SMEs DEVELOPMENT IN INDONESIA: DO ECONOMIC GROWTH AND GOVERNMENT SUPPORT MATTER?

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ABSTRACT

There is an ongoing debate in the literature on development of small and medium enterprises (SMEs) in less developed countries (LDCs) on two issues: The survival of SMEs in the course of economic development and the importance of government promotion programs for SMEs development. This research aims to examine those issues with Indonesian data. As a means to address those issues, it uses a simple regression model. It shows that both real gross domestic product (GDP) per capita and government development expenditure (in which part of it is used to finance SMEs development promotion programs) have positive correlations with SMEs share in GDP. With this finding, the research argues that SMEs in LDCs have a chance to survive and even to grow in the long-run for three main reasons: (a) they have a niche market for themselves; (b) these enterprises act as a 'last resort' for the poor; and (c) the production linkages between SMEs and large-enterprises (LEs) in the form of subcontracting have become increasingly important, and thus, they will grow along with the growth of LEs.

INTRODUCTION

The development of small and medium enterprises (SMEs) and changes over time in their structure (e.g. employment and output shares, output composition, market orientation, and location) are usually thought to be related to many factors, including the level of economic development and government promotion programs. The main objective of this research is to examine empirically the effects of those two factors on the growth of SMEs. Specifically, it aims to answer two research questions:

1. Will SMEs die out and the economy will be dominated by large enterprises (LEs) in the long-run as economic development proceeds, or these enterprises will survive and even grow along with LEs?

2. Are government promotion programs important for the growth of SMEs?

For this purpose, it develops a set of hypotheses and employs Least Square to test them.

Next section explores the importance of SMEs in the Indonesian economy. Thereafter, Section 3 examines main constraints faced by SMEs. Section 4 deals with gender aspect of SMEs development. Section 5 observes the importance of government sponsored SMEs development programs. Theoretical contributions on the links between SMEs growth and the two factors being analysed are given in Section 6. Methodology, results and discussion of the results are given, respectively, in the next two sections. Finally, concluding remarks of this study are given in Section 9.

This study uses the SMEs definition adopted by the National Agency for Statistics (BPS) which uses the number of workers as the basis for determining the size of an enterprise. In its definition, small enterprises (SEs) and medium enterprises (MEs) are business units with, respectively, 1–19, and 20–99 workers, and LEs are units with 100 or more workers.

SMEs' CONTRIBUTIONS TO THE INDONESIAN ECONOMY

In Indonesia, SMEs have historically been the main player in domestic economic activities, especially as a large provider of employment opportunities, and hence a generator of primary or secondary sources of income for many households. For low income or poor farm households in rural areas, SE units of fewer than 20 workers in non-farm activities are especially important. These enterprises have also been an important engine for the development of local economies and communities (Tambunan 2006).

These enterprises are very important in Indonesia mainly because of their following characteristics. First, these enterprises, which are mainly owned by indigenous or local people, account for more than 90% of all firms (Table 1) and thus they are the biggest source of employment, providing livelihood for over 90% of the country's workforce. Second, they are scattered widely throughout the rural areas and also they are mainly agriculturally based activities, thus they are important as an engine for rural economic development. Third, they are labor intensive, mainly less-educated women and youngsters. Fourth, most of these enterprises (especially SEs) finance their operations overwhelmingly by personal savings. Fifth, they are less dependent on import and they produced mainly simple consumer goods for domestic market, for low income consumers. Other important characteristics of SMEs in Indonesia which may make them more different than their counterparts in developed countries are that both workers employed and entrepreneurs are low educated, and, as Tambunan

Table 1 Total units of enterprises by size category: 1997–2006 (000 units).

	1997	1998	1999	2000	2001	2003	2004	2005	2006
SMEs	39,765.20	36,813.60	37,856.30	39,784.00	39,964.07	43,460.30	44,777.44	47,102.80	48,929.60
LEs	2.1	1.8	1.8	5.7	5.9	6.5	6.7	6.8	7.2
Total	39,767.30	36,815.40	37,858.10	39,789.70	39,969.97	43,466.80	44,784.14	47,109.60	48,936.80

Source: BPS

Table 2 Unit distribution of SMEs by sector in Indonesia, 2000, 2005 and 2006 (%).

Sector	2000				2005				2006			
	SE	ME	LE	Total	SE	ME	LE	Total	SE	ME	LE	Total
Agriculture	59.23	2.22	1.20	59.11	55.86	1.74	0.85	55.75	53.68	1.57	0.74	53.56
Mining	0.38	0.67	1.18	0.38	0.50	0.69	1.60	0.50	0.54	0.58	1.67	0.54
Manufacture	6.57	14.91	33.57	6.59	5.95	14.30	36.98	5.97	6.56	15.82	35.47	6.58
Electric, gas and water supply	0.03	1.02	3.08	0.04	0.03	0.97	2.98	0.03	0.03	0.90	2.96	0.03
Construction	0.31	3.63	4.42	0.32	0.34	4.08	4.30	0.35	0.33	3.52	4.41	0.34
Trade, hotel and restaurant	24.37	55.36	24.95	24.43	25.89	53.38	21.83	25.95	27.13	54.03	24.11	27.19
Transport and communication	4.70	2.89	3.88	4.70	5.54	4.48	4.67	5.53	5.52	4.46	4.47	5.52
Finance, rent and service	0.13	11.14	20.60	0.15	0.13	11.22	18.06	0.16	0.15	10.51	17.68	0.17
Services	4.28	8.17	7.12	4.29	5.76	9.13	8.72	5.77	6.06	8.60	8.50	6.06
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: BPS

(2004) found, many people established their own business (especially in SEs) were motivated by poverty rather than by entrepreneurship spirit.

