

# Insights on the Development of Micro, Small, and Medium- Sized Enterprises in Indonesia



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By

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**Cambridge  
Scholars  
Publishing**



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This book first published 2024

Cambridge Scholars Publishing

Lady Stephenson Library, Newcastle upon Tyne, NE6 2PA, UK

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

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ISBN (10): 1-0364-0343-2

ISBN (13): 978-1-0364-0343-0

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# CHAPTER 1

## INTRODUCTION

### **1.1 The Importance of Micro, Small, and Medium Enterprises**

Micro, small, and medium enterprises (MSMEs) are the backbone of the economy in many countries, representing 95% of all companies worldwide and accounting for 60% of employment. In many countries, more than 90% of companies can be categorized as MSMEs, and most of them can be classified as micro-enterprises (MIE), with fewer than ten employees. From a global perspective, it is recognized that this group of enterprises, although individually small in size, plays an important role in economic development because they are the main source of job creation and output growth, not only in developing countries but also in developed countries. Based on country studies in the 1990s, Tambunan (2009a, b) shows that there were 12 million or around 63.2% of the total workforce in the United States (US) who worked in 350,000 companies that on average employed less than 500 employees, and in this country companies with fewer than 500 employees are considered MSMEs. This business group, also known as foundation companies, covers more than 99 percent of all business entities in the US and is the core of the country's industrial base. MSMEs are also important in European countries. In the Netherlands, for example, the number of MSMEs reaches 95% or more of the total number of businesses in this windmill country. Like in the US, in other advanced industrial/OECD countries such as Japan, Australia, Germany, France, and Canada, MSMEs are also very important engines for their economic growth and technological progress.

ILO data in 2019 shows that workers in micro and small enterprises (MSEs) accounted for 70% of total employment worldwide. These companies are major job creators in developing and least developed countries. In these countries, 4 out of 5 new positions in the formal sector were created by MSMEs, which was around 90% of total employment. In the formal sector alone, these companies contributed up to 33% of gross domestic product (GDP) (ILO, 2019).

MSMEs have a dominant share in the number of companies and employment in all countries that are members of the G20. This business group plays an important role in economic development and job creation in these countries. In Japan, for instance, MSMEs (companies with less than 300 employees or a maximum capital of 300 million yen) accounted for 99.7% of companies and employed about 70% of the workforce. In the manufacturing sector, they generated about half of the value added (ICSB, 2019).

The WTO in its 2020 report stated that many MSMEs depend on international trade in their activities, either because they export their products through direct or indirect channels, or import inputs to produce goods to sell domestically. These enterprises are the main employers of women and young people and are the main drivers of innovation (WTO, 2020).

Because they are the largest creators of employment opportunities, MSMEs, especially MSEs, are very important in improving income distribution, alleviating poverty, especially in rural areas, and developing entrepreneurship, especially for women.

In large countries such as India, China, and Indonesia, apart from creating jobs, the presence of MSMEs is also considered very important because of their potential contribution to the growth of exports of manufactured products, diversification of the manufacturing industry, and development of the rural economy (Tambunan, 2009a,b).

Levy et al (1999) emphasize the importance of MSMEs and their performance for economic development in most less developed countries. Therefore, the governments in these countries have supported their MSMEs through various programs, with subsidized credit schemes being the most important one. International institutions such as the World Bank, United Nations Industry and Development Organization (UNIDO), and many donor countries through bilateral cooperation have also done a lot, both financially and technically, in empowering MSMEs in developing countries.

In developing countries in Asia, MSMEs have made a significant contribution over the years, measured by their share, especially in: (a) the number of businesses; (b) total jobs created; (c) total production produced and added value; (d) GDP formation; (e) number of businesses founded by women entrepreneurs; and (f) regional distribution of industry. According to Narain (2003), the contribution of MSMEs is very important because they generally: (a) cover between 80% and 90% of all businesses; (b) provide more than 60% of employment in the private sector; (c) generate between 50% and 80% of total employment; (d) contribute approximately

50% of sales or added value; (e) accounts for about 30% of total direct exports.

According to Asian Development Bank (ADB) statistics, in the Asian region, MSMEs contributed 96% of total businesses, absorbed 62% of the workforce, and contributed an average of 42% of GDP (OECD, 2017). The 2019 MSME Economic Indicators Database shows the number of officially registered MSMEs in 176 countries by region, as mentioned in the following table. The numbers in brackets show the ranking of the number of MSMEs in various regions.

