

# **THE PRO-POOR PLANNING AND BUDGETING PROJECT**

## **Working Paper No. 1**

### **Poverty Reduction through Developing Micro, Small and Medium Enterprises**

**HICKLING**

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**The complete list of Working Papers produced by the Pro-Poor Planning and Budgeting Project is as follows:**

1. Pengentasan Kemiskinan melalui Pembangunan Usaha Mikro, Kecil dan Menengah (Poverty Reduction through Developing Micro, Small and Medium Enterprises)
2. Towards a National Poverty Reduction Action Plan
3. Review and Evaluation of Pro-Poor Programs in Indonesia – A Summary Overview
4. Improving Local Government Planning for Enhanced Poverty Reduction
5. Program Keluarga Harapan – PKH: Two Case Studies on Implementing the Indonesian Conditional Cash Transfer Program
6. Perencanaan dan Penganggaran yang Berpihak pada Masyarakat Miskin: Studi Kasus dari Tiga Provinsi (Pro-Poor Planning and Budgeting: Case Studies from Three Provinces)
7. Kajian Kesejahteraan Keluarga dan Pemberdayaan Gender di Provinsi Nusa Tenggara Timur, Jawa Tengah dan Sumatera Selatan (Planning and Budgeting for Improved Family Welfare)

**The project also produced the following publications in cooperation with BAPPENAS:**

- Pro-Poor Planning and Budgeting Newsletters (Volumes 1 – 3)
  - Buku Panduan – Perencanaan dan Penganggaran yang Berpihak pada Masyarakat Miskin (Handbook on Pro-Poor Planning and Budgeting) (2008)
  - Kumpulan Bahan Latihan Pemantauan dan Evaluasi Program-Program Pengetasan Kemiskinan (Resource Book of Training Materials for Monitoring and Evaluation of Poverty Reduction Programs) (2008)
  - MDGs Scorecards for District Governments (11 were produced in collaboration with the district governments of Manggarai, Sumba Barat, Sumba Timur and Kupang in East Nusa Tenggara, Semarang, Wonosobo, Banjarnegara, and Purbalingga in Central Java, and Palembang, Ogan Komering Ilir and Ogan Ilir in South Sumatra).
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# Abbreviations and Acronyms

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ADB	Asian Development Bank
ADD	Alokasi Dana Desa [village development grants]
APBD	Anggaran Pendapatan dan Belanja Daerah [district/municipal annual budget]
BAPPEDA	Badan Perencanaan Pembangunan Daerah [district/municipal development planning board]
BAPPENAS	Badan Perencanaan Pembangunan Nasional [national development planning board]
BPS	Badan Pusat Statistik [central bureau of statistics]
DPRD	Dewan Perwakilan Rakyat Daerah [district/municipal legislature]
GDP	Gross Domestic Product
KDP	Kecamatan Development Program (a World Bank funded bottom-up development program and approach); known as PPK in Indonesian
LE	Large Enterprise
LKBB	Lembaga Keuangan Bukan Bank [financial institution that is not a bank]
LPEM	Lembaga Penyelidikan Ekonomi dan Masyarakat [Institute for Economics and Social Research]
MDGs	Millennium Development Goals [Tujuan Pembangunan Milenium]
ME	Medium Enterprise
MFI	Micro Financial Institutions
MSME	Micro, Small and Medium Enterprises [Usaha Mikro, Kecil dan Menengah]
NTT	Nusa Tenggara Timur [East Nusa Tenggara Province]
P3DM	Program Penguatan dan Pengembangan Desa Menuju Desa Mandiri [East Sumba district program for village strengthening and development]
PKK	Pembinaan Kesejahteraan Keluarga [government-sponsored family welfare organization/approach]
PPK	Program Pengembangan Kecamatan [see KDP]
PNPM	Program Nasional Pemberdayaan Masyarakat [national community empowerment program]
RAPBD	Rencana Anggaran Pendapatan dan Belanja Daerah [local government annual budget]
RKPD	Rencana Kerja Pembangunan Daerah [annual district development plan]
RPJMD	Rencana Pembangunan Jangka Menengah Daerah [district/municipal mid-term development plan]
SE	Small Enterprise
SKPD	Satuan Kerja Pemerintah Daerah [local government agency/department]
SME	Small and Medium Enterprises [Usaha Kecil dan Menengah]
SMERU	Jakarta based research institute
SPKD	Strategi Penanggulangan Kemiskinan Daerah [district/municipal poverty alleviation strategy]

# 1. Introduction

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Micro, small and medium enterprises (MSMEs) hold a strategic position in the Indonesian economy. It can even be said that they are the backbone of the economy, constituting 98 percent of all business units in Indonesia. MSMEs have the ability to use production resources efficiently, create job opportunities, and improve income distribution. In 2006 the output of MSMEs reached almost 58% of the total Gross Domestic Product (GDP) and absorbed 82% of the total workforce; more than 73 million people.

Micro and small enterprises have a particularly high level of endurance. This was proven during the Indonesian economic crisis, which struck during the end of 90's, where the majority of businesses suffered serious negative effects; many were closed down or merged with foreign companies. Most of the businesses that did survive were MSMEs, which continued to produce outputs and add more value to the economy. Generally these businesses are semi-formal, labor intensive, and distributed throughout Indonesia—they absorb a high proportion of the work force in many regions. Thus the regions of the country benefit highly from their development. MSMEs are an important part of the supply chain, in which they are providers of goods and services to bigger business groups, and their continuous growth depends on the knowledge and skills of their workers (for example: handicrafts, manufacturing, etc.). With a large portion of MSMEs the economy will have more endurance against external disruptions and have a better chance of growing while developing stronger medium sized enterprises. MSMEs are generally financed with personal savings, thus they are not highly affected by monetary fluctuations.

