

## 9. Micro, Small and Medium Enterprises Development Policy

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### Abstract:

Over the recent several years the strategic role of the micro, small and medium size enterprises to overcome Indonesia's national socio-economic problems was established, which requires good governance for developmental policy planning and implementation. Cases of it are briefed in this contribution.

**Key words:** Indonesia, micro, small and medium size enterprises, policy, systemic thinking, sustainability

### 9.1 Introduction

It is institutional agreement that betterment of Micro, Small and Medium Enterprises (MSME) could overcome national problems on poverty alleviation, job creation, income disparity reduction and development of under-developed regions. The strategic role of MSME requires good governance for developmental policy planning and implementation because it might influence national economic sovereignty within globalization process.

At present, about 99.98% of business units in Indonesia are MSME which amount to 48.9 million units over various sector in agriculture, manufacturers and services. More than 85.4 million MSME work forces spread from urban area down to remote places. MSME contribute 57% of product and services. Those facts put MSME at highest priority for increasing GDP as well as distributing people prosperity over the country.

MSME development strategy in Indonesia was stated in the Medium Term Action Plan (MTAP) on 2002, back up by studies of ADB SME-TA. The MTAP contains multi-objectives which are:

- (1) To create conducive business environment for MSME growth through institutional arrangement for MSME policy formulation and implementation, national and local regulations harmonization and information access supports.
- (2) To strengthen MSME competitiveness and capacity with non financial incentive such as Business Development Service Provider, Cluster system and Incubator for start-up companies.
- (3) To increase MSME access to various source of funds such as Micro Banking and Micro Finance Institution (MFI).

This research aims to analyze Indonesia current condition and situation of MSME empowerment and financing practices and to recommend policy instruments to stimulate solutions over MSME classical problems. This policy research applies the concept of "system thinking" and seven steps of the learning cycle of soft system methodology (Checkland, 1981). This study used participatory approach through Focus Group Discussion, In-depth Interview and field observation. Literature study about legal aspect and other countries best practices were carried out extensively.

### 9.2 Problem and Constraints

The main problem in the making of policy on MSME was the disagreement among the decision makers about the **definition** and **criteria** differentiating the three scales of enterprises, so that it was difficult to make the planning activities either for empowerment or financing of MSME.

The main problem faced by micro enterprises, often called as informal sector, was the non-existence of law protection for their business. Due to the unclearness of the definition and criteria of micro enterprises, the formal banking institution difficult to set standard procedures for micro credit and what kind of policy relaxation can be materialized without violating the banking law.

The specific problem still faced by SME was inefficiency of bureaucracy in handling the legality aspects such as permit procedure. Economic externality factor due to the increase of world oil price and other energy sources also affect SME production feasibility. Limited provision of service product from the financing institution, particularly credit guarantee system was classical problem for SME. The availability and quality of Business Development Service (BDS) for SME and the limited technological resources also inhibited the growth of the prospective SME.

Effective MSME empowerment requires the review of the influence of existing policy processes to condition and dynamics of related institution involvement. The influence would also cause differences in the degree of legalization of various institutions, particularly at rural level, recognized as formal and informal institutions.

Community participation in decision making process is a social constraint for collaborative effort to achieve the local economic development goals. The application of banking prudential principle in credit disbursement by means of 5C (character, capital, capability, credibility, collateral) is difficult to be fulfilled by MSME. Consequently, that only 39.06% of MSME could access the bank services.

### 9.3 Policy Analysis

By comparative study from other countries which succeed in MSME development (China, Japan, Korea and Taiwan)

there are seven main policies were identified to increase developmental efforts effectiveness, i.e.:

- (1) Open up financing channels through Micro Financial Institution (MFI)
- (2) Strengthen structural reformation and regulation
- (3) Accelerate credit guarantee system and tax incentive support
- (4) Establishing business environment for fair competition
- (5) Improving public services system and infrastructure
- (6) Empowering local institutions and entrepreneurship
- (7) Encourage technological innovation and its dissemination.

This study analyzed those policies relevance to the Indonesia practices of MSME empowerment and financing conducted by the government, private business and banking sector. The result of this comparative analysis was used as basic assumptions for the improvement of current policy and action plan.

### *9.3.1 Government*

MSME empowerment policy conducted by the central government together with the local authority is directed to achieve the goals of increasing productivity and value added of SME products, improving MSE capacity in the rural areas and under-developed regions, and encouraging the technology based new entrepreneurs.