**Table 1.1 Region-wise MSMEs (Numbers)**

No	Region	MSMEs per Region	Rank
1	East Asia and the Pacific	102,289,112	(1)
2	Europe and Central Asia	35,027,833	(4)
3	Latin America and the Caribbean	17,217,911	(6)
4	The Middle East and North Africa	10,066,801	(7)
5	North America	33,729,168	(5)
6	South Asia	75,924,258	(2)
7	Sub-Saharan Africa	48,185,712	(3)

Source: <https://www.smefinanceforum.org>.

The table above shows that the East Asia and Pacific region has the highest number of MSMEs, followed by South Asia, Sub-Saharan Africa, Europe, Central Asia, North America, etc. In these countries, job creation through MSMEs often provides direct benefits to poor and vulnerable communities, especially women and youth, thereby reducing poverty, improving their economic status, and so on. Entrepreneurs in MSMEs are the support of the economy in the process of effectively utilizing local resources that have not been fully utilized such as an abundant workforce, personal savings, and natural resources.

According to the SME Finance Forum, MSMEs are at the heart of job creation, covering 9/10 businesses and 2/3 of jobs worldwide. According to estimates, by the end of 2030, 600 million jobs will be needed to absorb the growing global workforce, both skilled and unskilled, especially in Asia and sub-Saharan Africa (World Bank, 2018). However, meeting financial needs is a big challenge and hampers the growth of MSMEs in all regions of the world. MSMEs need more financial support to sustain and grow. It is estimated that around 131 million or 41% of formal MSMEs, especially in developing countries, have unmet funding needs. Unmet credit demand is estimated at around \$4.5 trillion. Women-owned

businesses are predicted to contribute 23% of MSMEs and 32% of the financing gap (IFC, 2019).

In Indonesia, the importance of these enterprises is especially because of their characteristics, which include:

- 1) their number is huge, and especially micro enterprises (MIEs) and small enterprises (SEs) are scattered widely throughout rural areas, and they may have a special 'local' significance for the rural economy;
- 2) as being populated largely by firms that have considerable potential for employment growth, their development or growth constitutes a significant element of policies to create employment and generate income and so to reduce poverty. Awareness of this fact may also explain the growing emphasis on the role of MSMEs, especially MIEs and SEs in rural social and economic development in the country. As in many other developing countries, in Indonesia, the agricultural sector is unable to absorb the increasing population in the rural areas. As a result, migration from villages to big cities especially Jakarta, the Capital of the country, and others like Surabaya (the provincial capital of East Java), Semarang (the provincial capital of Central Java), Bandung (the provincial capital of West Java), Medan (the provincial capital of North Sumatera) and Makassar (the provincial capital of South Sulawesi) has increased dramatically, causing high unemployment rates and related socio-economic problems in these cities. While, on the other hand, non-farm activities in rural areas, especially rural industries are quite a dynamic part of the rural economy. Therefore, the Indonesian government has been making serious efforts to support rural industries as they have great potential to generate rural productive employment. In this respect, MSMEs can play a key role since rural industries consist largely of this category of enterprises;
- 3) MSMEs use technologies that are in a general sense more 'appropriate', as compared to modern technologies used by large enterprises (LEs), to factor proportions and local conditions in Indonesia; that is, many raw materials are locally available but capital, including human capital, is very limited, especially in rural areas;
- 4) the majority of MSMEs in Indonesia are located in rural areas, and they are mainly agriculturally based as well as agriculturally oriented activities. Therefore the Indonesian government's efforts

to support these enterprises are also an indirect way to support the development of agriculture;

