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PROMOTING SME DEVELOPMENT IN INDONESIA

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ABSTRACT/RESUME

Promoting SME development in Indonesia

Micro, small and medium-sized firms (MSMEs) are a key source of employment and economic growth in Indonesia. They contributed to the country's economic resilience during the 2008-09 financial crisis. But many suffer from low productivity, curbing their role in boosting living standards. There are several ways to spur MSME productivity growth over the medium term.

The first route would be to encourage the formalisation of small firms. Lessening red tape through simplification of the licensing process and lower tax compliance costs would help. Avoiding excessive rises in the minimum wage in provinces where it is already at a reasonable level would also be important. Looking forward, it would be useful to remove rigidities in the formal labour markets, while moving to some form of unemployment benefit system to insure workers against job-loss risks.

The second route would be to boost investment. Clarifying property rights for real estate, and making the information collected by the credit bureau available to all financial institutions would ease access to finance. At the same time, the development of financing alternatives such as venture capital, leasing or micro-finance would enhance credit supply. The poor state of infrastructure, in particular in the transportation and electricity sectors, is also perceived as an important impediment to investment and could be remedied by increasing public infrastructure spending on cost-effective projects.

The third route would be to enhance the quality of human resources. The country suffers from a lack of skilled workers, and policies should aim both at increasing the pool of workers and making education and training institutions more responsive to evolving labour-market demand.

Indonesia has a long tradition of supporting MSMEs. But responsibilities between the different levels of government and within the central government need to be clarified to minimise overlap and inefficiencies. A rigorous assessment of existing programmes would allow schemes to be consolidated and scarce public funds to be directed to their most cost-effective uses.

This Working Paper relates to the 2012 *OECD Economic Review of Indonesia* (www.oecd.org/eco/surveys/Indonesia).

JEL classification: J3; O4; G1; I2

Keywords: Indonesia; productivity; micro and small firms

Promouvoir le développement des PME en Indonésie

Les micro, petites et moyennes entreprises (MPME) sont une source majeure d'emplois et de croissance économique en Indonésie. Elles ont contribué à la résistance de l'économie durant la crise financière de 2008-09. Cependant, beaucoup de ces entreprises souffrent d'une faible productivité, ce qui limite leur rôle dans l'amélioration des niveaux de vie. Il existe plusieurs moyens de stimuler la croissance de la productivité des MPME sur le moyen terme.

Le premier moyen serait d'encourager les petites entreprises à s'engager dans l'économie formelle. Il serait utile, à cet effet, de réduire la bureaucratie en simplifiant les procédures d'octroi de licences et d'abaisser les coûts du respect des obligations fiscales. Il serait aussi important d'éviter toute hausse excessive du salaire minimum dans les provinces où il atteint déjà un niveau raisonnable. Dans le futur, il conviendrait de réduire les rigidités sur le marché du travail formel, tout en adoptant une forme de système d'indemnisation du chômage afin d'assurer les travailleurs contre le risque de perte d'emploi.

Le deuxième moyen serait de stimuler l'investissement. La clarification des droits de propriété immobilière, et la mise à la disposition des informations recueillies par le bureau du crédit à toutes les institutions financières faciliteraient l'accès aux financements. En même temps, le développement d'autres solutions de financement telles que le capital-risque, le crédit-bail ou le microcrédit renforcerait l'offre de crédit. Le mauvais état des infrastructures, en particulier dans les secteurs des transports et de l'électricité, est aussi perçu comme un obstacle à l'investissement, auquel il serait possible de remédier en accroissant les dépenses publiques pour financer des projets d'infrastructure rentables.

Le troisième moyen serait de rehausser la qualité des ressources humaines. Le pays souffre d'une pénurie de travailleurs qualifiés, et il faudrait mettre en œuvre des politiques visant à accroître le nombre de travailleurs disponibles et à rendre les établissements d'enseignement et de formation plus réactifs à l'évolution de la demande sur le marché du travail.

L'Indonésie a depuis de longues années une politique de soutien aux MPME. Il est cependant nécessaire de clarifier les responsabilités entre les différents niveaux d'administration et au sein de l'administration centrale afin de réduire au minimum les doubles emplois et l'inefficacité. Une évaluation rigoureuse des programmes existants permettrait de consolider les dispositifs en place et d'allouer les maigres ressources publiques à leurs usages les plus rentables.

Ce Document de travail se rapporte à l'*Étude économique de l'OCDE de l'Indonésie 2012* (www.oecd.org/eco/etudes/Indonésie).

Classification JEL : J3 ; O4 ; G1 ; I2

Mots clefs : Indonésie ; productivité ; micro et petites entreprises

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Promoting SME development in Indonesia

By

Annabelle Mourougane¹

Small firms are especially numerous in Indonesia, and the number of small firms per capita is much higher than in most other countries (Kushnir *et al.*, 2010). They have historically been the main players in domestic activity, especially as providers of employment opportunities. Small enterprises have also been an important engine in the development of local economies and communities.

This paper seeks to identify ways to ensure that small firms make their fullest contribution to job creation and productivity to underpin sustainable growth over the long term. It starts by describing the main characteristics of small firms in Indonesia, as well as their role in supporting the economy during the 2008-09 global crisis. The paper then examines ways to boost their productivity over the medium term by encouraging them to formalise and invest. It then looks at policy changes that could help to enhance the skills of the workforce, before reviewing policy support. A last section makes policy recommendations.

Small firms helped the economy weather the 2008-09 financial crisis

There is no commonly agreed definition across institutions and countries of what is a small firm (Box 1). This analysis relies on a wide range of databases, which adopt different definitions. To the extent possible, the focus is on the broader concept of micro, small and medium-sized firms (MSMEs). But when not possible the analysis covers just small and medium-sized firms (SMEs).

1. Senior Economist, OECD Economics Department. This paper was originally prepared as part of the 2012 *Economic Survey of Indonesia* published in September 2012. This work has benefited from valuable suggestions from Gregory Bounds, Andrew Dean, Lucia Cusmano, Robert Ford, Peter Jarrett, Miriam Koreen, Andrzej Kwiecinski, Elsie Lotthe, Cristina Martinez, Jonathan Potter, James Sheppard, Stephen Tompsen, Danielle Venn and Gert Wehinger, all OECD staff. The author would also like to thank officials from the Indonesian government for their helpful comments and contributions to this paper. Special thanks go to Anne Legendre and Mee-Lan Frank for excellent research assistance and technical preparation.

Box 1. What is a small firm?

An important constraint in analysing SME development is the great diversity in the definition and classification of small firms across institutions and countries. The most common practice is to rank firms by number of employees. But other variables like net assets, sales and investment levels are also sometimes used. There is also variation in defining the upper and lower size limits of an SME. Finally, the coverage varies depending on whether the informal sector and micro firms are included or not.

Below are the definitions from the main sources used in this work:

- *Data from the Ministry of SMEs and Co-operatives and Bank Indonesia.* The data follow the definition set out in the 2008 Law. Micro firms are defined as enterprises with net assets less than IDR 50 million (land and buildings excluded) or enterprises which have less than IDR 300 million total annual sales. Small firms are enterprises with net assets from IDR 50 million to IDR 500 million (land and buildings excluded) or with total annual sales from IDR 300 million to IDR 2.5 billion. Medium-sized firms are those with net assets from IDR 500 million to IDR 10 billion (land and buildings excluded) or with total annual sales from IDR 2.5 to 50 billion.
- *World Bank Enterprise Survey.* Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is a medium-sized firm. The survey covers only the formal sector and firms with more than 5 employees.
- *International Finance Corporation – MSME country information.* The definition varies across countries. For Indonesia, data are for the formal sector and taken from the Ministry of SMEs and Co-operatives and follow the definition in the 2008 Law.
- *Tax registration.* For tax purposes, small firms are those that have assets valued between IDR 50 million and IDR 500 million with an annual turnover of between IDR 300 million and IDR 2.5 billion, while medium-sized enterprises are those that have assets valued between IDR 500 million and IDR 10 billion and have a yearly turnover between IDR 2.5 billion and IDR 50 billion.

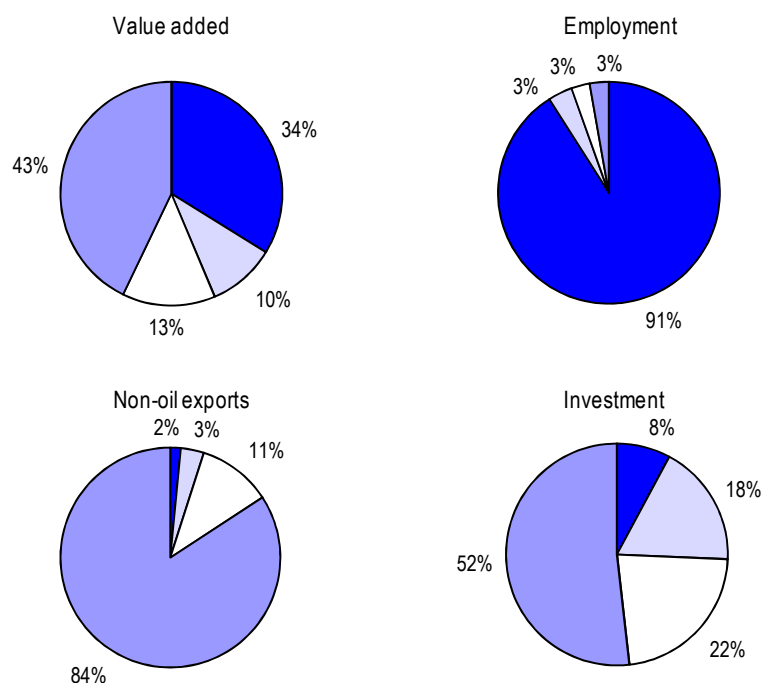
Source: Ministry of SMEs and Co-operatives, World Bank Enterprise Survey, Bank Indonesia.

A snapshot of the MSME sector

MSMEs constitute the dominant form of business organisation and represent more than 99% of the total number of firms in Indonesia, 97% of employment but only 57% of value-added (Figure 1). Most are scattered widely through the rural parts of the country. They generally serve small and localised markets and are responsible for half or less of investment. While micro enterprises are mostly in the agriculture sector, small firms dominate in the trade and hotel sectors. Medium-sized firms account for a tiny part of MSMEs. This “missing middle” in the production structure is common in South-East Asia.

Figure 1. Firms' demographics in Indonesia

2010



Source: Ministry of SMEs and Co-operatives.

As in regional peers, most SMEs in Indonesia are privately and domestically owned and have the status of sole proprietorships (Table 1). The majority of these firms are gathered in co-operatives whose number almost doubled from 2005 to 2011.

As in other countries, SMEs in Indonesia have a lower propensity to export than larger firms (Table 2). The share of SMEs in non-oil exports has been declining since 2008; they now represent less than a fifth of non-oil exports, though part of SME output may be exported indirectly through subcontracting arrangements.

One specificity of SMEs in Indonesia is that most operate in the informal sector. The percentage of firms that are run with formal registration is, as expected, lower for Indonesian SMEs than for large firms, but also lower than for such firms in Cambodia and Vietnam. Moreover, the number of years spent in the informal sector is higher, suggesting that incentives to become formal are lower in Indonesia than in regional peers.

SMEs are more likely to pay a bribe than large firms, and a greater share of survey respondents seem to expect to have to bribe officials to obtain a license (though not a government contract) than in Vietnam or the Philippines (Figure 2). The former outcome could reflect SMEs' lower bargaining power but also sometimes their non-compliance with regulations, which makes them a more likely target for corrupt officials. There is also evidence that corruption at the local level (where licenses are usually delivered) reduces entrepreneurship in Indonesia (Vial, 2011).

