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Trade and investment liberalization and the development of small and medium enterprises: A perspective from Indonesia

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BACKGROUND

In most Asian economies, small and medium-size enterprises (SMEs) are considered as the engine of economic growth by virtue of their sheer number as well as significant economic and social contributions. The role of these enterprises in industrial development in Asia is more pronounced than in Europe or North America. The contribution of SMEs in developing Asia is vital in as much as they make up about 80 per cent of all non-agricultural enterprises, yet generate about the same percentage of total employment. In addition, they contribute between 40 per cent and 70 per cent of total value-added.

In ASEAN countries, SMEs have played increasingly strategic roles, especially in the aftermath of the 1997 Asian financial crisis. As these economies modernize and industrialize, SMEs are providing the much-needed inter-firm linkages required to support large enterprises to ensure that they remain competitive in the world markets. SMEs generally account for more than 90 per cent of establishments, between 20 per cent and 40 per cent of total domestic output and employment of between 75 per cent and 90 per cent of the domestic workforce (table 1).

In Asia, the ability of SMEs to contribute to exports varies widely. In China, the percentage share of these enterprises in each country's total exports ranges from 40 per cent to 60 per cent, whereas in other countries such as Indonesia and Thailand the share is very low (table 2). This varying ability to export is, in itself, an indication of how competitive SMEs can or cannot be in the global economy, and of the fact that specific support measures might be needed to improve their performance.

Table 1. Non-agricultural SMEs in selected Asian countries*

Country/area	No. of non-agricultural SMEs in 2002 or later, or best guess ('000)	Percentage of GDP/ value-added (VA)/output	SMEs as a percentage of	
			All firms	Workforce
Brunei Darussalam[a]	30	n.a.	98	92
Cambodia	26	n.a.	99	45
Indonesia[b]	16,000	n.a.	98	94
Lao People's Democratic Rep.[c]	22	n.a.	n.a.	n.a.
Malaysia	205	15 (total output) 17.6 (VA)	84	32.5[i]
Myanmar[c]	34	n.a.	96	78
Singapore[d]	60-72	41 (manufacturing output)	97	58
Thailand	1,640	47 (VA)	96	76[i]
Philippines[e]	68	28 (VA)	99	99
Viet Nam[f]	2,700	42 (VA)	96	85
China[g]	8,000	60 (industrial output)	99	75
Taiwan Province of China[g]	1,050	n.a.	98.1	78.1
Hong Kong, China[g]	292	n.a.	98	60
Japan[g]	6,140	52 (manufacturing output)	99.7	72
Republic of Korea[g]	2,700	47.5 (gross output) 49 (VA)	99.7	75.3
Bangladesh[h]	n.a.	15 (GDP)	87	80
India[h]	n.a.	40 (industrial output)	95	80
Nepal[h]	n.a.	n.a.	79	98
Pakistan[h]	n.a.	15 (GDP)	60	80
Sri Lanka[h]	n.a.	55 (VA)	97	58
Developing Asia	n.a.	40-70 (VA)	80	80

Sources: APEC, 2002; RAM Consultancy Services, 2005; Narain, 2003; and UNCTAD, 2003.

Notes:

[a]Estimated active, 2004. [b]Includes micr o enterprises. Estimate of actual SMEs is closer to 700,000 firms. [c]As of 1998/1999. [d]Estimated active. [e]Excludes 744,000 micro enterprises, 2001. [f]Excludes 10 million micr o enterprises. [g]Best guess for 2000. [h]Estimated, as of 2002. [i]Manufacturing industry only .

* Definition of SMEs vary from country to country or even within countries from agency to agency. However, on average, based on number of employees, SMEs in these countries are defined as enterprises with 100 or less workers.

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Table 2. Share of SMEs in total exports by selected Asian countries

Country	Share of SMEs in total exports (%)
China	40-60
India	38
Indonesia	11
Malaysia	15
Republic of Korea	40
Singapore	16
Thailand	10
Viet Nam	20

Source: UNCTAD, 2003.

In many developing countries in the region where poverty rates and the levels of inequality are still high (Tambunan, 2007), SMEs have an important role to play. Their huge number is scattered widely throughout the rural areas and they provide a considerable contribution to employment. Therefore, their presence or growth can be used as a means of improving income distribution or alleviating poverty in such countries. Indeed, for these reasons, in many countries such as Indonesia the development of SMEs has been included in the national strategies aimed at reaching the Millennium Development Goals.