- 5) they finance their operations overwhelmingly by the personal savings of the owners, supplemented by gifts or loans from relatives or local informal moneylenders, traders, input suppliers, or in the form of payments in advance from consumers. Based on this fact, there is another important role that MSMEs can play, namely, as a means to allocate rural savings that otherwise would be used for unproductive purposes. In other words, if productive activities were not available locally in rural villages, rural wealthy farm households might keep and save any surplus money for zero interest inside their homes because, in many villages in Indonesia especially outside Java island, the banking system does not work very well or access to banks is still difficult or costly. Or they may use their wealth to buy land, cars, motorcycles, houses, and other unnecessary consumption goods which are often considered by many people in villages as status symbols. Although in general people in rural areas are poor or from the low-income group, many poor villagers can save and invest a small amount of capital either from their salaries as low-paid local civil servants or teachers or from their revenues as farmers; and they are willing to take risks in doing so. In this respect, MSMEs provide a good starting point for the mobilization of both villagers' talents as entrepreneurs and their capital. While, at the same time, rural MSMEs can function as an important sector providing an avenue for testing and developing rural entrepreneurial ability;
- 6) although many goods produced by MSMEs are also bought by consumers from the middle and high-income groups, it is generally evident that MSMEs' products are overwhelmingly simple consumer goods, such as clothing, furniture, and other articles and household items made from wood, bamboo and rattan, leather products including footwear, and various metal products. These products cater to the needs of local poor or low-income consumers. The enterprises are also important for securing the necessities for this section of the Indonesian population. However, many MSMEs also produce simple production tools, equipment, and machines to meet the demands of farmers and producers in the industrial, trade, construction, and transport sectors.

Apart from the reasons mentioned above regarding the importance of MSMEs in Indonesia, there are two other reasons why the Indonesian government supports these businesses. First, although evidence is difficult to obtain, many of these enterprises, especially medium-sized enterprises (MEs), may have experienced significant expansion of production scale, while most MIEs tend to grow only slightly and therefore do not pass through that size category. Therefore, MEs are considered as companies that have a 'LE seeding' function. The Indonesian government has high hopes that many MEs will soon graduate and become efficient and highly competitive LEs. Second, the Indonesian government also has high hopes for SEs and MEs to play their potential role as efficient and highly competitive suppliers or subcontractors globally, both to domestic LEs including multinational companies (MNCs) in Indonesia, and to companies in other countries involved in regional or global supply chains.

Given the importance of MSMEs outlined above, it is not surprising that during the 1997/98 Asian financial crisis as well as the 2008/09 global economic crisis, the Indonesian government spent a lot of money to support these businesses in the face of the crisis. For example, during the 2008/09 crisis, the government increased funds to finance a special credit scheme, called People's Business Credit, known as KUR (People's Business Credit), to increase MSME production. The government also tried to help export-oriented MSMEs which were facing a decline in world demand for their products by shifting their market orientation to the domestic market. To boost domestic demand, the government then launched a fiscal stimulus package.

## **1.2 Definition and Concept**

The definition of MSMEs varies greatly between countries, or even by various agencies/organizations within a country. MSMEs can range from part-time businesses without paid workers or unincorporated businesses without paid workers (often referred to as self-employed units) such as traditional business units making and selling handicrafts in rural Java in Indonesia to small-scale semiconductor manufacturers employing more than ten people in Singapore. They may range from fast-growing firms to private family firms that have stagnated or not changed much for decades. They range from enterprises that are independent businesses to those that are inextricable parts of LEs, such as those that belong to regional or global subcontracting networks. The only true common characteristic of MSMEs is that they are 'not large'; that is, whether or not a firm is an MSME is relative. Most enterprises from the MSME category are very



small, and about 70% to 80% employ fewer than five people. Only a very small number of firms, typically ranging from about 1%-4% have more than 100 employees.

In Indonesia, there are several definitions of MSMEs, depending on which agency provides the definition. However, Indonesia has also a national law on MSMEs. The initial one was issued in 1995 by the State Ministry for Cooperative and SME (Menekop & UKM), namely the Law on Small Enterprises Number 9 of 1995. It defines an SE as a business unit with total initial assets of up to 200 million Indonesian rupiah (IDR), not including land and buildings, or with an annual sales value of a maximum of 1 billion IDR, and an ME as a business unit with an annual sales value of more than 1 billion IDR but less than 50 billion IDR. Although the law does not explicitly define MIEs, data from Menekop & UMK on SEs include MIEs. In 2008, the Ministry issued the new Law on MSMEs Number 20. According to this new law, MSMEs are those with annual sales/turnovers of up to 50 billion IDR and fixed investments (excluding land and buildings) of less than 10 billion IDR. Besides this law, the National Agency of Statistics (BPS) defines MSMEs based on the total number of workers, i.e. MIEs, SEs, and MEs are business units with 1-4, 5-20, and 20-50 workers, respectively.