Micro, small and medium enterprises have several advantages in comparison to larger business units. Among others are: (1) most MSMEs are labor intensive, thus they employ large numbers of low skilled workers; (2) MSMEs supply materials to major companies (Luetkenhorst, 2004); (3) the presence of MSMEs is very important for an agrarian country where the economic structure is transitioning to an industrialized one; (4) MSMEs contribute to development of the economy because they require a relatively lower investment and they are able to start up businesses faster than larger enterprises; and (5) the role of MSMEs becomes very strategic in creating work opportunities to reduce unemployment. In a wider sense these businesses also contribute to reducing poverty. (6) During the economic crisis MSMEs have shown to be more durable than larger businesses. Table 2 shows the growth of business units and employees of MSMEs in the period 1999-2006.

However, micro, small and medium enterprises also include many informal businesses which are unreachable by manpower regulations and formal financing. In addition, MSMEs are also the closest to the poor: many poor people find employment in, or start up micro and small enterprises and the businesses produce outputs which are usually consumed by the poor.

In the Medium Term Development Plan (RPJM) and the Government Work Plan for 2008, the government has set a program for developing MSMEs consisting of five elements: (1) improving the business climate for MSMEs; (2) developing a business support system for MSMEs; (3) empowering micro scale businesses; (4) institutional

strengthening for gender and child mainstreaming; and (5) developing entrepreneurship and SME competitive excellence. In general the program for development of MSMEs is expected to increase productivity, export value, investment in MSMEs and micro business capacity. Furthermore, MSME development is also directed to nurture the entrepreneurial spirit based on science and technology, developing a variety of top MSME products.

With its highly informal character, micro and small enterprises are very closely related to poverty. Such closeness is tied in several ways. First of all, micro and small enterprises are the type of businesses which are very likely to be run by those who are in the category of poor (or the near poor group). Secondly, the outputs produced by the micro and small businesses are most likely to be consumed by the poor. Thirdly, if entrepreneurs in micro and small enterprises hire employees, these workers are most likely from a poorer group. With a lower intensity of interrelation, the above three arguments can also be applied to the medium size enterprises. It is important that decision makers understand the close relationship between MSMEs and the poor. This paper is meant to describe the poverty reduction aspect of MSME development.

This Working Paper is composed of six chapters as follows: Chapter one presents the introduction and Chapter two describes various definitions of MSMEs adopted by different government institutions. Chapter three discusses the condition of MSMEs, including the contribution of MSMEs to the gross domestic product, development of business units, the workforce, and exports. The description is based on statistical data for eight years (1999-2006). Chapter four looks at MSME financing, presenting the financing sources and the development of credit distribution and usage for this group while chapter five discusses the obstacles faced by MSMEs. Since many women are engaged in micro and small enterprises, the role of women in MSMEs will also be discussed in Chapter five. Chapter six will explain the interrelation between the development of MSMEs and poverty reduction.

The paper concludes that MSME development is an important factor in the economy, especially in terms of creating job opportunities, exports, and poverty reduction. It recommends that the Government promote MSME development through creation of a conducive and predictable policy environment, simplified laws and policies, encouraging establishment of best practices among MSMEs, and design of a tailored approach for MSME groups with various sizes and capabilities.

## 2. Definitions of MSMEs

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Small and micro entrepreneurs are an important part of the national economy which needs to be further mentored and developed. Mentoring and development are aimed to make these business units function well in the national economy, growing up to become resilient small entrepreneurs. During the economic crisis period of the end of the 1990s, small, micro and medium entrepreneurs showed their ability to survive under very unstable economic conditions. Even though plenty of mobility occurred in the form of closing down businesses and opening up new activities and businesses, it was nonetheless MSMEs that became the backbone that saved the Indonesian business sector during the crisis. Small and micro enterprises became a preferred category for those who decided to stay in business during such difficult times.

The definition of micro and small enterprise has long been agreed upon. A *micro enterprise* is a productive enterprise owned by a family or an individual of the Indonesian society, with gross revenue of a maximum of Rp 100 million per year. This definition is in line with the Decree of the Minister of Finance No. 40/KMK.06/2003 dated 29 January 2003. A variation of this definition can be found in a study by SMERU Research Institute written in the Field Report on the Existence of Strengthening Micro Enterprises (*Laporan Lapangan Keberadaan Upaya Penguatan Usaha Mikro*) (SMERU, 2003) which defines a micro enterprise as a non agricultural enterprise (including farming and fishing) which employs ten workers at the most, including owners and family members, having a turnover of a maximum of Rp 100 million per year, and assets other than land and buildings of a maximum of Rp 25 million.

*Small enterprises*, according to Law No. 9/1995 on Small Enterprises, are small scale productive enterprises and meet the criteria of a maximum net asset value of Rp 200 million, excluding land and buildings for business, or having a maximum annual turnover of Rp. 1 billion. Small enterprises can receive bank credit at the minimum of Rp 50 million up to Rp 500 million. In reality it is difficult to separate between micro and small enterprises (Sumantri, 2003).

A *medium enterprise*, according to Presidential Instruction No. 10/1999, is a business having a net asset of more than Rp 200 million up to a maximum of Rp 10 billion excluding land and buildings for conducting business. Its business setup can be in the form of an individual enterprise, a business unit with or without legal status. This business unit can receive bank credit from a minimum of Rp 500 million up to Rp 5 billion.

Other than the operational definitions, which vary as presented in Table 1, there are also other definitions that are frequently associated with micro and small enterprises, especially regarding those businesses that are not established as legal entities. According to an Integrated Businesses Survey, all of the businesses without legal status have gross revenues under Rp 1 billion. In 2003, 96.4 percent of non legal entity businesses employed less than 5 workers (micro enterprises), while 3.6 percent of this group employed 5-19 workers (small enterprises).

