STRENGTHENING THE DEVELOPMENT OF SMEs IN INDONESIA

Introduction

The purpose of this paper is to highlight the role and the potential of a crucial class of economic actors, dynamic small and medium enterprises (SMEs). Both in its policy orientation and its industrial structure, Indonesian industry has long been characterised by a "missing middle". Aggregate industrial structure is dualistic, with employment and output concentrated among large firms and micro-enterprises, and only modest contributions by SMEs. The macroeconomic climate favoured especially large-scale import-substituting industries (MLSIs), leading to a concentration of investments in specific sectors and at specific locations. Special incentives, opportunities and subsidies have been provided to large business groups and to large-scale public industrial enterprises, and there has been a long series of programmatic and regulatory interventions in support of microenterprises. But dynamic and independent SMEs typically lack the political influence to enjoy the benefits of special incentives, and are too large to get the assistance to microenterprises[1]

The decline in labour absorption in agriculture and the slow growth of employment opportunities in the other sectors of the economy, combined with the fact that the growth of the labour force has accelerated, have led to the problem of un-and under-employment. Actually Indonesia is undergoing from economic growth of 7% a year to a deep recession which will throw many out of work. The unemployment rate jumped from 7.7% in 1996 to 10% last year, and has much further to go.

All this has led to a new emphasis on the development potential of SMEs because they help to create employment and to generate income, especially for the poor, with lower capital cost than in longer firms and permit wider participation of especially rural population in the economy by small, indigenous entrepreneurs. These are important reasons for the Indonesian government to support the development of small firms in the country more seriously.

SMEs have to deal with a series of difficulties in export, investing abroad and industrial upgrading. The main difficulties for SMEs to *export* are the lack of international business information and inexperience in international business practices; competitions from other developing economies; the rising of labour cost and the lack of ability to maintain the level of quality. The difficulties encountered by SMEs in *investing abroad* are the lack of orientation and experience as well as the lack of resources to invest abroad. Lack of information about business opportunities abroad aggravates the problem. The main constraints in *industrial upgrading* lie in the incapability to adjust to technological upgrading due to lack of resources, especially skilled human resource. The lack of skilled human resource hampers the SMEs in adjusting to changes in industrial structure. SMEs are stuck with traditional technology and tend to avoid change.

During Repelita VI (1994-99) the government aims to consolidate the growth of export-oriented industries in the Repelita V period, stimulate the growth of new industries, promote increased efficiency and higher levels of international competitiveness, create an investment climate conducive to the establishment of export oriented industries, and encourage the expansion of export processing zones. More specifically, the government's industrial policy guidelines call for improvements in the distribution of industrial inputs and the dissemination of export market information, a more effective exploitation of the opportunities offered by preferential trade arrangements such as the General System of Preferences (GSP), and the adoption of improved production technology and equipment in order to enhance the quality of industrial goods manufactured in Indonesia. In addition, the government has also tailored some of its other policies to the promotion of export-oriented

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[1] Albert Berry and Brian Levy, Indonesia's Small and Medium-Size Exporters and Their Support Systems, Policy Research Working Paper, The World Bank, December 1994

industrialisation, with particular incentives being given to investors establishing export-oriented enterprises and foreign banks being required to devote a substantial proportion of their loan portfolios towards export credits.

1. The economic structure

The Republic of Indonesia is the largest archipelagic country in the world, comprising 17,508 islands stretching along 5,120 kilometers from east to west, and 1,760 kilometers from north to south.

In 1995, Indonesia's population reached 195 million with growth rate of 1.60%. The population is concentrated most heavily on the fertile islands of Java, Madura and Bali; in certain area exceeds 1,000 people per square kilometers. About 44% of the population is under 25 years old, representing a potential workforce.

Indonesia has become in the last years one of the growth centers and has recorded with other Asean countries, like Malaysia, Philippines, Singapore and Thailand one of the fastest economic growth in the world. In 1995, GDP at current market prices amounted to US$ 190.3 billion or approximately US$ 1,023 per capita with an economic growth rate of 8.1% (in 1996 the growth rate was about 6.5% and in 1997 about 6.5%). Manufacturing has continued to be one of the most rapidly growing of major economic sectors, which accounted for 24.3% of GDP in 1995.

In the face of rapid economic expansion in 1980s, Indonesia has effectively contained inflation to single-digit annual increase every year despite major inflationary pressures. These pressure have included a gradual depreciation of the rupiah against the US dollar, a substantial devaluation against the Japanese Yen, a widening of the tax base and the elimination of subsidies on fuel, food and other basic consumer goods.