Table 1. **Small firms' characteristics in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Age (years)	7.8	18.3	14.6	-	6.5	14.7	16.6	20.2	15.0
Proportion of private domestic ownership in a firm (%)	89.4	92.2	95.8	96.7	94.5	89.9	87.5	77.6	89.4
Per cent of firms with legal status of:									
Publicly listed company	0.5	60.3	10.1	0.0	0.0	0.8	2.0	5.3	1.0
Privately held Limited Liability Company	15.8	0.0	35.6	83.8	11.4	4.0	13.5	59.8	6.2
Sole Proprietorship	60.6	20.1	32.6	0.0	35.6	87.6	68.1	26	84.3
Limited Partnership	6.5	0.0	4.3	0.0	40.2	6.8	14.3	8.6	7.5
Proportion of permanent full-time workers that are female (%)	-	27.4	40.6	44.3	36.0	32.9	41.2	40.7	33.9
Per cent of firms with a female top manager	-	13.5	37.9	-	31.1	32.9	20.1	13.1	31.2
Per cent of firms competing against unregistered or informal firms	-	-	33.5	-	64.4	65.8	65.0	37.2	65.1
Per cent of firms formally registered when they started operations in the country	84.6	18.0	98.3	-	89.1	24.7	55.0	91.3	29.1
Number of years firm operated without formal registration	0.9	-	0.1	-	0.7	2.4	2.8	1.2	2.4
Per cent of firms identifying practices of competitors in the informal sector as a major constraint	33.4	14.6	25.7	-	16.7	14.7	16.0	8.1	14.7

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.

Source: World Bank Enterprise Survey.

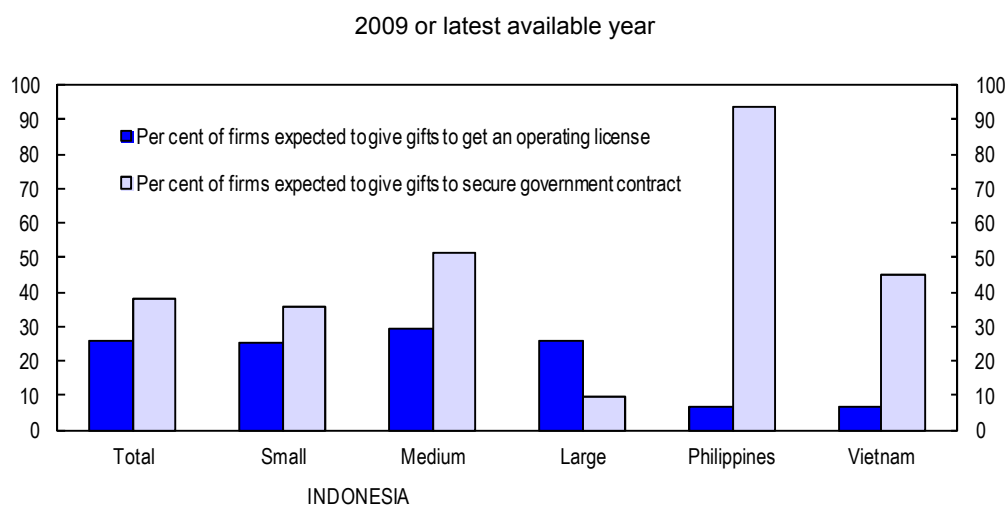
Table 2. **Small firms' foreign trade in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms exporting directly or indirectly (at least 1% of sales)	9.1	30.0	5.0	40.7	5.1	1.6	14.2	55.3	4.1
Per cent of firms using material inputs and/or supplies of foreign origin	-	30.3	23.6	14.3	42.5	2.5	12.4	55.9	4.9
Per cent of firms identifying customs and trade regulations as a major constraint	9.8	11.5	9.8	18.5	1.1	3.7	11.8	12.5	4.8

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.

Source: World Bank Enterprise Survey.

Figure 2. Indicators of corruption in selected economies



Source: World Bank Enterprise Survey.

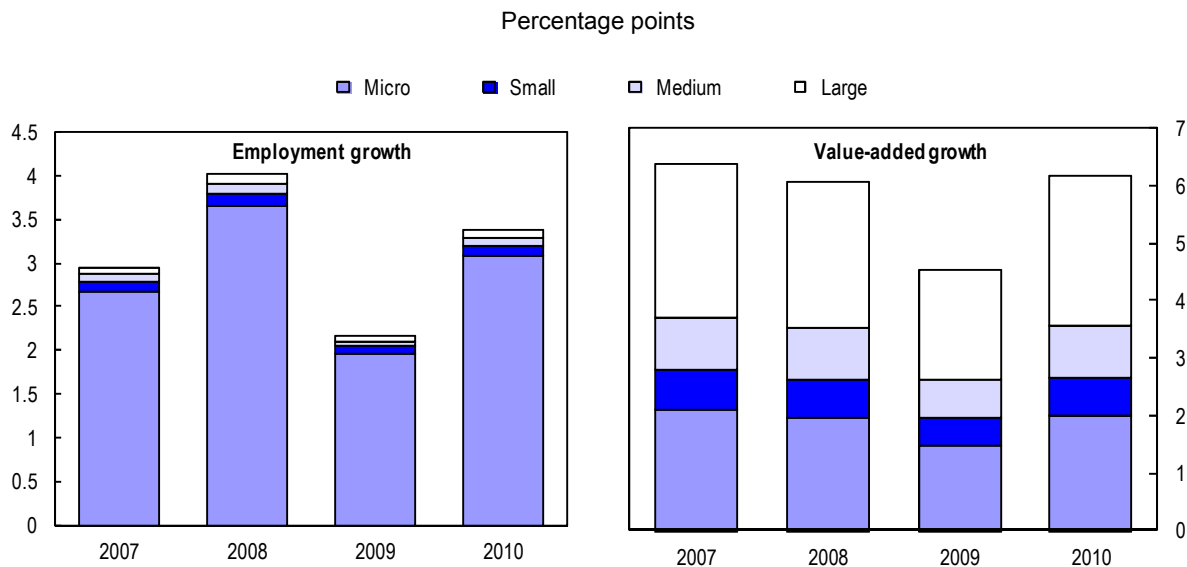
The role of small firms during the crisis

MSMEs have been the main contributors to employment growth in Indonesia in recent years (Figure 3). This helped to sustain household income during the crisis and is one of the factors explaining the steady decline in the poverty rate. MSMEs have contributed more to the growth of value-added than large firms, with micro firms representing the bulk of MSME contributions. One reason for this good performance may be the low reliance of micro and small firms on formal markets and credit, which allows them to respond more quickly than large firms to sudden shocks (Berry *et al.*, 2001).

Some of these developments could also reflect Indonesia's current stage of economic development. Indeed, according to Ayyagari *et al.* (2011), SMEs contribute more to employment in low- than in high-income countries. It seems, however, that SMEs account for a larger share of employment in Indonesia than in the average lower-middle income country. Another factor could, in principle, be business age: mature firms usually make up a large fraction of employment in developing economies (Ayyagari *et al.*, 2011). Although Indonesian SMEs are relatively mature, firms' age does not seem to be a significant factor in explaining employment shares (Figure 4).

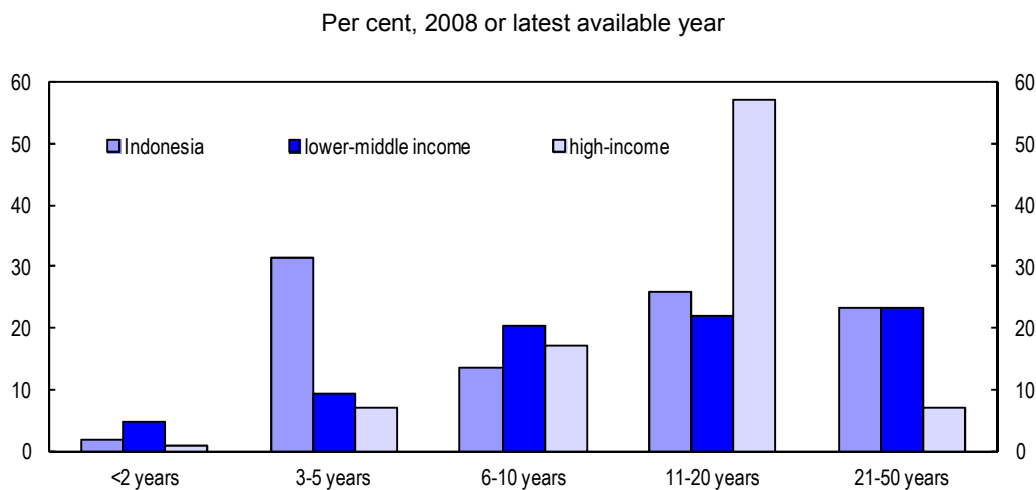
Good employment performance has not been accompanied by significant gains in productivity by small firms. Labour productivity appears to have increased faster for larger firms than for their small counterparts since 2008, and the gap between the two groups has widened (Table 3). Overall, small firms are found to be 80% less productive on average than large firms. This is consistent with what is observed in other developing economies and can be explained by the fact that small firms usually use manual modes of production (Ayyagari *et al.*, 2011; Banerjee and Duflo, 2005). They also lack inputs such as skilled workers, new machines and IT processes and the know-how to improve methods of production.

Figure 3. Contributions to employment and value-added growth



Source: Ministry of SMEs and Co-operatives.

Figure 4. Employment share by firms' age



Note: Micro firms are not included. Large firms are included.

Source: Ayyagari et al. (2011) "Small vs Young Firms across the World", *Policy Research Working Paper*, No. 5631, The World Bank, Washington, D.C.

Table 3. Labour productivity by type of firms

GDP per employee in IDR million

	2006-08	2009-10
Micro, Small and Medium Enterprises	1.2	1.3
of which: Micro	0.7	0.8
Small	6.1	6.5
Medium	10.1	11.6
Large	30.4	32.9
Comparison Large/MSMEs	25.1	25.8

Source: OECD calculations using data from the Ministry of SMEs and Co-operatives.

The issue of small firms' poor productivity performance is likely to gain in importance in the years to come. With the gradual economic integration of ASEAN economies and the implementation of regional free-trade agreements with China and India, Indonesian small firms are going to face stronger competition in the domestic market. In addition, production costs are expected to rise as the social safety net expands and the country moves to a greener economic footing.

International evidence suggests that a large SME sector is often associated with strong growth in GDP per capita, though there is little evidence on the direction in which the causality runs (Beck *et al.*, 2005). But a necessary condition for job creation by SMEs to translate into stronger long-term growth is that they not exhibit too low productivity. There are three ways to prevent this and to spur SME productivity growth. The first would be to encourage formalisation, as there is evidence that productivity is higher in the formal sector as firms enjoy easier access to finance. The second would be to remove obstacles to investment and facilitate SME growth. The third would be to increase the pool of qualified workers. These are reviewed in turn in the following sections.

