



Fossil-Fuel Subsidy Reform and Small and Medium-Sized Enterprises (SMEs): The impacts and possible responses

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This briefing note examines the relationship between fossil-fuel subsidy reform and Indonesia's many small and medium-sized enterprises (SMEs). How might we expect SMEs to be affected by fossil-fuel subsidy reform? What do we know about the impacts of reforms in the recent past? The note concludes by identifying avenues for further research, and actions that could be taken by governments and SMEs to minimize the potential negative impacts of fossil-fuel subsidy reforms.

Introduction

In Indonesia, energy subsidies—particularly fuel subsidies—have traditionally played an important role in determining the cost of living and the cost of doing business. But in the past decade, rising world oil prices and growing demand for fuel have rendered the subsidies unaffordable, leading to several substantial reforms. As necessary as this may be for fiscal reasons, Indonesia has a very large population of low-income households. This has made fuel subsidies more than just an issue of economic importance—they lie at the heart of controversial social and political debates as well.

The purpose of the paper is to explore the following question: does fossil-fuel subsidy reform matter for small and medium-sized enterprises (SMEs)?

These enterprises make up a large proportion of businesses in Indonesia and create a significant proportion of total employment. They have also been instrumental in reducing poverty. The way they are affected by fossil-fuel subsidy reform or fuel price increases will thus be very important in determining overall outcomes for social and economic welfare.



The paper begins by giving some background information about SMEs in Indonesia and describes two analytical approaches for exploring how they might be affected by energy subsidy reform: first, by the extent to which different kinds of SMEs report energy prices is a problem; and second, through the role that energy plays in SMEs' cost structures. It then explores how SMEs were affected most recently by increased gasoline and diesel prices in June 2013. It concludes with some thoughts on how the government and SMEs themselves can take action to ensure that SMEs are not unduly harmed by energy price increases.

SMEs in Indonesia: Some background

As in many developing countries, there are at least three main reasons why small (including micro) and medium-sized enterprises (SMEs) are very important to Indonesia.

First is their size. SMEs are very numerous—according to a database from the Ministry for Cooperatives and SMEs (UKM, 2013), there were 56.5 million SMEs in Indonesia in 2012. They are also very labour-intensive, using a mainly low-educated workforce. They play a crucial role, therefore, in generating employment and, by extension, alleviating poverty.

Second, SMEs, and especially small enterprises (SEs), are scattered widely throughout rural areas. This means that they may have a special local significance for the rural economy. They make an important contribution to regional economic development, and they also reduce the gap in development between rural and urban areas.

Third, SMEs have great economic potential. This is not limited to increasing Indonesia's gross domestic product (GDP). SMEs can also help to diversify the Indonesian economy, creating valuable export sectors in addition to the country's oil and gas sector. This is especially the case for products such as furniture, garments, footwear, creative products and various handicrafts.

But SMEs in Indonesia and other developing countries look very different to SMEs in more developed economies. About 99 per cent of SMEs in Indonesia are tiny or micro enterprises that have the following characteristics:

- They are unregistered and operate in the informal sector.
- The majority are found in rural areas.
- They do not adopt conventional/modern organization, management and accounting systems.
- They use mainly low-educated paid workers as well as unpaid family members.

Because of these characteristics, it is no surprise that most of the enterprises perform badly (e.g., low productivity and production of inferior goods) and have difficulties accessing all necessary inputs, including capital, high-quality labour, technology and information, as well as access to domestic and export markets.

The Importance of Energy Among the Current Problems Faced by SMEs

Indonesian SMEs (especially SEs) are often hampered by numerous constraints that limit their ability to sustain themselves or to grow, including institutional constraints. The exact combination of constraints may differ from region to region, between rural and urban areas, between sectors and subsectors and between individual enterprises within a sector or subsector or a region. A number of constraints, however, are common to all SMEs, including:



- Lack of funds to finance operations and capital investment.
- Lack of human resources with high skills.
- Lack of access to advanced technologies.
- Lack of up-to-date and comprehensive information.
- Difficulties in procuring raw materials and other required inputs.
- Difficulties with marketing and distribution.
- High transportation costs.
- Cumbersome and costly bureaucratic procedures, especially in acquiring licenses.
- Policies and regulations that generate market distortions.

