The following paragraph presents results of few selected cluster groups for the study for the purposes of growth dynamics analysis of SMEs operating under these clusters. Non availability of adequate data, it was not possible to make a detailed analysis of these clusters. However, attempts have been to provide a snap shot on the key activities of selected clusters.

## 4.2 Automotive and Component Industry Cluster

### *4.2.1 Background*

Automotive industry in Indonesia first started in 1957. At the same time automotive industry began with automobile assembling plant. After Ministry of Industry issued the Decree, vehicle components manufacturing started in Indonesia from 1976. With the rapid economic development in the country demand for car is increasing manifold. A large number of car assembly industries have been established to meet this demand. Many of them have started out sourcing for parts and components from within the local market and the region to cut down the cost. Government policy also encourages the foreign car assembly companies to gradually reduce their dependence on imported parts and components. Thereby such situation has created a big demand for locally produced parts and components.

Government also expects to create a wider manufacturing base by encouraging the local companies to produce parts and components which will decrease importation of parts and components. For the implementation of this program, government has given clear directives to the manufacturers to abide by the conditions stipulated in the manufacturing licenses in order to develop local capabilities to produce parts and components. Up to 1991 the number of industries which started producing automotive component grew to about 500. These SMEs have grown in and around Jakarta just to remain close to the market and other infrastructural facilities. Availability of skill workers and technical personnel also influenced to locate their industry in close proximity to Jakarta.

Among the local car producers PT ASTRA has been able to organise a cluster of SMEs those primarily supplies parts and components to ASTRA as per their specification and agreed prices. In 1971 PT. Toyota Astra Motor was established as a company for import and distribution of Toyota vehicles in Indonesia. As a link business PT. Multi Astra started to assemble Toyota vehicles in Indonesia in 1974. Then in 1976 PT. Toyota Moblindo was also established as a "welding plant and stamping plant" to produce motor component. Subsequently in 1982 PT. Toyota Engine Indonesia started production of Toyota engines (engine plant). In 1988, those companies then joined together to form ASTRA GROUP (PT. Astra International).

The initial capital of this company originated from two sources, namely the Toyota Motor Corporation (Japan) which owned 49% of capital and the PT. Astra International (Indonesia) owned 51% of its capital. The chart in the next page describes the flow of the business of the PT. Toyota Astra Motor.

PT. Astra International in 1995 recorded a sales turn over in the amount US$ 4.1 billion in Indonesia. This large amount of sale accumulated from the all subsidiaries of ASTRA Group which was made possible due to their competitive and high quality marketed both in the domestic and international market. Each of the subsidiary companies closely collaborated with each in achieving company's goal. One key strategy that helped this company to perform so well is by organizing production and marketing programs involving network of SMEs. These enterprises worked very closely and co-operated under the guidance of its parent company.

The products manufactured by this company include Toyota vehicles known by the model names Starlet, Corolla, Corona, Crown, Kijang, Dyna, Cressida, Hiace, Hilux, trucks and Land Cruiser. All these types of vehicle can be grouped into two major types namely the passenger and the commercial vehicle types.

This ASTRA company employed 4,000 regular workers where 50% of them are high school graduates and about 90% are permanent employees. If all the companies involved under the collaborative schemes participated by all SMEs (backward and forward linked companies) total manpower will be about 50,000.

*4.2.2 Process of change*

To support its various kinds of vehicle manufacturing in Indonesia, PT Astra International has developed cooperative ralationship with 70 SMEs component manufacturers from which 53 SMEs supply various components for two wheel vehicles (motorcycles) and 27 SMEs supply components for four wheel vehicles (Kijang Model of Toyota). Several other SMEs supply production materials (components) of PT ASTRA. Close business relationship among the net work of enterprises has enabled to PT. Astra International in increasing its productivity level. In two-wheel vehicle industry, the support of local components produced by the SMEs has been able to increase the local components up to 85% and for the four-wheel vehicle industry the local component has reached 51%. Under the scheme all companies performance are closely monitored by ASTRA. All necessary upgrading support assistances are provided by ASTRA to make sure that the smaller companies can meet the delivery schedule of ASTRA.

SMEs which deal with the marketing of PT. Astra International's products (Vehicle model) are Auto 2000, New Ratna Mitra, Agung Concern, Hadji Kalla and Hasjrat Abadi. With direct and indirect involvement of different types of SMEs it would be about 140 companies dealing in the marketing of ASTRA product. In early 1976, the market of PT. Astra's products reached to 22.7% of the total domestic market and in 1990 it has reached to 30% of the total national market. The products are among passenger vehicles such as the Kijang and Dyna. PT. Astra has successfully exported its products abroad since 1986 to several countries like Brunei Darussalam, Papua New Guinea, Malaysia and Japan.