**Table 1. Summary of Definitions for Micro, Small and Medium Enterprises Based on Various Regulations**

<b>Regulation</b>	<b>Classification</b>	<b>Criteria</b>
Law No. 5/1995 on Small Enterprises	Small Enterprises	Assets <= Rp 200 million excluding land and building Annual gross revenue up to Rp 1 billion Owned by an Indonesian and not related with medium or major companies
Central Bureau of Statistics (BPS)	Micro Enterprises	Less than 5 employees, including family members
	Small Enterprises	Up to 19 employees
	Medium Enterprises	Up to 99 employees
Law No. 10/1999 Bank Indonesia	Medium Enterprises	Assets Rp 200 million – 10 billion
	Micro Enterprises	Micro scale enterprise run by family Local HR and simple technology Easily started up and closed down
	Small Enterprises (UU No.5/1995)	Assets <= Rp 200 million excluding building and land. Gross revenue <= 1 billion
	Medium Enterprises	Assets <= Rp 5 billion for the industry sector
		Assets <= Rp 600 million excluding land and building and not included in the processing industry Gross revenue < Rp 3 billion

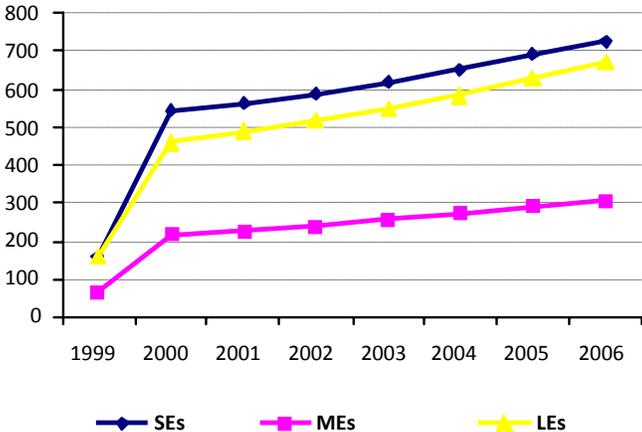
Source: Lembaga Penyelidikan Ekonomi dan Masyarakat (LPEM) (2004)

# 3. SME Profile in Indonesia

The following discusses the development of small enterprises (SE), medium enterprises (ME), and large enterprises (LE) based on the output, business units, and number of employees. Large enterprises are included in this discussion in order to compare them with small and medium enterprises.

In 1999 the share of GDP from non gas and oil by SMEs amounted to Rp 219.75 trillion or as much as 57.92 percent of the total national GDP — from Small and Medium enterprises respectively as much as Rp 156.72 trillion (71.31%) and Rp 63.03 trillion (28.69%). The share of GDP from non gas and oil by large enterprises amounted to Rp 159.59 trillion (42.07% of the total GDP). These data show that SMEs in 1999 had a more significant role in contributing to GDP from non oil and gas than that of the large enterprises.

**Figure 1. Annual GDP Generated by SMEs Not from Gas and Oil 1999-2006 (Trillion Rp)**



Source: Cooperative Statistics (2006)

In the period 1999 to 2006 the amount contributed by SMEs to the GDP from non oil and gas sources grew five-fold, reaching Rp 1,031.10 trillion in 2006. Thus, the share of SMEs increased to 60.54 percent; while the large enterprises’ share decreased to 39.45 percent of the total GDP from non gas and oil. Once again the data shows that SMEs have an important role and create added value in the Indonesian economy.

The large role played by SMEs in the Indonesian economy should also be seen in relation to the number of business units in operation. The increase of added value by this business category is also accompanied by an increased number of business units from year to year. The number of SME units increased from 37.8 million in 1999 to 48.8 million units in 2006; while the number of large enterprise units rose from 1,880 to 7,200 during the same period. For the last one year covered by the statistics (from 2005 to 2006) the number of small enterprises increased by 1.8 million units, while medium and large ones increased 10,800 and 393 units respectively. The unit growth and workforce absorption by SEs, MEs and LEs can be seen in the following table.

SMEs are known to be labor intensive; hence their growth can make an important contribution to creating work opportunities. In general the number of workers employed by SMEs increased in the period from 1999 to 2006. One of the explanations for the increase are the generally improving economic conditions of the post crisis period. In 1999 the number of workers absorbed by small enterprises was 59.93 million and rose in seven years to 80.93 million. In other words, the average annual increase in number of workers absorbed by small enterprises was 2.8 percent during this period. High absorption also occurred in medium and large enterprises. The development in the number of workers in small, medium and large enterprises is shown in Table 2.

**Table 2. Business Units & Worker Absorption by Small, Medium & Large Enterprises**

	Small		Medium		Large	
	Units (million)	Employee (million)	Units (thousand)	Employee (million)	Units (thousand)	Employee (million)
<b>1999</b>	37,8	59,9	52,2	4,5	1,9	3,4
<b>2000</b>	39,7	68,8	78,8	3,9	5,7	2,7
<b>2001</b>	39,9	70,9	80,9	3,8	5,9	2,9
<b>2002</b>	41,8	73,9	85,0	3,9	6,1	3,0
<b>2003</b>	43,4	77,9	87,3	4,0	6,5	3,1
<b>2004</b>	44,7	76,4	93,0	4,0	6,7	3,2
<b>2005</b>	47,0	79,0	95,8	4,2	6,8	3,2
<b>2006</b>	48,8	80,9	106,7	4,5	7,2	3,4

Source: Cooperative Statistics (2006)

Small enterprises make a large contribution to the agricultural, forestry and fishery sectors. The second largest contribution is in the trade sector, hotel and restaurants followed by third largest contribution in processing industry.

Indonesia is heading towards diversifying its exports, since the government has applied a non oil and gas export promotion policy, particularly in manufacturing. Compared to neighboring countries, Indonesia's export diversification has been slow and is still dominated by labor intensive and low technology. This leaves ample scope for Indonesian SMEs to increase their participation in increasing national exports.

However, very few small businesses have been able to penetrate the export market. The table below shows that around 80% of the non oil and gas exports are conducted by large enterprises, around 15% by medium size enterprises and only 5% by small enterprises. The export growth of small businesses is still below that of other sizes of enterprises. In the period from 1999 to 2006, exports by small enterprises increased by an average of 12% per year. Meanwhile, the average annual growth of export value of medium enterprises was around 22%, and of large enterprises around 15%.

The majority of non oil and gas exports came from processing industries. Small business export from non oil and gas processing industry was dominated by the garment industry, excluding shoes. However, since 2000, exports from the garment industry decreased and small business export became dominated by furniture industry, household equipment, and wooden kitchen ware.