Table 1 summarizes survey data on what Indonesian SEs in the manufacturing industry have reported as their most important constraints in 2005 and 2010. Energy prices and supply are reported as significant problems, though they are also the least frequently reported most important major constraint among the seven proposed by the survey, and made up a smaller proportion of responses in 2010 than in 2005.

TABLE 1: SHARE OF SEs IN MANUFACTURING FACING KEY CONSTRAINTS TO DOING BUSINESS, 2005 & 2010

Status	2005		2010	
	No. of enterprises	%	No. of enterprises	%
Have no serious obstacles	674,135	24.7	599,591	21.94
Have serious obstacles	2,054,565	75.3	2,133,133	78.06
Total respondents	2,728,700	100.00	2,732,724	100.00
Serious obstacles identified	No. of enterprises	%	No. of enterprises	%
Lack of capital	714,629	34.78	806,538	37.81
Marketing difficulties	629,406	30.63	495,100	23.21
Lack or high prices of raw materials	421,277	20.5	483,581	22.67
Other main constraints	162,238	7.9	184,516	8.65
High labour costs or lack of skilled workers	16,650	0.8	88,952	4.17
Transportation/distribution obstacles	54,945	2.67	39,676	1.86
High price or short supply of energy	55,420	2.7	34,770	1.63
Total respondents	2,054,565	100.00	2,133,133	100.00

Sources: Tambunan (2008); Badan Pusat Statistik (BPS) (2010a).



Data also show that the proportion of SEs that show energy pricing or supply as their most serious problem varies by group of industry. This may be related to differences in how they operate, such as the nature of their production processes. Figure 1 shows that, as a percentage of total manufacturing enterprises, energy is most frequently the most serious problem for SEs in tobacco-processing, followed by those who manufacture reproductions of publishing and recording media; machinery and tools; food; and paper and its products.