## 4.3 Leather Industry and Sukaregang

*4.3.1 Background*

Leather and leather product industry has grown quite in big way during the last decade. Export of leather product has increased nearly four times during the period of 1990-1994. This can be observed from the export of leather product in 1990 at the value of US$570 million and in 1994 it increases to US$1.9 billion. Department of Industry and Trade provided various support to develop leather products industry which can compete in the international market. As of todate leather product industry has been recognised as one of the top foreign exchange earner among the SME sector.

Among the leather product manufacturer, SMEs operating in Sukeregang Industrial area seems to have shown outstanding performances results in comparison with other producers in the country.

### *4.3.2 Area Description*

Sukaregang industrial area is the largest leather product industry cluster in Indonesia and it has the production capacity up to 3 to 4 million square feet leather per month. This leather industrial area has over 400 leather product manufacturing enterprises which are mostly small scale size. They need supply of 1,200 tons of finished leather valued at about US$ 2-3 million each month.

Leather industry clusters here basically produces processed leather goods needed by the industries engaged in the production of leather shoes, leather bags and other consumer products. Sukaregang leather processing industry is playing an important role for the leather industrial centres of Cibaduyut and the others. The leather industry raw materials needed by leather industry is originated from the area of Sukaregang.

### *4.3.3 The Sources of Raw Materials*

Required types of raw materials are produced both from local and foreign sources to produce good quality leather products. Other places which supplies raw materials to these companies include Aceh, Kalimantan and East Nusatenggara Province.

### *4.3.4 Trade Linkages*

As it is mentioned above the need for raw leather of the industry in Sukaregang is met by domestic as well as imported materials. They do not buy the materials individually but through raw leather collectors in Banda Aceh (Aceh Province), Samarinda (South Kalimantan) and Kupang (East Nusatenggara).

SMEs purchase raw materials from collectors by, because the collectors do not sell it in credit. Only about 10% of the processors in Sukaregang buy raw materials directly. These companies (around 90% of total entrepreneurs in Sukaregang) purchase raw materials from the larger companies. Then the processed leather is sold to processed leather collectors at the industrial centres in Cibaduyut.

The quantity of leather goods export from Indonesia will influence the future demand of processed leather. The increase of income of the Indonesia people will influence the demand for leather products. Large companies are very dominant in leather goods trade. Presently supply of raw leather is controlled by a few large companies in Sukaregang who are enjoying almost monopoly market. These companies purchase raw materials in large scale and thus economise in transportation cost. These leather is then processed and prepared for its use in the smaller companies.

However, notwithstanding the sharp economic development of the area, the domestic supply of leather has not entirely been able to meet the quality requirements of the leather shoe industry. Increasing volumes have therefore had to be procured from foreign sources in recent years, namely China and Korea. Given the difficulty to credit access for small-scale enterprises, this could negatively influence the future of the Sukaregang area.

## 4.4 Small Industrial Village of Pulo Gadung

### *4.4.1 Background*

The development of small industrial village (PIK) in Pulo Gadung in East Jakarta in 1982 originated from the idea to develop a small scale enterprise village to produce handicraft products and thus create employment. This effort has been made by the Jakarta Metropolitan to increase small businesses and help the people to raise their income level.

The smaller companies find it very hard to get access to industrial land and infrastructure and with infrastructure facility the small companies would be able to sustain their businesses and generate urban employment. Through this process government would be able to relocate smaller companies to this area by bringing them out of main city area. Many of these small scale businesses surveyed and prospered over the years under a very competitive market conditions. Despite the small size of the businesses here, many of them have successfully entered into export market with the help of trading houses based in Jakarta. This cluster has been benefited from the supply of abundant workers who moved to Jakarta from the adjoint areas in search of employment.

### *4.4.2 The Characteristics of PIK of Pulo Gadung*

Small Industrial Village (PIK) of Pulo Gadung is located in the Keluruhan of Penggilingan, Kecamatan (Sub District) of Cakung, Municipality of East Jakarta. In 1982 there were about 206 units established. Then it went up to 852 units in 1990 and this area will be able to accommodate up to about 2,000 small scale units.

The choice of Pulo Gadung area was based on the idea that this location is close to the large industry and main metropolitan city. It was hoped that large industries in Pulo Gadung area would also promote the small industry to supply their inputs. The other expectation was that many of these small enterprises will eventually be upgraded as medium sized companies.

### *4.4.3 Entrepreneurs and Manpower*

The small size companies in PIK in Pulo Gadung are producing various kinds of products mainly for the domestic market. To assist the small enterprises in PIK of Pulo Gadung, the Local Government of Jakarta has provided skill upgrading training courses for the workers. For this purpose the Government of Jakarta has collaborated with other institutions who were prepared to participate in the development of small enterprises in this area. In order to enhance the skill in designs and marketing, the local government of Jakarta is making a collaboration with the Provincial Office of the Department of Industry and Trade to promote the skill in product design and marketing to entrepreneurs and employees in the PIK area. The Provincial Office of the Department of Cooperatives and Small Enterprises Development got involved in providing support assistances to these smaller companies.

