue raising for local governments. See Yayasan Indonesia Forum (2000) *Laporan Hasil Kajian Otonomi Daerah* presented at the Konferensi Nasional Tentang Otonomi Daerah, President Hotel, Jakarta 9 May 2000.

If it is the case that taxes are to be imposed on inter-regional trade then caution must be taken to ensure against multiple tax exactions on the same product or commodity. Moreover any such trade tax would need to be standardised to prevent its misuse by local authorities to discriminate against outsiders (i.e. regions may impose lower tax rates on trade originating in-region than on that originating out of region).

However, Indonesia's national interest would be best served were there no formal taxes on inter-regional trade, as is currently the case. For this reason it is important to maintain Law 18/1997 without any substantial amendments.

However it is important to note that a law will only be effective if it is actually implemented. As noted earlier, the commitment to socialize and implement Law 18/1997 varies from region to region and there is sufficient evidence from fieldwork that a variety of illegal charges are still imposed upon inter-regional trade (see table 1 below). A common complaint from farmers and traders affected by these illegal charges is that they have no avenue to lodge their complaints, or to report offending officers<sup>15</sup>. A recent front page article in the national daily *Kompas* (3 May 2000) reports that truck drivers transporting agricultural produce in North Sumatra had become so frustrated at the lack of action by local authorities to stamp out the collection of illegal charges by local mafia (or *preman*) that they had decided to go on strike en-masse<sup>16</sup>.

What may be required is the establishment of a national institution (with branches at the provincial and Kabupaten level) to ensure no illegal distortions upon inter-regional trade. Such an institution could enforce the implementation of Law 18/1997. If this law is repealed or modified, the commission could ensure that trade and business taxes (including licensing fees) are not overly burdensome or discriminative so as to minimize the damage to the regional, as well as national economy. In either event the institution would be charged with the responsibility of ensuring Indonesia's national economic integrity, during and beyond the decentralization process. Given the important interface between domestic trade and competition issues, useful synergies may be realised by developing close links with the newly formed competition commission (KPPU) and other market supporting institutions such as the Anti-Dumping Commission and the soon to be formed National Consumer Protection Board.

---

<sup>15</sup> This is an important theme to be drawn from the various small business-government forums currently being held by The Asia Foundation in a number of provincial capitals (e.g., Makassar, Medan).

<sup>16</sup> 'Tak Tahan Melayani Pungutan Liar, 200 Sopir Truk di Belawan Mogok' *Kompas* May 3, 2000, page 1.