Distribution by section shows that SMEs are concentrated in agriculture, followed by trade, hotel and restaurant as the second and manufacturing industry as the third largest sector (Table 2). In this latter sector, they are involved mainly in simple traditional manufacturing activities such as wood products, including furniture, textiles, garments, footwear, and food and beverages. Only a small portion of total SMEs are engaged in production of machinery, production tools and automotive components. This is generally carried out through subcontracting systems with several multinational car companies such as Toyota and Honda. This structure of industry reflects the current technological capability of Indonesian SMEs, which are not yet as strong in producing sophisticated technology-embodied products as their counterparts in other countries such as South Korea, Japan and Taiwan.

In terms of output, SMEs performed relatively well. SEs and MEs grew at, respectively, 3.96% and 4.59% in 2001 and higher at 5.38% and 5.44% in 2006. While, LEs experienced a growth rate of 3.04% and 5.60%, respectively, during the same period (Figure 1). Even, in terms of GDP contribution, SMEs performed better than their larger counterparts as they accounted for more than 50% of GDP during that period. SMEs' output contribution to the annual growth rate of GDP was also higher than that of LEs (Figure 2). On average, the GDP growth share of SMEs was above 2%; whereas that of LEs was under 2%. Within SMEs, SEs' GDP growth share was higher than that of MEs.
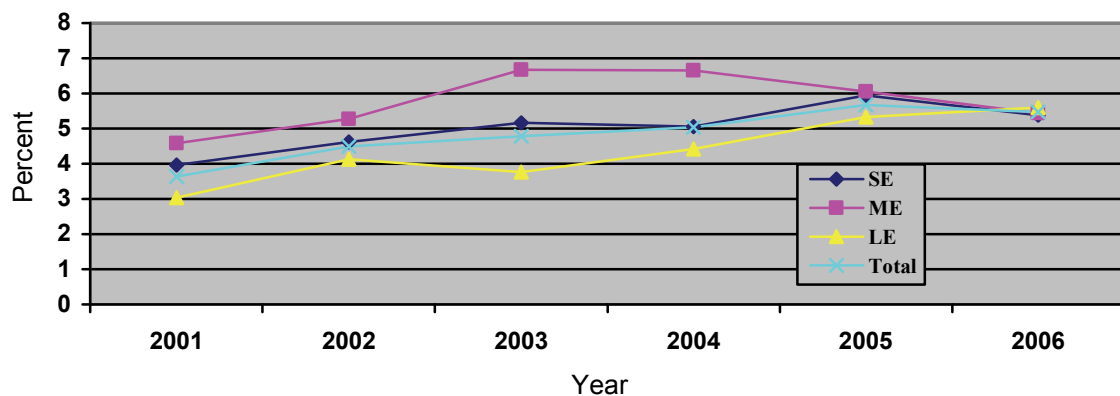

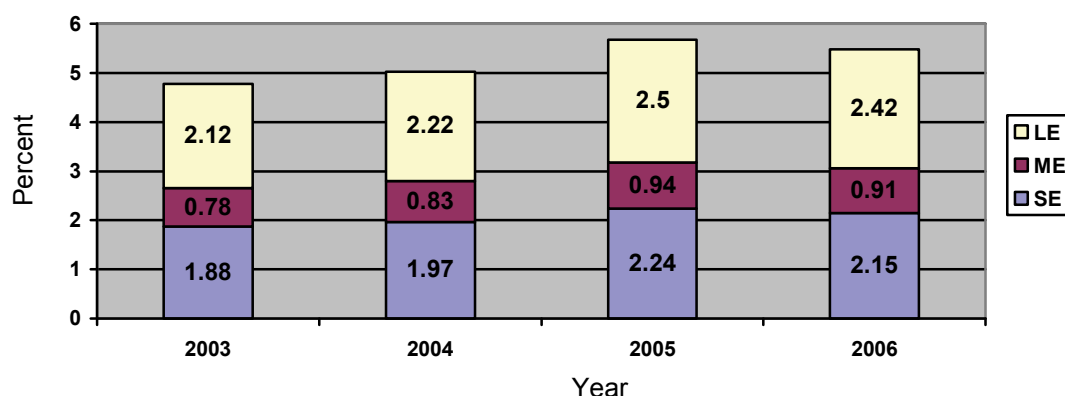*Figure 1.* Output growth rates of SEs, MEs and LEs in 2001–2006

Source: BPS

Figure 2. GDP growth contribution by size of firms in 2003–2006

Source: BPS

CONSTRAINTS FACING SMEs

The development of viable and efficient SMEs is hampered by several constraints.[1] The constraints may differ from region to region, between rural and urban, between sectors, or between individual enterprises within a sector. However, there are certain constraints that are common to all SMEs. These common constraints include lack of capital, difficulties in procuring raw materials, lack of access to relevant business information, difficulties in marketing and distribution, low technological capabilities, high transportation costs, communication problems, problems caused by cumbersome and costly bureaucratic procedures (especially in getting the required licenses), and policies and regulations that generate market distortions.