The Asian region provides good evidence of the benefits of international trade and investment liberalization policies. The impact of the reforms on economic growth and development of the domestic manufacturing industry in many Asian developing countries has been studied extensively. In Indonesia, for example, several studies have indicated that multinational corporations (MNCs) have been the source of a significant surge in manufactured exports. Trade policies in Indonesia have also played an important role in the change in composition and the growth of the country's manufactured exports. James and Ramstetter (2005) emphasized how low levels of protection adopted by the Indonesian Government in the 1980s, with respect to certain industries, were a key facilitator of the rapid export growth of those industries. Other Asian developing countries such as China, India and Thailand have also experienced positive impacts of international trade and investment reforms on their economy for the same reason.[1]

However, the effects of trade and investment liberalization, while positive on average, may have differing effects on different private sector groups. This policy brief reviews the available literature on the effect of liberalization on SMEs and provides some important policy lessons.

EFFECTS OF INTERNATIONAL TRADE REFORMS ON SMEs

Theoretically, reform towards international trade liberalization may affect (either positively or negatively) individual local firms in four major ways:

(a) Increased competition. Lower import tariffs, quotas and other non-tariff barriers have the effect of increasing foreign competition in the domestic market. This is expected to encourage inefficient/unproductive local firms to (i) attempt to improve productivity by eliminating waste, exploiting external economies of scale and scope, and adopting more innovative technologies, or (ii) shut down. Openness of an economy to international trade is also seen as a stimulus to increasing plant size (i.e., scale efficiency) as local firms adopt efficient technologies, management, organization and methods of production;

(b) Lower production costs due to cheaper imported inputs. Local firms benefit from lower input costs, thereby allowing them to compete more effectively with imports in the domestic market as well as in export markets;

(c) Increased export opportunities. Opening up to international competition will not only induce increased efficiency in domestic firms but will stimulate exports by those firms;[2]

(d) Reduced availability of local inputs. The elimination of export restrictions on unprocessed raw materials will increase exports of such items at the cost of local industries.

Thus, in the case of SMEs, it can be expected that international trade liberalization will increase foreign competition in domestic markets, and will thus hurt some inefficient or uncompetitive SMEs, while benefiting efficient or competitive SMEs. The efficiency effects of foreign trade liberalization may be observed in an increase in average plant size among SMEs as well as (presumably) lower average costs of production. However, the international literature on the effect of foreign trade policy on SMEs presents some surprising and quite important findings. The seminal work of Tybout (2000) on the micro-dynamic effects of international trade liberalization on manufacturing firms in developing countries, for example, consistently shows just the opposite – increases in import penetration as well as reductions in protection are associated with reductions not increases in plant size. Thus, rather than improve efficiency immediately, an important finding by Tybout was that liberalization might work against the (scale) efficiency of SMEs in the short term (or that if there are gains in efficiency, they are quite small).[3]

Tybout's work is supported by the findings of Tewari (2001) from Tamil Nadu's experience in the past 15 years following the removal by the Government of India of restrictions on many industries, including textiles, and the simultaneous liberalization of trade. The lifting of restrictions allowed anyone to establish business in such industries and there was a spate of entries by relatively small firms, notably in the textile industry. Firms with 400-500 spindles set up shop, in contrast to the 10,000- to 20,000-spindle plants that larger firms operated. By the mid-1990s, the average plant size in the spinning industry had fallen significantly.[4]

In the many existing studies on SMEs in Indonesia, perhaps the only evidence on the effects of trade reforms on SME exports before the 1997/1998 Asian economic crisis is that found in a field study conducted by Berry and Levy (1994). They surveyed 91 SME exporters in three subsectors of manufacturing, and conducted intensive interviews with 30 to 40 public and non-profit agencies active in SME issues between January and June 1992. The three subsectors were garments in Jakarta and Bandung (both in West Java), rattan

[1] See, for example, country studies on China (Liu and Shu, 2003), India (Pradhan and others, 2006), and Malaysia, Thailand and the Philippines (Rasiah, 2004).

[2] This is generally supported by econometric results. (See, for example, Aggarwal, 2001).

[3] Tybout, 2000.