**Table 1**  
**Examples of Tax-Type Distortions in Inter-regional Trade**

<i>Tax type distortion</i>	<i>Explanation</i>
Illegal exactions during transport (South Sulawesi)	From the rice producing area of Sidrap to the port town of Pare-Pare in South Sulawesi there are usually 2 police posts where payments must be made. Further payment to the police is required for entry into the port of Pare-Pare. Each post requires payment of between Rp 3000-5000 (although some drivers complain that demands are often for larger amounts). From Sidrap to the provincial capital, Makassar (approximately 4 hours to the south) there are seven police posts, as well as three weigh bridges. Other drivers and traders interviewed were transporting cattle from Bone (on the east coast of the peninsula) to Makassar and reported that the 5 hour trip might involve payment of around 20 illegal charges. Traders typically estimate the largest expected loss from these charges and pass these losses on to farmers in the form of lower prices. (Source: Fieldwork carried out by David Ray and Rahim Darma, Pare-Pare South Sulawesi April 2000)
Compulsory payment of the 'Third Party Contributions' (West Nusa Tenggara)	As explained in the main text, the 'third party contributions' (Sumbangan Pehik Ketiga - SPK) facility requires local business to provide 'voluntary' payments to local government. The SPK operates as a tax, but it is not recorded as because it is meant to be a 'contribution' or 'gift' from the community to local authorities. Since the implementation of Law no. 18/1997, provincial and kabupaten governments have used third party contributions to increase revenues, or at least to offset the expected fiscal losses associated with the removal of the various kinds of trade taxes and levies. Examples of the misuse of the SPK facility can be found, amongst other places, in the province of Nusa Tenggara Barat, where tobacco producers are obliged to 'volunteer' Rp. 80 to local coffers for every kilogram produced. Similarly, in the cattle market in Mataram, Lombok, traders must pay SPK Rp 2000 for each head of cattle traded. (Source: Field research carried out by David Ray and Lukman Muslimin in West Nusa Tenggara June 2000)
Inter provincial export tax on commodities (Lampung)	The <i>peraturan daerah</i> (local regulation) from the Provincial government in Lampung (Nomor 6 Tahun 2000 - <i>Retribusi Izin Komodoti Keluar Propinsi Lampung</i> ) imposes a tax or 'license fee' (of between Rp. 2/kg and up to Rp. 150,000 /kg) on 180 commodities when leaving the province of Lampung. Also, all non-Lampung products without proof of origin will also be taxed at this rate. This sets a dangerous precedent and might be a sign of things to come. The logic of the tax, according to the accompanying explanation, is that Law 22 provides local government with the authority to raise funds by taxing local economic activities. This regulation is remarkable in the way it defies various central government laws and instructions as well as the January 1998 Letter of Intent signed with the IMF ( see appendix 1) on domestic trade barriers. There is no mention of Law 18/1997, which banned all such taxes or retributions. Nor is there any mention of the article within Law 22 which stipulates that all local government taxes and retributions must be in accordance with central government legislation ( <i>undang-undang</i> ).
Illegal charges at weigh bridges (South Sulawesi)	After Law 18/1997 became effective, weigh stations throughout South Sulawesi were closed, but in the past 12 months have become active again. A major reason for the establishment of weigh stations throughout this and other provinces is to prevent road damage from overloaded trucks. Ironically, their presence ensures the opposite result. This is because the weigh bridges are being openly misused by Department of Transport officers to extract illegal payments from drivers. To compensate for these and other illegal payments (e.g., those required by the police), driver and traders must overload to ensure adequate margins. When there are no weigh bridges on the planned route, drivers tend to reduce their load. However, this is rarely so. For a province with a relatively small

	<p>population, South Sulawesi has a large number of weigh stations. For example, on the road from the northern part of the province, Kabupaten Luwu Utara, to Makassar (the capital in the south) there are 6 weigh stations, including two that are less than 25 km apart (i.e. in the town of Datae in the Kabupaten Sidrap and in Lumpue near the port of Pare-Pare). The amount each truck must pay is between Rp 5,000 - 20,000, depending on the amount of excess weight. Maximum capacities are determined by the provincial Department of Transport office in such a way to ensure that all product transport vehicles are overweight. For example, six wheeled vehicles with a 6-7 ton capacity are allowed a 4-ton limit, 12-13 ton capacity vehicles are only allowed an 8 ton limit. According to drivers surveyed transporting at, or under, the maximum tonnage allowed is extremely uneconomic. (Source: Fieldwork carried out by David Ray and Rahim Darma, Pare-Pare South Sulawesi April 2000)</p>
Levies on fish traders (North Jakarta)	<p>Traders at the Muara Baru fish market in North Jakarta have recently been complaining about the imposition of unnecessary fees and charges by local authorities. DKI Jakarta Governorial Decree 192/2000 on fees in the fisheries sector grants a cooperative under the State Ministry of Cooperatives the authority to charge daily 'security' charges from all fish traders in the market, although little security is provided and most traders complain of harassment by various gangs. In addition to this security levy, fish traders complain of having to pay a 2 percent surcharge on all fish coming in from other regions. (Source: <i>Jakarta Post</i> August 24<sup>th</sup> 2000, 'Fish traders complain of illegal levies').</p>
Inter-provincial tariffs (Kalimantan – South Sulawesi)	<p>Throughout Indonesia, there are examples of drivers and traders having to pay what amounts to a tariff to enter a province. Traders bringing in furniture from East Kalimantan into South Sulawesi through the port of Pare-Pare must pay an informal landing fee of Rp 5000 per unit (in addition to a variety of other charges within the port, along the roads and also at weigh stations). According to traders and drivers transporting goods in the opposite direction there are no equivalent informal landing charges in East Kalimantan ports. (Source: Fieldwork carried out by David Ray and Rahim Darma, Pare-Pare South Sulawesi April 2000)</p>
Illegal exactions during transport (Aceh)	<p>An important weakness in the distribution system in Aceh involves the major road link between Banda Aceh (the capital of Aceh, situated in the extreme north of the province) and Medan, which is over the border to the south in North Sumatra. Drivers complain that during the 12 hour road journey they are forced to stop no less than 30 (and even as much as 50) times to pay illegal passage fees. Those drivers and traders interviewed estimate that the journey would require Rp 700,000 to Rp 1 000,000 in illegal fees, or around 40-60% of total transportation costs. This in turn increases the final cost to consumers of imported goods in Aceh. It is not clear who collects these illegal payments (pungli), although some drivers interviewed explicitly mentioned the police and the army, and the sometimes violent methods used to extract these payments. (Source: Fieldwork carried out by David Ray accompanying USAID economic assessment team Aceh July 2000)</p>
Fees for quality control (Bandung, West Java)	<p>As with the fish market case described above, a common complaint from smaller traders and producers is that local government charges a fee for a service never actually carried out. According to Persepsi Daerah (1998), the Livestock Service of the City of Bandung (<i>Dinas Peternakan Kodya Bandung</i>) charges a fee for quality testing on fish and meat traded at market stalls. In reality no testing is carried out, by traders must pay the fee to get the necessary quality tested stamps</p>