In the integration of institutional development policy and MSME empowerment mechanism, it is necessary to consider combining top-down with bottom-up approach while also appreciate external inputs. Conceptually, the government task in empowering MSME should place its role as 'advisor', and develop community participation framework from their socio-cultural element. Social institution in the community becomes **internalized** as of each community member expressed in their daily business practices.

The sustainability of the MSME program would be more insured if all elements involved participate from planning up to implementation. People participation could improve community knowledge and build their social interest, so they able to detect any deviation in policy instruments of MSME support.

The participation aspect of community development is essential to micro enterprises because relate to human resources and social institutions, so that the **sustainability** of the government's support can be attained.

### *9.3.2 Private Business*

Business companies, particularly the big enterprises have been involved in SME development through partnership mechanism such that applied by ASTRA group successfully through the **cluster system**. Various types and versions of cluster system have been implemented by several business and governmental institutions with support of international agencies. One of the cluster systems that can be considered as practical reference is conducted by Ministry of Industry.

The cluster support system activity includes training and managerial assistance to SME on the product quality standard, market information and efficient procurement mechanism. Other technical assistance includes product test, market research, trade/export promotion, legal advocacy and public communication. For that purpose, assistance fund from off-takers companies is needed either in cash or in line as part of their corporate social responsibility. Selection criteria are sector with growth potential, ability to expand labor income and job opportunity, and commitment of the off-takers on end-product marketing.

BDS Provider, business consultants, trading associations and organizations of private business could be the reliable source of MSME services. The value-added support activity could include ISO trainings for SME, as well as certification of quality standard. Scope of organization that could give aids for MSME is numerous, not only local institutions but also international agency and multinational enterprises.

### *9.3.3 Banking*

At the beginning of December 2007, Bank Indonesia (BI) had lowered the BI-rate down to 8% with the objective to stimulate normalization of banking loan interest so that the real sector has more flexible in conducting new investment or strengthening its working capital. However just few of MSE that has reliable access to banking, and generally bank still tends to prefer tertiary sectors, in services and trades.

Some policies have been issued by BI related to MSME concerning the deliverance of Small Enterprise Credit and providing technical assistance for MSME development. Private bank also conducts special outreach efforts including the utilization of formal MFI in order to be able to expand their services to MSE in remote areas. The Ministry of Finance together with BI has utilized the government budget for MSE credit. Up until now this program runs well with relatively low Non Performing Loan and most of the involved MFI sustain.

In 2005, the Ministry of Cooperatives and SME in collaboration with Local Development Bank issued Financing Scheme for capital strengthening of MFI with cooperative status. This scheme combined financial assistance with capacity building. The magnitude of loan, sectoral distribution, utilization and repayment of each revolving fund was managed by MFI cooperatives. This program will proceed of direction the Revolving Funds Management Agency founded in 2006 by the Department of Finance upon the suggestion of Ministry of Cooperatives and SME.

The problems being considered as in technical matters are assessment of the **credibility level** and supervision for MFI to maintain business sustainability. Therefore, professional certification for inspectors and manager of MFI

cooperative is needed in collaboration with *National Certification Agency* and related local authorities.

## 9.4 Policy Reform Design

This study formulates the policy reformation of MSME empowerment and financing on the basis of sustainable development principles. This was concluded from review of the government experiences which deliver large amount of state budget through various projects but actually functioned only during the project activation period.

On the other hand, the efforts from the government and BI which consistently supported the interest of MSME have resulted various valuable learning. This study summarizes the learning process and found the keywords from the efforts in empowering and financing SME, that is,

From this keyword, MSME policy instrument can be designed with the sustainable development principles which are satisfaction of human needs by the efficient use of resources, social equity and good decision making. Hereby MSME policy requires three prerequisites:

- (1) Incentive system applied by the central and local government has to guarantee the independent of MSME so that their business could grow on the basis of fair market mechanism.
- (2) Functional role of financial sector in MSME investment and working capital has to rely on effective regulation and supervision aspects, particularly for micro in developing area.
- (3) MSME utilizing natural resources as their raw materials must consider ecological conservation as well as to prevent pollution of production wastes which could make living environment degradation (green business).

The policy design of MSME empowerment and financing remains to focus on poverty reduction target and expansion of job opportunity. Currently in Indonesia, on July 2007, there was 37.17 millions of poor population (poorer of the poor) (17.75% of the total population), and if added by the economically active-poor and less affordable people amounted to 76.4 millions. Generally the poor community lives in left-behind regions, coastal areas, and remote islands where 60% of them work in farm. Therefore, MSME policy has to be prioritized for under-developed regions and agricultural-marine sector.