In 2003, BPS conducted a survey on enterprises with 0 (i.e. self-employment units) to 19 workers in the manufacturing industry. The enterprises are divided into two sub-categories: Very small or micro enterprises (MIEs), i.e. with 0 to 4 workers, and SEs, i.e. with 5 to 19 workers. The findings as given in Table 3 show that the main problems faced by the majority of the respondents are lack of capital and marketing difficulties. In Indonesia, although there are various government-sponsored SME credit schemes, the majority of SMEs, especially MIEs located in rural/backward areas, never received any credit from banks or other financial

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[1] Unfortunately, evidence on constraints faced by LEs is very rare, and there are no data from BPS. Some reports on competitiveness and business environment may give an idea about business constraints faced by LEs (e.g. distorted market, labor disputes, red tape, burdensome tax system, lack of infrastructure, too many retributions, etc.). However, there are data on the constraints on technology acquisition.

institutions. They depend on their own savings, money from relatives and credit from informal lenders for financing their daily business operations. In marketing, SMEs in general do not have the resources to explore their own markets. Instead, they depend heavily on their trading partners for marketing of their products, either within the framework of local production networks and subcontracting relationships or orders from customers.

Table 3 Main problems faced by SEs and MIEs in manufacturing industry, 2003.

	SEs	MIEs	Total SEs and MIEs
Have no problem	46,485 (19.48)[*]	627,650 (25.21)	674,135 (24.71)
Have problem	192,097 (80.52)	1,862,468 (74.79)	2,054,565 (75.29)
• Raw material	20,362 (10.60)	400,915 (21.53)	421,277 (20.50)
• Marketing	77,175 (40.18)	552,231 (29.65)	629,406 (30.63)
• Capital	71,001 (39.96)	643,628 (34.56)	714,629 (34.78)
• Transportation/ distribution	5,027 (2.62)	49,918 (2.68)	54,945 (2.67)
• Energy	40,605 (2.40)	50,815 (2.73)	55,420 (2.70)
• Labor cost	2,335 (1.22)	14,315 (0.77)	16,650 (0.81)
• Others	11,592 (6.04)	150,646 (8.09)	162,238 (7.90)
Total SEs & MIEs	238,582 (100)	2,490,118 (100)	2,728,700 (100)

Source: BPS

Note: * = %

As a comparison, based on limited sources of information (e.g. government surveys and case studies), Table 4 shows four main constraints facing SMEs in individual ASEAN countries. Although they vary by country, it appears that SMEs in all the countries studied face lack of capital as one among the main constraints. In Indonesia, majority of SMEs, especially in rural areas, never received any credit from banks or from existing government sponsored SMEs credit schemes. They depend fully on their own savings, money from relatives and credit from informal lenders for financing their daily business operations.

Interestingly, although it is well-known from the literature that the lack of adequate skills is also a major constraint to SMEs, especially SEs and MIEs, Table 4 indicates that these surveyed enterprises did not consider it as a serious problem. However, this may be due to the fact that many owners of SEs and MIEs were not aware that their productivity is low and the quality of their products inferior compared to the products of the LEs or imported products, especially since many of these enterprises produce only for low-income consumers in local markets that enjoy natural protection from competition from similar goods produced by larger enterprises or from

Table 4 The four most important constraints facing ASEAN SMEs.

Member country	Constraints									
	Raw material	**Marketing**	**Capital**	**Energy**	**Information**	**Technology and skill**	**Infrastructure**	**Tax**	**Inflation**	**Market environment***
Indonesia	x	x	x	x						
Philippines		x	x		x	x				
Vietnam			x			x	x			x
Cambodia			x	x		x				x
Lao PDR	x		x					x	x	
Thailand	x	x	x			x				
Malaysia	x	x	x			x				
Brunei		x	x		x	x				

Note: *including regulations, restrictions, legal framework, or discrimination policies in favor of Les.

Source: Tambunan (2008)

import. The problem of unskilled entrepreneurs in MIEs and SEs are shown in Table 5.

Table 5 Education of entrepreneur in non-farm MIEs and SEs by gender, 2003 (%).

Level of Education	Female	Male
Not finished primary school	27.88	14.27
Finished primary school	40.82	39.49
Finished high school first degree (SMP)	18.62	25.87
Finished high school second degree (SMA)	11.77	18.37
Higher education	0.91	6.5

Source: BPS

WOMEN ENTREPRENEURS

At least two main characteristics of development of women entrepreneurship can obviously be observed in LDCs. First, SMEs are more important than LEs for women entrepreneurs. Second, within SMEs, the female/male entrepreneur ratio is generally higher in SEs than in larger-sized and more modern enterprises. This is due to the fact that women in LDCs are more likely involved in informal activities than men, which consists predominantly of SEs, either as self-employed or employers or paid/unpaid workers. Database from the International Labour Organization (ILO) indicate that almost 95% of SEs in LDCs are performed by women as self-employed; though the percentage varies between countries or regions.