**Table 3. Non Oil and Gas Export Development According to Business Size, 1999-2006**

	Amount (Trillion Rp)				Share (%)			
	SEs	MEs	LEs	Total	SEs	MEs	LEs	Total
<b>1999</b>	16,51	36,08	233,65	286,24	5.8	12.6	81.6	100
<b>2000</b>	21,14	54,31	314,51	389,96	5.4	13.9	80.6	100
<b>2001</b>	21,50	59,36	344,27	425,13	5.1	14.0	81.0	100
<b>2002</b>	20,47	66,82	311,92	399,21	5.1	16.7	78.1	100
<b>2003</b>	19,94	57,16	305,44	382,54	5.2	14.9	79.8	100
<b>2004</b>	24,41	71,14	375,24	470,79	5.2	15.1	79.7	100
<b>2005</b>	28,05	82,29	433,86	544,20	5.1	15.1	79.7	100
<b>2006</b>	30,30	91,90	485,20	607,40	5.0	15.1	79.9	100

Source: Cooperatives Statistics (2006)

Rice (2000) stated that there are several things which cause difficulties for SMEs to export its products:

- 1) SMEs generally produce goods that are used domestically; hence SMEs only make indirect export, which is by transacting with foreign tourists.
- 2) Many SMEs produce one type of agricultural commodity, e.g. coffee, rubber, pepper and coconut produce. The level of uniformity of the agricultural produce is usually controlled by nature itself. Agricultural products that are processed by SMEs are differentiated by the method and seeds being used and are not uniform. Whereas international trade is only possible for products that meet certain standards, hence it is more difficult for MSMEs to export.

Due to the above factors, MSMEs generally cooperate with larger companies to sell their products in order to achieve acceptable quality standards.

The presence of larger companies as partners, also known as patrons for small enterprises, provides an important role to strengthen the MSMEs' capacity to export. Indonesia's Ministry of Cooperatives and SMEs defines patrons as: individuals, companies, cooperatives and institutions, both government and private, which assist and/or coach small enterprises in marketing, raw material, training, capital and other services that enable the small enterprises to develop independently.

Not many micro and small enterprises in Indonesia have entered into partnerships; in 2003, only about 6.7 percent of enterprises without legal entity status were in partnerships. Half of the groups taking part in partnerships provide raw material/goods, one third take part in marketing and around one quarter are in the form of cash or capital goods. Very few partnerships provide guidance, training or coaching.

There are various reasons for the very limited extent of partnership development among SMEs. Larger companies are usually not eager to go into partnership with enterprises without legal business status. This is related to the aspect of legal certainty of the cooperation or partnership. Other factors relate to difficulty of controlling the quality of the products.

## 4. Financing SMEs

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Financing SMEs can be seen from several perspectives. In the beginning of this section we will discuss in general the sources of financing for SMEs. Afterwards, a specific analysis will be made on credit for SMEs. Credit distribution and usage for SMEs will be presented.

### 4.1. Sources of Financing

The 2000 statistical data show that 82,960 SMEs get financing from non banking financial institutions, 385,383 SMEs get financing from banks, while other financial sources are used by 661,630 SMEs. Financing from venture capital decreased from 16,002 units to 7,970 SMEs (BPS 2001). It is apparent from the above data that most of the capital for micro enterprises comes from informal financial institutions.

Entrepreneurs from this group find it difficult to connect with banks because they are confronted with administrative procedures and collateral requirements. Difficulty in accessing banks is considered as one of the obstacles for MSMEs to develop their businesses. This condition results in MSMEs being more in favor of using People's Credit Banks (BPR) and other financial institutions, which set higher interest rates than general commercial banks, but with simpler administrative procedures. In order to get MSMEs closer to the general banks, it is necessary to simplify credit application procedures.

Furthermore, assistance for MSMEs, especially those receiving bank loans, needs to be conducted by an independent institution. This is meant to increase the competitiveness of the MSME group and also gain a wider market access. An alternative advocated by Muhammed Yunus, founder of the Grameen Bank, is to develop and widen micro credit.

**Table 4. Number of Businesses without Legal Entity  
According to Source of Main Capital Credit**

	1999	2003
Bank	399.282	399.051
Cooperative	87.627	89.321
LKBB	71.153	81.262
Ventura	8.590	10.373
Individual	770.492	653.292
Family	383.807	324.307
Others	742.556	897.114

Source: Integrated Small Business Survey (BPS)

SMEs use a variety of financing sources. Based on the data of the Integrated Small Business Survey from the Central Buresu of Statistics (BPS) for 1999-2003, the largest financing source for SMEs without legal entity is from family, individuals, etc.; whereas the smallest financing source is venture capital. Financing from banks comprises only 16 percent—but that is still more than that from cooperatives and financial institutions that are not banks (LKBB). This indicates that SMEs are still far from the reach of banks.

This group is still dominated by individual financing sources (individual and family) and others. It is not apparent from the survey data what the source marked “others” covers. It could possibly be informal and traditional financing, such as “loan sharks”.

The reasons that few small enterprises borrow from banks is the lack of collateral and lack of interest on the part of the small enterprises. Not knowing the bank’s procedures, difficult procedures and high interest rates are not the only reasons for small enterprises to not borrow from banks. It has become an important issue for the banking sector to dig further into finding out why the small enterprises lack interest in borrowing from banks.

**Table 5. Reasons for Not Applying for Bank Loans by Businesses without Legal Entity (percentages)**

	1999	2003
Not knowing the procedure	16.4	16.7
Difficult procedure	11.1	10.8
No collateral	27.9	31.1
High interest rate	9.8	8.8
Not interested	34.0	31.5
Proposal rejected	0.6	0.9
Total	100.0	100.0

Source: Integrated Small Business Survey (BPS)

Table 5 shows that the reluctance of businesses without a legal entity status to borrow from banks decreased from 1999 to 2003. There is a decreased proportion stating lack of interest and difficult procedures as reasons for not applying for bank loans. This indicates an increased interest to borrow from banks. The same is indicated by the fact that there is a reduction in the percentage stating that high interest rates keep them from applying. Nevertheless, banking procedures are quite difficult to penetrate by groups intending to borrow. This is indicated by the increased percentage of businesses, whose proposals have been rejected.