## **Non-tax barriers to trade**

There is a range of local government imposed measures which can interfere in the domestic competition environment. Many of these measures can be used to discriminate against out-of-region business. List below is a sample of some of the measures more commonly found in Indonesia.

### *Price Controls*

A local government may wish to establish a minimum price for a particular product when the production and inter-regional sale of that product is critical for the region's economic health. The aim of such a minimum price law is to ensure that local producers get sufficient returns to stay in business. It however destroys the competitive advantage of out-of-region producers who can produce and sell at lower prices. The effect of such a minimum price law would be to protect less efficient local producers from more efficient out-of-region producers.

In other circumstances a local government may wish to impose maximum price controls for a particular good produced and sold within the region. Such controls are often designed to ensure low cost access to inputs for local downstream producers. This disadvantages out-of-region producers who must pay full market price for similar inputs. It also disadvantages local producers who cannot get access to out-of-region markets where prices offered by buyers are higher than local price ceilings. It also means that producers must reconcile rising production costs against fixed revenues.

An example involves cotton production in South Sulawesi. Until recently farmers were required by the provincial government to enter into a 'partnership' agreement with the only cotton factory in the area (at the time). To ensure a stable low cost supply of cotton for the factory, cotton prices were also determined by the provincial government with inflation falling to the disadvantage of the farmer (Persepsi Daerah 1999). In recent years new entrants have increased the number of cotton factories in the area. However geographic rationalisation of the cotton market ensures continued monopsonistic practices (*rayonsiasi* - see the section below).

In other cases, maximum price controls on agricultural commodities have been set by a trade board on behalf of the local government. This can seriously disadvantage local farmers, particularly when the trade board is made up of local traders, as was recently the case in Flores<sup>17</sup>.

### *Required in-region processing of local raw produce*

Provincial governments often try to force local farmers and producers to sell their produce to in-region downstream processors by banning or inhibiting sales to out-of-

---

<sup>17</sup> See Persepsi Daerah (1999 p 5).

region processors. This is usually done through the use of export taxes and other forms of restrictions/barriers on the outward movement of goods.

The rationale for this policy is to ensure that locally produced raw produce is also processed in-region. This might help to increase in-region output and employment opportunities, and also to help capture a greater share of value added for regional producers. However, required in-region processing regulations disadvantage local farmers who can usually get better prices for their produce by selling to more efficient out-of-region or international processors (e.g. cocoa beans and cashew nuts in South Sulawesi). These regulations would also disadvantage out-of-region processors who require supply from in-region producers. Moreover in some cases, due to the particular processing techniques used, local processing of a commodity might preclude its downstream use in offshore markets (e.g. fermented cocoa beans in the US).