As a regional comparison, based on a survey of official reports and studies on MSMEs from individual countries in Southeast Asia, Tambunan (2009a) managed to collect information on the definitions of MSMEs in all member countries of the Association of Southeast Asian Nations (ASEAN). As can be seen in Table I.2, the definitions and concepts of an MSME vary between member countries. There is no common agreement on what distinguishes an MIE from an SE, an SE from an ME, and the latter from an LE. In general, however, based on various existing official reports and government data on the enterprises in those reviewed countries, an MIE employs less than five full-time-equivalent employees, although many in this subcategory of MSMEs do not use wage-paid workers; instead, they use unpaid family members as helpers. MIEs of this kind are usually called self-employment enterprises. While an SME can range from less than 100 wage-paid workers in, for instance, Indonesia, to 150 laborers in Malaysia or 199 workers in the Philippines, in Indonesia, enterprises with 100 employees or more are defined as LEs, while in Brunei Darussalam LEs are those using more than 100 workers, or in Viet Nam, they are units with 300 or more full-time employees.

Table 1.2 Definitions of MSMEs in ASEAN Member Countries

Member country	Employees	Annual Sales/turnovers	Fixed/productive assets	Invested Capitals
<b>Brunei Darussalam</b>				
MIE	≤5	-	-	-
SE	6-50	-	-	-
ME	51-100	-	-	-
<b>Cambodia</b>				
MIE	<11	-	50,000 US\$	-
SE	11-50	-	50,000 US\$ - 250,000US\$	-
ME	51-100	-	250,000US\$-500,000US\$	-
<b>Indonesia</b>				
MIE	≤4	≤300 m. IDR	≤50 m IDR.	-
SE	5-19	>300 m. IDR - ≤2500 m. IDR	>Rp50 IDR - ≤Rp500 IDR	-
ME	20-99	>2500 m. IDR- ≤Rp50 b. IDR	>Rp500 IDR. - ≤Rp10 b. IDR	-
<b>Lao PDR</b>				
MIE	1-4	<100 m. kip	<70 m. kip	-
SE	5-19	<400 m. kip	<250 m. kip	-
ME	20-99	<2000 m. Kip	<1200 m. kip	-

<b>Malaysia</b> MIE -manufacturing & its related services SE - “,” ME - “,”  MIE - service, incl. ICT, & primary agriculture SE - “,” ME - “,”	≤5	≤ 250,000 RM  250,000 RM - < 10 m. RM 10 m. RM - 25 m. RM  ≤ 200,000 RM  200,000 RM -< 1m. RM 1m. RM – 5m. RM	-  - -  - - -	-  - -  - - -
	<200/100 <9	<10m kyat “,”	- -	<5m kyat “,”
	≤9 10-99 100-199	- - -	≤3m. P above 3m. P – 15 m.P above 15m. P – 100 m.P	- - -
	≤199	-	<15m.S\$	-
<b>Myanmar</b> SME MIE				
<b>Philippines</b> MIE - manufacturing SE - “,” ME - “,”				
<b>Singapore</b> SME -manufacturing & services				

<b>Thailand</b> MIE - manufacturing SE - manufacturing & services - trading: - wholesaling - retailing ME - manufacturing & services - trading: - wholesaling - retailing	≤4	-	<50 m. THB “,”- “,”- <30 m. THB	<500,000 THB <20m. THB ≤9m. THB “,”- 20m. THB- 100m. THB 9m. THB “,”-
	<50	-	50m. THB- 200 m. THB	
	<25	-	50m. THB-100m. THB	
	<15	-	30m. THB-60m. THB	
	50-200 25-50 15-30	-		
<b>Vietnam</b> MIE SE ME	<10	-	-	-
	10-49	-	-	<1 b.VND
	50-299	-	-	1b. VND – 10 b. VND

Source: Tambunan (2009a)

Table I.2 also shows that all reviewed member countries not only use the number of workers to define their MSMEs but also monetary variables such as annual income and/or the value of fixed or productive assets (excluding land and buildings), and/or the value of invested capital (excluding fixed assets), and the values of these variables vary by country. However, the value of fixed assets or invested capital is less easy to use than, for example, the number of employees because many MSMEs, especially the smallest and also the most traditional (i.e. MIEs) do not have an exact estimate of the amount of fixed assets or capital they invest, or like LEs in general, they probably don't want to give out this kind of information. The value of fixed assets or invested capital also tends to change more frequently than the amount of labor used because it depends on many factors, especially inflation, technological progress which tends to be more capital intensive over time, the level of economic development, and the sector concerned.