## 4.2. Credit for SMEs

One way to promote development of MSMEs is by providing soft capital loans. In relation to credit distribution, the Coordinating Minister for Social Welfare and the Bank of Indonesia apply the following definitions: *Micro Enterprise Credit* is credit given to micro enterprise clients, either directly or indirectly, owned or run by the poor or near poor according to the definition of poverty by the Central Bureau of Statistic (BPS) with a maximum credit ceiling of Rp 50 million. *Small Enterprise Credit* is credit given to small enterprise clients having net assets at a maximum of Rp 200 million other than land and building for operating business or a maximum annual turnover of Rp 1 billion with a maximum credit ceiling of Rp 50 million. *Medium Enterprise Credit* is credit given to entrepreneurs other than micro and small enterprises, for which criteria will be set later, with a credit above Rp 500 million up to Rp 5 billion.

From 2000 to 2004, the proportion of credit distributed by banks to small businesses was relatively small at an average of 18.4% per year; and it appeared to decrease. In comparison, the credit proportion distributed to large businesses averaged 81.6% per year.

In 2005 there was a significant increase in credits for small enterprises, from around 17% in 2004 it rose to 51% in 2005. This increase was due to increased financing by sharia banks, which in most part was for MSMEs. Additionally, the UN General Assembly declared 2005 as the Year for National Micro Credit, which aimed to reduce the number of poor people. At the same time, the Government of Indonesia proclaimed 2005 as Indonesia's Micro Credit Year. This proclamation was also part of the Government of Indonesia's Poverty Reduction Action program. The program's targets, as stated in the MSMEs Empowerment Action 2005-2009, were to: (1) increase the productivity of MSMEs; (2) increase the labor absorption by MSMEs; (3) increase the product competitiveness of MSMEs; and (4) create MSMEs based on science and technology.

**Table 6. The Position of Rupiah Credit and Foreign Currency in Public Banks in 2000-2005 (in Billion Rupiah)**

Year	Total	Large Enterprises		Small Enterprises	
		Nominal	%	Nominal	%
2000	269.000	212.375	78,9	56.625	21
2001	307.594	245.025	79,6	62.569	20,3
2002	365.410	303.145	82,9	62.265	17
2003	437.942	363.974	83,1	73.968	16,8
2004	553.548	459.933	83	93.615	16,9
2005	689.510	335.650	48,6	353.860	51,4

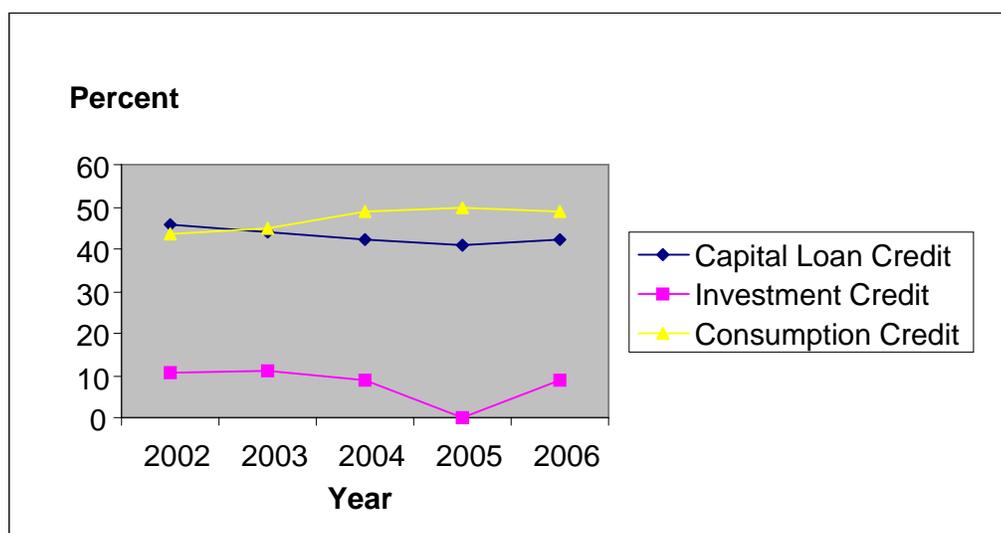
Source: Bank of Indonesia

To promote the distribution of credit to MSMEs, the central bank of Indonesia provides guidance to and cooperates with related agencies in providing technical and financial assistance as well as credit distribution. Indonesia also cooperates with Swisscontact (Swiss Foundation for Technical Cooperation) and IFC (International Finance Corporation) through PENSA (Programme for Eastern Indonesia SME Assistance) and continues to cooperate with PEAC (Promoting Enterprise Access to Credit). Indonesia's cooperation with Swisscontact among others is to facilitate the Kasku program (*Kupon Akses Keuangan* or Financial Access Coupon), where the member's bank can access information about the candidate debtor from potential SMEs via the internet.

In 2006 Bank Indonesia introduced a linkage program award for banks that support credit provision for MSMEs and conducted an exhibition on MSMEs to increase its promotion. Additionally, a regional credit loan scheme was developed to support MSMEs. Other technical assistance is providing information, training and research. Within the same year, Bank Indonesia also signed a Memorandum of Understanding on developing a Bank Partner Financial Consulting Service (*Konsultan Keuangan Mitra Bank - KKMB*) and MSMEs Assistance in the marine and fishery sector.

Micro, small and medium credit is mostly used for consumption and capital. In 2004, credit for consumption exceeded that for capital. The high rate of consumption credit does not have any impact on the development of MSMEs. There is a need for concrete efforts to increase the distribution of investment credit.

**Figure 2. Credit Segment of MSMEs Based on Usage, 2002-2006**



Source: Bank of Indonesia

As mentioned earlier, MSMEs are business groups close to the poor. One way to reduce poverty is by empowering MSMEs. Access to capital is one of the many obstacles faced by MSMEs. Micro Finance Institutions (MFI) are therefore highly needed to overcome these obstacles.