[4] Other important studies of the effect of trade reform on SMEs include Valodia and Velia, 2004, Tewari and Goebel, 2002, Kaplinsky and others, 2002, and Roberts, 2000.

furniture in Jakarta and Surabaya (East Java), and carved wooden furniture in Jepara (Central Java). Of 33 interviewed rattan product exporters, all but one of the firms were found to have exported 90 per cent or more of their output, while 26 of the 33 firms had started exporting the same year that they began production. Most of the firms started exporting or had increased the export share of their total production after the Indonesian Government imposed bans on the export of unprocessed and semi-processed rattan in 1986 and 1988-1989, respectively.

Therefore, it appears that the ban was one of the key factors leading to a major expansion in rattan furniture exports by Indonesian SMEs. Many other cases also show that free exports of raw materials have created difficulties for Indonesian SMEs. For example, the metalworking industry clusters in the country experienced serious problems due to the lack of local scrap (exported mainly to China). In the electronics manufacturing sector, subcontracted SMEs faced difficulties due to the lack of brass, which was one of their main raw materials, as it was also freely exported.[5]

Official data on the total value of trade and total number of SMEs show no indication that SMEs in Indonesia have been negatively affected by the international trade reforms. Moreover, protection instead of open market policies by, for example, restricting certain activities to domestic SMEs may actually contribute to the abuse of local market power while also insulating firms from competition, making them less able to penetrate foreign markets or develop improvements in technology, productivity and efficiency.

Some studies on SMEs in Indonesia have suggested that most SME development programmes (e.g., subsidized credit, various training programmes, external trade promotions and subcontracting schemes) have not been very successful.[6] The studies argue that friendly macroeconomic policies, including those on trade (e.g., import and export regulations) are very important for SME growth. For example, based on his analysis of the effects of macro- and micro-policy environments on rural industries in Indonesia, van Dierman (2004) stated that a significant number of macro-policies, such as trade (protection) policies, placed additional costs and burdens on rural SMEs. He argued that macro-policies which created a favourable economic environment, as reflected by consistently high growth rates in GDP, and which were not biased in favour of large enterprises provided the best stimulus for SME growth.

There is an important ongoing debate in Indonesia on whether the participation of SMEs in the global economy leads to their sustainable growth. Some of the experts have a rather pessimistic view of the issue.[7] For example, Sulandjari and Rupidara (2002) found that enterprises and workers in the wood furniture industry cluster in Jepara[8] had gained substantially from participating in export activities. However, they also found that the industry's prospects for further growth were questionable. On the input side, the industry was found to be suffering from the increasing scarcity, and hence rising cost, of its raw material, wood. On the output side, it was suffering from intensifying competition posed by Viet Nam, China and other countries. They concluded that the cluster's gains were not sustainable and that the intensifying price competition in the international market was actually promoting the use of cheaper, illegal wood supplies. While these findings may not be generally applicable to other clusters, they nonetheless raise interesting issues for future research.

EFFECTS OF INVESTMENT LIBERALIZATION ON SMEs

As with trade liberalization, investment liberalization should also take into consideration what the impact (positive and negative) would be on SMEs. Theoretically, investment liberalization affects SMEs in a number of ways. On the positive side, a better investment environment generates many new firms or/and encourages existing firms (including SMEs) to expand their production capacities. The expansion of local SMEs can also take place with direct links to large enterprises, including multinational corporations/foreign direct investment (MNCs/FDI) through, for example, subcontracting production linkages ("complementary effect"). In other words, MNCs/FDI act as a growth source for local SMEs and facilitate their access to export markets.

Several studies have examined the export spillover effect of FDI on domestic firms, which often takes place through subcontracting arrangements.[9] Although these studies do not categorize domestic firms by size, it can be assumed that well-developed SMEs (i.e., those with better technologies, highly skilled workers and good management systems) can benefit from this spillover effect. On the negative side, however, reforms aimed at FDI liberalization may have the effect of increasing the number of new large enterprises at the cost of existing SMEs that are unable to compete (the "competition effect").

The gradual, long-term process of investment liberalization started with the introduction of the Foreign Direct Investment Law, 1967 (which marked the beginning of the openness to FDI), followed by "real" liberalization with the introduction of various incentives to attract FDI (including more sectors open to FDI) in the second half of the 1980s. A further boost was provided by the IMF Reform Agreement after the 1997/98 economic crisis. Limited literature on the effect of investment policy reform on SMEs in Indonesia makes it difficult to say whether this process has created complementary net effects or competition net effects on local SMEs.[10] However, official data on the growth of investment made by SMEs suggests that the more open investment environment in Indonesia has accelerated investment activities in this group, with their share in total private investment increasing in the past six years.