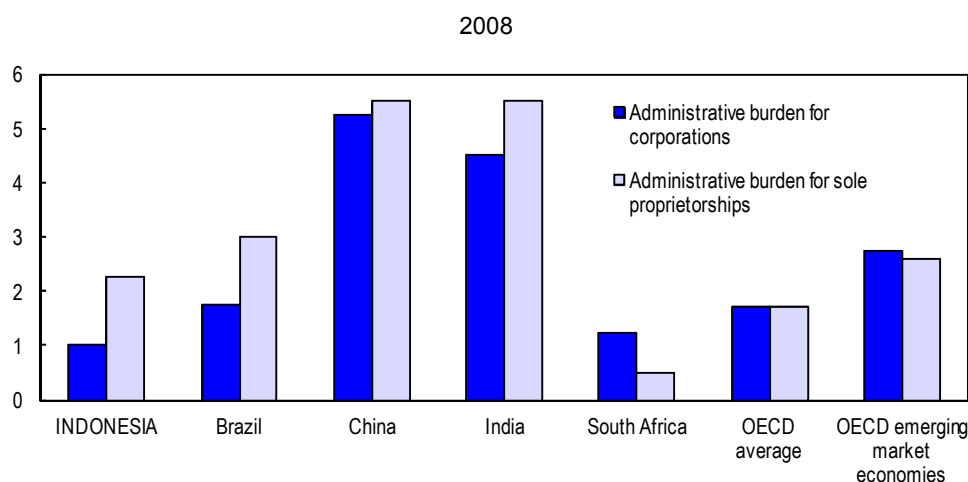
Encouraging the formalisation of small firms

According to the 2009 World Bank Enterprise Survey, only 25% of small firms are legally registered when they start operating in Indonesia. Indeed, red tape, high tax compliance costs and rigidity in the formal labour market can hamper formalisation. Reforms in these areas are nonetheless unlikely to be sufficient to foster formalisation, if firms expect no benefit from registration. It is thus necessary to make more visible its advantages.

Reducing red tape

A heavy regulatory burden can influence firms' decisions to become formal. Evidence from Mexico, Colombia and Malaysia suggests that the simplification of business registration procedures can lead to an increase in the number that register. Administrative costs to register a firm, as measured by a *de jure* indicator, are lower in Indonesia than in other emerging-market economies and than in OECD countries (Figure 5). Important progress in this area has been achieved in Indonesia in recent years. The time needed to start a business in Jakarta has, for instance, been reduced by 70% since 2006. These improvements can be attributed to the nationwide introduction of a computerised system for company registration – *Surat Administrasi Badan Hukum* (SABH) – and the creation of standard incorporation forms for limited liability companies.

Figure 5. Administrative burden to register a business in Indonesia and selected economies



Note: The indicator ranks from 0 (less restrictive) to 6 (most restrictive). OECD emerging market economies include Czech Republic, Hungary, Korea, Mexico, Poland, Slovak Republic and Turkey.

Source: OECD.

However, despite this improvement, starting a business is still more cumbersome in Indonesia than on average in members of the Asia-Pacific Economic Cooperation (World Bank, 2012). While micro firms are exempt from licensing requirements, the burden is heavy for small firms, which pay more per employee or as a percentage of sales than larger firms. In practice, small firms in Indonesia need twice as many days to get an operating licence than their larger counterparts. Small Indonesian firms also face a disadvantage compared to counterparts in some regional peers. According to the World Bank Enterprise Survey, it takes fewer than 10 days for a small firm to obtain an operating licence in Vietnam as compared to more than 20 in Indonesia. In addition, Indonesia imposes a minimum capital requirement of IDR 50 million (around USD 5 300) when starting a limited liability company, 25% of which needs to be deposited in the founder's bank account. Most other APEC economies have abolished such requirements, and the Indonesian authorities should consider phasing it out as well.

Regional government licenses that impose a large burden on businesses are the main issue to be tackled. Decentralisation and the resulting transfer of the regulatory oversight to 440 cities and districts in the early 2000s are reported to have worsened the business environment. It has increased the number of levies and costs with which firms have to cope with and has created generalised over-regulation and regulatory uncertainties (KPPOD, 2008). A large majority of regulations are now imposed at the regional level (Box 2), leading to highly variable situations across the country. According to World Bank (2012), it is easiest to start a business in Yogyakarta and most difficult in Manado.

Consistent with the objective stated in the 2010-14 National Development Plan, 12 500 sub-national regulations are in the process of being reviewed. But the focus has been on eliminating illegal taxes and user charges. Some attention has been devoted to licenses that would be detrimental to growth or would be inconsistent with national regulations, but efforts need to be pursued. Excessive licensing creates a barrier to entry to markets and may also impede innovation and flexibility. As suggested by the 2012 OECD Review of Regulatory Reform, effort should be made to systematically review the stock of significant sub-national licensing requirements and assess their costs and benefits to ensure that they remain cost-effective and deliver the intended outcome (OECD, 2012a). Since 2011, academic studies on sub-national regulations are required by law but a quantitative assessment is not explicitly asked for and the studies are not well integrated in policymaking and in public consultations. In this regard, the OECD's

Competition Assessment Toolkit can provide useful information on ways to achieve the objectives that typically underpin business licensing without unnecessarily harming competition. Specific attention should be given to examine the impact of licences on MSMEs. Licenses that are found to be unnecessary should be phased out. A pre-requisite would be to take stock of all existing sub-national regulations. This would also allow benchmarking and encourage the dissemination of best practises.

Box 2. The licensing process in Indonesia

This box reviews the various licenses required for a firm to operate in Indonesia and current processes to obtain them.

Indonesia has put in place a simplified licensing system for SMEs. SMEs whose asset is below IDR 5 billion usually choose this option, while large and foreign companies seek BKPM licenses that offer some investment facilities (OECD, 2012a).

The business license for location (SITU) is the most difficult to obtain. The government must assess whether the proposed business location complies with its spatial plan. It is a pre-requisite for other licenses and is issued by the economic section of the regional government (*kabupaten*). Rules to obtain SITU vary across the country. The process is particularly cumbersome and costly in the region of Kupang, where any of 270 different tariffs could be applied, depending on the specific business, and firms need to renew their license every year.

In addition to SITU, there are also construction (IMB) and nuisance permits (HO). The construction permit combines building function, land use, road access and safety requirements. It requires not only blueprints of the building, but also approval by local authorities (village and sub-district heads) and neighbours. The nuisance permit assesses the disturbance caused by business activities such as traffic or noise. It requires approval by neighbours.

The trading license (SIUP) is required for firms engaging in trade activities. It is valid for the whole country. This license is usually needed to obtain bank loans and to be able to participate in government tenders. In the same vein, the industrial registration (TDI) is the major technical license required for SME industrial activities.

Firms are also often required to apply for various product-specific and activity-specific licenses. Examples include permits to produce or transport commodities. These licenses may be issued by the central, regional or local governments. Some of them need approval from local business associations.

Finally, firms have to pay a *retribusi*, a government tax or payment that is collected as payment in return for a service for the issuance of permits from various government agencies.

Source: SMERU (2009), the Asian Foundation (2007), OECD (2012a).

The national government has approved legislation mandating the simplification of local licensing requirements. It also set statutory limits for the time needed to issue two licenses that are governed at the national level but are issued by local governments. Fees for local licences were also eliminated for SMEs by decree in 2007. Still, the implementation of these regulations varies across localities in the absence of clear implementing guidelines. Only some local governments have simplified their licensing requirements by merging procedures, introducing statutory time limits and eliminating or reducing licensing fees. Local governments should be encouraged to rationalise and consolidate licensing processes. One way forward would be to sanction regional governments that fail to make significant progress in this area.

Since the mid-1990s, the government's strategy to streamline the business licensing process and reduce compliance costs has been based on the establishment of one-stop shops. These are local government offices that consolidate the processing of business licenses from separate departments into one location and thus help to provide faster, simpler and less costly services. General guidelines for the establishment of one-stop shops were issued in 1997. In 2006, the Ministry of Home Affairs issued

regulations instructing local governments to set up one-stop shops within a year. Most Indonesian cities have by now complied. The rest need to follow suit. Regarding central-government licenses, a 2009 Presidential decree introduced the concept of a one-stop-shop system (PTSP). The law required the consent of some 16 ministries to delegate their authority to BKPM, the government investment agency, in licensing and non-licensing services. All relevant ministries have now signed off on the various decrees, and implementation of PTSP is underway.

Further simplification and automation of the process could speed up registration. Experience from Singapore shows that establishing a virtual one-stop shop that collects all required information through a single online interface and shares it within the government can reduce registration time. The Indonesian authorities have already taken steps in this direction. In January 2010, they launched the National Single Window for Investment (NSWI), an electronic platform for investments that enables investors to apply for license and non-license services online in the Free Trade Zone and Free Port of Batam. In addition, a central government initiative aims to implement an integrated information system for transferring data from the local one-stop shops to the BKPM and to the relevant ministries. These initiatives are welcome and should be pursued.

Additional improvement could be achieved by gradually moving to a single licence for registering and operating a business. This question is currently being discussed within the central government for the licences for which it is responsible. However, discussions are still at a very early stage. Going forward, the authorities could envisage moving from the current model, which relies extensively on licensing, to regulations that would apply to anyone who engages in certain business activities. This approach enables businesses to enter or expand in markets more easily and would reduce the scope for illegal side payments (OECD, 2012a). Existing licensing schemes should be evaluated to determine whether their removal or a shift to regulations instead of licenses might lower barriers to entry.

Simplifying tax procedures

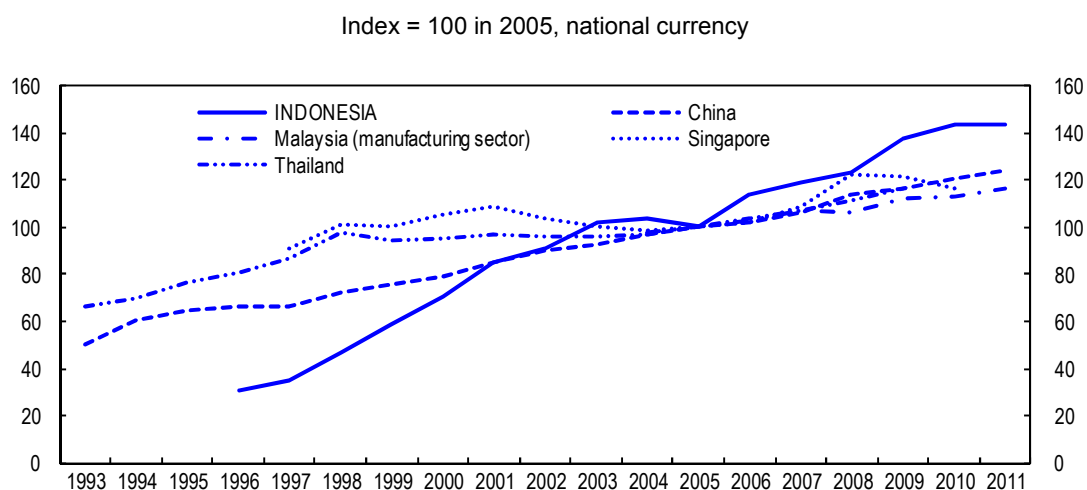
Excessive tax compliance costs – *i.e.* the amount of time and resources required by firms to comply with the tax system – can distort the choice of business form, including the decision to move from dependent employment to establishing a business and/or the decision to structure an SME in incorporated or unincorporated form. Nonetheless, the tax system does not appear to be the major factor explaining informality in Indonesia. At the moment micro firms are effectively exempt from tax, and there are some specific provisions for small firms. As SME tax collection represents only a small part of total public revenues, adjustments to policies to further reduce the tax compliance costs for SMEs are currently being discussed by the Indonesian government through the establishment of a simplified tax system for small firms (Arnold, 2012).

International evidence suggests that the establishment of a simpler taxation system for micro and/or small firms can encourage more start-ups and the formalisation of unregistered workers. For very low-turnover businesses for which a simplified procedure may still be excessive and discourage participation in the formal economy, there may be a need to introduce a simple tax (for instance, a turnover-based tax) to replace regular income tax and/or VAT. A pre-condition for this measure to work in the case of Indonesia would be to prevent potential tax evasion that could occur by keeping a part of turnover out of registers. Another measure to lower compliance costs would be to allow small firms to adopt cash accounting (based on daily cash entries of payments/revenues) and other simplified accounting procedures and to be subject to less frequent filing requirements. From the point of view of maximising the efficiency of the whole tax system, a preferential tax treatment for small firms needs to be carefully designed to prevent such a system from becoming an obstacle to firms' development as the advantages of the special regime will be lost if firms grow beyond the revenue threshold.