Comparison of MSMEs between countries becomes more difficult because some countries usually do not define MSMEs as such, but refer to MSMEs in certain sectors. In Malaysia, for example, before the establishment of the National SME Development Council (NSDC) in June 2004, there was no standard definition of enterprise in use. Various organizations or institutions that support or are related to the development of MSMEs define this group of companies based on their criteria, usually referring to the number of permanent employees, shareholder funds, and, most recently, annual sales turnover. One example, the Small and Medium Industries Development Corporation (SMIDEC), a government agency specifically to support the development of MSMEs in Malaysia, defines MSMEs as companies with an annual sales turnover not exceeding 25 million Malaysian Ringgit (RM) and a maximum of 150 permanent employees. Bank Negara Malaysia (Central Bank of Malaysia) defines MSMEs as companies with shareholder funds worth less than 10 million RM. Previously, among the various definitions, the definition used by the Ministry of International Trade and Industry, which is responsible for industrial development in Malaysia, was more widely accepted, because the manufacturing sector in the country's economy mostly consisted of MSMEs (Tambunan, 2009a).

As in several other member countries, the absence of a standard definition of MSMEs in Malaysia hinders the collection and compilation of MSME data for assessing development needs and business performance across economic sectors. To assist in better identification of MSMEs in all economic sectors and for more effective targeting of enterprises related to the design of MSME development policies and programs, new definitions

for MSMEs in the manufacturing (including related services), agriculture, and services (including information) and sectors communication technology/ICT) was introduced in 2005. The criteria used in defining MSMEs are annual sales turnover and number of workers. This guide provides a broad definition of MSMEs, as well as specific definitions for MSMEs, SEs, and MEs (Table I.2). For broader coverage, a business is considered an MSME as long as it meets the established thresholds for annual sales turnover and number of permanent employees (UNDP, 2007). “Guidelines for the Definition of MSMEs in Malaysia” was issued by the Bank Negara Malaysia Secretariat on 13 September 2005 for circulation to all ministries and non-departmental government agencies, and also to financial institutions (APEC, 2003).

In the Philippines, there are two operational definitions of MSMEs: one employment-based, the other asset-based. The first is the most widely used (Resolution of the Central Bureau of Statistics and SMED Council No. 1, Series 2003) (Aldaba, 2008). Like several other member countries, the Philippines has changed its official definition of MSMEs several times since 1991. In that year, to encourage the development of MSMEs, the Philippine government implemented the Magna Carta of Small Businesses (Republic Act 6977) which outlines general policies for the development of MSMEs. The law, among other things, mandates the establishment of SME Development Councils (SMED) across the country to encourage public-private sector partnerships in advancing MSMEs. What is meant by MSMEs is any business activity or business entity engaged in industry, trade, agribusiness, and/or services, whether individuals, partnerships, cooperatives, or corporations, whose entire assets include those arising from loans, but do not include land. above which the office, plant, and equipment of a particular business entity are located, must have a value that falls into the following categories: MIE is a unit with a maximum number of employees of 9 people and fixed assets of less than 1.5 million Pesos (P); SE with 10-99 employees and fixed assets between P1.5 million to P15 million; and ME with a minimum number of employees of 100 and a maximum of 199 people and fixed assets of more than P15 million and a maximum of P100 million (Aldaba, 2008).

This definition was later changed by Resolution No.3 of 1995 issued by the SMED Council. The Council has defined MSMEs as 'any business activity or undertaking', whether engaged in industry, agribusiness, or services, regardless of whether it is a sole proprietorship, partnership, cooperative, or corporation, whose asset size corresponds to a specified amount. In 2002, Republic Act No. 9178, otherwise known as the Barangay

Micro Enterprises (BMBE) Law of 2002, redefined existing categories by dividing MSMEs into MIEs, SEs, and MEs as given in Table I.2, and in January 2003, the SMED Council also did the same (Tambunan, 2009a). Thus, Philippine MSMEs do not have assets of more than 100 million pesos or more than 200 employees. In March 2003, the Central Bank of the Philippines adopted the above SMED Council definition to apply to financial institutions' MSME programs (Sibayan, 2005).