### *4.4.4 Problems and Prospects of the PIK of Pulo Gadung*

Marketing is a typical problem of these enterprises that means too much competition within the group. Majority of the producers are using intermediary channel to market their products. They do not get direct access to prospective market due to inadequate organisational resources. As a result they have to depend on big marketing companies who of course organises supply order for them on regular basis. This working relationship between large buyers and local small producers have helped to continue businesses. Efforts are being made by the government support agencies to project PIK of Pulo Gadung made products through exhibitions and trade fairs.

## 5. SME promotion

SMEs are supported by a wide range of technical assistance institutions in the areas of investment, production and marketing. These include public agencies, special programs (e.g. for credit), business associations, cooperatives, non-governmental organisations, and donor agencies. The general issue is how effective these institutions are; that is, what benefits they deliver and at what cost.

### 5.1. The role of the government in SME promotion

#### *5.1.1 Policy Strategy*

The Government of Indonesia's emphasises among the declared objectives and priorities with regard to its current industrialisation policy SME sector's accelerated development for making higher contribution to socio-economic development of the country. The development of small-scale industry is considered an important means of ensuring the creation of sufficient job opportunities to meet the needs of the growing population, of giving support for weak economic groups, of promoting pribumi firms and of providing a mechanism for a more equitable distribution of wealth.

In general, SME policy in Indonesia aims to create a business environment conducive to strengthening the position of SMEs as an integral part of the national economy. One of the goal for the next future is to increase initiatives and participation of SMEs in all aspects of the Indonesian economy through the development of human resources in order to enhance their productivity, competitiveness, and self-reliance. Besides, the government intends to elaborate a policy which deals with the main difficulties actually encountered by SMEs in export, investing abroad and industrial upgrading. More specifically, the governments policy aims to increase the capability of SMEs in the areas of small scale industries and handicrafts, agro industries, agro business, trade, housing, communications, finance, mining and energy, tourism and health. To implement those basic policy, operational policy has been formulated as follows:

1) To increase market access and market share of SMEs.
2) To increase capability and access to capital sources and strengthen capital structure.
3) To strengthen organisational and managerial capability.
4) To increase access to technology.
5) To strengthen business networking.

Further, the government aims to provide small-scale entrepreneurs with equipment and technical expertise through a improved skill upgrading education system, to encourage the emergence of small-scale industries in the remote and still underdeveloped parts of the country and the establishment of industrial estates and export processing zones. Among other areas it specially focuses to improve efficiency in the allocation of resources to maximise growth of manufacturing sector.

There is hardly any institution involved in economic development in Indonesia which does not in some way claim to be making a contribution to promoting small industries. The institutional infrastructure of SME promotion is relatively extensive and includes the following range of agencies in the Government sector:

- Ministry of Industry with its subordinate institutes and technical service centres
- Ministry of Manpower with its subordinate training institutes and productivity centers
- National Agency for Export Development (NAFED)
- Indonesia Export Training Centre (IETC)
- Agency for the Assessment and Application of Technology (BPPT)
- Development Technology Centre - ITB
- Universities and other industrial research institutes.

Despite the involvement of many organisation in providing support services to SMEs, most often the target SMEs are not adequately happy about the quality of assistances received by them from the support organizations. These assistances are not usually demand driven and available when they need it.

The country wide network of vocational training institutes (BLK) managed by Ministry of Manpower provides training to the SMEs workers in order to enhance their productivity. The infrastructures of these training centres are some time used for training cum production centres to boost level of skill of selected sector (e.g. rattan, woodworking etc).

When these institutions were set up the operating expenses used to be provided by government from its own budget. Since recently there has been a shift in government policy by gradually reducing its contribution towards operating budget. As result of this policy change, these institutions are now trying to work or to raise revenue out of the services provided to the target group. Adequate impact analysis was not possible under the scope of this study.

### *5.1.2 Government Initiated Promotional Programs*

In order to get SMEs group synergy and continually maintain their competitiveness, Government has initiated many support program to assist SMEs growth.

Along with the policy shift in Indonesia from interventionist to liberal and open, and strong thrusts towards privatisation, promotional programs have been shifting from those direct and subsidising to those which will motivate and lead SM. towards fuller exertion of their market-oriented private sector initiatives.

One of the features of government's policy is to promote very small production units both in urban and rural areas. In urban areas such attention is directly connected with the need for private sector development and poverty alleviation. In rural areas, this has been addressed primarily in the context of rural development, poverty alleviation and women in development. Private sector donor organisations (NGOs) are collaborate in the formulation and implementation of this policy.

#### *5.1.2.1 Financial Assistance*

The objective is to provide an environment in which SME entrepreneurs can both become more self-reliant and also obtain assistance when they need it. In this connection, the government is earmarking

1-5 per cent of the net profits of State-owned enterprises for the development of small-scale industries, and national commercial banks are being encouraged to channel 20 per cent of their loans to small businessmen. With largely short-term funding available, the banks have difficulty in general in fulfilling the 20% quota. The granting of these credits is not linked with any specific program (i.e. providing technical support); the results are high credit risks and non-performing loans due to defaulting small enterprises. Linkage with a program of technical assistance at the operating level could conceivably bring about more beneficial results.