Limiting the rise in labour costs

MSMEs employ most of the Indonesian workforce. As such, labour costs are an important factor bearing on their incentives to formalise. Unit labour costs have been steadily increasing since the mid-1990s and appear to have grown faster than in regional peers (Figure 6). This reflects developments in wages (as social contributions barely exist) and productivity.

Figure 6. **Unit labour costs in selected Asian economies**



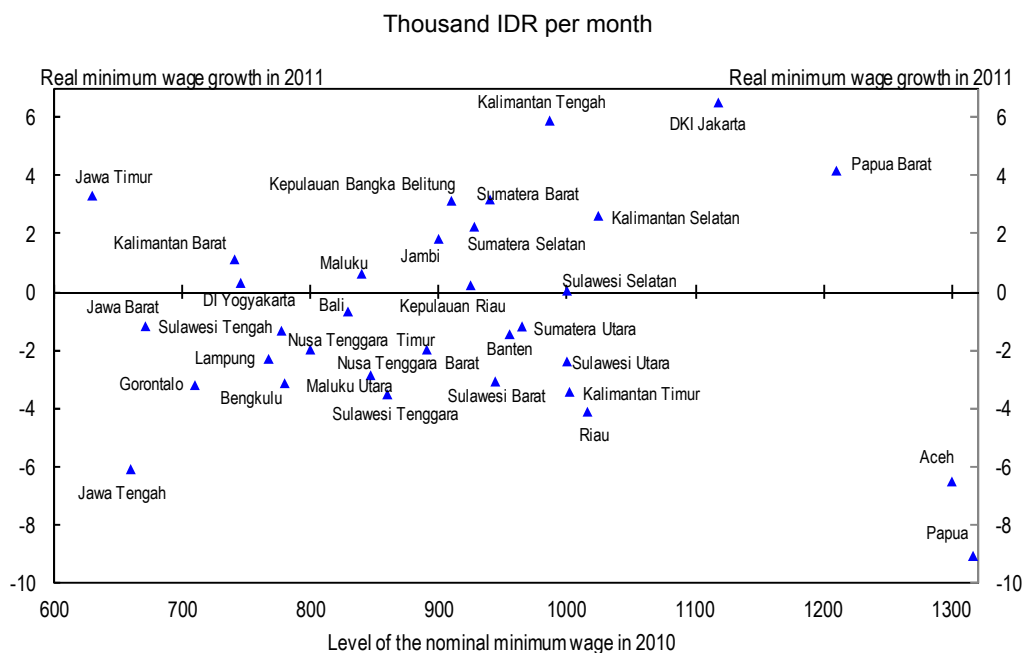
Source: OECD calculations using national sources.

Resisting excessive increases in the minimum wage

A factor bearing on SME labour costs is the minimum wage. Minimum-wage provisions have become increasingly onerous, especially since decentralisation in 2001, when they became the prerogative of local governments. Indonesia has one of the highest relative minimum wages in the world, equal to 65% of the average wage of salaried workers, although the situation varies somewhat across provinces. Minimum wages are used as the main reference for salary negotiations, rather than just as a social safety net for the poor workers. However, firms can easily opt out of minimum-wage requirements if they prove they cannot afford them (Saget, 2008).

Minimum wages rose by 8.8% on average across all provinces in 2011, with increases of more than 15% registered in some. According to the Ministry of Manpower and Transmigration, minimum wages are projected to rise by 9.2% on average in 2012. Jakarta is expected to experience an even higher rate (18.5%), with the monthly level rising to IDR 1.5 million (USD 170). Although a jump in excess of productivity gains may be justified in areas where the minimum wage is low and below an estimated decent wage, there does not seem to be a clear negative relationship between the 2010 level of the minimum wage and its 2011 increase across provinces (Figure 7). If anything, the relationship appears to be slightly positive. In any case, increases cannot be justified in terms of catch-up effects. In provinces where the minimum wage is above an estimated decent wage, increases in the inflation-adjusted minimum wage should be kept in line with trend productivity gains. In addition, it would be useful to introduce a youth sub-minimum wage, which could offset some of the effect of high minimum wage on employment opportunities for new entrants. Such an instrument is common in OECD countries, such as the United States, and also exists in India.

Figure 7. Real minimum wage increases by province



Source: OECD calculations using Statistics Indonesia data.

Reforming the labour code

Severance payments are high by international standards and hiring and dismissal procedures for formal-sector permanent workers are amongst the most restrictive in East Asia. At the same time, the complexity of the rules makes labour costs difficult to predict. Legislation pertaining to fixed-term contracts is also rigid, which limits their use by small firms. These factors contribute to widespread labour-market informality and the extensive use of employees without contracts (OECD, 2010a). According to some estimates from the Ministry of National Development Planning, 62% of employment was informal in 2011. While formalisation will certainly augment workers' income, it should also boost their productivity, as there is evidence that formal workers have easier access to training than their informal counterparts.

The labour code has proven extremely difficult to reform, even though in effect it has provided only weak protection to workers. For example, only a third of eligible employees who lost their jobs in 2008-10 actually received severance pay (World Bank, 2010d). A way to counter resistance to reform would be to compensate the reduction in severance payments and employment protection by the introduction of unemployment benefits, which are currently non-existent. Supplying unemployment benefits would have the advantage of pooling risks and providing coverage to the workers who need it most. However, the cost of providing unemployment benefits is found to be particularly high in emerging-market economies with large informal sectors (OECD, 2011). Requiring benefit recipients to search for work would be a way to counter moral hazard, but this may prove difficult, given the limited institutional capacity Indonesia has at the moment and would require significant investment in activation policies. A more promising approach would be to limit the amount of such benefits and to complement them with individual unemployment saving accounts as in Austria. Such accounts would be potentially tax-supported and provide assistance to liquidity-constrained unemployed individuals during their job search. By allowing workers to run down their accounts when they are unemployed, workers internalise the cost of unemployment benefits. This strengthens the incentives facing the employed to avoid job loss and those of the unemployed to return to

work quickly. This option would be less costly than the introduction of a standard unemployment benefit system but is also likely to be more difficult to administer.

Boosting small firms' investment

Gains in SME productivity could be achieved through investment. Obstacles to investment vary widely with the size of firms. According to the World Bank Enterprise Survey, access to finance is by far the most important impediment to investment for small firms in Indonesia. A large informal sector is also reported to discourage investment, as do high electricity costs and political instability.

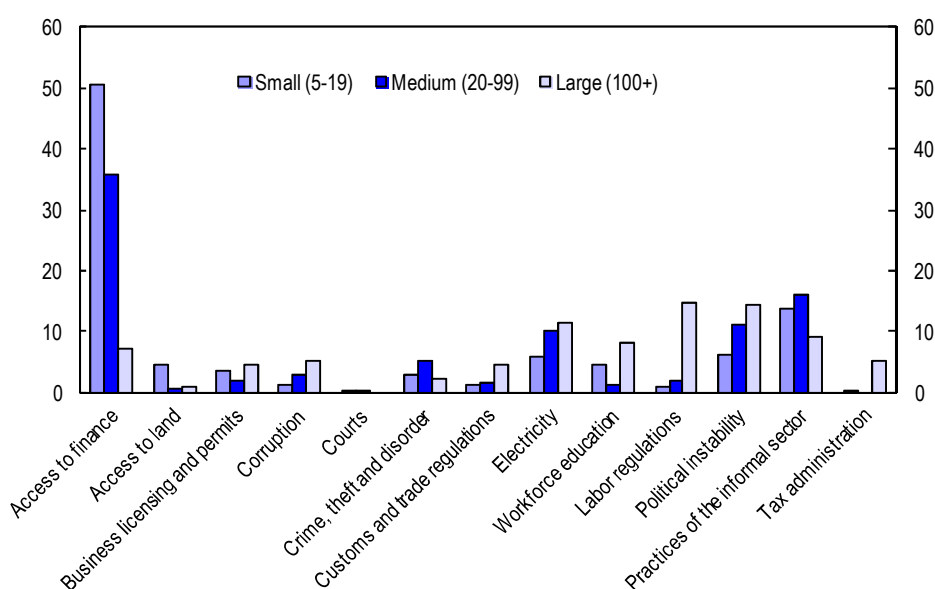
Access to finance

Small firms' financing is the most binding obstacle to investment by far (Figure 8). This is consistent with the 2005 Bank Indonesia survey on MSMEs, which suggests that access to finance becomes increasingly problematic as the scale of the business decreases. It is also similar to what is observed in developed and other developing countries (Beck *et al.*, 2006). Access to credit is particularly stringent for Indonesian small firms operating in the informal sector. One consequence is that a large amount of capital is provided by self-financing or informal sources such as loans from individuals and family (Table 4). In 2009, 90% of informal enterprises in Yogyakarta or Banten had no bank loans but rather used a social network of family, friends and neighbours as their main source of financing (ADB, 2010).

Given the severity of these financing constraints, the authorities have focused on measures to facilitate access to the banking sector. In 2001, banks were asked to establish self-determined targets for SME lending and report them. This replaced a 1992 regulation that required at least 20% of their loans to be directed to SMEs. Over the years, banks have channelled an increasing share of their liquidity to the

Figure 8. Principal obstacles to investment by size of Indonesian firms

2009, per cent



Source: World Bank Enterprise Survey.

MSME sector. Non-performing-loan ratios suggest that the quality of loans to small firms compares favourably with conventional loans (World Bank, 2010a). But bank loans remain concentrated in the trade and service sectors and in the Java and Bali regions. In addition, most loans are used to finance working capital, while investment financing represents less than one-third of the total (Table 5).

Table 4. **Small firms' access to finance in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Share of investment financed internally (%)	41.9	34.0	85.6	27.5	85.4	86.2	85	81.9	85.8
Share of investment financed by banks (%)	5.3	35.9	5.2	49.9	6.1	5.7	6.5	8.5	6.0
Share of investment financed by supplier credit (%)	9.5	7.1	2.3	2.3	0.3	1.3	0.1	1.5	1.1
Share of investment financed by equity or stock sales (%)	0.0	3.9	0.6	12.3	0.8	2.4	4.9	6.0	3.0
Share of investment financed by other financing (%)	43.3	19.2	6.3	8.0	7.5	4.5	3.5	2.0	4.2
Share of firms using banks to finance working capital (%)	11.6	44.3	11.8	53.0	30.6	10.8	35.9	39.8	13.8
Share of loans requiring collateral (%)	97.4	61.7	43.1	98.4	99.1	81.1	94.6	91.7	83.6
Share of firms identifying access to finance as a major constraint (%)	16.3	13.4	15.3	34.9	15.2	14.8	12.4	5.7	14.3

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.

Source: World Bank Enterprise Survey.

Table 5. **Bank loans to SMEs**

End 2011

	IDR billion	Per cent of total	Per cent of total loans
Total	479 887	100	21.6
Sectors			
Agriculture, livestock, forestry and fishery	32 948	6.9	28.4
Mining and quarrying	3 995	0.8	4.7
Manufacturing industry	52 820	11.0	15.4
Electricity, gas and water supply	1 244	0.3	2.7
Construction	24 943	5.2	33.0
Trade, hotel, and restaurants	224 874	46.9	54.3
Transport and communication	19 288	4.0	20.2
Financial, ownership and business services	30 690	6.4	17.0
Services	35 429	7.4	19.5
Not identified	89 086	18.6	13.0
Region			
Java and Bali	297 414	39.8	20.6
Outside Java and Bali	450 299	60.2	57.9
Type of credit			
Working Capital	375 296	78.2	34.9
Investment	104 587	21.8	22.6
Business size			
Micro	102 905	21.4	4.6
Small	150 912	31.4	6.8
Medium	226 069	47.1	10.2

Source: Bank Indonesia.