In Thailand, before the Asian financial crisis of 1997/98, there had been no proposed and generally accepted national definition of MSMEs, and various public institutions had used their own MSME classification criteria, mainly to suit their respective institutional needs. For example, the Small Industry Finance Corporation (SIFC) and the Small Industry Credit Guarantee Corporation (SIGCC) define an SE as a company that has fixed assets worth less than 50 million Thai Baht (THB) (but neither of them defines an ME); The Department of Industrial Promotion defines an ME as a business unit with fixed assets worth between 20 million THB and 100 million THB and having 50-200 employees, and an SE having fixed assets worth less than 20 million THB and having less than 50 employees; The Federation of Thai Industries (FTI) classifies an ME as a company with total assets in the range of 20 million THB - 100 million THB and 5-200 employees, and an SE as a company with fixed assets of less than 20 million THB and employing less than 50 people; and for the Bank of Thailand (BOT), a company with fixed assets worth no more than 50 million THB is considered an ME and a company with assets of less than 20 million THB is considered an SE (White, 1999). Many papers written about MSMEs in Thailand contain different explanations regarding the national definition of MSMEs in this white elephant country. For example, according to Leopairote (1997), before 1997 the Royal Thai government applied the following definition to company activities: (i) an SE employs no more than 50 workers and has registered capital of no more than 10 million THB, and (ii) an ME employs 50-200 workers and has registered capital between 10 million THB and 100 million THB.

It was only in recent years that Vietnam has had an official definition of MSMEs. Initially, the process of achieving an official definition of MSMEs was slow. This comes after more than 25 years of private sector reform. Historically, the private sector in Vietnam had long been depressed and even marginalized in some areas of the economy in the northern part of the country before the country's unification in 1975 and this continued to be treated in this way throughout the country during 1976-1985. The origins of private sector development in Vietnam can be

traced to 1986 when the government adopted the Doi moi (economic reform) policy and recognized a multi-stakeholder economy. Another important step taken was the 1992 Constitution, which recognized the private sector in the economy and guaranteed the protection of private ownership in the country's economic life. Thereafter, along with the restructuring of state-owned enterprises and attracting foreign investment, especially in the form of foreign direct investment (FDI), the pace of private sector reform began to accelerate. The enactment of the Companies Law in 1999 has created a new impetus, a breakthrough for the development of the private sector in the country. To comply with the rules and regulations of the World Trade Organization (WTO), many laws in Vietnam were changed and promulgated, thereby creating a fairer competitive environment (Tambunan, 2009a).

After joining the WTO in 2006, Vietnam has implemented deeper reforms as its government's commitment to the WTO, contributing to the establishment of a level playing field, which is considered very important for the development of the private sector in the country (Cuong, et al., 2008). On November 23, 2001, Government Decree 90/2001/ND-CP for the first time provided an official definition of MSMEs as independent business entities that register their businesses following applicable laws and regulations, with registered capital of no more than 10 billion Vietnamese Dong (VND) or with an average number of employees per year of no more than 300 people. According to this Decree, MSMEs include (i) companies registered and operating under the Companies Law of 1999; (ii) business entities registered and operating under the state-owned company law; (iii) companies registered under the Cooperatives Act 1996; and (iv) households registered based on Government Decree No 02/2000/ND-CP dated 2/2/2000.

Before 1998, several provinces in the country had set their own MSME criteria such as the number of permanent workers being less than 500 people, the value of fixed assets being less than 10 billion VND, and the movable capital and monthly income being less than 20 billion VND. In June 1998 the government issued Public Letter 681/CP-KCN on the strategic direction and policy of developing MSMEs, which stated that MSMEs are businesses with registered capital of less than 5 billion VND or a permanent workforce of less than 200 workers. This legal document is the basis for implementing measures to support the development of MSMEs.