In 2007, the open unemployment was recorded as much as 9.8% (10.6 millions of labor force) so that the policy on MSME empowerment and financing is also needed to perform in the industrial and municipal area where the flow of urbanization still going on. For that purpose, specific policy instruments were formulated:

- (1) Cluster System for Regional Priority SME Commodities
- (2) Integrated Incubator System for Technology-based SME
- (3) Credit Guarantee System for Micro and Small Enterprises
- (4) Regulation and Supervision System for Micro Finance Institution

### 9.4.1 SME Cluster System

Cluster system becomes one of the strategic approaches for the development of MSME, since cluster is proven beneficial either for the business network itself or for regional economy. The cluster characteristic as economic agglomeration which involving upstream and downstream industries and the possibility of combining among the business scale becomes best alternative for the acceleration of MSME development.

Cluster development process is strongly related to collaboration mechanism among the stakeholders within the cluster. In business context, Participative Partnership mechanism should become the way of increasing efficiency, effectiveness and productivity of business network supported by access to market, capital and technology through management capability improvement (see Figure 1).

There are four important aspects used as the approach in forming the framework of Participative Partnership, i.e., business aspect to secure feasible business, social welfare aspect to guarantee business benefit delivery, participation aspect of the stakeholders to maintain the sustainability of business and technology aspect to secure production techniques and quality.

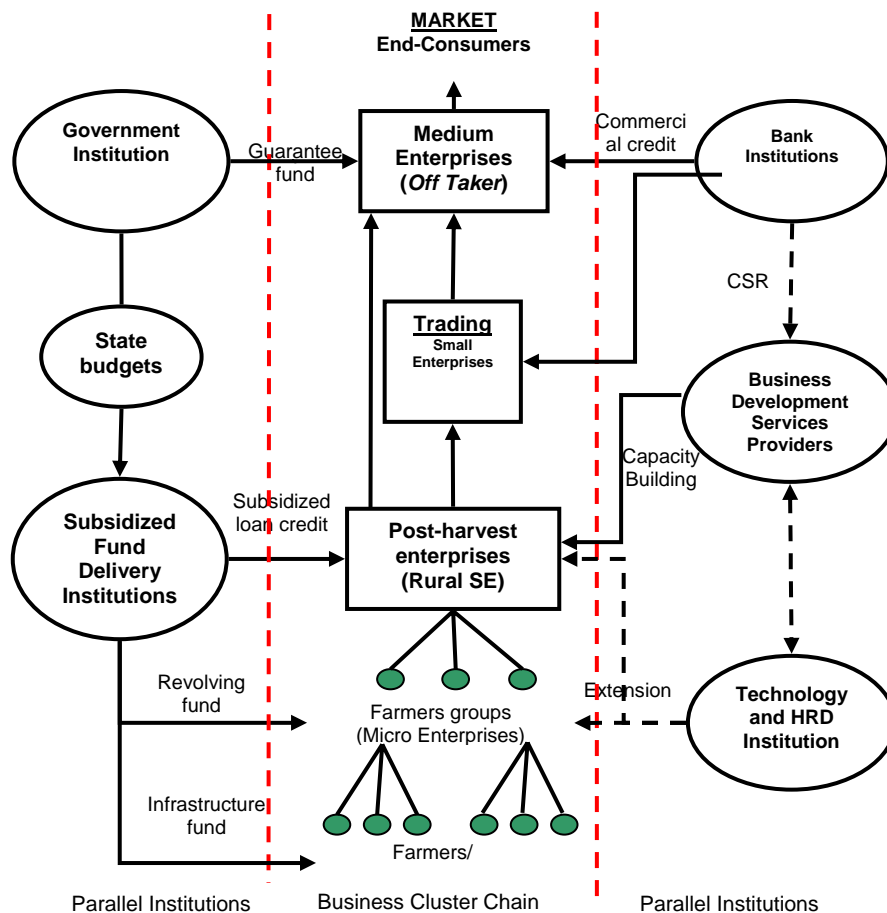


Figure 9.1: MSME Cluster System –Agriculture

#### 9.4.2 Integrated Incubator System

The existence of Incubator is important because generally SME is volatile in nature and easy to failure especially in the start-up phase. To overcome the situation, Bank Indonesia (BI) and the government provided start-up fund through venture capital state owned company.

Incubator is an institutional that provides infrastructure and services in order to increase added value of business carrying the idea and concept of technology and entrepreneurs (technopreneurs). Business incubator gives aids in education, training and internship, supported by technological, management, market, and capital access as well as information exchanges.