BPS data from various years indicate that women entrepreneurs in Indonesia have also been increasing since the 1980s when the country achieved rapid economic growth leading to rapid increase in per capita income. According to a number of studies (e.g. Manning 1998; Oey 1998), the reason for the increasing number of women-owned enterprises are partly due to the increase of women's educational level, and to the economic pressure the women faced in their households. Recent BPS data on SMEs in manufacturing industry show two interesting facts (Table 6). First, it reveals that only about 29% of manufacturing SMEs are run by women. Second, the rate of women entrepreneurs tends to decline by size: The rate in SEs is higher than that in MEs. If total number of enterprises by gender of entrepreneurs or owners can be used as an indicator of current state of the art of women entrepreneurship development, then the table suggests that becoming an entrepreneur, especially in larger, modern and more complex businesses in Indonesia is still dominantly a man culture.

Table 6 SMEs in manufacturing industry by Gender, 2006 (%).

Sex	Size		
	SEs	**MEs**	**SMEs**
Male	77.33	83.75	71.01
Female	22.67	16.25	28.99
Total	100.00	100.00	100.00

Source: BPS

The relatively low representation of women entrepreneurs in Indonesia can be attributed to at least four main factors. First, low level of education and lack of training opportunities that make Indonesian women severely disadvantaged in both the economy and society may play an important role. It is especially true for women living in rural areas or in relatively backward provinces. This can be seen obviously from BPS data on women entrepreneurs in SEs in the manufacturing industry according to province and university degree diploma. As shown in Table 7, the majority of women entrepreneurs in SMEs having university degree are found in Java and Sumatera, the western and more developed part of the country.

Table 7 Women entrepreneurs in SMEs by university degree and region, 2004 (person).

Region	Women entrepreneurs with university degree	Total women entrepreneurs
Western and more developed regions		
Sumatera	10,402	740,724
Java and Bali	58,240	4,030,236
Eastern and less developed regions		
Nusa Tenggara	909	276,300
Kalimantan	4,196	266,756
Sulawesi	2,365	233,686
Maluku and Papua	88	42,936
Nasional	76,200	5,590,638

Source: BPS

In addition, a report on gender mainstreaming in the education system in Indonesia (Jalal 2004; quoted from Suharyo 2005) shows that the illiteracy rate for women is still higher than men and the gap between men and women in rural areas is much higher than that in urban areas. Many rural women speak only their native language and never read newspapers, making them very restricted in their communication with the outside world. Particularly among women living in rural areas, there are still many social,

cultural and religious taboos that prevent those women who can and should be accessing higher education from doing so. Many parents living in rural areas still have the traditional thinking that (higher) education belongs to men only, especially since after marriage women leave to join their husbands' families and, therefore, are not regarded as being useful to their own families in the long run.

However, although this traditional thinking still exists in rural society, it depends on the economic condition of the family as well as education level of the parents or husbands. The better the economic condition of the family or the better the education of the parents/husbands, the less traditional their attitudes are towards women receiving better education.

Second, heavy household chores. Especially in rural areas, women have more children, and there are more demands on them to perform their traditional role of being responsible for housework and child care, and therefore they have fewer hours of free time than men, both during the weekend and on weekdays.

Third, there may be legal, traditions, customs, cultural or religious constraints on the extent to which women can open their own businesses. Especially in rural areas where the majority of population are Muslim and rather isolated from big cities like Jakarta, Islamic-based norms have stronger influence on womens daily life. This makes female behavior or attitude in rural areas less open than male (or than urban women) to a "doing modern business" culture. In such a society, women must fully comply with their primary duty as their husband's partner and housewife, they are not allowed to start their own businesses or to do jobs that involve contact with or managing men, or simply they are not allowed to leave the home alone. Even if women do have their own business, in many cases, they defer to husbands or other family members in key business decisions, and many turn over greater power to these other family members as the business grows. All these constraints lead to an exclusion of women from entrepreneurial activities. While, in rural areas relatively close to urban areas with good transportation and communication links, changes in local society attitudes about traditional role of women being responsible for housework and child care and men for income in the last 30 years are observable.

Fourth, lack of access to formal credit and financial institutions. This is indeed a key concern of women business owners in Indonesia. This is found to be more problematic for women in rural areas or outside of major metropolitan areas such as Jakarta and Surabaya. This constraint is related to ownership rights which deprives women of property ownership and, consequently, of the ability to offer the type of collateral normally required for access to bank loans. In Indonesia, men are still perceived as the head of

the family, and thus, in general, men are still perceived as the owner or inheritor of family assets such as land, company and house.

Probably because of the above reasons, especially cultural or religious constraints, it is found that in Indonesia, particularly in rural areas, economic necessity or wanting to improve family income is a more predominant factor for entrepreneurship among women. Economic pressures have meant that women are being permitted to take up paid employment outside the home or to run income earning activities beyond their traditional role (Syahrir 1986; Rusdillah 1987).