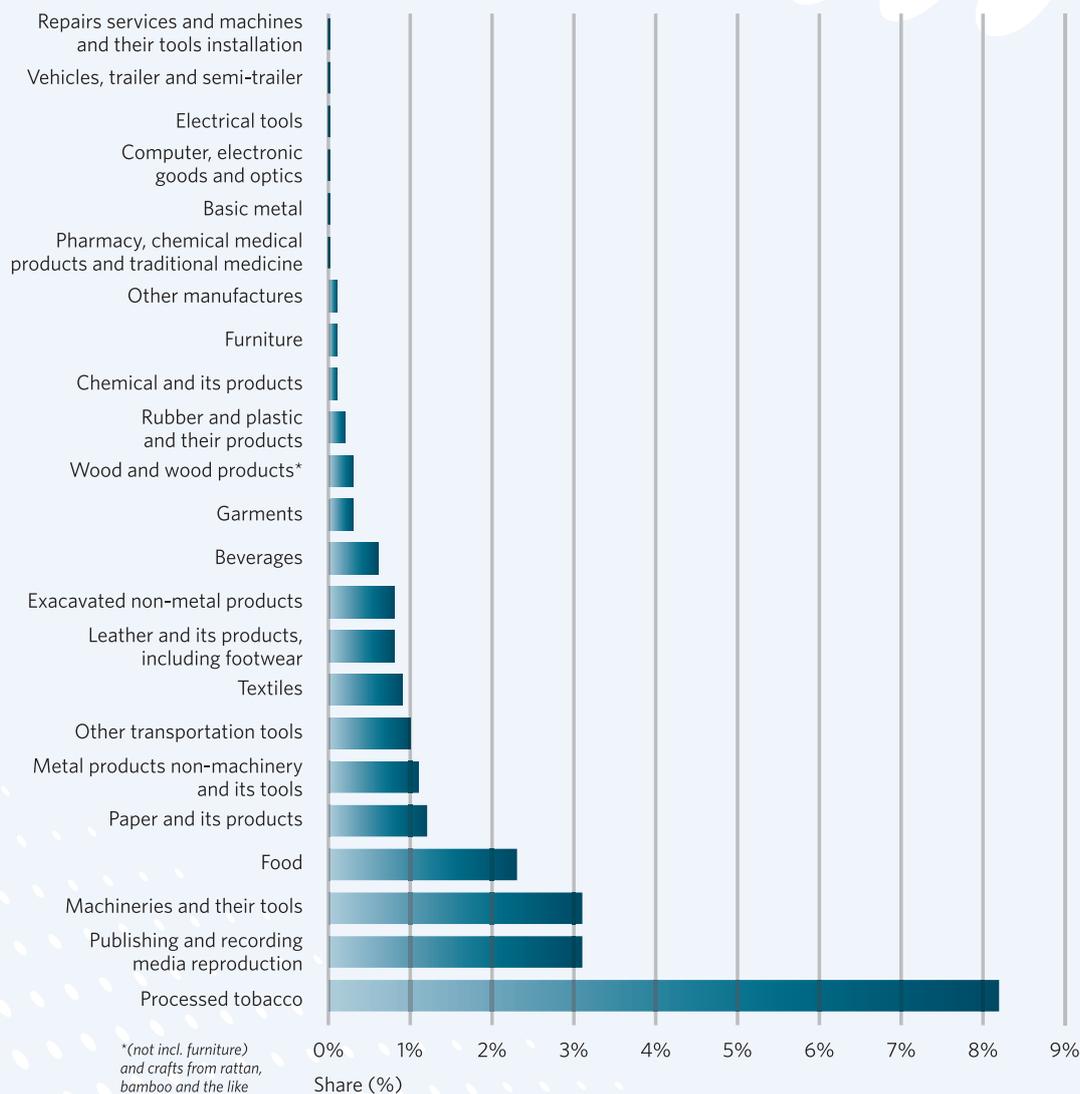


FIGURE 1: PROPORTION OF MANUFACTURING SEs FACING ENERGY AS THEIR MAIN CONSTRAINT, BY INDUSTRY GROUP, 2010

* Including crafts from rattan, bamboo and the like, not including furniture.

Source: BPS (2010a).



The variety may also be linked to issues such as geographical location, the condition of the local energy market and local transportation networks. As shown in Figure 2, it is obvious that the majority of SEs having this particular problem are located outside Java and Sumatera. More specifically, Figure 2 suggests that the five provinces where energy costs are the biggest issue are West Kalimantan, Kepulauan Riau, West Nusa Tenggara, Gorontalo and Banten.

