



Effect of Forest Law Enforcement Governance and Trade License on Competitiveness of Indonesian Wooden Furniture in the European Union Market

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ABSTRACT

In May 2003 the European Union (EU) initiated an action plan (FLEGT - Forest Law Enforcement, Governance and Trade) followed by the issuance of EUTR (European Union Timber Regulation), effective March 2013, which prohibits the entry of illegal timber and timber products into the EU market. Indonesia as one of the exporting countries reacts with the FLEGT-VPA since 2007 where the Indonesia Timber Legality Assurance System (Sistem Verifikasi Legalitas Kayu - SVLK) forms the basis of the agreement and recognized by the EU through FLEGT licensing of November 15, 2016. This study is intended to examine the effect of licenses on competitiveness of Indonesian wooden furniture products in EU market. The study covers 8 provinces of wooden furniture center in Indonesia. The methods used include interviews, surveys, focus group discussions; involving producers and related institutions. The data obtained were processed and analyzed using Diamond Porter Model. The FLEGT license has increased the competitiveness of Indonesian wooden furniture in facilitating entry into the EU market. However, there are other factors at play such as relatively new nature of FLEGT-VPA and FLEGT licensing, transition period that every major policy process such FLEGT Licenses experience, level of implementation the EUTR as an incentive towards FLEGT-VPA, timber price, quality, availability, technical performance, logistics and fashion trends, especially for furniture retailers. All these factors have implications for the competitiveness of Indonesia's FLEGT licensed timber in the EU.

KEYWORDS: FLEGT-VPA, FLEGT License, Diamond Porter Model, competitiveness, Indonesia wooden furniture.

I. INTRODUCTION

European Union (EU), which consists of 28 countries, has an important role in trade of world wooden furniture (Renda et al 2014). EU has become the world largest importer in wooden furniture between the periode of 2005-2016 as the total import volume reached 43% of the total world wooden furniture import (UN Comtrade, 2017).

Despite being seen as the world largest importer in wooden furniture, the majority of the wooden furniture supplies come from the EU member countries. Hence, the exporters that came from countries with Voluntarily Partnership Agreements (VPA) enter a very crowded and competitive market (IMM, 2017). However, the wooden

furniture supply from the EU member has decreased from 92% in 2003 to 85% in 2012. This opens up the opportunity from countries outside of EU to enter the market (Renda et al. 2014 and Lord et al. 2010). China and other countries took advantage of this increase of opportunity to supply the wooden furniture to EU market. As much of 84 % of imported furnitures that originated from the countries outside of EU comes from Asia Pacific; dominated China with market share reached 64% of the EU's total import came from countries outside of EU (Renda et al. 2014). As UN Comtrade (2017) also mentioned, based on the export value, China was the main wooden furniture supplier in 2006 to 2015. In 2006 China's market share in the EU was 48.03%,

increasing to 62.54% in 2014 and slightly decreasing to 61.83% in 2015; but China remains the leader of supplier to the EU.

Indonesia is the second largest exporter after China in 2006, but the value of export of Indonesian wooden furniture to the EU was only 23.79% of the value of Chinese exports. Indonesia's wooden furniture exports to the EU continued to decline in the period 2006 – 2015, while Vietnam continued to enjoy average export growth of 4.4% per year with an aggregate value of 34.8% in the same period

Suwita (2016) mentioned that the competitiveness of Indonesian wooden furnitures in EU market has decreasing for the last eight years. Furthermore, according to Lord et al. (2010), the decreased of Indonesian market share in wooden furnitures caused by the supply side impediment that include the production, quality and the product distribution.

The increase of the global awareness to reduce the illegal logging has motivated EU to actively participate through the governance of their trade regulations. Since the 1st of March 2013, EU implemented the European Union Timber Regulation (EUTR) that ban the illegal timber and timber product that come from the illegal timber to enter the EU market. In order to verify that all the timber imported comes from legal source, the EU requires that all the importers do the due diligence.