Finally, the participation rate of female entrepreneurs varies by region. Interestingly, although the majority of the population and a larger number of SEs are located in Java, the island, Nusa Tenggara (NT) in the eastern part of the country has the highest ratio of female/male entrepreneurs, which means that there are more female than male entrepreneurs in NT. However, this does not necessary reflect the higher spirit of female entrepreneurship in NT than in the rest of the country. NT is a region with a very high unemployment rate. Economic activities such as mining, manufacturing industry, construction, agriculture and banking are more or less stagnated on this island. Most matured or married men are working in low income-generating activities such as transportation, motorcycle repair workshops or in agriculture as marginal/subsistent farmers owning less than 0.5 ha of land, or as civil servants. So, as a family survival strategy, the wife is 'pushed' to do something outside the home to earn income. Therefore, the high participation rate of female entrepreneurs in NT is most likely to be a reflection of a family survival strategy rather than a spirit of entrepreneurship. In other words, female entrepreneur development in NT is more a "push" rather than a "pull" phenomenon.

SMEs DEVELOPMENT PROGRAMS

While it is impossible to itemize all government programs, The SMERU Research Institute has been able to map most important existing SMEs assistance programs provided by government and non-government institutions during the period of 1997–2003. The data in Table 8 show that there were 64 institutions, categorized into six groups, whose assistance programs to strengthen SMEs were successfully mapped. A total of 594 programs were identified, and most of them were provided by the government (65%). Other programs were conducted by NGOs (18%), donor agencies (8%), banking institutions (5%), private companies (2%), and other institutions. The scale of each assistance program varied greatly based on

the amount of funds, time frame and geographical scope. Hence, one program cannot be directly compared with another.[2]

Table 8 Number of institutions and assistance programs to strengthen SMEs, 1997–2003.

Institutions	Number of institutions	Number of assistance programs		
		Total	Still continuing	
			Total	%
(a) Government institutions	13	388	127	32.7
(b) Banking institutions	7	31	25	80.7
(c) Private companies	10	12	12	100.0
(d) Donor agencies	8	46	15	32.6
(e) NGOs	20	109	79	72.5
(f) Others	6	8	8	100.0
Total	64	594	266	44.8

Source: SMERU (2004)

Table 9 shows that the type of assistance activities varied. The number of activities within each program also varied, but generally ranged between one and three. Of the 594 assistance programs, there were 1,044 types of activities. In total, the most common types of activities were the provision of training (22.9%), capital assistance/credit (17.3%), facilitation (16.1%), and the dissemination/ introduction of new technology (15.2%).

The data in Table 9 show that government agencies are the most common institutions that introduced new technology (27.9%) and provided training (21.1%), whereas other institutions mostly provided capital assistance. Of all the institutions, government agencies played the most prominent role (50.9%), followed by NGOs (29.4%) and donor agencies (10.1%). Based on the type of activity, training was mostly undertaken by government institutions (46.9%) and NGOs (37.2%). Capital assistance was mostly provided by local and international NGOs (50.3%), followed by government institutions (15.5%) and banking institutions (14.9%). Facilitation was mainly provided by NGOs (52.4%) and government institutions (35.7%).

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[2] For more detailed information about each program from each institution, including the name of the program, type of assistance, program executor, timeframe, fund used, area, beneficiaries, status, problems and potential, see SMERU at www.smeru.or.id.

Table 9 The proportion of assistance programs to strengthen SMEs based upon the type of activities and the implementing institutions.

	A[*]	B	C	D	E	F	Total
Capital assistance	5.3	52.9	25.0	21.0	29.6	28.6	17.3
Training	21.1	13.7	22.2	19.0	29.0	21.4	22.9
Facilitation	11.3	9.8	19.4	7.6	28.7	0.0	16.1
Information	1.9	7.8	2.8	3.8	1.6	21.4	2.6
Facilities	16.2	2.0	5.6	8.6	1.0	0.0	9.7
Promotion	3.0	3.9	13.9	6.7	1.0	7.1	3.3
Dissemination/introduction of new technology	27.9	0.0	0.0	6.7	1.3	0.0	15.2
Guidelines	4.3	0.0	0.0	0.0	0.7	0.0	2.4
Others	9.0	9.8	11.1	26.7	7.2	21.4	10.5
Types of activities	531	51	36	105	307	14	1,044

Source: SMERU (2004)

Note: [*] see Table 8

In Indonesia, numerous government promotion programs for SMEs have been created nationwide, including: Small Enterprise Development (generally known as the KIK/KMKP subsidized credit program for SMEs); the Small Enterprise Credit (KUK) scheme; the credit program for village units (KUPEDES); small rural development banks (BKD); human resource development training programs (such as in production techniques, general management (MS/MUK), management quality systems (ISO 9000), quality control methods, entrepreneurship (CEFE, AMT), and extension services); Cooperatives of Small-Scale Industries (KOPINKRA) in clusters; small-scale industrial estates (LIK), the Foster Father scheme; Small Business Consultancy Clinics (KKB); the Export Support Board of Indonesia (DPE), common service facilities (UPT) in clusters; and an incubator system for promoting the development of new entrepreneurs.

Government departments, specifically the Directorate-General of Small-Scale Industry from the Department of Industry, and the Office for the State Minister for Cooperatives and SMEs have taken the lead in the implementation of the SMEs development programs. These departments, like other departments, have regional offices for the delivery of these various services in their respective regions.

The data from the Integrated Business Survey 2003 from BPS shows that the government played a significant role in supporting the development of SMEs. The survey indicated that, out of a total 481,714 non-farm SMEs receiving government support in 2003, 203,563 firms (or 43% of the total) received support through one or more of the various government programs.