MFI can be categorized into two groups, namely MFI of a nature rather similar to banks such as the People's Credit Bank (BPR) and the Indonesian People's Bank (BRI) Units, and those which are not like banks, such as savings and loans cooperatives and units, private pawnshops, public financial institutions, village credit institutions and State-owned Pawnshops (Perum Pegadaian). Perum Pegadaian provides financial assistance service with a relatively simple and fast process. Statistics show that the public favors borrowing from MFI that are not like banks.

The Indonesian Economic Report for 2006 (Bank Indonesia, 2006) noted that credit distribution to MSMEs cannot be put into the same category as credit distribution to other sectors, since it requires an approach and strategy that is adjusted to the local conditions and customs. MFIs are considered to be capable of adapting to the characteristics of MSMEs that tend to be not bankable by the commercial banking sector. MFIs are able to provide credit service in favorable scales without collateral and strict regulations. Additionally, an MFI often becomes an extension of formal financial institutions to distribute funds to MSMEs (LPEM, 2004).

The Institute for Economics and Social Research (LPEM) (2004) quoted a statement by the Asian Development Bank and the World Bank that the existence of MFIs covers three key elements. *First*, MFIs provide a variety of financial services—it is an element that matches the actual public needs being served. *Second*, MFIs serve low income groups of society (the poor becomes the main beneficiary). *Third*, MFIs use a contextual and flexible procedure and mechanism in order to be more reachable by the poor requiring service. The above three matters appear to match the characteristics of the poor, who tend to have simple patterns, and it also appears that MFIs do not set requirements that are generally “feared” by the poor.

A study by LPEM (2004) concludes that micro finance institutions set loan requirements for their members that are quite simple. MFIs only require an ID card, a signed agreement and collateral. However, the collateral is a requirement, which is often hard to meet and it is therefore not the main requirement for a loan application. MFIs tend to rely on trusting the borrower.

Yet, the existence of MFIs leave several problems because supervision on such institutions have not been clearly regulated (Bank Indonesia, 2006: 259). The study by LPEM (2004) indicates that the main obstacle for the development of non banking MFIs is the limited source of capital. Their main capital source is from the main savings, members' compulsory savings, clients' savings and government assistance fund such as the fuel compensation fund.

To support reduction of poverty, the government, especially the local governments, can cooperate with MFIs in creating a regional information system, which maps the poor into (LPEM, 2004):

1. entrepreneur-poor that are productive;
2. 'chronically-poor'; and
3. 'elderly-poor'.

MFI loans would be effective for the members of society, who are in the first category. To eliminate poverty in the second and third group would require a sustainable government program such as food subsidy and other programs.

Developed countries, such as the U.S. and Japan have special agencies to deal with issues of financing SMEs. In the U.S. there is the Small Business Administration and in Japan the Small and Medium Business Corporation. These agencies receive full support from the government, both politically and financially. Basically, the agencies' functions are to:

1. provide guarantees for the credit or financing given by banks to MSMEs;
2. provide technical assistance in their business field based on needs; and
3. provide credit or direct financing for MSMEs that are not reached by banks.

## 5. Obstacles Faced by MSMEs

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Despite their advantages, MSMEs also face a number of difficulties and many analyses have been made on problems faced by small and micro entrepreneurs. This chapter is not an attempt to dissect or refer to all of the available literature. Rather, it will highlight several dimensions, which need to be taken into account in understanding issues faced by small and micro entrepreneurs. The chapter is divided into two main sections, namely (1) general issues and (2) an analysis on women in micro and small enterprises.

### 5.1. General Obstacles

A National Conference on Small Enterprises held in Cipanas, West Java in August 1997 by the Indonesian Chamber of Commerce (KADIN), the Association of Indonesian Economists (ISEI), and the Asia Foundation identified the following eight main problems faced by national small enterprises (Gopar, 1998):

1. ***Capital.*** Small enterprises face capital problems in the form of high and expensive credit interest rates; limited information on the source and procedure for submitting financing proposals from non banking financial institution; complicated system and long credit procedure (both banking and non banking financial institution); and lack of financial institution's understanding regarding small enterprises in assessing their suitability to obtain financing.
2. ***Marketing.*** Small enterprises have difficulty in marketing their products because (a) their bargaining position is weaker than that of their partners (especially in determining prices and payment procedures); (b) entrepreneurs' associations are not involved in coordinating product marketing, and (c) they lack market information.
3. ***Raw Materials.*** There are difficulties in obtaining raw materials, which tend to be inadequate and fluctuating in supply, expensive and with unstable prices, low quality of materials due to non existent standardization, and the requirement to pay materials in cash.
4. ***Technology.*** Small enterprises face lack of and difficulty in maintaining skilled laborers, lack of access to and information about sources of technology (especially technology meeting the needs of micro and small enterprises).
5. ***Management.*** Management problems relate to internal problems of small entrepreneurs, i.e. low managerial skills, tendency to mingle business financial management with household and family finances as well as difficulty in organizing similar entrepreneurs for synergizing.
6. ***Bureaucracy.*** Small entrepreneurs also face problems with bureaucracy in the processing of permits and licenses, which is not transparent, expensive and complicated, as well as other types of levies that are not accompanied with sufficient service.
7. ***Infrastructure.*** Infrastructural issues are rates for electricity, water and telephone, which are relatively expensive, and bonded zone that is not entirely equipped with adequate facilities.
8. ***Partnership.*** Partnership issues, which are faced in terms of cooperation between small and medium or large enterprises, concern marketing, payment system (both product and raw material), and lack of technology transfer.

Another matter, which can be considered as an obstacle especially by micro and small entrepreneurs is **access to capital**. Due to its characteristics, this business group does not have access to formal financial institutions. They cannot borrow from banks. This low access is triggered by two things. *First*, is the informal nature of micro and small enterprises. This group does not have the full administrative ability to meet the loan requirements of formal financial institutions. The *second* issue is that micro and small entrepreneurs do not have adequate assets to be used as loan collateral. The most common solution is to borrow from non formal financial institutions, which could provide capital without collateral requirements. However, by using non formal financial institutions, the micro and small entrepreneurs become vulnerable to exploitation. An alternative model, which could be developed to bridge the access to capital is the social collateral such as the Grameen Bank or “*banking on the poor*” (Ferranti and Ody, 2007).