FDI is an important source of technology transfer to local firms in developing countries, suggesting that investment liberalization will also act as a stimulus for local firms. This observation is supported by many studies, although not explicitly on local SMEs[11], evaluating technology transfer or spillover from FDI in Indonesia as well as in other Asian developing countries (e.g., Tangkitvanich, 2004). Sato (1998), Iman and Nagata (2002), Tambunan (2007) and Pantjadarma (2004), who all studied subcontracting linkages between foreign firms and local SMEs in Indonesia, also arrived at the common conclusion

[5] Interview with Mr Daniel Suhardiman, Group Manager, PT Panasonic Manufacturing, Indonesia.

[6] For explicit or implicit discussions on the Government's programmes for supporting SMEs in Indonesia see, for example, Sandee and others, 2002, van Dierman, 2004 and Sato, 2000.

[7] See, for example, Kaplinsky and others, 2002 and Humphrey, 2003.

[8] See, for example, Sulandjari and Rupidara, 2002, and Loebis and Schmitz, 2005.

[9] See survey results in Pradhan and others, 2006.

[10] The positive effects of FDI on SMEs also depend on the quality of FDI. See Tambunan, 2007, for details.

[11] See, for example, Takii, 2005, Blomström and Sjöholm, 1999, Thee, 2005, and Sato, 1998.

that through such production linkages, foreign firms played a valuable role in the capacity-building of local SMEs.

The majority of case studies on subcontracting in Indonesia indicate, however, that such production linkages do not develop smoothly, despite investment liberalization. This is attributed to many factors, such as:

(a) The inability of many local SMEs to meet the required standard of quality due to their lack of technology and skills (so they are not selected as local subcontractors to FDI-based companies);

(b) Market distortion;

(c) The institutional coordination problem indicated by, among others, the lack of consistency and coherence in policy;

(d) An underdeveloped business environment characterized by information asymmetry, rent-seeking lobbies, and difficulties in accessing financial and technological facilities.[12]

KEY POLICY LESSONS

Overall, the literature reviewed in Tambunan (2007) suggests three key policy lessons that may assist in shaping future SME policy in Asian developing countries.

First, open market policies are preferable to protection (e.g., by restricting certain activities to domestic SMEs), as protection may lead to abuse of local market power and ultimately reduce the ability of SMEs to penetrate foreign markets or develop improvements in technology, productivity and efficiency. However, given the fact that the majority (if not all) of SMEs in those countries are not yet ready to compete, trade liberalization should be accompanied with specially-designed SME development schemes in order to improve their competitiveness through capacity-building (including possible linkages that can be formed with large enterprises). Otherwise, in the long term, local SMEs may die out.

Second, trade policy reform may have unintended negative side effects on SMEs, such as the creation of supply shortages of key raw materials used by SMEs. All possible direct and indirect negative effects on SMEs should be explicitly taken into consideration in designing a trade policy reform.

Third, the absorptive capacity of local SMEs in the host country is essential to achieving significant benefits from the presence of foreign companies. Without adequate human capital or investments in research and development, spillover from FDI to local SMEs will fail to materialize. Consequently, FDI policies in the host country need to be complemented by:

(a) Special programmes, especially in the areas of technology, skills and management, which support efforts by local SMEs to become efficient and highly competitive local subcontractors or to integrate into global production networks; and

(b) Improvements in regulations related directly as well as indirectly to subcontracting, in order to increase the willingness of both sides – i.e., FDI-based companies and local SMEs – to establish such linkages.

Of course, subcontracting may only be a first step towards integrating into global production networks. The second step, after "learning from doing" as local subcontractors, is for SMEs to become national or even regional suppliers, or supporting industries for certain global products. To reach this level, local SMEs require a great deal of government support, not only directly through special schemes as mentioned above, but also indirectly through the creation of a "friendly business environment" (e.g., easy access to credit, technology, raw materials and information, stability in prices as well as interest and exchange rates, and adequate infrastructure).

REFERENCES

Full references to all papers and sources mentioned in this policy brief are available in Tambunan, T., 2007, ARTNeT Working Paper Series, No. 42. Available at: http://www.unescap.org/tid/artnet/publication.asp.

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[12] The studies include Sato, 2000, Supratikno, 2001, Thee, 2005, and Iman and Nagata, 2002.

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