Due to its technologically based characteristic, the business incubator in general is developed by university in conjunction with commercialization of its technology. Beside university, R&D institution either individually or collaborating with other agencies, carry out business incubator with the objective to stimulate new entrepreneurs.

Empowerment of public-private sponsorship for business incubators needs integrated management within Technopark System which refer to best practices in the Beijing Business Incubator Institute. The professional incubator role becomes very important because start-up MSME is usually still weak in planning business entity and lack of network of fund sources, technology and market information.

#### 9.4.3 MSE Credit Guarantee System

In the era of regional autonomy, the local government has increasing role in managing local economy growth. The local government has tried to utilize the APBD optimally to finance the development needs and does not allow its fund in less productive placement. MSME development is specifically supported in capital empowerment either though revolving fund program or allocation of credit guaranteed fund like in the provinces of Riau, Gorontalo and Bali.

MSME credit guarantee would ensure the bank to give credit to feasible MSME but does not have bankable guarantee. For the local government itself, this credit guarantee is expected able to encourage MSME investment in order to expand job opportunity, strengthen the social-politic stability and would increase tax revenue for the local government. Credit guarantee also has leverage factor and does not cause market distortion.

The complex business evaluation with the credit guarantee system can be simplified in the form of mere financial

statement and field observation by the bank official. BI has conducted several studies on local credit guarantee institution (LPKD), where major obstacles were found in the legal aspect. Currently, a government regulation about the MSME guarantee system is being discussed especially that related to mechanism of LPKD. The Minister of Finance as the government authority will issue decree on minimum capital and operational business permit for LPKD at district and provincial levels.

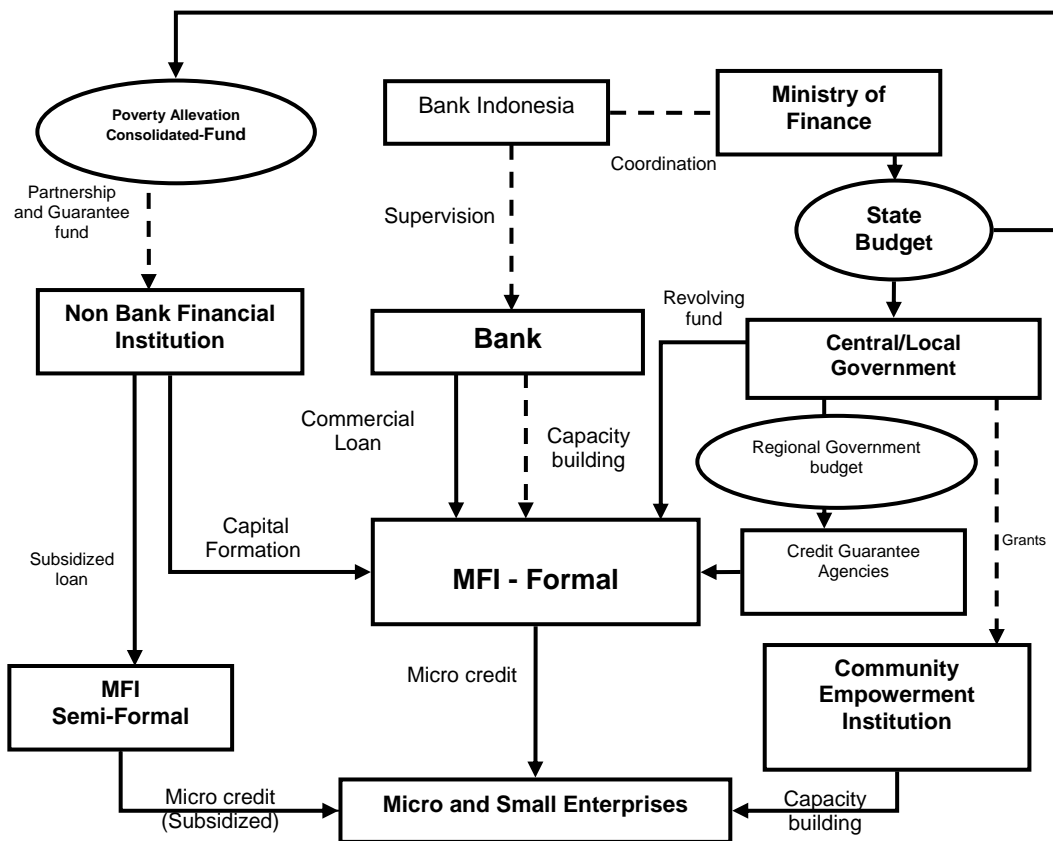


Figure 9.2: MFI – Bank Linkage System (PHBL)