Collateral and property rights

The lack of collateral is often reported to be the binding constraint to credit access and results in harsher bank lending terms and conditions for small firms than for large firms. In addition, SME managers sometimes lack the skills needed to apply for a loan and meet bank standards, and hence promoting financial education could be very useful in this context. Efforts have been made in this area through the development of the Indonesian Financial Inclusion framework. In some other cases, the use of SME assets as collateral entails so much effort that in the end small firms would have to provide collateral with a higher value than that of the loan received. Since 2004, commercial banks have been allowed to accept assets other than land or buildings as deductions in determining loan loss reserves when allocating credit to SMEs. This measure, however, failed to significantly enhance small firms' access to credit.

Both creditor and lender rights need to be strengthened. Stronger creditor rights would allow lenders to reduce the risk of future losses. This is particularly important given the weak judicial system. Simplifying current costly loan-recovery procedures would also be helpful. Securing borrowers' property rights to assets they can pledge as collateral can help borrowers both in accessing finance and in obtaining cheaper and longer-term loans. Beck *et al.* (2008) show that, in terms of access to external finance, small firms benefit disproportionately from higher levels of property rights protection. In particular, despite some improvement, property rights regarding land are poorly defined and constrain the ability of small borrowers to use their properties as collateral. Indeed, the 1960 Agrarian Law recognises the rights of local communities over ancestral lands (OECD, 2012b). But subsequent laws governing the use of forest, water, minerals and plantations fail to reflect this entitlement. As a result, complex and opaque regulatory requirements for the issuance of permits and concessions allow corruption and conflict to thrive. The authorities need to clarify land rights provisions covering both individual and communal rights so as to reduce their regional diversity. The capacity of legal provisions to ensure debtors and creditors' rights relies nonetheless on an effective enforcement of the law.

Another way to boost bank loans is to provide government credit guarantees to non-bankable firms, *i.e.* those that have a profitable business but do not have access to bank loans. This is the objective of the people's business credit programme (*Kredit Usaha Rakyat*, KUR), launched in 2007. To supplement the collateral for loans, the government and some co-operative state banks provide a guarantee fee. There is a credit ceiling of IDR 500 million. The interest rate is determined by a Committee chaired by the Coordinating Ministry of Economy. Four state-owned banks, 26 regional banks, 2 sharia banks and one private bank participate in the programme.

KUR is estimated to have had a positive impact on wages and production (BRI, 2009). By end-2011 it had benefited 2.2 million people for a total disbursement of IDR 29.5 billion. Although the programme is judged to be relatively successful, it is reported to suffer from leakages, with some firms benefiting from the guarantees while they had access to credit. It would be useful to estimate the magnitude of these leakages, identify their source and take appropriate action to fix them. Another limitation of the programme is that its support is concentrated on certain regions (Java and Bali 49%, Sumatra 23% and Kalimantan 10%). Credit distributed to the productive sector, in particular agriculture, has been on the rise but remains smaller than that to the trading sector (38.5% of total disbursements). One way to expand the sectoral and regional coverage would be to allow more banks to qualify for the scheme, even though this may bring extra risk on the government balance sheets. In addition, the government could act to improve awareness among entrepreneurs of the range of financing options available to them. Finally, now that the programme has been in place for a few years, it would be useful to reduce the number of ministries involved in design and implementation, which amounts to 10 at the moment.

Credit-guarantee companies can also help viable but non-bankable MSMEs to obtain loans by providing guarantees. International experience suggests that these companies represent a powerful

instrument to ease SME access to finance, while limiting the fiscal burden, assuming they are properly designed to ensure that they are financially sustainable and that they target non-bankable firms rather than merely providing more favourable conditions to firms which could access market credit in any case (OECD, 2012c). So far, however, these firms have been perceived as unprofitable businesses and rather play the role of insurance companies in Indonesia (Djamhari, 2010). They also lack expertise. While experience from Asian countries highlights the importance for guarantors to have sufficient capitalisation and prudent risk-management practises (Shim, 2006), initial capital requirements appear to be excessively restrictive (IDR 100 billion at the national level, IDR 25 billion at the provincial level). It would be useful to adjust the regulation of credit-guarantee companies and encourage them to refocus their business model on the provision of credit guarantees, rather than insurance.

Information asymmetries

Contrary to the conventional wisdom, recent evidence suggests that banks want to expand their activity in the MSME segment, especially as margins in other banking markets have narrowed. But obtaining information on the creditworthiness of potential clients is costly. MSME borrowers often have no financial track record and are unable to provide reliable information. As a result lenders are likely to perceive the risk of lending to MSMEs to be greater than what it is in reality and will charge higher interest rates or be reluctant to lend at all.

One way to overcome the high cost of screening and monitoring clients is through the establishment of credit registries that provide reports on firms' loan repayment histories. Love and Mylenko (2003), in a study of 5 000 firms in 51 countries, find that the presence of private credit registries is associated with lower financing constraints and a higher share of bank financing. According to World Bank (2006), the availability of credit history information is found to reduce processing time, costs and default rates. A credit registry is likely to be more effective to the extent that it obtains both positive and negative information, builds credit histories for a large number of potential borrowers and processes comprehensive credit reports in a timely fashion. This requires sufficient capacity in banks to be able to process such information. To address this issue and in response to the ASEAN's SME development roadmap, Bank Indonesia and the Ministry of SMEs and Co-operatives will start to develop an SME-specific credit scoring system in 2013.

A public credit bureau already exists in Indonesia, but its scope needs to be broadened. Established in 2006, the Credit Bureau (*Biro Informasi Kredit*, BIK) collects and records credit/loan data in the Debtor Information System. The data are then processed to generate Individual Debtor Information (IDI) Histories. BIK has helped to improve transparency and information. Its information is restricted to credit and is more oriented toward consumer credit than commercial lending, as in many other countries (Wattanaputtipaisan, 2003). As a result, it does not improve access to finance by new firms that undertake risky investments that can potentially lead to high economic returns. A limitation of the BIK is that its access is still restricted. Data collected by BIK can be used by financial institutions, who are members (commercial banks, large rural banks and non-bank credit card suppliers). Other financial institutions can become members subject to the banking supervisor's approval. Letting non-bank financial institutions become members could spur SME lending.

Improving accounting and auditing standards can also facilitate SME access to finance by reducing informational opacities and encouraging lending based on financial statements. One possibility would be to have recourse to simpler standards, which would take into account the costs and the capability of SMEs to prepare financial statements and focuses on the need for information on cash flows, liquidity and solvency. One such example is the International Financial Reporting Standards (IFRS) for SMEs, which are about to be adopted by many OECD countries, though not all (International Finance Corporation, 2011).

Financial deepening and banking competition

The legal and regulatory framework of the financial sector plays a critical role in improving the SME financing landscape. Banking regulation that allows entry of efficient banks and promotes market competition may reduce margins in traditional business lines and induce banks to develop SME banking. Both firm-level and industry-level studies suggest that having developed financial markets benefits small businesses more than large firms.

The characteristics of Indonesia's banking system may inhibit lending to small firms. Even though it has more banks than other South-East Asian economies and is largely open to foreign banks, the market is concentrated. This stems from the explicit policy of encouraging mergers and industry consolidation since the 1998 Asian crisis. The four (partially) state-owned commercial banks account for one-half of the loans and the ten foreign banks for one third (Table 6). Large banks hold dominant market positions in rural and micro-finance. Although licensing is open, the minimum capital requirement is fairly high for commercial banks and rural banks in some regions, and it is not easy to obtain a license (World Bank, 2010a). As a result, new entrants usually take over an existing bank. Looking forward, the authorities envisage adopting a multi-license model to move toward regional standards. In addition, caps on bank ownership became effective in July 2012, except for banks that fulfil a range of criteria such as passing BI's financial tests that focuses on good corporate government practice and getting approval from the banking regulator. These policies could also hamper market entry. It would be useful to investigate the effect of these recent and mooted regulations on entry in the banking sector and reconsider those that are found to be a major obstacle to entry.

Table 6. Loans to SMEs by type of banks

End-2011

	Loans to SMEs IDR billion	Per cent of loans to SMEs	Per cent of total loans
State-owned banks	222 645	46.4	29.2
Private national banks	194 234	40.5	19.4
Regional development banks	31 314	6.5	17.8
Foreign-owned banks and joint venture banks	9,971	2.1	4.1
Conventional/Islamic rural banks	21 723	4.5	52.9
Total	479 887	100.0	

Source: Bank Indonesia.

Some specific restrictions in rural banking can prevent market deepening. At the moment, rural banks can be owned only by Indonesian citizens. Easing this restriction would increase opportunities for capital and technology transfer. Finally, rural banks are subject to stringent restrictions for opening new branches. Branches may be opened only in the same province as the main office, and the bank must have been financially sound over the past year, have maintained a capital adequacy ratio of at least 10% and have current information technology. Although Bank Indonesia is applying these restrictions in a very liberal manner, it would be advisable to eliminate these requirements.

While the stock market has performed relatively well since the 2008 global crisis, it remains shallow compared to regional peers, and small companies have been reluctant to go public. Despite the existence of the specific Initial Public Offering (IPO) process for SMEs, the number of small companies being listed is extremely limited. One explanation is the disproportionate costs incurred after an IPO in terms of information disclosure. Less onerous reporting and disclosure requirements for small firms, while

preserving the need to ensure good governance and transparency, could also make IPOs an attractive option for financing.

Some segments of the non-bank financial markets are insufficiently developed, with the result that young growing firms are not well served. They need more resources than can be provided by informal investors, family or friends or their own capital. But they are too small to rely on institutional investors, banks or stock markets. Venture capital and alternative financing such as leasing and micro-finance aim to fill that gap.

The venture-capital industry can finance SMEs with a strong potential for growth but which do not manage to obtain financing through traditional channels because they have not yet demonstrated favourable performance. This industry is still underdeveloped in Indonesia and constitutes a small segment of the country's financial sector. In particular, it has not managed to attract new investors in recent years, and most venture-capital companies are owned by the government or large national companies. One reason may be the shallowness of stock markets. In particular, the small number of IPOs, which provide an exit opportunity for venture capitalists, has been found to be a significant explanatory variable explaining firms' engagement in venture capital (Jeng and Wells, 2000). Against this background, the government has granted venture-capital companies tax exemptions for investments made in some industries. But this risks distorting the allocation of scarce capital and increasing rent-seeking behaviour, and should be reconsidered. Moreover, the existing restriction of 85% on foreign ownership of venture-capital companies could hamper entry and would best be removed. This is particularly important as the lack of expertise in the industry is costly.

As in other countries in Asia, most venture-capital companies do not provide genuine risk capital (Naqi and Hettihewa, 2007). Some function like commercial banks, albeit with fewer restrictions, and still rely on collateral. In February 2012, the Minister of Finance issued a decree to encourage them to focus on non-bankable firms. It also introduced regulation on entry requirements, licensing and capital requirements. These changes go in the right direction, but it will be important to regularly assess their effect. However, efficient monitoring of the venture-capital market will require a significant improvement in the quality and coverage of statistics, in particular a clear distinction between venture capital and private equity.

Leasing (*i.e.* renting machinery or equipment whose ownership rests in the hands of a financial institution), can relax financing constraints facing SMEs. This arrangement is particularly suited to the needs of new SMEs that do not have a long credit history nor collateral, especially when financial markets are shallow. Clients benefit from a number of advantages including simple collateral arrangements and flexible contracts. Collateral is easier to repossess, and capital requirements are lower for leasing companies. Leasing is also an accepted mode of financing under Shariah rules.