#### *Forced use of local facilities*

A related problem to that described above is the forced use by local exporters and traders of particular local government sanctioned or owned services and/or facilities. A recent example has been reported by CESS/TAF (2000) where food exporters in North Sumatra are virtually forced to use local government quarantine services in order to qualify for the required phytosanitary certificate. Local exporters can opt to have their consignments fumigated elsewhere at much lower costs, but later encounter serious difficulty when their export consignment is processed at the port.

#### *Forced sales to local monopsonists*

A provincial government may also seek to support a local company, trader or cooperative by bestowing upon it monopsony rights for a particular commodity produced within that province. Such policies typically depress farmgate prices, whilst substantially increasing the trading margin for the licensed monopsonist (e.g. the citrus trade in West Kalimantan – see below). When cooperatives are involved, it is often the case that they are non active, and only exist on paper but nevertheless provide rent seeking opportunities for local government officers<sup>18</sup>. The net effect of such monopsonist licensing is lower farmer incomes, higher consumer prices, and if the incentive environment is sufficiently distorted, the potential collapse of the local industry

A well-known example of how such local government action can favor particular businesses and traders over others, at high social cost, involves oranges. In 1991, the Governor of West Kalimantan issued a decree that, in effect, required all oranges destined for inter-island trade to be sold to PT Bima Citra Mandiri. The effects on trade

---

<sup>18</sup> Persepsi Daerah (1999) note a recent example in East Nusa Tenggara where farmers in Ende were officially forbidden to sell their produce to traders, but must instead sell to KUD (local government) cooperatives. There were however no cooperatives functioning as traders, only local government KUD officers who were able to exploit their position to collect a quasi-tax from traders.

were disastrous; farm prices for oranges dropped substantially and exports fell by 63%. Consumers off Kalimantan were also worse off, either because of the decrease in exports or because the monopsony buyer was also a monopoly seller of West Kalimantan oranges.

### Quantitative restrictions on inter-regional trade (Quotas)

Provincial and district level governments should be prohibited from imposing quantitative restrictions on goods and commodities involved in inter- and intra-regional trade. Some local governments, such as the provincial governments in Nusa Tenggara Barat and South Sulawesi fix the number, and destination, of livestock for shipment from producing areas.<sup>19</sup> This quota policy is designed primarily to preserve cattle resources in producing areas. The rationale used to defend the quota is that in response to robust demand for meat in Jakarta and other urban centres, cattle farmers will sell their entire herd today with little regard for future. This rationale is based on the assumption that bureaucrats can make more informed decisions about cattle production than the farmers and traders actually involved in the industry who have clear interest in its sustainability and long term success. Moreover, the policy is based on the assumption that quotas system will actually work. Evidence to date suggest that this policy does not limit shipments, but simply increases bureaucracy costs, creates new opportunities for rent seeking by local officials and also creates new ‘secondary’ markets for quota rights.

### Government Procurement

Issuance of government tenders and contracts is an area where policy makers can play a direct role in ensuring open and competitive markets. In exercising public works projects powers, there is growing concern that local authorities will discriminate in favor of local suppliers and contractors, at the expense of the competitors from Jakarta and other cities and regions.<sup>20</sup> Key criteria for determining winning bids for government tenders should be a combination of experience, technical capability, and price. However, as outlined in Presidential Decree 18/2000 on government procurement, a firm’s size and place of domicile are crucial factors determining who can tender for projects. For small to medium sized projects, the decree requires government offices issuing tenders to give ‘priority’ to local companies. Moreover, outside firms winning bids over a certain size are obliged to employ or work together with local firms. Such stipulations clearly restrict competition for procurement by disadvantaging large and non-local firms.

---

<sup>19</sup> Every year Provincial office of Livestock Services (Dinas Peternakan) announces the quantitative restrictions on livestock involved in inter-island trade originating from NTB. These restrictions also apply to the amount, type and weight of cattle that can be slaughtered. The most recent announcement was in December 1999 which restricted the number of cattle that can be exported from NTB (or slaughtered) to 11500, down from 23000 the year before. See Surat Keputusan Kepala Dinas Peternakan Propinsi NTB Nomor: 1348a/XII/UT/1999 and Nomor: 188.4/1835/UT/XII/98 (Fieldwork carried out by David Ray, Gary Goodpaster and Lukman Muslimin, West Nusa Tenggara July 2000).