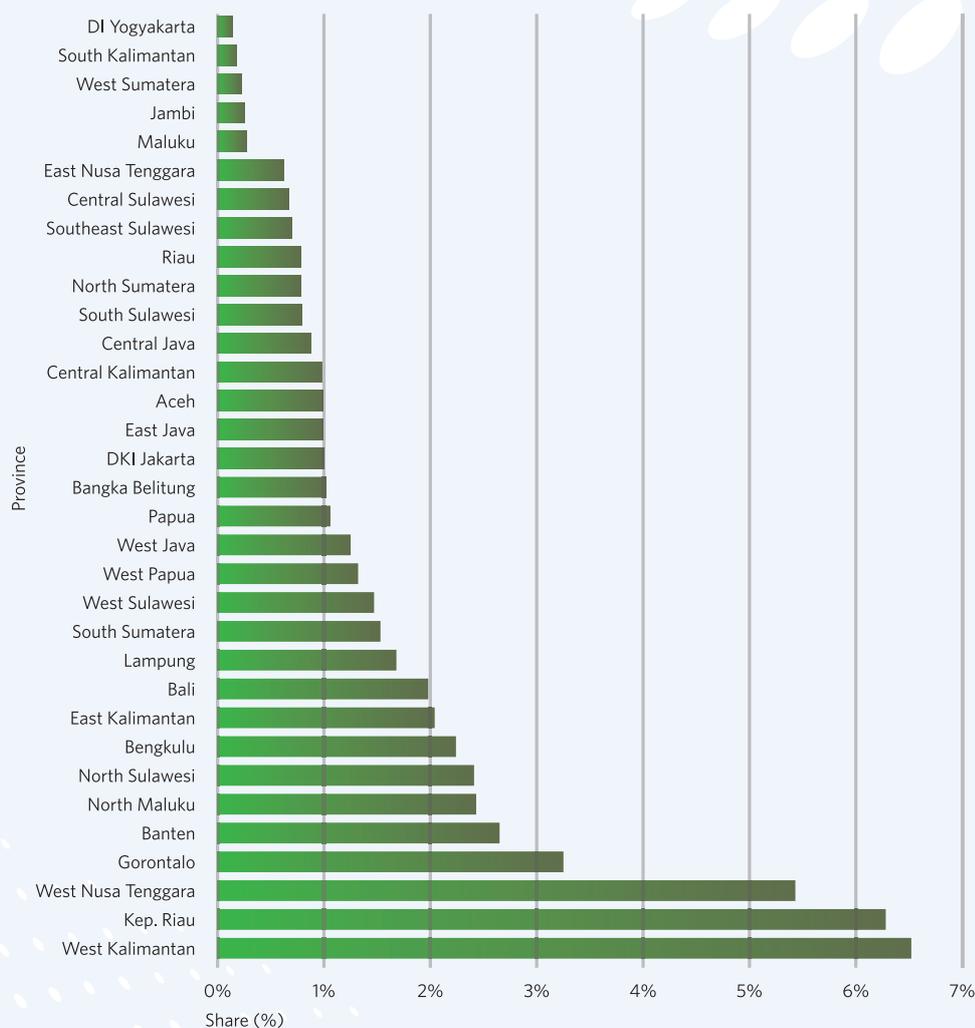


FIGURE 2: PROPORTION OF MANUFACTURING SEs FACING ENERGY AS THEIR MAIN DIFFICULTY, BY PROVINCE, 2010

Source: BPS (2010a).

But the data that are available also raise many questions. The BPS only has detailed data on the manufacturing industry.¹ No equivalent data exists for SMEs in other industries. In addition, the data do not distinguish between the problems of energy price and supply, and do not indicate the specific energy sources (e.g., electricity, liquefied petroleum gas [LPG], kerosene) causing the most significant problems for different types of SME.

¹ Including data on medium-sized enterprises (MEs), available from other BPS publications (*Statistics on Medium and Large Enterprises*), though not summarized here.



Such information is crucial for examining the impact of fossil-fuel subsidy reforms. Energy used will vary significantly by type of enterprise: for example, handicrafts will have high transportation costs but use virtually no electricity; others, such as food processing, will make extensive use of kerosene. It can be assumed that reforms to gasoline and diesel prices, such as that implemented in June 2013, will only affect certain groups of SMEs, such as those in traditional industries like food and beverages, or those making products from wood, bamboo and rattan, and leather products. In these industries, the key type of energy used by SMEs is kerosene, followed by Solar-brand diesel and gasoline. Reliable data are required to accurately predict the impacts of reforms and to ensure SMEs are prepared.

The Importance of Energy in the Cost Structure of SMEs

Although, it is generally known that SMEs, particularly SEs, are much less energy intensive in comparison to large enterprises (LEs), energy costs are still significant: running from around 10 per cent to more than 65 per cent of the total cost of production (United States Agency for International Development [USAID], 2008).

For SEs (including micro enterprises), no national data are available on cost structures or composition of inputs used. There are, however, some studies based on field surveys that show that energy costs are not the largest component of total production costs for SEs in Indonesia, although the percentage share varies by group of industry.

The survey data from BI & PS-IUKMPU (2010), summarized in Table 2, show that operation costs are just a small component of total production costs for SEs in wood processing, food and beverage, textile and footwear industries in some regions in the country, including in West Sumatera and West and East Java. Operation costs include energy costs, though energy is not necessarily a dominant component of operation costs. For example, in the wood processing industry, the share of energy costs in total operation costs is about 13.55 per cent. In other industries the share is much higher, such as the food and beverage industry, where fuel costs represent 42.4 per cent of operation costs. SMEs in the latter industry use boilers as the source of steam for their production processes. Coal, diesel and oil are the common fuels used to operate boilers, which all result in high production costs.

TABLE 2: COST STRUCTURE OF SES IN SELECTED GROUP OF INDUSTRY

SELECTED GROUP OF INDUSTRY	% SHARE				
	KEY RAW MATERIALS	SUPPORTING MATERIALS	LABOUR	OPERATIONAL	CAPITAL
Wood processing	64.07	4.42	26.40	4.48	0.63
Food and beverages	69.9	11.6	11.2	5.9	1.4
Textile	63.2	7.69	21.51	5.78	1.82
Footwear	56.6	10.3	27.0	4.1	2.0

Source: BI & PS-IUKMPU (2010).



National data for MEs with respect to the manufacturing industry exist in the BPS annual publication *Statistics for Medium and Large Industry*. As shown in Figure 3, these data reveal that energy is not the largest component of total production costs for MEs; however, the share varies by group of industry, depending on, among other factors, the nature of the production process and energy-efficiency measures taken by individual firms in the industry.