The EUTR is one of EU action plans in the context of Forest, Law Enforcement Governance and Trade (FLEGT) to combat the illegal logging by regulating the Trade (T) as the complement to the other action plans through the law enforcements and improving the governance (as the FLEG part of the FLEGT). In order to implement the FLEGT action plans, EU demands that the producers should engage in the Voluntary Partnership Agreement on FLEGT (FLEGT-VPA) which is a voluntarily partnership between EU with the country of producers. Once EU agrees to implement the agreement, the partner country will receive the FLEGT licence. Based on that licence, the wooden products from the partner countries no need to provide the due diligence and could enter the EU market. This could improve the competitiveness of the wooden products and benefits the partner countries.

Indonesia is one of the 15 wood producers countries that agree to implement the FLEGT-VPA agreement with EU. To this day, Indonesia is the only one that holds the FLEGT-VPA licence from EU. In accordance to that, this paper questions ‘how is the role of FLEGT-VPA licence in improving the Indonesian wooden furniture competitiveness in EU market?’ To answer the question, this paper will describe and analyse the role of the FLEGT licence in improving the competitiveness of the Indonesian wooden furniture.

II. CONCEPTUAL FRAMEWORK

The increase of the illegal logging activities has driven the international environmental organizations to ban the tropical wood products in the international market. As the results of this ban, the buyers from USA, Japan and EU required the producers to provide the ecolabel certification to all the wooden products they produced (Indrawan, 2012).

The rise of illegal logging also received responses from producer/exporter countries in East Asia and other regions and in September 2001 held a meeting in Bali in order to intensify efforts at the national level and strengthen bilateral, regional and multilateral cooperation in the context of eradicating illegal logging. The result of this meeting was the *Bali Declaration on FLEG (Forest Law Enforcement and Governance)*. The declaration stated that the countries involved in the meeting would promote the eradication of illegal logging by improving the governance, to support the law enforcement activities.

Following the Bali Declaration, the main consumers of the wooden products stated that they would also support the initiatives by regulating their market access to improve the trade governance. EU was the first consumers that respond the initiatives by preparing the FLEGT action plans. In 2006, Japan following the EU steps through implemented Goho-wood, then followed by USA in 2008 with their *Lacey Act Amendment*, and in 2008, Australia implemented *Illegal Logging Prohibition Act (ILPA)* (Jonsson et al, 2015 in *UNECE/FAO Forest Products Annual Market Review 2014-2015*). The various actions that implemented by the importers countries became obstacles to enter that countries markets, so that the ability of producing countries to fulfill them is a competitiveness for the producing country.

Competitiveness is the ability to create a way to improve the welfare of the community by increasing the percapita income and excel in global productivity, efficiency, and profitability which in accordance to the international specialization (Maulana, 2017). Maulana (2017) argues that the main factors that influence the competitiveness are demands and supply. The Data that is available usually showed the analysis on the supply so that the production could be pressed as the competitiveness measurement. Meanwhile, if we look at the demands, we could see that the producers do not have enough capability to enter the international market because of the market dynamics such as the change of the taste and technology and various protective policies implemented by the buyers. However, there are different factors that influence the export on primary products and the manufactured products.

Ray et al. (2007) mentioned that the high demand on products that are legally verified motivated the emerging of the concept of market competitiveness through the policy improvement of the legal wood supply. EU market is one of the markets that demand the legality to comply with the environment sustainability standard at the international

market. Renda et al. (2014) also mentioned that the need to comply with the environmental standards is one of the key factors that influence the wooden furniture competitiveness when the products enter the EU market.