Table 1

The inflation rate in the five years:

Year	The inflation rate (%)
1992	4.9
1993	9.8
1994	9.2
1995	8.64
1996	8.00
1997	9.20

Source: Central Bureau of Statistics

The Indonesian economy is currently going through a rapid structural change in order to minimise its too much dependence on oil and gas export. The share of oil and gas in total exports, which in 1985 was 68,2%, had by 1995 fallen to 23%. The non-oil/non gas export has risen from 31.8% in 1985 to 77% in 1995.

Table 2

Contributions of Sectors to GDP, 1994 and 1995

	1994	1995
Agriculture	17%	16.9%
Mining and quarrying	9.4%	9.2%
Manufacturing Industries	23.1%	24 %
Electricity, gas and clean water	1.1%	1.1%
Construction	7.3%	7.6%
Trade, hotel and restaurant	17.1%	16.7%
Transportation and communication	7.1%	7.1%
Finance, leasing, and services	18.4%	
Services		9.2%
Banks & Financial Institutions		8.9%

Source: Central Bureau of Statistics

Rapid transformation of Indonesia's economic structure has been driven by the economic boom generated from oil in the 1970s resulted in higher contribution from the manufacturing sector in GDP (from 12.7% in 1983 up to 23.1% in 1994). With trade, services, transportation and communication also growing rapidly along with the expanding economy, agriculture's share has been cut from 22.9% in 1983 to 17% in 1994. The mining and quarrying sector also has been cut from 20.8% in 1983 to 23.1% in 1994.

The composition of Indonesia's manufacturing broadly reflects the country's relative faction endowments, in that resource-based and labour-intensive manufacturers are dominant items (table 3). Among the major manufacturing branches in Indonesia textile and footwear industries have recorded a remarkable growth performance. Textile industry has acquired a highly integrated structure and is aimed mainly at exports market. Over time it has become an important non-oil/gas source of foreign exchange. A number of advantages are available to textile producers in Indonesia: a large domestic market, a skilled and educated labour force, and low labour costs. The exploitation of these advantages has enabled the Indonesian textile industry to grow substantially in both size and scope. Similarly, there has been a dramatic increase in the shoes industry's output, especially in the production of rubber-soled sports shoes and leather shoes. Significant domestic and foreign investments have contributed to the creation of a substantial manufacturing capacity for footwear.[2] In addition, a large number of SMEs has grown up across the country supporting some stages of the industrial process. These SMEs are mainly engaged in leather tanning and play an important role for bigger textile and footwear industrial centres.

Table 3

Manufacturing (Quarterly Production Indices of the Major Manufacturing Industries - Large and Medium Industries, 1993 = 100)

	1994	1995	
Description	Average	Quarter I	Quarter II
Food, beverages and tobacco	132.57	129.03	124.56

[2] Ibidem, pp. 100-110.

Textile, garments and leather	109.09	118.70	117.99
Wood, bamboo, rattan, willow and the like, including furniture	103.06	102.79	105.01
Paper and paper products, printing and publishing	113.65	121.23	124.57
Chemical	108.92	114.12	113.66
Non metallic mineral products, except coal and petroleum	125.91	142.99	134.28
Basic metal	107.62	130.93	132.01
Fabricated metal products machinery and equipment	113.63	112.11	109.98

Source: Central Bureau of Statistics

The changes in the Indonesian economic structure were made possible by exploitation of new natural resources, making better use of indigenous raw materials for exportable items and promotion of labour intensive type export oriented industries. Since the mid-1980s, the investment and trade policies were liberalised considerably and the deregulations in the industrial policy was pursued.

Foreign trade plays a vital role in Indonesia's economy and economic development. Exports totalled US$. 45,418.0 million and imports US$. 40,628.7 million. Manufactured export growth has been a major component in Indonesia's successful adjustment of current account balance. Indonesia registered an export growth from 29.1 billion US$ in 1991 to 45.4 billion US$ in 1995. Indonesia was also able to reach a trade surplus of 4.8 billion US$ (table 4). In this process SMEs played an important role in making a significant contribution to the overall economy. Phenomenal growth of exports has continued into the 1990s with products such as toys, electronics, textiles, garments, leather, footwear and furniture.