Despite these advantages, leasing, which is provided by multi-finance companies, has played a limited role in Indonesia in recent years, though it was widely used before the 1998 Asian crisis. Since then, the share of leasing in total revenues of multi-finance companies has declined from 17% to 12% in 2010. As multi-finance companies rely mostly on bank loans for their financing, they are sometimes unable to offer competitive rates (World Bank, 2006). The lack of expertise in credit risk assessment related to leasing has also discouraged multi-finance companies from entering these markets. The Indonesian authorities could foster leasing activity by freeing the industry from existing restrictions. In particular, phasing out the current limits on foreign ownership to a maximum of 85% of equity capital could enlarge the pool of financing for multi-finance firms and bring in technology and expertise. Another option would be to phase out the current investment restriction set out in a 2000 Minister of Finance decree according to which the total investment made by a multi-finance companies cannot exceed 40% of its own equity.

In recent years, micro-finance initiatives have gained prominence in Indonesia, as in other developing economies. According to Mixmarket data, such loans amounted to USD 274.4 million in 2010 and were allocated to almost 410 000 borrowers. Many of the providers are informal as they have a strong incentive to operate in the least regulated segment (Box 3).

Box 3. Micro-finance in Indonesia

Indonesia has a long history in micro-finance. The first micro-finance institution, *Badan Kredit Desa*, was established 100 years ago.

The largest proportion of micro-finance institutions are well within the formal sector. Commercial banks account for about 80% of the loans. *Bank Rakyat Indonesia* (BRI) dominates the sector. BRI has an operational advantage because of its extremely wide network of branches enabling it to reach rural villages. This makes it difficult for any newcomer to challenge its position. According to BRI corporate policy, loans to MSMEs should make up to at least 80% of the bank's total portfolio (World Bank, 2010a). BRI's premier micro loan product is Kupedes, which provides loans up to IDR 100 million, with an interest of around 1½% per month. Clients are in general small traders located close to a BRI unit. Loans are made on the basis of income or clients' characteristics rather than collateral.

Table 7. Characteristics of selected Indonesian micro-finance institutions

USD, 2010

	Average deposit balance per depositor	Average loan balance per borrower	Cost per borrower	Gross Loan portfolio (million)	Number of active borrowers	Personnel	Return on assets (per cent)	Women borrowers
BMT Sanama	-	-	-	147.3	-	12	1.8	-
BPR AN	111	512	82	1.7	3 387	25	4.9	865
BPR AK	116	677	61	4.5	6 600	48	4.2	1 772
BPR BMMS	346	1257	215	0.7	569	23	1.3	334
BPR DMG	395	1264	314	0.7	550	29	3.0	58
BPR Hitamajaya	126	715	171	1.7	2 326	31	7.8	-
BPR NBP 11	244	1035	91	7.0	6 765	95	6.5	3 124
BPR NBP 2	124	701	122	4.9	6 970	65	5.6	1 184
BPR NSI	104	314	29	3.9	12 479	60	9.1	7 363
BPR Pinang Artha	320	1372	246	1.5	1 061	30	3.7	271
BPR Surya Yudha Kencana	489	1749	128	66.1	37 783	568	5.1	10 521
Dian Mandiri	1	46	37	2.0	44 214	220	0.0	39 695
KOMIDA	27	88	23	3.2	36 109	252	3.9	36 109
KSP Bakti Huria	14	222	60	2.9	13 257	270	1.3	7 603
KSU MUK	84	93	22	0.5	5 277	26	12.7	4 569
MBK Ventura	15	80	23	16.9	212 316	1218	-5.6	212 316
Mitra Usaha Kecil (MUK)	11	120	33	0.7	5 920	48	6.4	5 200
Average	158	640	104	16	24 724	178	4.1	22 066
Median	114	595	72	8	6 683	48	4.2	4 569

Source: Mixmarket.

People's Credit Banks (BPR) are also present in the market. They operate in the formal sector and vary in terms of size, market niche and performance (Table 7). Finally, micro-finance is also provided by small-scale institutions, which could be formal or informal. Some operate under condition of uncertainty over their legal status, eligibility to mobilise deposits and by which levels of government they are governed. They can be pawn shops, institutions owned and regulated by local governments (LDKPs), NGOs, and small savings and credit societies (*arisan*). Co-operatives and NGOs usually provide subsidised loans for their membership and target groups. They compete with a number of government lending programmes run by departments or State-Owned Enterprises.

Source: World Bank (2010a), Shrader *et al.* (2006).

As banks incur a financial penalty when they lend to institutions without legal status, the financing source of these informal micro-loan providers is restricted. A law on micro-finance to clarify the status of institutions not falling under the Banking Act has been under discussion for more than a decade. Various proposals have been submitted to Parliament, but the law has not yet been approved. In 2009 a decree

created a regulatory framework under existing laws to govern non-bank and non-co-operative financial institutions that operate outside the regulatory framework. But the decree has not been fully implemented (World Bank, 2010a). Efforts should be stepped up to pass a new micro-finance law and expand the coverage of the regulatory framework.

Fostering infrastructure development

Poor infrastructure is reported to be one of the major factors influencing investment decisions. Despite some improvement, the road and railway networks are still in poor condition, and the capacity of seaports remains limited. According to data from the Indonesian Institute for Sciences (LIPI), transportation costs in Indonesia amount to around 30% of total production costs due to poor infrastructure, while companies operating in China need to allocate only around 12% of their production costs to transporting goods.

The lack of electricity infrastructure can also hinder MSME operations, since small firms seldom have alternative power sources. According to the Asian Foundation, almost half of the 13 000 companies surveyed in 2010 and 2011 experienced power outages at least three times a week. A World Bank report for 2011 ranks Indonesia 161st among 183 countries in the ease of businesses' getting reliable electricity supply.

Fostering infrastructure development has featured as one of the main priorities of the Indonesian government in recent years. Ending a long period of uncertainty, the Land Acquisition Law was finally passed in December 2011 and implementing regulations issued in August 2012. The law empowers the government to take over land for development while owners are guaranteed compensation.² Although the law is widely expected to accelerate infrastructure development, it is unlikely to be sufficient to quickly close the infrastructure gap, given the substantial needs.

In May 2011, the President of Indonesia launched the Master Plan for the Acceleration and Expansion of Indonesia's Economic Growth for the period 2011-25 (*Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia*, MP3EI). The plan provides a strategic direction for investors on where the government's economic development focus will be in the next 15 years. The MP3EI foresees that about IDR 1924 trillion (some USD 213 billion) will be allocated to infrastructure sectors during the period 2010-14. The authorities expect about 72% of these funds to be financed by the private sector or through public-private partnerships or foreign direct investment (Box 4). However, attracting such a high level of private and foreign investment may be challenging in the current business environment. Raising the amount of infrastructure investment the government intends to finance will not have a dramatic effect on the public deficit in the long run (Figure 9). It could even improve the government balance for sufficiently large private financing. Given the large pay-offs investment in infrastructure are likely to have at the country's stage of economic development, the authorities should consider faster increases in direct

2. The bill covers infrastructure projects such as roads, dams, tunnels, railways, ports and airports, oil, gas and geothermal facilities, power plants and their distribution networks, hospitals and telecommunication networks. It is limited to government projects but allows government to partner with state-owned firms and the private sector. The bill shortens to two years the process of deciding on a project location, with a possible extension of one year. It gives a clear timeframe for land acquisition that includes decisions over a location, an appeals phase and compensation to be decided by a court within 30 days. It will also shorten the time it takes for infrastructure projects to acquire land. Compensation can come in the form of cash, land swaps, share ownership, assisted relocation and/or other forms agreed by both parties. The bill gives local government the power to decide on the location of a project and charges the National Land Agency with overseeing the acquisition process. A separate presidential regulation, which was issued in August 2012, set a maximum time limit of 583 days for the completion of land acquisition and details of steps to be taken for the handover of land for public projects.

public spending on infrastructure. Reducing energy subsidies or increasing tax collection efforts appear to be the most efficient ways to finance this additional spending.

Box 4. Main features of the Master Plan

The *Masterplan Percepatan dan Perluasan Pembangunan Ekonomi Indonesia* (MP3EI) is based on the development of six economic corridors, the strengthening of national connectivity and the acceleration of technological and R&D capacity. Within the different economic corridors, the plan identifies sectors that have high growth prospects and where Indonesia has the potential to increase its competitiveness. For the nation as a whole 22 sectors have been given priority, mostly natural resource sectors. The plan also singles out regional investment in infrastructure and development in human resource and technology that would boost growth in these sectors. In addition, the plan highlights the need to implement some cross-cutting reforms. These include ensuring the consistency of national and regional laws and regulations, developing the regulatory framework and putting in place incentives to promote investments.

The plan is expected to be implemented in three sequential phases:

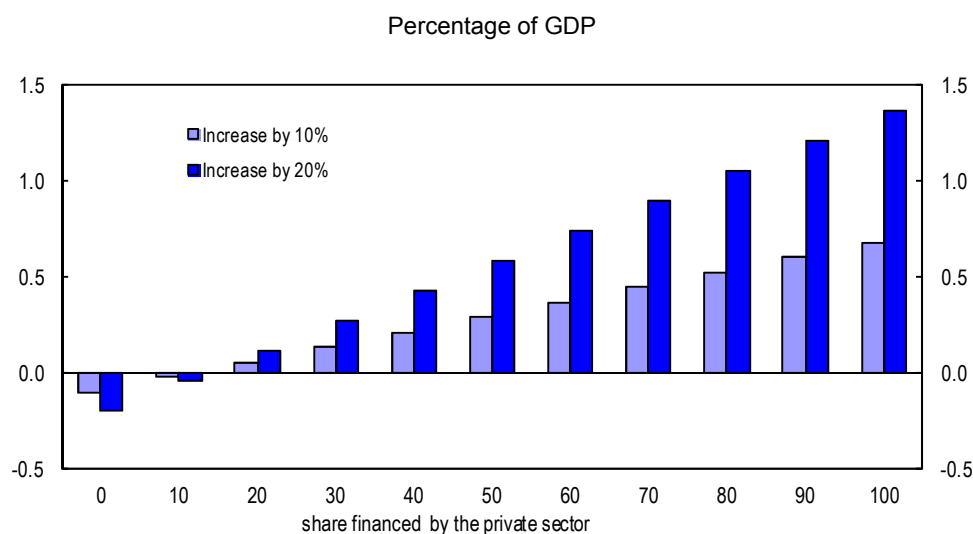
- From 2011 to 2015, the focus will be on measures that can be easily implemented, on speeding up the process of issuing pending regulations and on preparing the ground for the next phases. Few projects during this phase represent new initiatives. Most appear to be projects that were already in the pipeline over the past several years.
- From 2016 to 2020 the focus will be on the acceleration of long-term infrastructure development and on boosting innovation and promoting higher value-added industries.
- From 2021 to 2025, it is assumed that the foundation will be in place for Indonesian industries to compete globally and use high-level technologies.

The plan is governed by presidential decrees. Over the next 15 years, the plan targets IDR 4 276 trillion (USD 468 billion) of which 45% will be directed to infrastructure sectors. 51% of total investment is expected to be covered by the private sector, while SOEs would contribute 18%. Central and local governments would finance about 10% of investment mostly in the form of basic infrastructure provision, such as roads, seaports, airports, railways and power generation. The remaining 21% will come from foreign investment and PPPs.

Source: Master Plan (2011), World Bank (2011b).