The remainder (52% of the total) received support from NGOs, foreign foundations and a number of large private companies. The distribution by region shows that the majority of those receiving support from the government are located in Java and Bali. However, as a percentage of the total number of SMEs receiving government support in a region, the region of both Barat and Timur scored the highest, while Java and Bali ranked third.

To assess the effectiveness of SMEs assistance programs, SMERU (2004) conducted a field study on 172 respondents in six districts/towns (including Kabupaten Sukabumi, Bantul and Kebumen, and Kota Padang, Surabaya and Makassar) consisting of SMEs in trade, industry, and services. These were informal, non-legal entities whose turnover and number of employees fluctuated, and which operated with only simple technology. Because a large number of assistance programs recorded in the field were capital assistance programs, the impact on respondents was generally economic. The finding shows that a majority of the SMEs did claim that their business had improved because of the assistance programs.

LONG-TERM SMEs GROWTH

The development of SMEs and changes over time in their GDP shares, output composition, market orientation, and location are usually thought to be related to many factors, including the level of economic development and government supports. Given this thought, the questions addressed in this paper are twofold: (1) whether SMEs will die out or grow with the increase in real income per capita, and (2) are government supports important for the development of SMEs?

'Classical' Paradigm

In discussing the role of SMEs and their pattern of development in LDCs, attention usually focuses on seminal articles by Hoselitz (1959), Staley and Morse (1965), and Anderson (1982), among some others. Their works often classified as the 'classical' theories on SMEs' development. Started first by Hoselitz (1959) in his study on industrialization in Germany, which indicates that in the "early" stage of development, the manufacturing sector in the country was predominated by artisans or craftsmen and as the process proceeded many of them grew into larger-sized and more modern establishments of industry; while smaller and traditional units of production die out. Following Hoselitz's work, Parker (1979) and Anderson (1982) had developed general growth phase typologies based on the experience of the

industrialized countries to explain changes in the size structure of industry by region and over time in LDCs. According to this approach, in the course of economic development, the composition of manufacturing activities, if classified according to scale, appears to pass through three phases. In phase one, at the "early" stage of industrial development which may be characteristic of predominantly agrarian economies, household and artisanal activities (MIEs) in manufacturing industry are predominant in terms of their total number of production units and share in total manufacturing employment. This is a stage of industrialization in which a large number of MIEs (mainly in rural areas), coexist with a quite limited number of larger-scale (mainly foreign or state-owned firms located in urban areas or large cities). In this stage, MIEs are predominant in activities such as garment-making, smithy, footwear, handicrafts, masons, industries making simple building materials and various crop-processing industries. They are closely related to agricultural production, as providers of rudimentary inputs to and of processing services for output from agriculture, and of the non-food needs of the rural population.

In phase two, in more developed regions with higher incomes per capita, SMEs emerge and increase at a comparatively rapid rate, and act to displace MIEs in several sub-sectors of manufacturing. There are some factors which might explain the expansion of these industries in this particular stage of development. Steel (1979), for instance, emphasizes the importance of a growing cash market for the expansion of SMEs: Increased urbanization and expanding cash markets give rise to a shift from traditional household activities to complete specialization of the entrepreneur in small scale production and increased use of apprentice and hired labor (p. 9).

In phase three, at the "later" stage of development, large factories (LEs) become predominant, displacing the remaining SMEs in some activities. According to Anderson (1982), this phase is partly a product of phase two, since the recorded growth of output and employment in LEs can be divided into; (a) the growth of once small firms through the size structure, and (b) the expansion of already large domestic and foreign concerns (p. 914). However, the expansion of LEs in this stage may also be caused, to a certain extent, by new large-scale entrants, which is not explicitly taken into account by Anderson.

In this final phase, the use of economies of scale with respect to plant, management, marketing and distribution (depending on types of products and flexibility in production); superior technical and management efficiency; better productive coordination and access to supporting infrastructure services and external finance; and concessionary finance along with investment incentives, tariff structures, and government subsidies are all powerful causes

or incentives for firms to grow larger. In practice it is often found that these factors are more favorable for large or modern industries than for small and traditional ones and so they may explain the eventual better performance of larger enterprises than small ones in advanced stages of industrialization.

Both Hoselitz (1959) and Anderson (1982), among some others in this 'classical' thesis of SMEs development, predict that advantages of SMEs will diminish over time and LEs will eventually predominate. They believe that in the course of economic development, reflected by the increase of per capita real income/gross domestic product (GDP), the 'economic' share of SMEs (i.e. their shares in GDP, employment, sectoral output, and number of enterprises), will decline steadily.

'Modern' Thesis

In the 1980s, a new issue, called **flexible specialization** emerged and many research or seminar papers, articles in journals and books on this issue have been published since then. The born of this new issue was the result of a long debate on how to interpret the new global pattern of production caused by globalization forces and industrial restructuring. These have changed the way in which production and labor are organized. Some authors argued that global production has been undergoing a transformation from Fordist (or mass production) to non-Fordist production.[3] The concept of flexible specialization has been closely associated with Piore and Sabel's (1984) seminal work on the 'second industrial divide' in which they discussed the re-emergence of craft based regions in some countries in West Europe, i.e. Italy, Austria and Germany.[4] Piore and Sabel argued that SMEs located in these regions have become the new dominant form of industrial organization. These industries are characterized as industries with high and multi-skilled workers, 'flexible' machinery which embodies the latest technology and small batch production of a range of specialized products manufactured for the global market.