Another obstacle for MSMEs is **institutional**. The term institutional in this context has a broad meaning. Many entrepreneurs, especially micro, are not registered as legal entities. This becomes one of the factors inhibiting their access to formal financial institutions. Another result of the absence of institutional support is the human resources lacking basic skills, motivation and adequate work ethics.

In the analyses reviewed, the obstacles faced by MSMEs are identified by using questions usually given in a closed structure and with a set selection of answers regarding obstacles and issues faced by small and micro entrepreneurs. For example, in a research by the Central Bureau of Statistics (BPS) (1994) a percentage distribution of types of main obstacles are presented, which were faced by traders without legal business status in 1992 in Central Java. The results were gathered from an analysis based on a Household Business Survey (*Survei Usaha Rumah Tangga*) in 1992 in Central Java. The following table presents the distribution of main obstacles faced by these entrepreneurs.

**Table 7. Main Obstacles Faced by Traders without Legal Entity in Central Java, 1992 (percent)**

Main Obstacles	Total
None	37,79
Lack of capital	26,33
Marketing difficulties	15,31
Difficulty in procuring materials	2,56
Lack of expertise	0,40
Others	4,90
More than one obstacle	12,71
Total	100,00

Source: Central Bureau of Statistics (BPS) (1994)

There are three interesting observations from the above table. *First*, around 38% of all respondents state that they do not face obstacles in their businesses. This percentage is rather high considering the general perception that small and micro enterprises are relatively burdened with problems. *Secondly*, we can see that the two main problems faced by small and micro entrepreneurs are lack of capital and marketing difficulties. *Thirdly*, only about 13% of the respondents state that they have more than one obstacle (of the total options given).

Another study that especially looked into the informal and traditional business sector (*usaha sektor informal dan tradisional*) (Mangkuprawira, 2002) stated that this sector reflects the economic sustainability and society's self employment in the national economy. The issues faced can be differentiated into micro and macro ones. *Micro issues* cover the quantity, quality and type of products, business model, level of technology (simple technology), low quality of human resources, financial access, marketing, and limited information. *Macro issues* include business climate, mentorship and development, financing and guarantee, and business permit.

Another way of viewing the issues faced by small businesses is to differentiate them into internal and external ones (Rice and Ganiarto 1990). *Internal issues* are more or less identical to the micro issues presented by Mangkuprawira (2002) above. Meanwhile, *external issues* brought up by Rice and Ganiarto (1990) covers the same macro issues as mentioned above and then adds infrastructure to the list. Rice and Ganiarto (1990) also argue that most of the external factors hindering small and medium businesses come from the government.

The findings presented above are only a few among many others. The sequence of issues presented by each study on small and micro entrepreneurs are considered to be consistent with one another in as much that those types of issues have been used many times as background material in the policy making process. In a critical study, the Asian Development Bank (ADB, 2001) tried to review the said issues. Specifically, the study looked at the conformity between common assumptions in the policy making process and confronted them with the actual reality. The study was conducted using a method of in-depth interview series and group discussions. It is important to remember that the research was carried out within the scope of small and medium entrepreneurs. The major findings are presented in Table 8.

**Table 8. Some Assumptions and Facts about SMEs**

No.	Assumptions	Facts
1	The main problem of SMEs is access to financing, since SMEs do not have collateral and the bank credit procedure is too complicated	<ol style="list-style-type: none"> <li>1. SMEs have access to financing, either for investment or work capital, by cooperation or from a third party</li> <li>2. SME groups claiming that they require 30 percent additional working capital say that they have never applied for credit to a bank</li> <li>3. Credit issues vary among economic sectors</li> <li>4. SMEs want a simple credit application procedure</li> </ol>
2	Business development service is very important for SMEs and should be freely provided by the government, since SMEs cannot afford it	<ol style="list-style-type: none"> <li>1. Majority of SMEs seek their own solutions for their problems</li> <li>2. SMEs are starting to use business development services outside their companies</li> <li>3. Education/quality of human resources is a key to development</li> <li>4. SMEs are willing to pay for this service, however they do not have adequate information on the availability and benefit of the business development service</li> </ol>

Source: Asian Development Bank (2001)

As shown in Table 8, there are several assumptions that are quite similar to the findings of interviews and group discussions, but there are also several matters that do not match. The facts gathered from the series of interviews and group discussions have put the issues in a better context, for example the need for special treatment by the government. This business group wants the government to not make permits, licenses and others difficult. Basically, the business group requires good governance to stimulate legal certainties in doing business.

It should be noted that this Asian Development Bank study (2001) also includes medium size businesses. This of course affects the results. For example, this would affect the findings on the group managers who, in the case of medium size businesses, are more educated with a higher level of business formality and business development service. Indeed, there are several studies starting to indicate critical reviews on the facilities and assistance directed toward small and medium enterprises (see among others studies by Hermanto (2002) and Triaswati (2002)).

## 5.2. Women in Micro and Small Enterprises

The discussions and analyses mentioned above cover the totality of small and micro entrepreneurs. In this part, we will specifically analyze the obstacle faced by small and micro women entrepreneurs. Why do we need to analyze small and micro women entrepreneurs? Women entrepreneurs are not a new concept in the Indonesian economy. They have been present even before the colonial times. For example, in many cases batik craftswomen are entrepreneurs. She is simultaneously a worker, seller and manager of all her business activities. However, the more formal the enterprise becomes, the less do these women appear as the entrepreneurs.

One of the important roles held by women entrepreneurs, is in the small and micro enterprises. This enterprise group is more favorable to women since it supports the family, enhances their self realization and opens the opportunity to increase the level of family welfare [<http://www.indagkop.com>]. In other words, small and micro enterprises become a vehicle for women entrepreneurs to help them alleviate economic difficulties in their households. Nonetheless, these small and micro women entrepreneurs are not free from obstacles, e.g. women's access to information on capital, technology, raw materials, markets for product distribution and little knowledge on business management. Most of the micro and small businesses pioneered by women do not have a legal status; hence they face difficulties in further developing the businesses.