Making loans available to small businesses and micro-enterprises at the village and community level in rural areas is the goal of programs operated through the branch offices of the state-owned Bank Rakyat (KUPEDES, BKK)[9]. KUPEDES's (Kredit Umum Pedesan) objective of turning money-losing units into self-sustaining profit centers formed the framework for the program's approach to the types of financial services offered, the policies and procedures selected, the organisational characteristics adopted to run the program, and the type of support and technical assistance requested from the government, donors and the Bank.

The success of the BRI/KUPEDES project is based on its simple design, which in turn, was guided by good policies: (1) nontargeted credit, except for loan size; (2) nonsubsidized lending; and (3) self-sustainability through savings mobilisation and profitable operations. In 1994 more than half of the loans financed microenterprises and small-scale trading activities. Agricultural lending accounted for about one-fifth of the lending program. The biggest increase was in loans for working capital, used mostly for home construction and repairs. Started in 1989, working capital loans made up 29 percent of the portfolio by 1994.

In addition, activities specific to individual regions have been initiated with the participation of non-government organisations (NGO). Here it is a matter of utilising the savings accumulated by self-groups at the municipal level in granting small loans through local banks and reinforcing the collaboration between small businessmen with the rural banking system (Lembaga Pembina Swadaya Masyarakat - LPSM).

The Bank Indonesia has since 1973 operating a special loan program to provide small enterprises with a long-term investment and working capital at low interest rates. The primary target group for these subsidised loan programs included the Indonesian indigenous businessmen (Pribumi) and economically weaker classes as distinct from the small businessmen of Chinese ethnic group. In spite of considerable sums being made available by the Bank Indonesia at subsidised interest rates, the effects of the program were modest, accounting for only about 5% of total loans given out to industrial sector. Taking the large number of small industries into account, it is estimated that less than 1% of the target group actually profited from the program.

The government is also attempting to propagate a "foster parent" system, under which existing large-scale companies, both private and State-owned, are being persuaded to support local small-scale industries through the offer of subcontracting arrangements, technical and managerial support, quality control supervision, credit guarantees and other direct and indirect forms of assistance.

Within the scope of the special reports (Small and Medium Industrial Enterprise Project - SMIEP and Small Enterprise Development Program - SEDP), the comunity of lenders (World Bank, European Comunity, The Netherlands, Japan) has made long-term investment and working capital

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[9] Kupedes: Indonesia's Model Small Credit Program, OEC Précis, Number 104, http://www.worldbank.org/html/oed/pr104.htm.

available to the SME by way of loans at market rates. This financial support for the SMEs is augmented with technical assistance and training programs. The 1991 allocations having been disbursed in full, a renewal of the SEDP, financed by the EC, is planned.

It has been found that in spite of current initiatives and program, there is a shortage of credit and risk capital available at conditions compatible with current needs for financing investment and operations in the SME sector, the availability of such capital is largely dependent on programs and projects supported by foreign lenders.

Although this great emphasis on this sector, most of the programs implemented have been less than impressive. With a high share of available capital channelled to the large, capital intensive firms, those parts of the manufacturing sector producing at the other end of the size structure traditionally had to make do with nothing but the tiny amounts of capital they themselves can accumulate.

For successful small enterprises to obtain working capital and to expand rapidly, important issues are therefore their access to external finance, the effectiveness of measures to reduce imperfections in capital markets, and the availability of compensatory schemes to help small enterprises obtain finance.

*5.1.2.2 Technical Assistance and Training*

Technical assistances to SMEs are provided through the following support schemes sponsored by government:

- the small industry development program (BIPIK) implemented by the Ministry of Industry
- the technical training programs operated by the Ministry of Manpower;
- the resources flowing to small industry from the state-run large industries under the "foster father" program (Bapak Angkat).

<u>BIBIK Program</u>

The BIBIK program is directed primarily toward assisting the small indigenous entrepreneurial businesses (Pribumi) which have clustered in the industrial zones (sentras), operating in about 6000 centres. The primary instruments used here are (I) providing central facilities (UPT-Technical Service Units); (ii) consulting at the operational level, and (ii) conducting training seminars for small businessmen. The program is managed at the provincial Government, mainly through the provincial offices of the Ministry of Industry (KANWIL). Due to the Ministry's nation-wide organisational structure and the country wide distribution of the 6,000 centres, the BIPIK has probably the greatest "reach" of all the SME promotional programs.

<u>Training Programs operated by the Ministry of Manpower</u>

The countrywide network of vocational training institutes (BLK) managed by the Ministry of Manpower conducts technical schemes intended to enhance the qualifications of the labour force available to small industries. The infrastructure of the BLKs has been utilised by some foreign donor organizations to run "training cum production centers" specific to certain sectors (e.g. rattan and woodworking). These programs are aimed at boosting the skills of the labour force available to small industry.