As underlined in the 2010 *OECD Economic Survey*, an increase in public spending will need to be complemented by additional reforms. Some progress has already been made: new regulators have been established in the rail transportation and water and sanitation sectors, but they are not fully independent. A set of guidelines clarifies the use of private-public partnerships in network industries. In addition, it will be important to strengthen the powers of existing regulators and improving co-ordination between national and local authorities. Regarding the electricity sector, priority should be given to phasing out electricity subsidies. The authorities have envisaged raising electricity tariffs in 2013 by around 3.5% per quarter (15% for the whole year). The authorities should pursue their efforts to lower electricity subsidies, given their long-term deleterious effects on economic growth and the environment. Widespread communication of the benefits and distributional gains of subsidy removal and recourse to existing well-targeted cash-transfer schemes will help to overcome resistance to reform. In any case, until subsidies are significantly reduced, adequate compensation to the state-owned electricity producer, as suggested by the OECD Guidelines on Corporate Governance of State-Owned Enterprises, would improve its balance sheet and ease financing for such crucial investments.

Figure 9. Long-term effect of an increase in public infrastructure spending on the public balance



Source: OECD calculations using elasticities from Sahoo and Dash (2011), "Economic Growth in South Asia: Role of Infrastructure", *The Journal of International Trade & Economic Development*, Vol. 20, Issue 4, pp. 1-36.

Promoting innovation by enhancing the enforcement of intellectual property rights

Innovation is likely to be a major source of SME productivity improvement. SMEs can support innovation, not only as knowledge exploiters but also knowledge sources. Small firms in Indonesia appear to innovate less and have less recourse to new technology than regional peers (Table 8). This partly explains aggregate developments in R&D spending as a percentage of GDP in Indonesia, which is low and has not risen as fast as elsewhere. Commonly used indicators of R&D outputs such as fees received from royalties, licenses or patents granted are also lower in Indonesia than in Brazil, China and India.

Table 8. Small firms' role in innovation in Indonesia and selected Asian economies

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms with an internationally recognised quality certification	-	12.2	8.6	6.8	6.0	1.6	6.3	40.8	2.9
Per cent of firms using technology licensed from foreign companies	-	-	2.4	-	0.9	2.4	10.3	35.4	4.0
Per cent of firms having their own website	29.0	8.5	36.7	23.6	25.6	4.2	9.2	45.3	5.7
Per cent of firms using e-mail to interact with clients/suppliers	43.7	36.3	49.4	45.4	74.5	9.4	31.1	81.8	13.2

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.

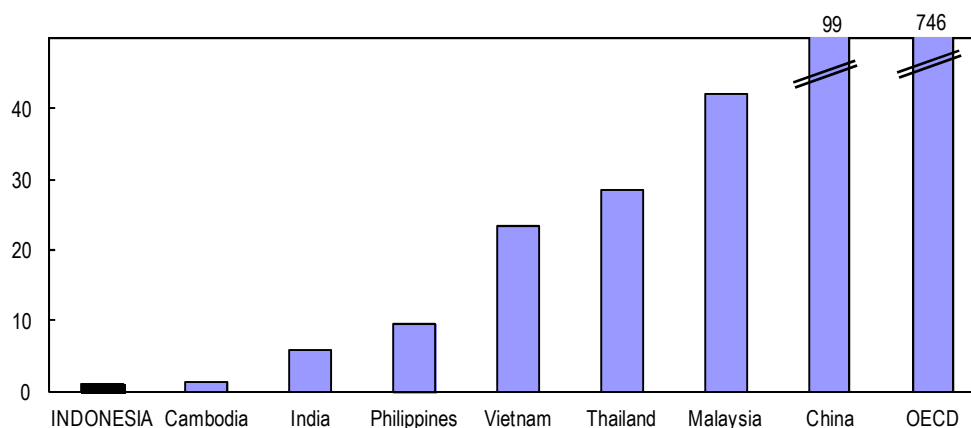
Source: World Bank Enterprise Survey.

Well designed intellectual property protection will encourage innovation. As many small firms operate in the informal sector, they tend to adopt strategic methods such as trust and secrecy more than formal paths to protecting their intellectual property. When Indonesian small firms adopt formal protections, they have a clear tendency to use trademarks above all other instruments, particularly patents,

which are mostly used by foreign companies. This is similar to what is observed in other countries and is likely to reflect the nature of firms' innovation activity (Cusmano and Dean, 2011). However, Indonesia performs poorly *vis-à-vis* regional peers in terms of number of registered trademarks (Figure 10).

Figure 10. Trademark registrations

2010, per 100 000 persons



Source: World Intellectual Property Organisation indicators, 2011.

Intellectual property rights (IPR) legislation was updated to meet international standards in the 2000s. The passage of a new copyright law in July 2002 and accompanying regulations in 2004 strengthened Indonesia's IPR regime. During the same period, the delegation of IPR matters to specialised commercial courts helped to build expertise in the legal system. This has sped up the process, and resulting intellectual property decisions have been judged to be largely sound (Antons, 2007). In addition, special measures have been taken to meet the needs of small firms, raise their IPR awareness, diffuse knowledge about the variety of intellectual property instruments, lower the cost and time for application, and encourage firms to develop their own IPR strategies. The most important measure was the introduction of a special lower fee for small firms filing and administering their intellectual property, with an exemption for micro firms. The authorities also plan to hold courses or implement other capacity-building programmes to provide financial and technical assistance and facilitation for registration of SME trademarks and designs.

Despite the government's significantly expanded efforts to improve enforcement, intellectual property piracy remains a major concern. A lack of company confidence in enforcement mechanisms deters SMEs from accessing the system in the first place. It is costly to monitor potential infringement of IPRs, and the threat of litigation by more resourceful firms can sometimes intimidate SMEs. In March 2006, a presidential decree established a national taskforce for IPR violation prevention. It was intended to formulate policy to prevent IPR violations and determined additional resources needed for prevention, as well as to help educate the public and improve international cooperation to prevent violations. It is important to follow up and allocate more resources to improve enforcement of IPR regulations. In addition, policies should reduce the time and cost of enforcement procedures and improve firms' confidence in the process. Some countries, like the United Kingdom, have streamlined procedures to make patent litigation more accessible to SMEs (Cusmano and Dean, 2011). Adopting a similar approach could be useful for Indonesia.

Increasing the availability of qualified labour

The lack of qualified personnel can be a barrier to productivity growth and is likely to be even more so in the future as the economy moves toward a knowledge-based economy and the size of the non-agricultural part of the economy (which is more education intensive) expands. According to the 2010 World Bank Skill Survey, the skills of senior education graduates do not meet the expectations of Indonesian employers. Only 7% are rated ‘very good’, with most considered just ‘fair’. Although most employers think their workers do not suffer from insufficient basic skills, 40% indicate they lack thinking and behavioural skills as well as vocational skills that are transferable between jobs like computer literacy and language proficiency.

Deepening the pool of skilled workers

Improving access to education is key to raising the general skill level. Enrolment rates have increased at all education levels in Indonesia and have resulted in significantly higher attainment in the younger generation (15 to 29 year-olds), with 35% of the associated labour force having an upper secondary diploma or higher in 2007, as opposed to only 22% for the 30 to 59 year-old cohort. Despite these improvements, the country lags behind regional peers in secondary and higher education, and there are large inequalities in access. As indicated in the 2010 *Economic Survey*, enrolment is particularly low in secondary education, suggesting the need to smooth the transition from primary to higher levels of education. Plans to implement universal secondary education and provide funding to 9.5 million high-school students, including students at general high schools, vocational high school and Islamic schools is expected to enter into force in 2013, although funding still need to be allocated in the 2013 Budget. Early dropping out could also be reduced by allocating additional government spending to extend conditionality in income-support programmes and include secondary school attendance. In addition, a higher per-student transfer under the School Operations Fund programme (*Bantuan Operasional Sekolah*, BOS)– which includes direct block transfers to schools to finance non-payroll recurrent expenditures – for schools located in remote areas and catering for poor students would improve financial support to students from disadvantaged backgrounds. Increased conditional cash transfers to poor households could be an alternative option.

Programmes have been put in place to provide skills to the large number of youths who drop out without any qualification. In the public technical training centres (*Balai Latihan Kerja*, BLKs), trainees receive around 140 hours of basic school training. But the centres suffer from a severe lack of capacity, stemming mostly from budget cuts in the aftermath of the 1997-98 Asian crisis. Their curriculum, which is designed by the central government and is limited to a small number of topics, also does not always reflect local firms’ skill needs. Moreover, certifications are issued by the centres themselves and are not valued by employers. In the end, it remains unclear whether such schemes achieve their objectives. Beside formal education, “non-formal” education in the form of equivalency programmes (*pakets*) allows participants who had no access to the formal education system to get qualifications up to upper-secondary level. But, at the moment, there is no follow-up monitoring to check whether these programmes have proven successful in lifting the skills of past participants and in favouring their integration in the formal labour market over the medium term. It would be useful to rigorously assess the cost-efficiency of all existing programmes aiming at upgrading dropouts’ skills and phase out those found to be inefficient. Such an evaluation would also help to identify potential ways to improve programmes that are found effective.

Aligning education and training systems with labour-market demands

In addition to raising enrolment rates, there is a need to improve the quality of education services. Employer surveys suggest that a high share of educated workers does not have the expected level of skills from their level of education. Indeed, the skills provided by the education system are not uniform across

schools or among students within schools (World Bank, 2010d). Ways to raise teaching quality have been put forward in the 2010 *Economic Survey*. In particular, the 2005 Teacher Law is an important development and creates incentives for teachers to engage in training. However, the law needs to be complemented by efforts to monitor progress in teaching quality through regular assessments of teachers' pedagogical skills. Continued efforts to tackle teacher absenteeism would also yield substantial payoffs. At a minimum, teacher attendance needs to be monitored more effectively.

Vocational schools offer an alternative path to provide students with generic skills necessary to find a job. Their programmes last three to four years and are targeted at 16 to 18 year-olds. Training providers teach mostly technical topics. The curriculum is defined by the Ministry of National Education, with little input from private-sector firms. Moreover, the general coverage of the curriculum is found to be insufficient (World Bank, 2011a). The sector has expanded rapidly in recent years, with a growing number of private-sector providers. The authorities wish to expand it further to reach a 30/70 general/vocational ratio by 2015. Achieving this target is likely to prove extremely costly (World Bank, 2010e). Rather than increasing further the number of vocational training providers, it would be preferable to enhance the importance of generic skills in vocational schools' curricula and focus more on transferable vocational skills (such as computer literacy) and on on-the-job and practical training which are highly valued by employers. This could be done by strengthening the links with the productive sector. Finally, removing education from the negative investment list, as is currently examined in the context of the revision of the 2010 Investment List, would open up the market to competition from foreign vocational-training providers.

Training can also be delivered through apprenticeship programmes aiming at developing workplace learning in the private sector. These initiatives have been regulated since 2005, but companies retain most responsibility on the content and certification, with the government just monitoring whether the regulations are applied. Overall there is little information on the quality and quantity of training provided through this channel (Martinez-Fernandez and Powell, 2010).

Non-formal vocational training provides workers and students with specific and upgraded skills. However, the system does not reach dropouts but is rather used as a complement to formal education. According to the Ministry of National Education, almost 70% of students in the non-formal sector were also enrolled in formal education, while 16% were working. In addition, the quality of services varies across institutions due to the lack of standards in the certification process and weak enforcement of rules once accreditation has been granted. The priority is to ensure good quality for all the training courses and to facilitate access for the poor. Steps have been taken in this direction. The government has started to develop standards for training. This needs to be complemented by a comprehensive quality-control system that will ensure rules are enforced.

Changes to the tertiary-education sector are also required to make it more responsive to firms' needs. Accreditation data show that the average quality of university programmes is improving, albeit slowly, and private institutions are reported to be of poor quality. In addition, some sectors, like manufacturing, experience shortages of higher education graduates, suggesting that curricula may not be connected to sector-specific demands. In its Higher Education Long-Term Strategy 2003-10, the government sought to improve the quality of higher education and enhance its ability to respond to evolving labour-market demand. It is important to grant more autonomy to tertiary-education institutions so that they can adapt more easily to firms' skill requests and ensure high-quality teaching. In August 2012, a Higher Education Bill was passed to increase the autonomy of higher education institutions.