Table 4

Development of Indonesia Export-Import (Billion US$)

Year	Export	Import	Trade Surplus
1991	29.1	25.9	3.2
1992	34.0	27.3	6.7
1993	36.8	28.3	8.5
1994	40.1	32.0	8.1
1995	45,4	40.6	4.8

Source: Central Bureau of Statistics

As an essentially resource based economy, Indonesia has long been dependent on imports to satisfy its demand for manufactures. Yet the booming industrial development performed by the country has reduced this dependence. Above all, the decline of manufactured imports has been accompanied by a significant shift in their composition. Whereas the share of capital goods imports has risen, underlying the development of Indonesia's own downstream processing and manufacturing, the need to import consumer goods has increasingly diminished. Indeed, the share of processed food, iron and steel products has declined due to their manufacturing within Indonesia. On the other hand, textiles and garments as well as machinery and equipment imports has risen constantly, showing Indonesia's commitments to industrial activity.

Traditionally Japan is the leading trading customer in Indonesia followed by the United States (table 5).

Table 5

Major Trading Customers (Billion US$)

Country	1994	Share	1995	Share
Japan	10.93	27.3%	12.29	27.1%
USA	5.83	14.6%	6.32	14 %
Singapore	4.15	10.3%	3.77	8.3%
Netherlands	1.32	3.3%	1.45	3.2%
Hong Kong	1.32	3.3%	1.66	3.7%
Germany	1.26	3.2%	1.38	3.1%
United Kingdom	1.04	2.6	1.13	2.5%
Malaysia	0.74	1.9%	0.99	2.2%
Australia	0.71	1.8%	0.92	2.1%
Italy	0.66	1.7%	0.78	1.8%
Spain	0.45	1.2%	0.53	1.2%
France	0.42	1.1%	0.52	1,2%
Belgium & Luxembourg	0.41	1.1%	0.66	1.5%
Thailand	0.40	1.0%	0.70	1.6%
Philippines	0.36	0.9%	0.59	1,3%

Source: Central Bureau of Statistics

During the period from 1979 to 1986 there seems to have been a slight reduction of the duality in the industrial sector. The number of large and medium sized operations (with annual growth rates of 8.9% and 6.4%, respectively) almost doubled (from 0.52% up to 0.83%) while their contributions to employment rose slightly (from 19.37% up to 32.60%). During the same period, the number of cottage and household firms (CHIs) and small factory units (SIs) showed a decline in employment from 90% to 67% and also the annual figures of the number of establishments show a slight decline from 99.5% to 99%.[3]

Although the number of small operations and their contribution to employment have apparently dropped significantly the percentages confirm that small firms are still a significant and frequently dominant component of the manufacturing sector in terms of the number of establishments as well as employment.

The increase in number of workers in medium and large firms (MLSIs) at a greater rate than in SIs indicates that the MLSIs are playing an increasingly important role in labour absorption even though they lag behind SIs and CHIs in terms of total number of establishments and persons employed. Employment in MLSIs has been created, to a significant extent, through the establishment of new enterprises, especially in the 1980s. Massive foreign investments and a wide range of economic reforms in the past ten years, which provided relatively more facilities to large well-established businesses than to small relatively poor units seem to be the major reasons which explain the growth of MLSIs in the 1980s. Table 6 show us that the job opportunities by sector are indicated in.

[3] Tambunan, T., The role of Small Firms in Indonesia, Small Business Economics, Review, 1992, p. 60-61

Table 6

Job opportunity by sector

	1996	1997
Agriculture	39.00	39.13
Mining	0.94	0.96
Manufacturing	11.64	12,14
Electricity, Gas and Potable water	0.26	0.26
Construction	4.32	4.63
Trade	13.01	13.36
Transportation	3.51	3.58
Social Services	11.99	12.31
Financial Services	0.94	0.96

Source: Department of Manpower

In the process of industrialisation, the ability of small firms to survive depends much on whether they are flexible enough to transform themselves into highly efficient production units by up-grading of production technologies, capable of innovation and of raising product quality for the export market and able to adapt themselves to changing demands of domestic and foreign consumers. Small firms which are not able to implement a innovation strategy will quickly decline and exit from the market in the course of industrialisation and on the other hand small firms will graduate to medium size industries.

A main constraint for very small firms (CHIs) is the relatively low level of labour productivity. The following factors can help us to explain this main characteristic of small firms: a) bad management and marketing; b) employment is dominated by unpaid family members who work irregularly or part time and for a limited number of days per year; c) the production process has strong seasonal fluctuations; d) under-reporting by entrepreneurs who do not keep systematic records; e) different price structure in rural and in urban areas and different pricing systems between producers in CHIs and in other size groups of industry; and f) a certain proportion of the output may be for self-consumption and is, therefore, not included in the reported value of output or sales[4].