Foster Father Scheme-BAPAK ANGKAT

Among the programs which promote the linkage between SME and large-scale industry (LSI) commonly termed "subcontracting relationship" we find the Bapak Angkat system under which larger sized companies are encouraged to tie up with SMEs to carry out few down stream production activities as their subcontractor. Larger companies provide assistance to subcontracted companies in the form of sharing of technology, set up quality control and provide skill upgrading training. In line with the government strategy each promotional agency makes appeal to the larger sized companies reminding them of their moral obligation to assist the SME firms. Approach in the implementation of this scheme it is quite different from the traditional subcontracting program between two firms where production sharing is the key concern. The linkage between SME and large-scale industry (LSI) has been developed fairly well in the garment industry and to a certain extent in the machinery industry.

Competent subcontracting SME can produce parts and component at lower cost that their larger counterparts, reduce the industry's dependence on imported parts and components and contribute to the establishment of a solid engineering base essential for the further development of the machinery industry.

In order to get SMEs group synergy and continually maintain their competitiveness, Government has initiated many support program to assist SMEs growth. Among them we find a few schemes namely *PUPUK, Bapak Angkat.*

Under Bapak Angkat system, larger sized companies tie up with a selected group of SMEs to carry out few down stream production activities as their sub-contractor. Larger companies provide assistance to subcontracted companies in the form of sharing of technology, set up quality control, provide skill upgrading training. In line with the government strategy each promotional agency makes appeal to the larger sized companies reminding them of their moral obligation to assist the SME firms. Approach in the implementation of this scheme is quite different from the traditional subcontracting program between two firms where production sharing is the key concern.

So far the results of this scheme has yet to be evaluated in the light of economic parameters. However, as of todate a few success record has come out from this scheme. A few clusters thus formed with the initiative of few large companies namely PT. Astra International, PT Unilever Indonesia, PT Bakrie Brothers, PT Barata Indonesia, PT IPTN has shown some good results in making the SMEs more competitive and dynamic. On the whole, the application of the funds liberated by resource transfers under the foster father concept has to date not been ideal. Under current practice, the funds are applied more to maintaining non-productive promotional structures; the program with its general topic seminars and advisory activities deals hardly at all with the real development deficits among small businesses. Especially those types of business which are highly relevant to developing the Indonesian industrial sector are hardly touched at all by this transfer of resources.

Generally we can affirm that while almost all conceivable programs are under operation in Indonesia, a large number of them have not been functioning effectively, due to the absence of proper planning and coordination, institutional weaknesses of executing agencies, budgetary constraints, technical obsoletion etc. In recent data SME some functions of SME promotional programs are be taken over by the private sector on a commercial basis. Since 1988 a new form of investment became very popular, the industrial collaboration characterised by the import of machinery and components and the export of final products. In this context, in particular machinery exporters in industrialised countries organize special training programs in order to transfer new technologies, technical and management assistance to the local personal staff.

Finally, a major characteristic of SME development policy was to consider SME as the weak and handicapped segment of the industrial sector and therefore there has always been a strong social element in SME development policies and programs, which is represented by a protectionist policy and subsidies for the enterprises. Under a liberalised economy only real competitive SMEs will survive. As quality and standardisation requirements rise, production shifts towards industries with more advanced technology. Lacking access to better technology and raw materials, many small firms relied on simple technology risk to be pushed out of the market. One of the traditional features, is that the number of subcontracting and export-oriented SMIs that are modern and equipped with latest technology, capable of making positive contribution to industrial growth, is relatively small. The most notable technological innovations by SME are taking place in electronics and chemical industries, but technological improvement is gradually emerging in almost all subsectors. One of the main issues for the future will be therefore to create technologically competent SMEs that can provide effective subcontracting services to key large-scale industries. A high technological level combined with entrepreneurial vitality induce flexibility and responsiveness to changes in economic conditions transforming SME in the most dynamic part of the private sector. In conclusion under an economy in the process of integration into the global economy socially-oriented SME development policy are neither effective nor accepted. It will therefore be an urgent task of the Indonesian government to re-orient and to formulate an effective development policy for such SME. Subsidies and protections should be replaced by intensive skills and management training to make SMEs really competitive in the international market.

### 5.2. The role of APEC

Since the products or goods handled by SME's are quite different from those products given tariff and non-tariff barriers, there is no problem for the SMEs with the agreement on tariff and non-tariff barriers as a result of Uruguay Round. However, in investment sector, it is necessary to promote business partnership between foreign investment and SMEs.

Indonesia, member of APEC expects this institution to play an active role in SMEs promotion. Holding a conference on individual APEC member's industrial development would enhance SMEs understanding of doing business and cultivating potential business partners in the APEC region.

Human resource development, technology transfer and business networking are the three main topics of experience-exchanging conferences, especially the last topic. Through business networking, economies expect conferences to increase SMEs business opportunities and to create contact and networking among SME entrepreneurs. Some other important cooperative activities include the Apprenticeship Program, a Study Visit Program and Business and Information Networking.