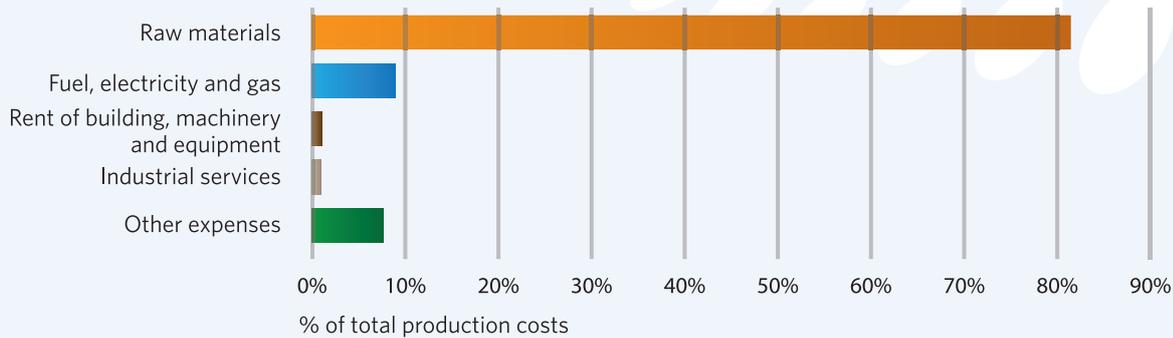


FIGURE 3: COST STRUCTURE OF MEs IN MANUFACTURING INDUSTRY

Source: BPS (2010b).

What We Know From Experience: How Have SMEs Coped with the Latest Increases in Energy Prices?

Even if energy takes up a very small percentage of the production costs of SEs, as illustrated above, an increase in energy costs can still seriously affect them. Vulnerability to energy price increases is to some extent determined by a business's ability to cope with change: can they pass the extra costs on to their consumers, or must they absorb losses themselves?

A business's ability to fully or partially pass on costs to consumers will depend on the type of goods they produce or the type of market they serve. SEs producing essential goods, such as street food stalls that low-income groups depend on, ought to face relatively inelastic consumer demand. SMEs selling non-essential goods with elastic demand, such as furniture, toys, or clothing, may have more difficulty passing on the extra costs to consumers.

At the point of writing, no detailed studies had yet been published about the impact of the June 2013 price reforms for gasoline and diesel on SMEs. However, anecdotal reports from various newspapers indicate that the impact seems to be significant. For instance, the *Republika* newspaper has stated that many SMEs in the West Java city of Sukabumi may have to close down because of the fuel subsidy policy (Republika Online, 2013a). Citing complaints that the rising costs of production have made it difficult to expand, *Antara News* (2013b) has stated that the price changes have been felt by many SMEs in East Java, and have even threatened some businesses with bankruptcy. In the East Java city of Malang, at least 10,000 local SMEs are facing bankruptcy due to the sharp rise in operating costs (especially transportation costs) that followed the fuel price change (Antara News, 2013b).

According to Kompas newspaper, the State Ministry for Cooperatives and SMEs and BPS have estimated that the impact of the fuel price reform has generated financial problems for many SMEs in Indonesia (Purwanto, 2013). According to the study, although the resulting increase in production costs is not as bad as in 2005, when fuel prices were first increased, it has still created significant problems for many SMEs (Antaranews.com, 2013a, 2013b).



Studies of the 2005 energy price reforms on SMEs have come to different conclusions. For instance, a case study in North Sumatra in 2007 shows that the business performance of local SMEs was not significantly affected by the increase in fuel price in 2005 (Rizal, 2007). Other findings—such as those from a survey conducted by the Ministry for Cooperatives and SMEs in 2006 (cited in Sinaga, 2013)—show that product costs and incomes were affected considerably. This survey covered 37,950 SMEs over 33 provinces that use kerosene, solar oil and gasoline in a range of businesses, including food processing industries, rice milling, fishery, food stalls, batik (Indonesian traditional cloth), industries producing simple building materials like tiles and brick, and city transportation. It found that production costs increased by an average of 28.1 per cent—in micro enterprises, by 34 per cent; in small enterprises, by 24.6 per cent; and in medium enterprises, by 29.6 per cent—and that net income dropped by 18.37 per cent. With respect to coping strategies, the survey found that about 76.8 per cent of the total surveyed SMEs had increased their selling price; 45.4 per cent had reduced the size or quantity of their products; 63.6 per cent had reduced quality of their products; 39.7 per cent had reduced their profit margins; 39.7 per cent had increased production cost efficiency; and 6.11 per cent had pursued “other” strategies in addition to the above.