<sup>20</sup> ‘Daerah jangan monopoli proyek’ *Bisnis Indonesia*, Tuesday, 4th March 2000.

### Regional allocation of markets (Rayonisasi)

Provincial and district level governments should be prohibited from licensing or sanctioning the division of marketing/production territories and/or the allocation of markets for goods and services on behalf of local and non-local companies and individuals. A local government may seek to support a local firm or individual by allocating to it marketing areas that competitors cannot access. This disadvantages local consumers by limiting choice. Moreover, the lack of competition within the allocated sector often translates into higher consumer prices. The allocation also disadvantages non-local suppliers who wish to gain access to these markets

A well-known example of rayonisasi involves tea processing. In West Java, the Nusamba Company built four tea-processing factories even though there was already excess tea-processing capacity there. To secure fresh tea leaves, Nusamba persuaded the Governor of West Java to instruct Bupatis to “rationalize” the tea market by allocating sales of tea leaves to certain factories (Persepsi Daerah 1999). The instruction was clearly protectionist for a local interest and advantaged Nusamba over its competitors, whether local or more distant. At the same time, it allowed Nusamba to act as a monopsonist, permitting it to determine prices to tealeaf sellers.

Other examples of *rayonisasi* can be found throughout Indonesia. In the West Nusa Tenggara island of Sumbawa, farmers are limited to raising/producing only one type of cow (Bali Sapi). This in turn severely limits market opportunities for local cattle producers. Meanwhile in the smaller neighboring island of Lombok, cattle farmers have full freedom and flexibility in production, and as a result are more successful<sup>21</sup>. Another example of *rayonisasi* can be found in the cotton producing areas of Bulukumba, South Sulawesi. One monopsonist, a local factory, controlled this industry for a long time. Recently, there have been a number of new entrants. However each factory buys exclusively from particular production areas, leaving farmers with no choice but to sell to their respective monopsony buyer.<sup>22</sup>

### Forced partnership programs (Kemitraan)

Provincial and district level governments should be prohibited from enforcing or coercing firms and/or individuals into partnership programs (Kemitraan). Involvement in such programs must be purely voluntary. Provincial and district government authorities, in particular the Estate Crop Services offices, sometimes actively encourage the formation of partnership programs between small-scale agricultural producers and large firms. The expectation from these programs is that small farmers will be empowered from their relationship with large firms. Evidence to date suggests that many of these programs unfairly tie the small farmers to selling their output to the larger partner firm, often at unfavorable prices.

---

<sup>21</sup> Fieldwork carried out by David Ray, Gary Goodpaster and Lukman Muslimin, Nusa Tenggara Barat July 2000.

<sup>22</sup> Ray and Darma 2000.

### *Anti-monopoly requirement for BUMD (local government owned enterprise)*

According to Law 22/1999 (articles 84 and 108) Provincial, District and village authorities may own and run public enterprises. Caution must be taken to ensure that BUMDs are not allowed to operate in an anti-competitive and non-transparent manner and are not given special privileges from local governments that are not otherwise available to private sector firms. For this reason all BUMD should be prohibited from engaging in monopolistic and other forms of anti-competitive behaviour as defined in Law No.5/1999.

### **Conclusion**

Internal trade barriers and local discriminations against out-of-region businesses work to undermine the integrity and solidarity of a nation. In decentralising, Indonesia must ensure that increased regional autonomy does not weaken nationhood. To enjoy the efficiency benefits of decentralization Indonesia must continue to have a unified and integrated national economy. This means only minimal barriers to inter-regional trade and business. Domestic trade and competition policy should remain as a matter 'national concern' and therefore not devolved to either Provincial or District level government.