In conclusion, the main topics expected by Indonesian government to be promoted by APEC are the following:

1. Transfer of technology know-how from developed economies to developing economies.
2. Marketing/information networking
3. Human resources development cooperation such as training, education, extension and others.
4. Soft loan assistance such as: seed capital, start up scheme, venture capital, and others.

### 5.3. Non governmental organisations (NGOs)

A large number of NGO supported SME projects are under implementation in Indonesia which are working mostly in isolation. As of todate it is yet to be seen the creation of a sustainable NGO supported SME development organisation which can support SME assistance on selfsutainable basis. Various chambers and industries associations have also embarked into SME promotion services especially in the large cities. These organisations are more closer to SMEs than before in terms of their institutional linkages. On the overall a well organised institutional support system does not exist in Indonesia to promote a dynamic SME sector which can compete at the international level. But government is looking into this matter seriously in order to strengthen the SME promotion and development through closer cooperation between government support institutions and private sector organisations.

In the non-governmental area the following institutions are to be cited in conjunction with SME promotion activities:

- Appropriate Technology Group - Dian Desa
- Indonesian Chamber of Commerce and Industry (KADIN)
- Institute of Management Education and Development (IPPM)
- Yayasan Dharma Bhakti ASTRA

PUPUK is a NGO which concentrates its activities exclusively on the promotion of small scale industry. It provides professional services to target enterprises in developing new products, organises marketing through selected channels and help in establishing linkage with the Bank credits.

## 6. Foreign investment policy

The main reason for investing in the Indonesian market is its comparative advantage to Thailand, Malaysia, Taiwan, South Corea of the low labour cost for labour-intensive operations compared. The economy of Indonesia is undergoing rapid diversification to minimise its dependency on oil and gas exports which used to be the major source of foreign exchange. One effective effort to realise this is by encouraging private investment, including Foreign Direct Investment (FDI)[10], in Indonesia, particularly in the sectors of manufacturing, agro-industry, and services oriented more to the world market. The government realises this policy by improving the incentive system and the climate for foreign investment. In 1989, the Government issued what is called Negative List of Investment (DNI - Daftar Negatif Investasi), listing sectors of investment that are regulated. This means that there a further requirements if the investors intend to do business in those sectors. The negative list of Investment (DNI) of 1993 has reduced the number of investment sectors form 51 to 33 out of which 8 are absolutely closed for FDI companies and 6 are closed for any investment (including FDI) such as retail trade, radio, and television broadcasting, casino/gambling, marijuana, veneer (rotary) and penta chlorophenol, dichlorodiphenyl trichloro ethane, dieldrin, chlordane. Other sectors are open for

[10] *Indonesia: Regulations on FDI (Foreign Direct Investment)*, BKPM, 1996

FDI if there are plans to export the products, to have partnership with state-owned companies, or to use a certain level of technology. In addition the DNI also regulates 37 project activities reserved for small industries and business holders which may be cooperated with medium and large scale industries/businesses.

Import duties on capital goods and raw materials for 2 year production are exempted or reduced. Export oriented projects can continue to enjoy the exemption or refund of import duties and value added tax on raw materials used for the production of exported products without time limit.

On taxation, attractive incentives are available in the form of accelerated double declining balance method of depreciation on capital goods, carry forward of losses and various deductibles before tax. Income tax rate is progressive, being 15% as the lowest rate and 35% as the highest. To avoid double taxation, Indonesia makes agreements with foreign investing countries.

There is no longer any requirement for foreign shareholders to take minority positions at some point in the future. A FDI (Foreign Direct Investment) may be established as in the form of a (a) joint venture between foreign capital and domestic capital owned by Indonesian citizens, and / or Indonesian legal entities; or (b) straight investment, namely with 100% foreign ownership. It is required, however, that not later than 15 years of commercial operation, the straight investment company starts to be divested by selling some of its shares to Indonesian individual(s) and/or business entity(ies), through direct placement and/or indirectly through domestic stock exchange. A company which is initially 95% foreign-owned is not subject to any divestment requirement.

The minimum amount of the capital required to be invested in a foreign-owned company in Indonesia is no longer prescribed. The new regulation stipulates that the amount of the capital to be invested is to be decided by the investors themselves.

In the latest deregulation, foreign investors are no longer encouraged to invest in the remote areas of Indonesia. They are basically free to chose the location where they wish to operate, with a condition that the factories should be established in areas zoned for industry. Industrial Estates are preferred by the Government, but they are not compulsory.

A foreign investment company can extend its operating license for an additional 30 years, after a 30-year initial operating period.

Since the foreign investment law was enacted in 1967 until the end of June 1996, foreign investment approvals have reached a total value of more than US$ 162.6 billion excluding investment in Oil & Gas Mining, Banking & Financial Services.