The main argument of the flexible specialization thesis is that SMEs can grow fast or even faster than LEs with the process of development. In many West countries, including Japan, Sweden and US, SMEs in some subsectors, e.g. electronics and automotive, have been found to be very significant as sources of invention, innovation and efficiency, and these enterprises are also capable to stand the competition with LEs, and even to improve their relative position these days in several instances.

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[3] See for instance, Piore and Sabel (1983, 1984), Harvey (1990) and Scott (1988).
[4] In their interpretation, the first industrial divide occurred during the nineteenth century with the emergence of mass production, and the second industrial divide has occurred in the late twentieth century with the re-emergence of craft industries (Piore and Sabel, 1984).

Many studies support this thesis. Liedholm (2002), for instance, investigated the determinants of survival and growth of SMEs in Africa and Latin America. Location was found to be an important factor: SMEs located in urban and commercial areas are more likely to survive or even to grow than those located in rural areas. Urban and commercial location is also associated with faster income growth. Thus, this study suggests a positive relationship between the increase in income and the growth of SMEs.

Thus, in contrast to the 'classical' paradigm, the flexible specialization literature, which can be classified as the 'modern' paradigm on SMEs development, suggests that as income per capita increases in the course of economic development, the 'economic' share of SMEs would increase; although the assumed positive correlation will vary among countries due to differences in many internal factors, including level and pattern of economic development and basic economic conditions.

'Pro-SMEs Policy' Thesis

The pro-SMEs policy advocates argue that SMEs enhance competition and entrepreneurship and hence they have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. From this perspective, government supports for SMEs will help countries exploit the social benefits from greater competition and entrepreneurship (World Bank 1994, 2002, 2004). This suggests that government development expenditures have positive effects on the growth of SMEs, and the effects are both indirect (i.e. public services and infrastructure) and direct (e.g. government sponsored special credit schemes and training programs for SMEs).

METHODOLOGY

As a means to answer the two questions, this study adopts a simple regression model (Least Squares) by using quarterly data on SMEs from the BPS for the period of 1994–2006. BPS started to publish time series data on SMEs in Indonesia since 1993 covering limited range of aspects, namely number of units, total workers employed and output value. Information on real GDP per capita and government development expenditure was also from BPS.

As explained before, the main aim of this study is to answer two questions, namely whether SMEs would persist in the course of economic development or are mainly a transitional feature of Indonesia's economy,

and are SMEs dependent on government assistance to grow? In this study, economic development is measured by level real income per capita (GDP p.c), government support to SMEs by the ratio of total government development expenditure to GDP (G/GDP), since there are no time series data on total government expenditures in financing SMEs development programs, and the growth of SMEs by the share of SMEs' total value added in GDP (SME-GDP). Thus, in quantitative analysis in this study, GDP p.c. and G/GDP are the two explanatory variables, and SME-GDP is the dependent variable. Control variables to account for other factors known in the literature to affect SME performance such as R&D expenditure as a percentage of total sales, skilled workers employed, etc. are not included in the model since no data are available.

RESULTS AND DISCUSSION

The regression results are presented in Table 10, which may help to answer the two questions. Although, the model encounters an autocorrelation problem, which means that the observation from any one year of the variables included in it is likely to be the result of the value from the previous year, the regression coefficients of the two independent variables are positive and significant. However, G/GDP performs better than that of GDP p.c., since the latter variable has a very small, 1.03E-08, slope (beta) coefficient which may be said to bear no effect on SMEs share in the GDP.

Table 10 Least square regression of SME growth, 1993–2006.

Independent variables	SME-GDP			
Intercept	52.66170	(0.370224)*	(142.2427)**	(0.0000)***
GDP p.c	1.03E-08	(2.23E-09)*	(4.605535)**	(0.000)***
G/GDP	0.027693	(0.008987)*	(3.081543)**	(0.0034)***

Observations	: 52
R-squared	: 0.338348
Durbin-Watson statistic	: 0.241933
F-statistic	: 12.52850

Notes: * = std. error; ** = t-statistic; *** = probability

The results have some important implications for the debate mentioned earlier in this paper. With respect to the survival of SMEs over time, although GDP p.c. bears no effect on SME share in the GDP, the

increase in GDP p.c. overtime does not lead to the decline of SME's output growth. In other words, the regression results do not suggest that SMEs in Indonesia will disappear in the course of economic development as real income per capita increases. At least there are two main reasons for that. First, the majority of SMEs produces a variety of simple and cheap consumption goods, mostly for local markets and consumed by poor or low income households. They survive and grow in competition with LEs and imported goods because they differentiate their products by nature or acquire. With that, they create a niche market for themselves, which are outside the competitive area of similar but more sophisticated items produced with modern machines by LEs. In such circumstances, the SMEs have a better chance to survive and hence to grow. They will probably be out priced in the market if they try to compete with LEs for exactly the same products when the economies of scale prescribe a large scale production and it depends on modern technologies. Moreover, although real income per capita in Indonesia increases annually, the majority of the population in the country still earn low income or poor and near poor, and this means that local demand for SMEs' cheap products are still large.