Generally, experience shows that the effect of the increase in the price of fuel on SMEs takes place through direct and indirect channels (see Figure 4).

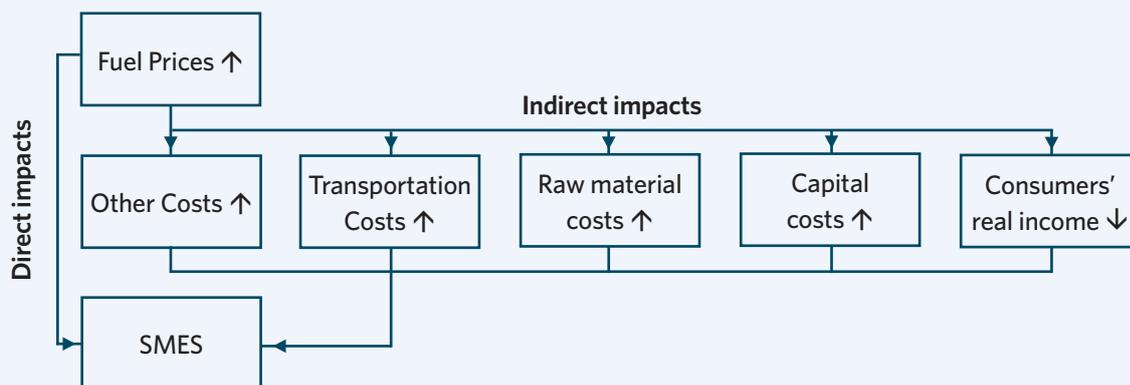


FIGURE 4: THE MAIN CHANNELS OF THE IMPACT OF THE INCREASE IN FUEL PRICE ON SMEs

Direct Impacts

Direct impacts increase the total operational costs of SMEs because they must pay more for energy. The degree of the increase will vary by industry group, according to the amount of energy and the type of energy they consume.

For example, SMEs making bread are very dependent on gas for use in ovens, such that energy costs represent 7–8 per cent of the total cost of bread production. Every day, bakeries consume an average of three 12-kg cylinders of LPG. When the government announced plans to raise the price of 12-kg cylinders of LPG in early March 2013 from IDR70,200 to IDR95,600—a total increase of IDR25,400 (or 35 per cent)—the Indonesian Bakery Employers Association claimed that this would increase the cost of bread production by 2 per cent. Including recent increases in the cost of electricity, this would have increased overall energy costs by 10 per cent (Citra Indonesia, 2013).

The increase in total operational costs caused by an increase in the price of fuel also depends on the type of machines used and, probably more importantly, adjustment measures taken by producers in response to price changes, which will determine the efficiency of fuel use.



Indirect Impacts

Indirect impacts, on the other hand, occur through the knock-on effects that energy price rises have on other aspects of an SME's business—for example, increasing the costs of other inputs or reducing consumers' real income, thereby reducing demand, as illustrated in Figure 4.

Indirect effects on SMEs are generally expected to be more significant than direct effects. Indonesia's central bank, Bank Indonesia, predicted that annual inflation in 2013 could surge as high as 7.9 per cent, exceeding the government's estimate of 7.2 per cent, as a result of the increase in subsidized oil fuel prices (Berita 2 Bahasa, 2013). The immediate direct and indirect inflationary impacts of the June 2013 price reforms is estimated to be 2.45 per cent, made up of the following sub-components: the indirect effects on public transportation fares and commodities (food and other core items) contributing, respectively, 0.82 per cent and 0.40 per cent; and the direct impact contributing a further 1.23 per cent. According to Bank Indonesia, the impact would last for three months, notably in public transport costs (Berita 2 Bahasa, 2013).