As in many developing countries, the foods processing, beverages and tobacco industries are clearly dominant among small industries in Indonesia, ahead of textiles and wood processing, the building materials and ceramics industries. According to industrial census record in 1986, two main sectors namely foods processing and wood processing employ the majority of the work force (74% and 83% respectively) in small and very small firms.

2. Definition of SMEs

First of all we have to define small and medium industries (SMIs) in Indonesia. The term "SMI" in broader context includes heterogeneous groups of production and service units comprising:

1. livelihood activities that cannot be categorised as business enterprises;
2. micro-industries, that are normally used to denote a mix of livelihood activities and very small business oriented production units;

[4] Ibidem, Tambunan, p. 66-67

3. cottage industries, that are similar to micro-industries but comprising greater element of business orientation;
4. small-scale industries, that comprise smallest constituents of the modern industrial sector;
5. medium scale industries, that are modern, medium-sized industrial enterprises.

In this paper, the focus of discussions will be placed on cottage, small and medium industries. The *Central Bureau of Statistics* distinguishes, according to the number of workers, between cottage and household firms (less than 5 workers), small factory units (between five and nineteen workers) and medium-scale firms (between 20 and ninety-nine workers).

3. Status of SMEs in Indonesian Economy

Following the 1984 shift of industrial policy emphasis toward promoting exports in the manufacturing industries (excluding the oil industry), export effected by the manufacturing industries have risen dramatically. Here the large industries in the fields of textiles and plywood have made noteworthy contributions. While the agro-industrial sub-sectors have contributed only slightly to growth in export trading since 1985, the textile sectors (cotton spinning mills, cloth weaving, clothing), plywood, fertilisers and cement have taken over from the oil industry as the driving forces behind export dynamics in Indonesia business. Miscellaneous industrial sector particularly in the sub-sectors like toys, sporting goods, woodworking and rattan, has also made a considerable contribution to growth in exports. In all, the manufacturing industry share in overall non-oil exports rose in just five years from 25% to 41% (1985 to 1990).

Although Indonesian industrial export output was generated primarily by the large and medium sized companies, the small industries were able to boost exports enormously between 1985 and 1990. Rising exports - particularly in foods, textiles, clothing, leather goods and by the arts and crafts trades increases from 4% to 20% the export share in small industry output.

Small industry's share in overall manufacturing industry exports rose to a high level between the period 1985-1990. In total, between 1985 to 1990 small industries were able to double their export output ratio from 4% to 8%, measured against the industrial sector as a whole (including traditional raw materials industries but without oil related business).

Despite this considerable growth occurred in the SME sector in Indonesia, the majority of the SMEs with few exceptions have little incentive and motivation to restructure their production methods as long as there is demand for their products in the domestic markets. It appears that these are part of a closed circuit of supply and demand among the low income sector of the population, in which questions of technological competence and increased performance are hardly of any significance.

It is clear the SMEs include companies of varying degrees of capability and many of them distinguish themselves from the general image of technological backwardness among SME producers who mainly deal with the lower segment of the market. Among these SMEs there are few those who are operating in the market with high quality and competitive products are registering excellent record of performance both in the domestic and international markets.

Based on the current macro-economic environment in the country, the necessary improvement in performances is most likely to take place among large number of SMEs through technological improvements and continual innovation induced by market competition. Sustainable growth of SMEs would require effective promotion programs delivered to the right target group.

The small firms are not to substitute the role of medium and large firms in the sector, but to bring higher employment opportunities in the country. There are a number of factors explaining why in Indonesia the importance of small firms increases in the course of industrialisation, in contrast to experiences in other developing countries. First, increased globalization has rendered domestic markets in Indonesia more subject to volatility, as a result of competition from foreign firms. In this context the small firms have a comparative advantage to their larger counterparts due to their organisational and productive flexibility, which tend to be a main characteristic of small firms. Secondly, the recent deregulation movement in Indonesia may also have contributed to the viability of small enterprises. Finally, new manufacturing technologies with a high degree of flexibility, favour stylised and personalised products, reduce scale economies and promote the relative viability of small firms. At the same time the importance of efficiency in production processes increases the reliance of large firms in certain manufacturing sub-sectors on small firms for producing certain parts of products[5].

There are some other factors which favour small factories, like strong local markets supplied by small factories; service industries in which small firms have advantages of location; craft or precision handwork; simple assembly, mixing, or finishing operation are industries in which small firms have "advantages of market orientation"; the processing of dispersed raw material. The supply of cheap labour may also be an advantage for small firms. These small firms tend to prevail in some sub-sectors in which the production involves manufacturing operations that offer little scope for mechanisation, and in which simple traditional production techniques are used.