Second, the growth of SMEs, particularly SEs, in Indonesia is also partly related to the country's labour market condition. Many SE activities are undertaken by low income or poor households, either as a primary or a secondary source of income, as a means for them to survive. In other words, SE activities act as a 'last resort' for the poor. That is why the booming of SEs in Indonesia is often seen not as a sign of entrepreneurship development but merely as a symptom of distress. In some industries such as food and beverages, garments, and handicrafts, SEs are carried out mostly by married women from poor households, with the help of their husbands (if the husbands are unemployed) or without [if their husbands work in other low-paid income activities such as low-paid civil servants, taxi drivers, securities, seasonal construction workers, agricultural laborers] (Tambunan 2007).

Third, it is observed in recent years that the production linkages between SMEs and LEs in terms of subcontracting in Indonesia have become increasingly important because of the trend towards, what Richard (1996) called **diverticalization**. LEs, in order to remain competitive, increasingly focus on core competence and buy in other products and services. So, these SMEs will grow along with the growth of LEs in the course of economic development.

With respect to the important of government supports to SMEs, the result supports the pro-SME policy advocates which have three core arguments (World Bank 1994, 2002, 2004). First, SMEs enhance

competition and entrepreneurship and hence have external benefits on economy-wide efficiency, innovation, and aggregate productivity growth. From this perspective, government development programs specially designed to support SMEs will help the countries exploit the social benefits from greater competition and entrepreneurship. Second, SMEs, at least in many cases, are generally more productive than LEs but financial market and other institutional failures impede SME development. Thus, pending financial and institutional improvements, government financial supports for SMEs can at last boost economic growth and development. Finally, SMEs expansion boosts employment more than LEs growth because SMEs are more labor intensive. From this perspective, supporting SMEs may represent a poverty alleviation tool. In Indonesia, the main motivation behind the SMEs policy is indeed to generate employment and hence to reduce poverty. Many SMEs are able to upgrade their technology and increase their production capacity and hence survive because of government direct assistances especially in capital and training and technical assistances. One most recent and popular government support on SMEs has been the regulation that all supermarkets and hypermarkets should provide spaces for products produced by SMEs.

Of course, this does not say that direct interventions are more important than indirect ones for the growth of SMEs. Even, in many cases public policies or government development expenditures on such as infrastructure yield more results than direct supports for business development, including SMEs. For instant, based on their finding from a wood furniture SME cluster in Jepara (Central Java), Sandee et al. (2002) conclude that SME development programs combined with public interventions are likely to have contributed to the success of this cluster. A comprehensive development package, including technical upgrading through the provision of a common service facility for wood drying; export training, and support for participation in trade fairs; and investment in improvement of the regional infrastructure (container facilities, roads, telephone), helped the cluster to gradually develop export markets. From their cross country study, Acs and Szerb (2007) also argued that public policies focusing on such as increasing human capital, upgrading technology availability, labor market reform and deregulation of financial markets are important to support growth of SMEs. In other words, government direct supports to SMEs according to their actual needs accompanied with appropriate public policies or government expenditures on public facilities and infrastructures will have more positive impact rather than only direct supports on SME development.

CONCLUSION

Before drawing any conclusion, it should be noted that this study has some limitations. The most notable one is the fact that the empirical results were derived from a sample of Indonesian SMEs and hence the concern that the findings might be country-specific. Future studies could use samples of firms from other countries in different patterns or levels of development to test whether these findings can be extended and generalized. In addition, with respect to the link between SMEs growth and income per capita and government supports, it would be ideal to include other factors known in the literature to affect SMEs performance such as R & D expenditure as a percentage of total sales, skilled workers employed, etc., which are not included in the model since no data are available. The picture would also be much better if data on total expenditures of SMEs development programs were used instead. Unfortunately, such data are also not available. For future research, this kind of macro-level research should be supplemented with micro-level studies. For instance, to observe more closely the impact of government support on SMEs growth, a field survey should be conducted on two groups of enterprises in the same sector (and much better if they are in the same location) the ones which received government supports and the other ones which not.

   Regardless of these limitations, this study has made two important contributions to the literatures on SMEs development in LDCs in particular and theories of firm growth in general. First, it supports the 'modern' thesis that SMEs do not disappear in the course of income increases. Instead, they will grow along with LEs. As shown before, SMEs in Indonesia grew annually not only in output (see Figures 1 or 2) but also in number of unit (see Table 1). At least in the Indonesian case, there are three conditions which make SMEs able to stay in business or even to grow. Creating a niche market is the first and most important one. Thus, they do not compete directly with LEs. In other words, differentiated products are their key to survival. The second condition is the fact that SMEs activities are very important source of income for a large portion of the population. This suggests that as long as there is poverty, even though income per capita is high, SMEs will survive. The third one is that since the 1980s the business linkages in various forms including subcontracting between SMEs and LEs have become increasingly important compared with competition.

   A second aspect of this study highlights the importance of government supports on SMEs growth. This does not say, however, that direct interventions (for instance, special designed SMEs credit schemes) are more important than indirect ones (for instance, in terms of development

of infrastructure and creating business friendly environment) for the growth of SMEs. In many cases subsidized credit accompanied by appropriate public policies, which make it easier for SMEs to distribute and market their output and to buy their raw materials, is much more effective than introducing too many special supporting schemes for SME within a distorted market.

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