Generally, Renda et al. (2014) argued that the competitiveness in the furniture industry is distinguished based on upstream or downstream of the value chains. The upstream value chains' competitiveness could be observed from the (1) profitability, (2) raw material and its components supply, (3) the cost and the availability of the skilled labours, (4) technology investments, (5) research and development, (6) Innovation and design that includes the product's and design trend, (7) policy issues on research and development, innovation, copy rights and safety, (8) environmental issues and (9) the price trends. Meanwhile, the downstream value chains competitiveness are influenced by (1) the demand determinants, that include the disposable income of the consumers, housing investments and the demographic changes, (2) the contract segments and (3) retailers' format. However, another important key that need to be considered is the ability to combine those factors in to produce a good quality product in competitive price.

Scholars argued that the concept of competitiveness could be based on the comparative advantage concept based on the economy concepts Ricardo and competitive advantage based on the political and business concepts (Daryanto, A. 2014). The competitiveness could be seen in many levels, such as state, area, industry or group (Voon, 1998). According to Cho (2003), the international competitiveness of the national industry gain a superior market position when the industry reached high interest and constant growth on a certain time compare to other competitors.

Michael Porter introduced the theory of national competitive advantage in 1990. Porter argued that the welfare of a country is created not inherited; the growth is not only generated from the use of the natural resources, or the abundance of the labour, the interest rate, the exchange rate or the high economical scale as mentioned in the classical theories on welfare. Porter's competitiveness theory is known as "the diamond model" as Figure 1. This theory is essentially based on the principle of competing strategies in each industry. However, this theory is interesting because it is combined with an understanding in the fields of technological innovation, industrial economy, economic development, economic geography, international trade, political science and industrial sociology which are usually not included Porter (1990) continued that the countries that had succeeded in the industry or subsector of the industry are those that have the most supporting national 'diamond'. Porter also mentioned that there are four important characters of a nation as the determinant of the competitiveness. Those characters shape the environment where its local companies compete that would inhibit the

creation of the competitive advantage. Those four characters are as bellow:

1. Factor condition is a position of a nation in relation to the production elements such as skilled labours or infrastructures needed to compete in certain industry.
2. Demand condition is a character based on the home demands for industrial products or service.
3. Related and supporting industries; the availability of the supplier industries and supporting and related industries that have the international competitiveness.
4. Firms' strategy, structure and rivalry related to the management of a company to create, organize and govern the business and characters of the national competitiveness.

Those four characters of the competitiveness determinants later, both as individual or systematic would create a context where the companies were established and competing (Bakan and Dogan, 2012). This context comprises: (1) the availability of resources and skills that would be needed in the competitive advantage in a certain industry, (2) information that shapes the seen opportunities, (3) the direction where the resources and skills would be accumulated, (4) whether the goal of the owner, manager and employees are part of the competitiveness; and the most important is (5) whether there is incentive for the company to invest or innovate. The success of one nation in a certain industry is supported by the most dynamics and challenges environment that could stimulate and promote the companies to continuously innovate and extend their competitiveness. In this sense, the most successful countries in their industry or their sub-sector industry are those with the most valuable national 'diamond'.

A part of those determinants characters, Porter (1990) added two other important variables that needed and influenced the national system to complete the 'Diamond' Porter theory. Those are: (1) opportunity or chance and (2) government.

Opportunity or chance is an event that is occurred out of the control of the company (and the government). The opportunity could be present as new technology, warfare, the development of external politic and the big shift in international market demands. The opportunity could create disconnection that could dilute or reshape the structure of the industry and thus provide new opportunity to replace the old opportunity for the companies. The opportunity could play and important role to replace the competitive advantage in so many industry.

The government could increase or decrease the national competitiveness. The role of the government could be seen clearly through the policy that could give influences each character of the competitive determinants. The regulation could turn the condition of the domestic demands. Education investments could change the condition factor. The buying activity from the government could stimulate

the related and supporting industries. The policy that is implemented without any consideration on the impacts of the whole determinant system of the competitiveness tends to weaken the national competitiveness.