Two sectors that have existing or potentially strong backward (and forward) linkages with small firms are agriculture and MLSIs (medium and large firms). As output in these sectors increases, their demand for intermediate and capital inputs can generate backward linkages to small firms. The backward linkages from MLSIs to small firms (the former providing a demand for intermediate or capital goods produced by the latter) are most frequently discussed in terms of subcontracting arrangements. In Indonesia subcontracting is used widely among small producers as well, particularly in textile, leather, wearing apparel, wood products and fabricated metal products.
For many small firms, especially for food industries, the agricultural sector is important also through its supply side (that is, in terms of forward linkages)[6].

4. SME Clusters in Indonesia

4.1 Background

Industrial concentration is relatively more dense in the western part of Indonesia. Firstly, due to potential demand for consumer products in this area, because about 80% of the population live in the western part of the country. Secondly, the income per capita in the western part of Indonesia is relatively higher. Thirdly, the location choices is largely based on entrepreneurs' close access to official policy makers in Jakarta.

From the record of census it has been found that more than 70 of all SMEs are located in Java province (in 1993 on the total of 2.569.262 SMEs in the country 1.621.366 were in Java). There is no clear indication available in respect to pattern of SMEs geographical distribution over this island.

[5] Ibidem, Tambunan, p. 62
[6] [6] Ibidem, Tambunan, p. 70-71

In the case of larger sized enterprises, it mostly concentrated in the close proximity to major cities such as Jakarta, Bandung, Surabaya, Semarang. However, the SMEs have mostly concentrated in the industrial estates funded and managed by government funded organisations. Industrial estates are available such as in Jakarta, West Java, Surabaya (East Java), Cilacap (Central Java), Ujung Pandang (South Sulawesi), and Medan (North Sumatera). There are several completed industrial estates now in full operation. The large industrial estates are found in Jakarta, Bekasi, Karawang, Cilegon, Surabaya and Medan. Water, electricity, drainage, and other important facilities are adequately available in the industrial estates. In total, seven bonded zones have been established, one in Jakarta and the others in Batam Island located twelve miles south of Singapore, Ujung Pandang (South Sulawesi), Pasuruan (Est Java), Semarang (Central Java), Bekasi and Bogor (West Java).

High centralisation of power places constraints on economic development. The Jakarta government knows that economic development is being held back by over-centralisation, but it fears the political implications of letting go. The hand of central government is visible everywhere and local businessmen chafe at the restrictions this imposes. Referral back to Jakarta for getting a loan or clearance for every shipment can delay decisions and operational processes [7].

There are also big regional differences which *hamper* homogenous industrialisation. Real incomes in Sulawesi are only 65% of those in Java. While the outskirts of Surabaya and Jakarta are choking with light-industrial development, Ujung Pandang is surrounded by paddy fields dotted with ramshackle stilt houses. There has been some development. There is a small industrial estate, a new toll road and the trans-Sulawesi highway is due to be completed. But many local people still complain that the needs of Java come before those of Sulawesi. Also the government control of the rice trade has depressed prices and undermined the rice trading empires which has been the source of much of Sulawesi's wealth. Rice had been a key commodity in trade between the eastern parts of Indonesia, but now everything must go through Java. The ban of the export of rattan has had a similar effect. Goods that used to be exported direct from Sulawesi are now sold to Java for processing. Java-centric policies have led to underdevelopment in the east. The government is for example considering the construction of nuclear-power plants in Java, but has not yet developed hydro-electricity in Sulawesi. Although 21% of Indonesia GDP is now produced by manufacturing, in the eastern provinces the figure is only 5.6%. Although the Indonesian government has declared that decentralisation and the development of the east will be top priorities in the next ten years, there is still much work to do. Economic growth will make Indonesia's current political system increasingly impracticable and reforms are urgently needed[8].

In order to channel necessary assistance to the SMEs government has set up small industry assistance centers in different part of the country. As per records of 1995, there were more than 2,000 small industry centers in Indonesia, of which more than 60% are situated in the islands of Java and Sumatra. Among them 24% SMEs are engaged in food processing businesses, 23% are producing handicraft and general products and 21% are producing textile and leather products. Among these SMEs many of them are operating in clusters in a particular geographical area. Although there is no reliable data available as regards to their overall performance, it was evident from their business records that these SMEs are successfully competing under the present business environment and surviving for a long term.

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[7] The Javanese Empire, The economist - A survey of Indonesia, p. 16-17.

[8] The Javanese Empire, The economist - A survey of Indonesia, p. 16-17