

## *Executive Summary*

Indonesia is the largest economy of Southeast Asia (the 16th largest worldwide) and has experienced sustained rates of growth over the last ten years. The government of Indonesia recognises SMEs as key drivers of economic growth and social inclusion, and has enshrined SMEs as a policy priority through a national Micro, Small and Medium Enterprise (MSME) Law and a Ministry specifically devoted to SMEs (i.e. the Ministry of Co-operatives and SMEs). SMEs also feature prominently in the main government development strategies, such as the five-year National Medium-Term Development Plan that sets out the development priorities of the executive in office.

### **Key findings**

#### ***SMEs in Indonesia have scaled-up in recent years***

There has been a significant scaling-up process in recent years in which small and medium-sized enterprises have come to account for a larger share of national employment and investment compared with micro-enterprises. Nonetheless, Indonesia's average enterprise size is still small by international standards. Labour productivity gains have also been modest across all enterprise size classes, pointing to the importance of stronger labour productivity growth in the future if Indonesia is to reach higher levels of income. Indonesian data on SMEs are affected by the large domestic informal sector, which is estimated to account for about 70% of national employment and more than 90% of total business enterprises.

#### ***The business environment presents strengths and weaknesses for SME and entrepreneurial development***

Indonesia's business environment offers mixed conditions for SME and entrepreneurial activity. Macroeconomic conditions are generally healthy and include a stable political system, a prudent fiscal policy framework and steady economic growth. Indonesia has also made significant progress in the ease of doing business during the last five years. On the other hand, the national tax base is narrow, which restrains spending on public policies, and employment and education statistics point to skills gaps in the labour market. More business-friendly product and labour market regulations (e.g. on business licenses and permits and regulations on dismissal) hold the potential to foster business formalisation and enterprise productivity growth.

#### ***An SME Strategy would help strengthen the coherence of national SME policies***

Many ministries play an active role in SME policy, which poses a co-ordination challenge to ensure that existing programmes are coherent and complementary and have sufficient scale. The development and implementation by the government of an SME Strategy document that outlines policy objectives, policy targets, detailed policy measures and

government departments responsible for implementation would help improve the overall coherence of SME and entrepreneurship policies by helping reduce overlaps among programmes and fill policy gaps where necessary.

### ***Most programmes for SMEs are aimed at self-employed and micro-enterprises***

Indonesia has a large number of programmes for SMEs and entrepreneurs, although most of them are targeted at necessity-driven entrepreneurship, while relatively few address productivity growth in SMEs. Stronger spending on productivity-enhancing programmes – such as those aimed at the upgrading of workforce and managerial skills and strengthening of innovation in SMEs – are warranted if Indonesia is to improve its productivity performance.

The largest programme for SMEs is Kredit Usaha Rakyat (KUR) (i.e. People’s Business Credit), a government-backed loan guarantee with an interest rate subsidy. Support for innovation in SMEs consists principally of grants and advisory services, whereas common fiscal incentives such as R&D tax credits are underdeveloped. Policies targeting SME internationalisation comprise both traditional measures (e.g. export finance, market and export information, and export training) and innovative approaches (e.g. the use of state-owned enterprises as trading houses for small firms); however more could be done to build stronger linkages between foreign investors and local SMEs, including through targeted tax incentives.

### ***Subnational authorities are well empowered to enable the tailoring of national policies to the local context***

Indonesia exhibits significant diversity in SME and entrepreneurship activity and in the quality of the business environment across its provinces, calling for the tailoring of national policies to the local context. The major devolution process of the early 2000s has provided local authorities with the flexibility needed to adjust national policies to the local context, although there are co-ordination challenges related to the large number of national and local government institutions involved in SME and entrepreneurship policy. Furthermore, a recent law (Law 23/2014) that assigns to each level of government policy responsibility for a respective firm size class is a potential source of complexity for the design and implementation of appropriate SME policies.

### ***Stronger synergies could be established among existing programmes in the field of business development services***

Many ministries operate programmes that provide business development services (BDS) to entrepreneurs and SMEs in Indonesia. The Ministry of Co-operatives and SMEs has recently launched the Integrated Business Services Centres for Co-operatives and SMEs to improve the standardisation and accessibility of BDS nationwide. This is a good initiative which should help reduce the current fragmentation of the BDS offer, especially if further synergies are sought with similar programmes operated by other ministries.

## **Key policy recommendations**

- Improve data collection on SMEs by adopting and using more frequently an employment-based definition to allow better international comparison of the structure and performance of the SME sector between Indonesia and OECD countries.

- Develop and implement an SME Strategy that outlines the main SME policy objectives, targets and support measures and that defines roles and responsibilities of implementing ministries and agencies.
- Explore opportunities for integrating and merging programmes offering similar services with a view to streamlining the national SME policy offer. In the field of business development services, for example, consider merging some of the existing initiatives under the framework of the new Integrated Business Services Centres for Co-operatives and SMEs (PLUT-KUMKM Centres).
- Increase the focus on productivity-enhancing policies for SMEs through targeted measures aimed at strengthening workforce and managerial skills and innovation activity in SMEs and through business-friendly product and labour market reforms.
- Monitor the implementation of SME loan set-asides in commercial banks to ensure that they do not result in an increase of non-performing loans and/or in reduced competition in the banking sector.
- Develop stronger FDI-SME linkages through tax incentives for multinational companies that invest in the upgrading of local suppliers through training, mentoring or staff secondment.
- Consider amending Law 23/2014 regarding the responsibility for the development of specific business size classes by specific levels of government (micro-enterprises to regencies/cities, small enterprises to provinces, and medium-sized enterprises to the national government); this provision is difficult to implement and risks widening the development divide between more and less prosperous regions.





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