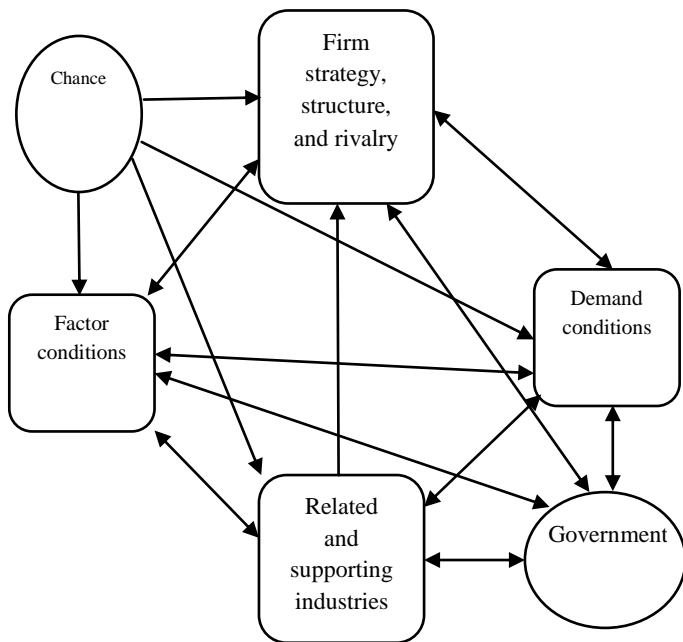


Figure 1. Porter Diamond Model (The Diamond by Porter, 1990)

III. RESEARCH METHODOLOGY

FLEGT licence is a new standard in the wooden furniture trade between EU and producer countries in FLEGT-VPA, where Indonesia is the only country that holds the FLEGT licence from EU. This research is an exploratory research where the role of the licence will be examined and analysed using inductive approach. We use Diamond Porter model to evaluate the role of the FLEGT licence as the competitive determinants in the Indonesian wooden furniture trade.

We use primary and secondary data in this research. Primary data was collected through online surveys by sending questionnaires to 459 respondents who export wooden furniture to EU and other markets. Those exporters were from eight provinces known as the center of the wooden furniture industry, such as Bali, Banten, DI Yogyakarta, DKI Jakarta, West Java, Central Java, East Java and North Sumatra. 125 exporters (27%) responded our questionnaires. In order to get in depth and clarify information on certain issues based on the surveys, we carried on focus group discussion (FGD). We invited 15 informants; those were government functionaries, associations, entrepreneurs, exporters, academics, Timber Legality Verification institutions (Lembaga Verifikasi Legalitas Kayu – LVLK), and furniture consumers. They were invited because of their knowledge and experience in furniture industry and or their involvement in the FLEGT-VPA agreement between

Indonesia and EU. Secondary data acquired from related ministerial offices, entrepreneurs associations, and International Independent Market Monitoring (IMM) institutions. Secondary data collected comprised of scientific publications, thesis/dissertations, reports, statistical data, website and other sources that support the information needed.

IV. RESULTS AND DISCUSSION

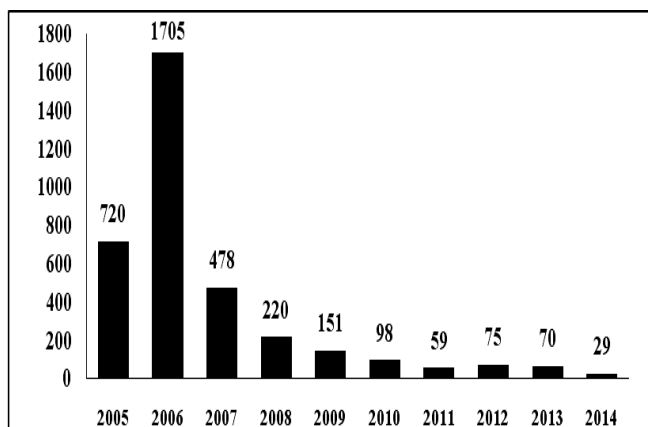
FLEGT Licence (the licence) has important role in supporting the competitive advantage of the Indonesian wooden furniture in the EU market. Based on the analysis using the Diamond Porter Model, the results show that:

The licence is closely related to the role of government of Indonesia in supporting the improvement of the competitiveness of the Indonesian timber industry, including wooden furniture by implementing SVLK (Timber Legality Verification System) through all timber value chains since 2009. By implementing the SVLK, producers are obliged to have a certificate of sustainable forest management or timber legality certificate to ensure that all timber harvested, processed, transported and traded is legal.