Traditionally Japan is the leading foreign investing country in Indonesia. Recently also the new industrialised countries (NICs) are becoming more and more important, especially Taiwan (see table 7).

**Table 7**

**The ten leading foreign investing countries in Indonesia are the following:**

| No. | Country | Project | Investment Value (US$. Mln) |
|---|---|---|---|

| | | | |
|---|---|---|---|
| 1. | Japan | 871 | 31,846.9 |
| 2. | UK | 195 | 27,444.8 |
| 3. | Hongkong | 346 | 18,239.1 |
| 4. | Singapore | 545 | 13,186.7 |
| 5. | USA | 242 | 12,258.2 |
| 6. | Netherlands | 148 | 10,380.1 |
| 7. | Taiwan | 474 | 9,094.2 |
| 8. | South Korea | 395 | 7,065.9 |
| 9. | Australia | 226 | 6,119.1 |
| 10. | Germany | 96 | 5,083.4 |

*Sources: BKPM (Investment Coordinating Board*

As the foreign direct investment by sectors is concerned, excluding the sectors of Oil & Gas Mining, Banking & Financial Services, considering the period from 1967 up to the end of June 1996, the highest number of projects can be found in the metal goods industry (840) and in the chemical industry (600), followed by the textile industry (490) and other services (432)[11]. In total there are 24 economic sectors of investment, excluding the sectors of Oil & Gas Mining, Banking & Financial Services. Approved FDI in the 24 sectors from 1995 up to the middle of July 1996 are listed in table 8.

Table 8

**Trend of foreign investment approvals by sector 1995 - July 15, 1996**

| No. | Sector | 1995 | | 1996 | |
|---|---|---|---|---|---|
| | | Number of project | Investment Value (US$. Mln) | Number of project | Investment Value (US$ Mln) |
| I. | Primary sector | 34 | 1,384.2 | 43 | 2.422.7 |
| 1 | Food crops | 9 | 414.9 | 16 | 211.2 |
| 2 | Plantation | 15 | 689.1 | 13 | 723.3 |
| 3 | Livestock | 2 | 49.0 | 1 | 15.3 |
| 4 | Fishery | 8 | 231.2 | 10 | 50.6 |
| 5 | Forestry | 0 | 0.0 | 1 | 13.5 |
| 6 | Mining | 0 | 0.0 | 2 | 1.286.8 |
| II. | Secondary sector | 454 | 26,892.1 | 295 | 11.428.8 |
| 7 | Food Industry | 38 | 1,331.8 | 23 | 453.8 |
| 8 | Textile | 52 | 471.1 | 23 | 306.3 |
| 9 | Wood Industry | 33 | 263.0 | 28 | 74.2 |
| 10 | Paper Industry | 16 | 2,540.5 | 14 | 2.850.7 |
| 11 | Pharmaceutical Industry | 3 | 36.7 | 3 | 29.5 |
| 12 | Chemical Industry | 113 | 19,367.7 | 67 | 5.404.9 |
| 13 | Non Metallic Industry | 11 | 289.3 | 17 | 561.0 |
| 14 | Basic Metal Industry | 16 | 291.7 | 6 | 33.5 |
| 15 | Metal Goods Industry | 153 | 2,258.1 | 109 | 1.696.9 |
| 16 | Other Industries | 10 | 42.2 | 5 | 18.0 |
| III. | Tertiary sector | 311 | 11,638.4 | 273 | 7.696.7 |
| 17 | Electrical, Gas & Water | 6 | 3,549.3 | 7 | 3.738.5 |
| 18 | Construction | 43 | 205.8 | 35 | 207.0 |
| 19 | Trade | 58 | 30.5 | 65 | 31.6 |

[11] Indonesia: A brief guide for investment, BKPM, Investment Coordinating Board, 1996.

| | | | | | |
|---|---|---|---|---|---|
| 20 | Hotel & Restaurant | 31 | 998.8 | 19 | 739.5 |
| 21 | Transportation | 47 | 5,539.5 | 13 | 684.9 |
| 22 | Housing | 22 | 1,062.2 | 20 | 1.636.3 |
| 23 | Office Building | 3 | 129.8 | 0 | 238.9 |
| 24 | Other Services | 101 | 122.5 | 114 | 383.0 |
| | Total | 799 | 39,914.7 | 611 | 21,511.2 |

*Sources: BKPM (Investment Coordinating Board)*

In Indonesia there is a government agency called BKPM (Investment Coordination Board) responsible for formulating the national investment policies and planning, promotion, licensing, control and evaluation of investments. The investment approvals and consecutively the operational licenses issued by BKPM, are based on the delegation of authority to BKPM by 13 sectoral Ministers who are responsible for the national management of the respective sectors. FDI application documents are submitted to BKPM, and then evaluated in terms of the suitability to various aspects such as sectoral policies, technology, market and finance. The investment approval also includes the granting of incentives and facilities. In addition to BKPM, each of the provinces in Indonesia has a regional investment service agency, namely the Regional Investment Coordinating Board (BKPMD). BKPMD is headed by a Chairman, who is a subordinate of and responsible to the Provincial Governor. BKPMD has the task to assist the investors in obtaining regional permits after the BKPM approval letter is issued.