Recognizing that the definition of MSMEs under Decree 90/2001/ND-CP is too general to provide useful data for policy formulation, the Government Agency for SME Development (ASMED) in June 2005



introduced further size segmentation in its MSME Development Plan for the period 2006-10. According to the new segmentation, MSMEs are classified into MIE (less than 10 people), SE (10-49 people), and ME (50-299 people) (Tambunan, 2009a). However, as stated by Cuong et al. (2008), the current classification of MSMEs still has certain limitations. First, this policy does not “separate” company domains, which may require different amounts of capital and/or employ different amounts of labor for production activities. For example, the service sector usually does not require as much capital as the manufacturing sector. This is why, as in other ASEAN member countries, the service sector (trade and repairs) is the largest group of MSMEs in Vietnam. Second, registered capital is not an ‘effective’ criterion because, at the time of classification, a company's working capital requirements may change, and may exceed previous requirements.

Cambodia, as another example, did not have an official definition of MSMEs until 2005. In terms of number of employees, the National Institute of Statistics (NIS) classifies companies with fewer than 10 employees as small companies. Companies with between 11 and 100 employees are classified as medium-sized companies. The Ministry of Industry, Mines, and Energy (MIME) defines an SE as a business that has less than 50 employees. Some ministries use one or both definitions, while others use different definitions, some based on asset value. These differences make it difficult to compare MSME data from various sources because their definitions often change over time from one period to the next. In July 2005, the Cambodian SME sub-committee proposed that the definition of business size, as shown in Table I.2, be applied to all ministries. It is unclear whether the definition has been used consistently since then.

For policy and statistical purposes, a definition based on the number of employees is the preferred choice of the SME Sub-Committee. When the total number of employees is inappropriate, such as when there is considerable variation over time in the number of employees in a company, then a definition based on financial assets is another alternative option (Bailey, 2008).

Table I.3 Main Characteristics of MIEs, SEs, and MEs in Indonesia.

Aspect	MIEs	SEs	MEs
Formality	operate in the informal sector, unregistered & pay no taxes	some operate in the formal sector, are registered & pay taxes	all operate in the formal sector, are registered & pay taxes
Location	majority in rural areas/villages	many in urban areas/cities	mostly in urban areas/cities
Organization & management	- run by the owner - no internal labor division -no formal management & accounting system (bookkeeping)	- run by the owner - no labor division (majority), -no formal management and accounting system (bookkeeping)(majority)	-many use professional managers, -many have labor divisions, formal organizational structures & formal accounting systems (bookkeeping)
Nature of employment	majority use unpaid family members	some hired wage laborers	-all hired wage laborers -some have a formal recruitment system
Nature of the production process	- degree of mechanization very low/mostly manual - level of technology very low	some use up-to-date machines	many have a high degree of mechanization/access to modern technology
Market orientation	majority sell to local markets and low-income consumers	-many sell to the national market and export -many serve middle to high-income group	-all sell to the national market and many also export - all serve middle and high-income consumers

Social & economic profiles of owners	<ul style="list-style-type: none"> <li>- low or uneducated</li> <li>- from poor households</li> <li>- main motivation: survival</li> </ul>	<ul style="list-style-type: none"> <li>- some have good education and are from non-poor households</li> <li>- many have business/profit motivation</li> </ul>	<ul style="list-style-type: none"> <li>- the majority have a good education</li> <li>- many are from wealthy families</li> <li>- main motivation: profit</li> </ul>
Sources of inputs	The majority use local raw materials and their own money	<ul style="list-style-type: none"> <li>- some imported raw materials</li> <li>- some have access to banks and other formal credit institutions</li> </ul>	<ul style="list-style-type: none"> <li>- many use imported raw materials</li> <li>- the majority have access to formal credit sources</li> </ul>
External networks	the majority have no access to government programs and no business linkages with LEs	<ul style="list-style-type: none"> <li>- many have good relations with the government and have business linkages (such as subcontracting) with LEs (including MNCs/FDI).</li> </ul>	<ul style="list-style-type: none"> <li>- the majority have good access to government programs</li> <li>- many have business linkages with LEs (including MNCs/FDI)</li> </ul>
Women entrepreneurs	ratio of female to male entrepreneurs is high	ratio of female to male entrepreneurs is high	the ratio of female to male entrepreneurs is low

Source: Tambunan (2009a).

### **1.3 Main Characteristics**

In Indonesia (as also evident in many other developing countries), besides the number of employees, annual revenues, or value of invested capital as the criterion to define an MIE, an SE, and an ME, an MIE can be distinguished easily from an SE or an ME just by reference to their different characteristics in many aspects, such as formality or ways of doing business, market orientation, social-economic profiles of their owners/producers, nature of employment, organization and management system, degree of mechanization (nature of production process), sources of main raw materials and capital, location, external relationships, and degree of women's involvement as entrepreneurs (Table I.3).