SVLK is Indonesia multistakeholder certification that established and developed in 2002. The objective of the SVLK is to reduce the illegal logging activities by improving the timber/timber products governance to support law enforcement policy in reducing the illegal logging activities.

Indonesia and EU set up FLEGT VPA agreement in 2007. where Indonesia make the SVLK as the basis of the agreement. The mandatory implementation of the SVLK has given confidence to the EU that timber and timber products produced, transported, processed and marketed from Indonesia have guaranteed legality. EU recognized the SVLK standards and its implementation in Indonesia by granting FLEGT licenses to Indonesia since November 15, 2016.

The mandatory implementation of SVLK has 2 impacts: First, supporting the sustainability of Indonesia's forests, because the obligation of certification for all business actors means that all business actors must use timber from legal sources so that there is no longer the use of wood from illegal logging activities. Although there is no research related to the impact of SVLK implementation on the reduction of illegal logging in Indonesia. The obligation to certify the whole timber supply chain will reduce the illegal logging activity for commercial use. The data provide by Ministry of Environment and Forest (2016) shows the decreasing trend of number of illegal logging cases from 2005 to 2014 (Figure 2).



Source: Ministry of Environment and Forestry (2016)

Figure 2. Numbers of illegal logging activities in Indonesia

Second, implementation of SVLK will guarantee that all the timber products that are produced and traded in Indonesia are legal. In doing so, it is expected that the obstacles resulted by the implementation of EUTR by EU or other regulation by USA, Australian and Japan could be eliminated.

Those impacts show that the government improves the national competitiveness in EU, USA, Australia and Japan; where supports the business to face the market challenges. EU recognized the SVLK standards and its implementation in Indonesia.

The mandatory implementation of SVLK improves the determinant factors of Indonesian wooden furniture national competitiveness, as explained below:

- Factor Condition. The implementation of the FLEGT licence affects the supply of legal raw material wooden furniture industry. This will support the Indonesian competitiveness in providing the legal raw material for the EU market. Hence, this will create the image Indonesia as a supplier for legal timber supplier in the world.
- Demand condition. The implementation of the licence would also affect the demand condition. The international demand on legal raw material/ legal products will also increase and will affect Indonesian competitiveness to supply the legal timber.
- The related and supporting industries for wooden furnitures, such as primary industries (plywood and sawmill) and the advanced industries (such as industry of Medium Density Fibreboard – MDF) would also be improved because of the legal raw material they use.
- For the purpose of the firm strategy and rivalry, FLEGT license advantage the company, as follow: (1) In competing in the EU market with the enactment of the EUTR, ‘legal’ Indonesian furniture that has been able to use FLEGT licenses; benefit from entering the EU market because there is no need for due diligence anymore as products from other countries. Companies could access 28 members of EU without any due

diligence, (2) faster delivery, (3) benefited as the suppliers of legal timber and protect the environment, (4) could increase the selling price because of the certification; in the international trade, buyers required that producers could provide goods that are obtained in a environmental and social friendly (Stefanak, 2011; Zeng et al, 2012; Wiersum and Elands, 2013; and IMM, 2017). In this sense, if the industries apply the FLEGT licence, it would have positive impacts to the wooden furnitures competitiveness.

Despite the positive impacts of FLEGT License to the determinant factors of the Indonesian timber trade competitiveness, however, the FLEGT license could not influence the opportunity. This because ‘opportunity’ is an event that could not be controlled by the companies nor the government.