## 7. Indonesia's Small and Medium-Size Exporters and Their Support Systems

The goal of this section is to provide detailed micro-level information on the new export participants, on their industrial organisation and the micro-environment for exporters. Particular attention will be given to the marketing, technological and financial support system and their adequacy to sustain SME dynamism in the future.

The analysis will focus on the main subsectors with SME participation- garments, carved wooden furniture, rattan furniture, - since the character of SME support systems and priority needs of firms depend in part on them.

A survey conducted in 1992 by the World Bank[12] revealed that while the garment exporters in Jakarta and Bandung and rattan exporters in Jakarta and Surabaya appear to be dominated by non-pribumi firms, the carved furniture exports in Jepara, a traditional center of wood carving in Indonesia, are dominated by pribumi firms. In both the garment and rattan sector there were no instances of firms that had begun as microentrepreneurs or small subcontracting graduating to become fully fledged direct exporters. The survey further uncovered a sharp bifurcation between firms that produced for the domestic market, and those that focused on exports. Most of the firms surveyed exported virtually all of their output, and very few of them cut their teeth in the domestic market before moving on to exports. The results also demonstrate clearly that the benefits of outward-orientation are non monopolised by the largest firms. On the contrary, all three sectors showed evidence of a nascent and dynamic class of new SME entrepreneurs.

Analysis of relative prices and comparative advantage are the standard economic tools used to account for export performance. Yet even with favourable market conditions, exports do not

[12] Albert Berry and Brian Levy, _Indonesia's Small and Medium-Size Exporters and Their Support Systems_, Policy Research Working Paper, The World Bank, December 1994.

proceed spontaneously, but through the medium of institutions, and via exchanges which involve transactions costs. Success in new export markets thus requires the emergence of transactionally efficient export institutions. The findings of the survey conducted in the three subsectors show that private channels - especially initiatives by foreign buyers - play a dominant role overall in establishing and sustaining linkages by SMEs with export markets; however, this role is more important for larger and non-pribumi firms and for firms that have already proven themselves in export markets, than for their smaller, pribumi counterparts and for new entrants, who rely heavily on collective marketing services (the most common is the assistance to participate in trade fairs) supplied by public agencies and industry associations. Further the linkages among an extended Chinese community that transcends national boundaries provides an important way into export markets for Indonesia's entrepreneurs of Chinese origin vis a vis their pribumi counterparts. Lacking spontaneous links to the international marketplace, pribumi entrepreneurs must rely on substitute mechanism, like subcontracting and direct marketing. Acquiring new capabilities, and improving upon those capabilities that a firm already has at its disposal, are therefore crucial in export markets. The findings upon the ways of technology acquisition show that the private channels have been the dominant mechanism for acquiring technology capability in all three subsectors. Subcontracting is considered an important mechanism of learning, but does not proved a major stepping stone into exports. Foreign buyers emerged as the most useful source of technological capability for both pribumi and non pribumi entrepreneurs as they share a strong mutual interest with the producers in the quality of product, often supplying designs, and assisting the firms in finding the best way to produce their items. Employment of expatriates emerged as an especially powerful mechanism for acquiring technological capabilities in both the rattan and garment sector, especially among non-pribumi entrepreneurs. Collective support mechanism [13] have played only a limited role in facilitating technological upgrading, as they are used especially by smaller pribumi firms.

The survey results suggest that neither of the two major technology-related initiatives under the umbrella of the Ministry of Industry - the Minsitry's extensive network of technology extension services, and its foster father program - have been of significant benefit to SME exporters. Public institutions generally lack the commitment resources and flexibility to provide high-quality support to SMEs. As is evident from the case studies, a firm's technological needs are highly specific to its individual circumstances - and specific needs of this kind simply cannot be met by a centrally-controlled, supply-driven network of technology extension services staffed by personnel whose specialised technological expertise is at best modest.

In principle industry associations might be better placed than a centralised ministry to collectively provide industry-specific knowledge. Indeed in both rattan and garments, industry associations provided useful technical or marketing support. However, overall Indonesia's industry associations tend to be exceedingly weak. They are not professionally staffed; they are rarely accountable to their members; they tend to be captured by powerful players/patrons in the industry, and consequently are viewed with ambivalent suspicion by smaller participants in the industry; and their umbrella organisation lacks credible autonomy from government.

A central lesson of the experience thus far is that, considering that private channels are the dominant source of technological capability for SME exporters, the government should not be in the business of direct delivery of technology provision. Rather, its role should be to facilitate and support the emergence of private networks of technology provision, subsidising the use of foreign private technical consultants and the training offered by non-governamental organisations.

[13] There are four collective mechanism for the acquisition of technological capability: support from the industry association or NGOs; the foster father program; support from public technology agencies; support from private consultants.