The effect of energy price increases on the cost of a business's raw materials and input commodities can be significant. For example, in 2008 Tempo Magazine announced that the increase in the price of fuel in late May had resulted in the collapse of thousands of SMEs in the Tangerang regency in the Province of Banten (Asia Pacific Solidarity Network [APSN], 2008). Around 50 per cent of the 17,353 SMEs in the region had closed down due to bankruptcy, including food stall traders, handicraft industries and cottage industries, especially those producing kerupuk (chips made of flour flavoured with fish or shrimp), tempe and tofu. Many of the SMEs had closed down because of increases in the price of these basic materials, public transport fares and production costs, while the remaining businesses were struggling to survive, with dim prospects for the future (APSN, 2008).

Indirect impacts on credit can also have a serious impact. As a response to increased inflation and to the continued depreciation of the rupiah, Indonesia's monetary authority decided to increase Bank Indonesia's interest rate from 5.75 per cent in May 2013 to 6.0 per cent in June and up again to 6.5 per cent in July (Bank Indonesia, 2013). This rise in the cost of credit makes it harder for SMEs that depend on bank loans, though this is not a large proportion of the SMEs in the country. More seriously, it will affect the larger businesses that depend on credit and have a relationship with SMEs (e.g., trading companies and large-sized car producers). If those firms have financial problems caused by higher interest rates, and therefore have to reduce production or even go out of business, the subcontracted or business-related SMEs will suffer the consequences as well.

Potentially, the most serious indirect effect on SMEs is the expected decline in purchasing power among low-income groups. Although data on the number of buyers of SMEs' goods and services broken down by income group are not available, the main customers for SMEs are from low-income households, as the majority of SMEs in Indonesia (as in developing countries in general) produce low-priced goods and services. Even if those low-income households do not spend their income on fuel directly, they are expected to be seriously affected by subsidy reforms, as the prices of goods and services, including transportation fares, rise as a result of the increased fuel prices. Following the price increases of gasoline and diesel in June 2013, the Ministry of Trade has estimated that the price of essential goods and services will increase by a minimum of 5 per cent to a maximum of 10 per cent, or on average around 8.2 per cent (Setiawan, Laoli, Prayogo, Werdiningsih, & Himawan, 2013). In reality, it is possible that the real impact could be much worse. According to the Organization of Land Transportation, transportation fares could increase up to 35 per cent (Republika Online, 2013b), although the government will allow them to increase only up to a maximum of 20 per cent (Setiawan et al., 2013).



According to BAPPENAS, the National Development Planning Agency, the latest price changes will see the poverty rate increase from 10.5 per cent in 2012 to 12.1 per cent in 2013: an overall increase of 1.6 per cent, despite government compensation funds. This would increase the total number of people living in poverty from 26.3 million to around 30.3 million (Purwanto, 2013). The Ministry of Finance reports that the inflation elasticity of the poverty line is around 1.3 per cent. In other words, if prices go up by 10 per cent, the poverty line will increase by 13 per cent to reflect the increased level of expenditure for a minimum amount of consumption (Deli, 2013). Other research, commissioned in 2013 by the Institute for Economic and Social Research at the University of Indonesia, showed that, under 10 different scenarios of price increase and targeting schemes, the most extreme of which was a 56 per cent price increase for all consumers, the shock would increase the poverty rate by 0.86 to 2.04 per cent (Wikarya, 2013).

Data from National Social and Economic Survey shows that after the 2005 subsidy reform, where fuel prices were increased by 30 per cent, the total number of poor people had increased from 35.1 million (16.0 per cent) in February 2005 to 39.05 million (17.75 per cent) in March 2006; an increase of almost 4 million people (Bappenas, 2006). It should be borne in mind, however, that the fluctuation in the number of poor people over 2005 and 2006 was a result of many factors—not only the 30 per cent increase in the price of fuel—and that medium-term trends in Indonesia have shown a marked decrease in those living in poverty, as per the 10.5 per cent poverty rate by 2012. To prevent indirect impacts on SMEs and SME employment and the associated feedback effects on the welfare of the poorest, we need to better understand the effect of fuel subsidy reform on the poor and how to entirely prevent associated increases in poverty.