The analysis on the impact of the determinant factors of Indonesian wooden furnitures competitiveness and the opportunity attribute, showed that, both individual and systematic, this could create a context where Indonesian companies could compete in international market (Bakan and Dogan, 2012). They refer context as ‘new’ environment that related to the supply of the legal raw material and the readiness to provide legal products. This ‘new’ environment became the main determinant factor in Indonesian wooden furniture competitiveness in the international market.

However, based on the observation of market independent (IMM, 2018), there is no increase on Indonesian wooden furniture imports in EU market after the 13 months of the implementation of FLEGT (see figure 3). The Indonesian wooden furniture imports, as explained in HS Code Chapter 94 gradually decreased for the first three quarter of 2017 and stay stable at the lower end during the last quarter of 2017. This is related to the transition period during which the consumer and buyer awareness of a new FLEGT licensed product is not yet fully developed. However, the prospects are increasing. According to the Independent Market Monitoring (IMM) project funded by the EU and coordinated by ITTO, by late 2017/early 2018 the market sentiment in the EU about FLEGT timber from Indonesia is generally positive. Among the importers surveyed in major importing countries such as UK, NED, GER, and France the majority (56%) are well aware of FLEGT licensed timber. 78% of the importers expressed their preference for FLEGT licensed timber and indicated that quality and pricing are an advantage. However, timely delivery is an issue. In addition, IMM team is also aware that the current information on market perception of Indonesia’s FLEGT licensed timber does not include EU member states in eastern and southern Europe. Therefore, consumer and buyer preferences in relation to FLEGT timber need to be assessed further.

The combination between price, performance/technical quality and the supply/logistic also part of critical

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consideration beside also trends that also consider as important for the furniture retailers in EU.

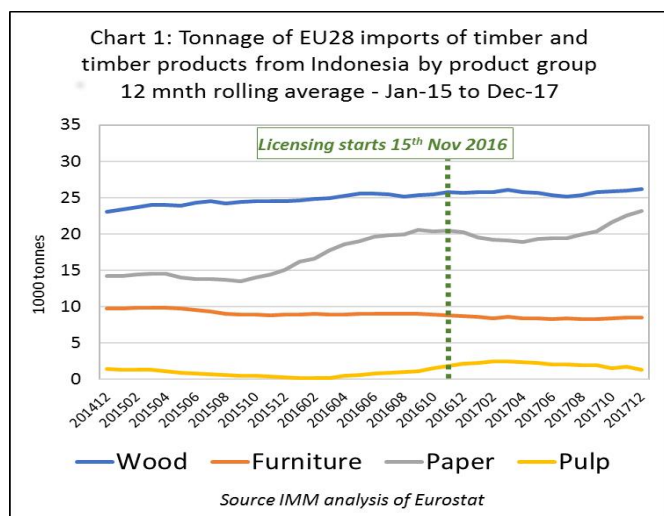


Figure 3. Import on Indonesian timber products by EU 2017 (2017)

CONCLUSION

The implementation of FLEGT benefits the Indonesian timber products competitiveness. The image of Indonesian timber products has improved and known as industry products that environmentally friendly. In this sense, the Indonesian wooden furniture competitiveness is increased for the EU and other regulated market.

Early indications are that EU market is responding well to Indonesia's FLEGT licensed timber. The buyer/consumer perceptions of reliability, quality, and price are positive, although delivery is still an issue because of some document mismatches and similar systemic issues. However, these are improving as well...

The actual potential of FLEGT licensing to increase the competitiveness of Indonesia's timber exports to the EU needs further analysis as several additional factors are at play at these need to be better understood:

FLEGT licensing is a relatively new system that is still in the process of "teething" or overcoming the initial system bottlenecks

EUTR, is a new policy system as well and its implementation across the member states in the EU still varies. The more uniform and synchronized implementation of the EUTR, the better potential for FLEGT products...

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