This paper identified two major types of inter-regional trade barriers that may arise out of, or be exacerbated by, the decentralization process. The first relates to tax-type barriers such as taxes, levies, licenses and other charges on domestic trade and business activities. Many of these charges were abolished by Law 18/1997. However this law is under threat of revision. Moreover many local governments are finding ways to sidestep the law, by finding more creative ways of taxing trade, such as forcing businesses to make 'voluntary contributions' to local government coffers, or by simply charging illegal levies. With regional governments pressuring their bureaucracies to find new ways of raising local revenues, there is also concern that business licensing costs will be increased.

The second trade barrier type considered in this paper relates to a range of non-tax barriers which inhibit the regional competition environment. These include price controls, quotas, required in-region processing of local raw produce, forced sales to monopsonists, regional allocation of markets (rayonisasi), forced partnership programs as well as a range of other policies and practices which discriminate against or place undue burden upon out-of-region business.

To help ensure that decentralisation does not contribute toward domestic economic disintegration, a number of broad policy suggestions can be made:

The Indonesian government should consider amending the constitution to provide for free internal trade and to secure the authority of the national government to override local action injurious to the national economic interest.

Also, to ensure continued free movement of goods across sub-national boundaries Law 18/1997 should be maintained. If the law is repealed, or substantially modified, national legislation is required to minimize the burden of multiple and discriminative taxation regimes.

Law 9/1995 on small businesses should be amended to ensure simplification and standardisation of business licensing procedures within local government.

Clear guidelines need to be established at the national level to ensure appropriate regulation of markets by local authorities. Such guidelines, should amongst others, prohibit local government from undertaking or tolerating price controls, quotas, export controls, unfair or forced partnerships, monopsonistic trading as well as a range of other distortions in the local competition environment

Finally, an independent national body (with local branches) needs to be established to ensure continued free, open and integrated domestic markets during and after the decentralisation process.

## Bibliography

- Bahl, R. (1998) *Implementation Rules for Fiscal Decentralization*, paper presented at the International Seminar on Land Policy and Economic Development, Land Reform Training Institute, Taiwan November 1998.
- Musgrave, R. (1983) “ Who should tax, where are what?” in McClure, C. (ed) *Tax Assignment in Federal Countries*, Centre for Research on Federal Financial Relations, ANU Canberra.
- CESS/TAF Center for Economic and Social Studies/The Asia Foundation (2000) *Provincial Outlook Sulawesi Selatan: Bahan Dialog Kebijakan Perdagangan dan Investasi dan Implikasinya Bagi Usaha Kecil dan Menengah di Sulawesi Selatan*, PRISM Project.
- Chotim, Erna Ermawati. (1998) ‘Isu Pelayan Birokrasi’, chapter in the proceedings for the *Konperensi Nasional Usaha Kecil II: Kekuatan Kolektif Sebagai Strategi Mempercepat Pemberdayaan Usaha Kecil*, 7-8 October 1998 Jakarta, The Asia Foundation, CESS and USAID.
- Darma. R. (1999) *Deregulasi Perdagangan Regional dan Pengaruhnya Terhadap Perekonomian Daerah, Kasus: Beberapa Kabupaten di Propinsi Sulawesi Selatan*, Persepsi Daerah, Sulawesi Selatan.
- Dwipayana, Anak Agung GN Ari. (1998) *Usaha kecil dan Birokrasi: Studi Tentang Pelayanan Perijinan Bagi Usaha Kecil di Gianyar, Bali*. The Asia Foundation, Jakarta.
- Persepsi Daerah (1999) *Deregulasi Perdagangan Regional: Pengaruhnya Terhadap Perekonomian Daerah dan Pelajaran yang Diperoleh*. Smeru Laporan Khusus, Jakarta December.
- Ray, D. and Darma, R. (2000). *Studi tentang Hambatan-Hambatan Pada Perdagangan dan Persaingan Bebas di Propinsi Sulawesi Selatan*. Partnership for Economic Growth, USAID.
- Yayasan Indonesia Forum (2000) *Laporan Hasil Kajian Otonomi Daerah’ presented at the Konperensi Nasional Tentang Otonomi Daerah, President Hotel, Jakarta 9 May 2000*.
- Yusuf, S. (2000) *Where the World is Heading Toward: Globalization, Localization and the pattern of development*. Development Economics Research Group, World Bank.