Conclusions and Policy Recommendations

In reviewing the relationship between fossil-fuel subsidy reform and SMEs, this paper has three key messages:

1. **In general, SMEs are less energy-intensive than LEs, but they are also more vulnerable.** This means that the direct financial impacts of energy price increases may not be as serious as those experienced by LEs; however, the capacity of SMEs to cope with any negative impacts is likely to be much lower, and even small negative effects can have much more serious impacts.
2. **SMEs are extraordinarily diverse, and the current state of knowledge is too poor to accurately predict in detail how energy pricing will affect different sectors or groups of industry.** SMEs differ in many ways, including the nature of their production processes, cost structures, profit margins, financial security, market demand, and their capacity to adjust to higher prices. Data does not currently exist to help predict what types of SMEs will be most seriously affected by energy price changes. Which types of business will be most affected by increases in the price of gasoline, diesel, LPG or electricity? For the time being, anecdotal evidence suggests that historical reforms to gasoline subsidies have most seriously affected SMEs related to food-processing industries, rice milling, fishery, food stalls, building materials (such as tiles and bricks) and city transportation. It is also clear that challenges are clustered in the eastern part of Indonesia, where energy prices are high due to long-distance transportation of fuel and a lack of local infrastructure (e.g., roads from harbours to centres of local economic activities/SMEs). Further research could usefully explore these issues in more detail and propose targeted mechanisms for supporting vulnerable SMEs during price reforms.
3. **Indirect impacts of energy price increases are likely to have the most serious effects on SMEs, especially through the costs of transportation, raw materials and capital.** This is the case for three reasons. First, SMEs in general are much less energy-intensive (including fuel-intensive) than LEs, so direct impacts are relatively smaller. Second, all firms of all sizes are dependent on at least land transportation, which has always been the main focus of fossil-fuel subsidy reform in Indonesia. Third, Indonesian SMEs, especially SEs, are heavily dependent on low-income households as their main buyers, and this particular group has always been the most seriously affected by increases in the price of fuel and related inflation, which reduces their available income and leads to a decline in market demand.

There is little value in further debate about why the government has decided to cut fuel subsidies. It is simply because the scale of subsidy expenditure is unsustainable, and that the fuel subsidy—intended to help low-income groups—appears to have been poorly targeted and thereby misallocated. Instead, the following actions should be taken by both government and SMEs to compensate for the problems that could be caused by the fossil-fuel subsidy reform.

From the government side:

1. **Increase access to bank finance for business-feasible SMEs, especially those that have great potential to contribute to GDP and future exports.** For example, this might include SMEs related to textiles and garments, foods and beverages, leather products, wood products (especially furniture), creative goods and handicrafts.
2. **Eliminate all unnecessary bureaucratic procedures to reduce time-consuming and costly steps related to SMEs getting the licenses they need.** This might include licenses to import raw materials and export goods and services.



3. **Reallocate a proportion of the funds that have become available from subsidy reforms for the development of infrastructure and public transportation facilities, especially in rural areas where the majority of SMEs are located.** Good infrastructure and public transport facilities will help SMEs in procuring raw materials and marketing. Funds can also be used to tackle SMEs' other priority problems: for example, to invest in education to increase the medium-term availability of skilled workers that SMEs need to grow and expand. Funds could be reallocated more generally to help implement Indonesia's existing policy in support of SMEs, which includes human resource development, entrepreneurship development and financing.
4. **Support SMEs to improve their efficiency in using energy.** For example, SMEs could be provided with technical as well as financial assistance in identifying opportunities for efficiency improvements and modernizing their production systems.
5. **Help SMEs utilize alternative energies.** Generally, SMEs need technologies that they do not have. It is therefore key to support the transfer of technologies with various partners, such as universities, LEs, non-governmental organizations and government agencies. Many issues need to be addressed for the effective transfer and development of technology for developing alternative energies, including institutional development, information, partnership and networking, collaborative research and development, intellectual property rights, financing and infrastructure.

SMEs also have a responsibility to take preparatory actions, of which at least the following two should be considered:

1. **Take appropriate measures to adapt to higher energy prices by increasing energy efficiency.** For example, using more efficient methods to heat or to process foods.
2. **Explore long-term solutions to rising energy costs.** This might include using alternative energy or developing renewable energy. For the sake of efficiency and taking into account the capacities of many SMEs, this action should be taken in a cooperative way either among SMEs or with local community actors such as universities or non-governmental organizations. As one feasible action, SMEs could develop electricity from small-scale or renewable power sources such as wind, solar, micro-hydro systems or sustainable biofuels. In many places, for instance, electrification from biomass energy has led to the development of SMEs in areas such as rice parboiling, roofing tiles and curing tobacco.



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