### **1.4 Motivation of the Book**

Everyone agrees that MSMEs have an important role in the economic development of every country, such as Indonesia. Especially as the main source of job creation, GDP growth, and development of non-oil and gas exports. However, recently, with the rapid progress of technology in entering the era of 'industry 5.0' which is dominated by various machines and applications based on artificial intelligence (AI), as well as the increasingly rapid flow of globalization along with increasingly liberal world trade, the question arises: are MSMEs still able to survive, especially in developing countries like Indonesia? Apart from that, with the obligation of all countries in the world to realize the Sustainable Development Goals (SDGs) that have been mutually agreed upon by 2030, the next question is: what is the role of MSMEs in achieving the 17 SDGs by 2030?

Some parties involved in this debate are somewhat skeptical because most companies in developing countries lack the resources necessary for competitive advantage such as technology, capital, entrepreneurship, market information, and technical skills. It cannot be denied that in the era of international trade liberalization, MSMEs in developing countries can only maintain their existence if they can internationalize. As stated by Long (2003), this capability is also an important factor in measuring their global competitiveness. The low competitiveness of MSMEs globally can be a serious obstacle for them to access not only international markets but also domestic markets because their products are unable to compete with imported goods.

The debate above does not arise without reason. The last quarter century has seen many countries across the development spectrum experience

unprecedented levels of activity in the process of trade liberalization. Today, carrying out international trade in goods and services, whether between countries in the same region (for example between ASEAN member countries) or between regions (for example between ASEAN and the European Union) is much easier than, say, three decades ago. Today, more countries than 30 years ago have undertaken significant trade reforms and are engaged in the process of integrating their economies with the world economy. Currently, there are several bilateral and regional agreements regarding trade liberalization, such as the Singapore-China Free-Trade Area (FTA), the North American FTA, and the Association of Southeast Asian Nations FTA or AFTA (Oktaviani et al., 2008). Consequently, in the case of AFTA, for example, there is a free flow of goods, services, and investment in ASEAN (Lloyd and Smith, 2004). In addition, ASEAN has expanded its FTA with other non-member countries, including China (known as the ASEAN-China FTA) which began in 2010. So naturally the flow of goods and services as well as investment entering the ASEAN market, including Indonesia's domestic market is getting bigger, which of course creates challenges for the sustainability of MSMEs in the country.

This book is about MSMEs in Indonesia. Based on the literature review, the latest country data on MSMEs, and own case studies/surveys, this book presents and discusses the latest developments of MSMEs, their main obstacles, their level of internationalization (export performance), their level of digitalization, and also women's entrepreneurship. The main aim of this book is to answer the following question: can Indonesian MSMEs survive amidst globalization, increasingly fierce competition in the global market, as well as technological advances, including the increasingly massive use of AI? This question is very important for Indonesia for two main reasons. First, MSMEs have historically been major players in the Indonesian economy, covering more than 90% of companies in various sectors and providing employment for more than 90% of the country's workforce, the majority of which are women and youth. Second, Indonesia's trade regime has changed from a protected market to an open economy. Since the end of the Asian financial crisis in 1997/98, the Indonesian economy has become more liberal not only in trade but also in investment, with more and more domestic sectors opening up to foreign players. With this unstoppable development, there are several reasons to worry that the majority of Indonesian MSMEs, especially MIEs and SEs, will not survive. In fact, at the start of the ASEAN-China FTA, many observers were somewhat skeptical that Indonesian MSMEs could sustain their businesses in competition with cheap goods from China. One

of the reasons is that many (if not all) Indonesian MSMEs are currently facing various obstacles, including a lack of human resources (workers and entrepreneurs/business owners), capital (especially for investment), and advanced technology. This is especially true of MIEs and SEs.

The impact of international trade liberalization or trade policy reform on economic growth and development of domestic manufacturing industries in ASEAN countries has been widely researched. However, this is not the case with the impact of international trade liberalization on the existence or growth of MSMEs in this region, and in Indonesia in particular. Research on this is still very rare. Apart from that, studies regarding digitalization, women's entrepreneurship, and cluster development related to MSME development are also still very limited, especially in Indonesia. Thus, this book can contribute to filling this gap.