#### 9.4.4 MFI Regulation and Supervision System

Micro enterprise financing is generally from own savings or loan from the money lender with very high interest. Therefore, the government and banking enhance MFI framework which are the rural bank (BPR) and Saving and Loan Cooperatives (KSP) with specific regulation. Effective supervision is reflected from adequacy and accuracy of the existing procedure. The adequacy of regulation implementation is calculated from components of credibility level evaluation, measured by the indicators such as Capital Adequacy Ratio (CAR), Return on Asset (ROA), Return on Equity (ROE), Loan to Deposit Ratio (LDR), Cash Ratio (CR) and Cost and Operational Revenue Ratio (CORR).

Currently, KSP supervision conducted by Local Office of Ministry of Cooperative is considered weak, meaning that the capability of the inspectors is inadequate because they are not trained with dependable procedures. This condition is different from the BPR supervision which is conducted by BI with the ratio of approximately one supervisor to 15 BPRs. The effective supervision is a tool to make early detection of cash flow problems, especially non performing loans.

The MFI which is generally has the activity of simple saving and loan operational only has one type of risk that is credit risk. As long as MFI has good manager and efficient control system, the risk management will work.

### 9.5 Policy Implication

Formulating the implication of the national economic policy has to be based on appropriate development economics theory so that the relation between the strategy and its implementation is clear. The government should ahead in formulating the policy so that market players are willing to share information to support the negotiation process. The rules for achieving consensus include minimum wage, tax incentives, loan interest subsidy and business credit guarantee scheme.

#### 9.5.1 Proposed MSME Law

Related to regulation aspect for MSME empowerment, the Ministry of Cooperatives and SME has taken initiative in proposing MSME Law as the replacement of the law *No.9/1995 for small enterprises*, so that MSME in Indonesia can obtain business credibility and fairness. The main objective and substantial of the incoming MSME Law are efforts in growing conducive business environment by setting up the policy instruments comprising financial aspect, facility and infrastructure, partnership, business permit, market opportunity, trade promotion and institutional support.

The important thing still in discussion is about the definition and criteria of net assets and annual sales revenue of MSME. Subject about the criteria of number of and business type are not contained in that proposed MSME Law.

Other important thing is the subject of **Partnership** between MSME and large scale enterprise covering technology transfer, product marketing network, business capitalization and upgrading of human resources. In the incoming MSME law, partnership can be conducted through various design mechanisms including plasma-nucleus, sub-contract, franchise, general trading, and specific collaboration scheme like profit sharing, operational collaboration, joint venture and outsourcing. In planning and implementing partnership program, it should be rely on mutual needs and benefit sharing. The unjust partnership practice, which is beneficial only to large scale enterprise can be avoided.

### 9.5.2 Local Regulation of MSME

Local economic development strategy in conjunction with the regional autonomy policy in general comprises:

- (1) Improvement of investment climate and production framework as well as creating interregional economic relationship which supports each other.
- (2) Better utilization of natural resources in the relatively under-developed regions while creating new economic potential regions.
- (3) Developing sustainable business activity located at production centers in priority regions as reliable economic growth poles.

The government support for MSME gives the priority for investment facility and infrastructure of agribusiness small scale and household industry. The SME financing with partnership and commodity cluster approach can be conducted through local government owned financial institution.

Most of the MSE are economically active poor with low education and weak market connections. Therefore, they require support in social empowerment and business partnership either from the government aid or companies through its Corporate Social Responsibility (CSR). Deregulation and incentive system in the region is essential in creating conducive climate for investment and MSE partnership development.

## 9.6 Conclusions

Recent effort by central and local government for MSME empowerment and financing is intensively carried out with billions rupiah budget. However, its impact on poverty alleviation and job creation in underdeveloped regions was found unsatisfactory. Specific state-aid program such as subsidize loan interest and revolving fund scheme mostly is not sustain. Hence, there should be policy reformation at all levels to manage governmental support effectively with less distortion of local market mechanism.

This study advice policy maker to encourage MSME law manifestation followed by related policy instrument such as MSE credit guarantee agencies and deregulation of ME registration procedure. Moreover, MSE and MFI capacity building must be increased utilizing various source of fund available such as CSR from state owned and big companies.

Policy research using Soft System Methodology with active participation of stakeholders could produce effective recommendation with holistic view and well appreciated by policy makers. Knowledge acquisition through Focus Group Discussion and Executive Workshop was much efficient to develop policy instruments.

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