There are a number of ways to address the long-standing issue of unequal access to higher education and cope with increase in tuition fees that could result from the law. First, encouraging participation in secondary education is likely to translate into higher enrolment rates in tertiary-level education, and measures to achieve this have been described above. Second, a range of cost-sharing instruments could be

used to alleviate the financial burden borne by poor students. A 2009 law already mandates that scholarships be available to at least 20% of the student population. As public resources are limited, more extensive use of student loans could be made. Indeed, international evidence suggests that a national income-contingent loan scheme that is based on charging moderate fees recouped via the tax system when the graduate enters the workforce and earns above a certain salary level would ease disadvantaged students' access to higher education (Schleicher, 2006). The provision of such loans is currently underdeveloped in Indonesia. One reason is that, like in many other Asian economies, Indonesia's past experience with such schemes has led to mixed results, with high delinquency rates leading to financially unsustainable programmes. But this stemmed essentially from poor administration and weak targeting. A second reason has been the low supply of bank loans. Better governance and targeting as well as more developed banking activity render student loans a more attractive option nowadays.

Strengthening workforce quality

Evidence from East Java suggests that the accumulation of human capital during working time is an important determinant of firms' growth (McPherson and Rous, 2010). Firms can participate in the provision of job-specific skills either through on-the-job training or through co-payments for external training. Employer-provided training is scarcer in Indonesia than in the Philippines or Vietnam (Table 9). Less than 3% of small firms are reported to offer formal training. One reason is that in an informal job setting, firms have few incentives to provide training, as trained workers can easily leave and use their upgraded skills elsewhere. This is particularly true as in-firm training is usually targeted at skilled and young workers. Informal in-house training can compensate for the lack of training and should be encouraged. In particular, inter-firm linkages in the value chain provide an opportunity for employees to learn new ways of operating or of marketing a product.

Table 9. **Small firms' training opportunities in Indonesia and selected Asian economies**

	Cambodia 2007	Malaysia 2007	Philippines 2009	Thailand 2006	Vietnam 2009	Indonesia 2009			
						Small	Medium	Large	All
Per cent of firms offering formal training	45.8	17.0	14.7	30.9	11.6	2.8	13.2	37.5	4.7
Per cent of workers offered formal training	–	26.8	59.5	33.6	66.0	56.5	55.6	39.7	52.9
Per cent of unskilled workers (out of all production workers)	25.8	63.6	7.8	79.7	10.5	19.6	23.0	36.2	20.4
Per cent of firms identifying an inadequately educated workforce as a major constraint	12.8	13.2	10.0	27.3	5.6	4.5	3.7	6.3	4.5

Note: Size is defined by the number of employees: from 5-19 the firm is small, and from 20-99 it is medium-sized.

Source: World Bank Enterprise Survey.

A last but important reason for the scarcity of training within SMEs is cost. There are currently few financial incentives in place. A number of OECD countries have introduced innovation vouchers to enable SMEs to finance support for new product or process development or invest in training. But an efficient system of controls would need to be developed for such a measure to be efficient in Indonesia. National training funds have also been used in many countries as an instrument for encouraging firm-based training. Examples include the Latin America Fund (National Industrial Apprenticeship Service, SENAI) and the Malaysian Human Resource Development Fund. These funds help to consolidate and administer various sources of financing for training and allocate it according to national priorities. They are usually managed by the central government and directed by a governing board that includes employer representatives. This helps to ensure that feedback from the labour market is incorporated into training content. The authorities

could create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use.

Developing entrepreneurship

The education level of entrepreneurs in small firms is low in Indonesia. Data from the 2003 Social and Economy Survey (*Susenas*) suggest that more than half of all top managers had no diploma or had completed only primary school. Low levels of entrepreneurial skills can magnify barriers to SME development. In particular, capacity building in terms of improving financial statements and management training is found to have a positive impact on SME development in Europe (European Commission, 2006). There is also evidence that entrepreneurial training for workers in the informal economy facilitates the transition from self-employment in the informal economy to micro enterprise development in the formal economy (Martinez-Fernandez and Powell, 2010). Several programmes already exist to foster entrepreneurship in Indonesia, but it would also be useful to include entrepreneurship activities in school curricula. International experience suggests that most effective courses use interactive teaching methods that incorporate practical experience (OECD, 2010b). However, improving entrepreneurship skills in Indonesia is challenging and will require removing obstacles to accessing formal training.

Policies to support small firms

Given the importance of MSMEs in Indonesia's economic development, support to small firms has been an important facet of policy. As in many other countries, support has taken various forms, ranging from giving privileged access to MSMEs in certain sectors to more traditional credit programmes or subsidies, as well as training and counselling.

Clearly defining responsibilities across the government

Since 2008 support to small firms is by law a public duty, but the responsibilities of the different levels of government still need to be clarified. Most central-government ministries are currently involved in the delivery of support to MSMEs, but local governments also provide their own programmes. SME support is also one of the objective of the Masterplan of Acceleration and expansion of poverty Reduction in Indonesia (*Masterplan Percepatan dan Perluasan Pengurangan Kemiskinan di Indonesia, MP3KI*), which aims at reducing poverty by empowering people. A lack of effective coordination has resulted in a plethora of sometimes overlapping measures and an inefficient delivery of support. More clearly defined responsibilities among the different levels of government would help to ensure resources are efficiently used. Local governments should play a crucial role in implementation, given the central government's limited ability to reach out to MSMEs dispersed throughout the archipelago. The role of the central government should be confined to providing financial resources and assistance to local governments and enhancing their implementation capacity. It should also give general direction, assessing progress toward achieving this goal and ensure equity of access to programmes in all regions. There could be economies of scale for the central government to run some specific programmes (such as loan guarantees) when they do not require face-to-face contacts.

Programmes managed by several central-government ministries should be consolidated. One option would be to devolve management responsibility to a single ministry. It would be responsible for developing an overall strategy and monitoring and evaluating progress of different ministries towards the goals of the strategy. It could possibly have control over SME development funding that is currently scattered in nearly all ministries. Other possibilities include the management of policy by a new SME agency, or co-ordination of different ministries by a high-level committee chaired by a senior member of the government such as the Vice-President.

Moving to a neutral financing of support

One particularity of Indonesia's support policy is that it is partly financed by mandatory savings by State-Owned Enterprises (SOEs). Indeed, since 2003 a law mandates SOEs to allocate up to 5% of their net profit to support development of MSMEs and co-operatives. Support includes the provision of soft loans to non-bankable firms through a partner programme as well as the provision of grants to assist capacity-building activities in such areas as production and processing, marketing and technical skills improvement through mentoring programmes, up to a maximum of 40% of the total cost of the investment. A less distortive way to finance support would be to have recourse to general taxation.

Improving the efficiency of support

As stated, there is a multiplicity of programmes providing support. For instance, at least five aim at easing farmers' access to finance (OECD, 2012b). A study of Indonesian SMEs in regional production networks suggests that assistance is often perceived as effective (Machmud and Siregard, 2009). However, the form of assistance that is most often delivered is not necessarily that which is perceived by firms as the most effective. Counselling, training and financial assistance are those most frequently provided but rank lower in terms of their effectiveness. By contrast business linkage and networking and technology development, which are less frequently offered, are perceived to be more effective than training and financial assistance. Moreover, at the moment, the authorities only monitor rather than evaluate programmes, focusing on those that are strategic (Suryahadi *et al.*, 2010). It is important to regularly assess the cost-effectiveness of existing programmes. To be credible and prevent policy capture, it would be preferable to assign this task to an independent agency. After such a rigorous evaluation is undertaken, it may be possible to consolidate support by phasing out inefficient measures and directing resources to the most cost-effective schemes.

One of the main strands of policy support has been to encourage the formation of SME clusters, the rationale being that, in theory, the latter can be the source of productivity gains through economies of scale in the purchase of raw materials or machinery or spreading of risks associated with demand fluctuations. By locating in geographical dense locations SMEs can also benefit from abundant natural resources and a pool of skilled workers and get easy access to markets (Chamindale and Van, 2008; Bair and Gereffi, 2001). Clusters also allow sharing of R&D expenditures and diffusion/sharing of information on new designs, processes, products and knowledge spillovers (Aylward, 2004). Finally, policy support to SMEs is easier when the latter are concentrated in a cluster. Empirically there is some evidence that small firms that are parts of clusters are in a better position to adopt innovations and to export when compared with dispersed counterparts (Marwadi *et al.*, 2010; Berry *et al.*, 2001). The main drawback is nevertheless that clusters in developing economies tend to be controlled by large dominant enterprises.

SME clusters can already be found in all Indonesian provinces, most of them in rural areas. Some reflect collaboration among a number of extended families that have a long history of cooperation. But there is also evidence that most Indonesian SME clusters tend to grow spontaneously without government intervention (Marijan, 2006). This was the case for instance for two large clusters for leather goods and traditional handicrafts in the Yogyakarta area, which have developed virtually without public intervention (Tambunan, 2005). Against this background, it may be useful to examine the effectiveness of policy measures aimed at encouraging the formation of clusters.

Indonesia has been protecting small firms in its FDI policies by reserving certain sectors for them and requiring partnerships with them in other sectors. These sectors are specified in the negative investment list. This policy was initially intended to foster collaboration between foreign investors and local small firms and can potentially create technological spillovers benefitting the latter. But, this restriction could also discourage foreign companies from investing and needs to be reconsidered. Such policies may also

raise obstacles to SME growth, as firms may be keen on staying small to benefit from this privileged access.

Box 5. Summary of recommendations: SME development

The following recommendations could help to foster SME productivity:

Business environment and labour market

- Systematically review all significant existing business licensing requirements at the national and local levels, with a view to simplification and ensuring they remain cost-effective. Sanction regional governments that fail to make significant progress in simplification and consolidation.
- Public finances permitting, increase public outlays on cost-effective infrastructure projects beyond what is already planned.
- Lower electricity subsidies and have recourse to cash-transfer schemes to compensate poor households for the rise in electricity price.
- In provinces where minimum wages are high in relation to average wages, resist increases that exceed trend productivity gains. Introduce a sub-minimum wage for youth directly linked to the general minimum wage. Reduce onerous severance payments and ease dismissal procedures in the formal labour market. In return introduce unemployment benefits coupled with individual unemployment saving accounts.
- Improve the enforcement of intellectual property rights.

Access to finance

- Clarify property rights for land.
- Make the information collected by the credit bureau available to all non-bank financial institutions.
- Remove the tax exemptions granted to venture-capital companies to support investments in some industries and the existing restriction of 85% on foreign ownership of such companies.
- Step up efforts to pass a new micro-finance law, and expand the coverage of the regulatory framework.

Human capital

- Extend conditionality in income-support programmes to include attendance in secondary education. Increase the per-student transfer under the School Operations Fund (BOS) programme for schools located in remote areas and catering for poor students or alternatively increase conditional cash transfers.
- Rigorously assess the cost-efficiency of all programmes aimed at upgrading dropouts and workers' skills, and phase out those found to be inefficient.
- Remove formal education from the negative investment list.
- Encourage tertiary education financing through student loans.
- Create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use.

Policy support

- Clarify government responsibility in the delivery of support to small firms. Regularly assess the efficiency of existing programmes, phase out inefficient measures, and redirect resource to the most cost-effective schemes.
- Re-examine the effectiveness of policies to encourage the formation of clusters, to reserve certain industries for small firms alone, and to require foreign direct investors to partner with local SMEs.

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