An analysis of women's issues in small and micro enterprises must be understood in two dimensions (Dewayanti, 2003:119). *First*, specific issues faced by women in relation with their position as women. The scope of this issue is connected to the concept of discrimination and subordination of women in the business system, the community and in the traditions and culture of the country. *Secondly*, issues faced by women as small entrepreneurs in relation with meeting family financial needs. It could be that this issue is not only faced by women, but also by men involved in the same type of business. Dewayanti (2003) specifically formulate two main scopes of issues in analyzing small and micro enterprises run by women:

1. *Definition of small female entrepreneurs.* Several definitions can be applied if we are talking about small and micro female entrepreneurs. It could, for example, mean women having their own business units, separate from their husband's or

other family members' businesses. An alternative would be a woman involved in a family business. The analysis of issues faced by both groups of women could be different.

2. *Balance of information about women and men.* Problems faced by small entrepreneurs who are women cannot simply be assumed to be consequences of discrimination against women. It could be that men face the same problems, and assuming that it is a matter of discrimination would then be incorrect.

In a research by the Central Bureau of Statistics (BPS) (1994), obstacles encountered by male and female traders without legal business status were specified by sex - the findings are shown in Table 9.

**Table 9. Main Obstacles Faced by Male and Female Traders without Legal Entity in Central Java, 1992 (in percent)**

<b>Main Obstacle</b>	<b>Men</b>	<b>Women</b>	<b>All</b>
Not available	36,65	38,80	37,79
Lack of capital	23,20	29,11	26,33
Marketing difficulties	16,32	14,40	15,31
Goods procurement difficulties	3,63	1,61	2,56
Lack of Expertise	0,46	0,34	0,40
Others	6,07	3,88	4,90
More than one obstacle	13,67	11,86	12,71

Source: Central Bureau of Statistics (BPS) (1994)

There are several important observations to be noted from the BPS survey. *First*, the percentage of both groups that state there are no obstacles is quite high considering that a closed selection system was used. Almost 40 percent of the respondents claimed that s/he does not have business obstacles. *Secondly*, there is no significant difference in the proportion of men and women who do not face obstacles. This underlines the analysis made by Dewayanti (2003) regarding the interpretation of small women entrepreneurs as facing discrimination. In fact, the male group faces more or less the same obstacles as women. However, the validity of this conclusion should be supported statistically at least by showing whether there are proportional differences among the two groups. *Third*, there are two types of main issues faced by enterprises without legal status, namely (a) lack of capital; and (b) marketing difficulties. In terms of the quality aspect, it is consistent with prior research results, which do not specifically look into women's issues.

Case studies also show that there are certain patterns for work distribution between men and women, especially if the business is owned and run jointly. A study conducted by Hariyono and Ningsih (1997) presented the structure of work distribution between men and women at a duck farm in Mojokerto Regency, East Java. The study showed that certain types of work, e.g. selling eggs at the market are fully handled by women. On the other hand, the role of women in this type of family business also evolved over time. Aryanti and Ernandayati (2003) also noted the role shift of female traders at the Ciwalengke Market in Majalaya, West Java. Once these female traders tended to assist their husbands in trading, but in time most of them held the main role in the market. Such dynamics need to be noted in the effort to advocate for women: it should not only be concentrated on small scale female entrepreneurs operating their own businesses; it should also focus on female workers running businesses with other people, such as

family businesses.

In a study based on in depth interviews and group discussions, the Asian Development Bank (2001) confronted several common assumptions regarding small (and medium) enterprises against the facts in the field. Several things that have become general beliefs are not entirely true. For example, the role of women is commonly assumed as marginal in small and medium enterprises. In fact, findings from interviews and discussions are that women have a significant role in business activities. The Asian Development Bank report also presented how women are successful entrepreneurs due to their meticulous and careful habits. The issue here was how women could become entrepreneurs, and not how to work after the businesses were established. Another finding of the research was that women face difficulties in getting loans, even though there was no discrimination in the procedure for applying for financial credit.

One way to propel the development of MSMEs managed by entrepreneurs who are women is to develop a business partnership model. This partnership model is expected to create a conducive business climate in the areas of product quality, promotion, marketing, assistance, mentoring and empowerment according to the programs designed by the Government. Especially for micro enterprises, the government needs to conduct institutional mentoring.

## 6. MSME and Poverty Reduction

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MSME can have a significant role in the efforts to alleviate poverty. This part of the Working Paper will describe this role.

MSMEs are distributed throughout Indonesia and exist in all sectors of the economy; from agriculture to service. This can significantly benefit the regions because most of the SMEs are micro enterprises in the informal sector. Therefore, MSME can indirectly play a role in increasing income and reducing poverty.

Poverty alleviation in Indonesia has not yet resulted in the expected progress. The number of Indonesians living under the poverty line in 2007 was 37 million people (16.5% of the population). This total had declined from 39 million (17.7% of the population) in the previous year. The MDG target to reduce the number of poor to 7.5% of the population in 2015 can probably not be achieved if the poverty alleviation acceleration follows the trend of the last decade. A more solid strategy is required to reduce the poverty.

A sustainable poverty alleviation program conceptually should be carried out in two main courses. The first course is from the employment side, to increase incomes of the poor. With employment, the poor can generate income and can be expected to escape poverty. The second is to support efforts of the poor in opening businesses. In both courses, the business form with the most potential for the poor is the micro and small enterprise.

Increasing incomes of the poor takes time. During the time until the poor groups can increase their income, a revenue transfer policy that functions as an income supplement is necessary for some groups of the poor. Without this kind of transfer policy, poor groups will suffer due to lack of livelihood resources. Direct (unconditional) cash transfers (BLT) or conditional cash transfers (Family of Hope Program / PKH) are examples of this kind of livelihood aid. Conditional cash transfers link direct aid to the poor with conditions to be met in order to receive the aid — for example school age children (7-15 years) must attend school with a minimum of 85% attendance, infants (0-5 years) must routinely be examined at Community Health Posts (Posyandu), and pregnant mothers routinely have health check ups. In the short term, the poor can use the aid to increase their consumption. In a longer term perspective, the next generation of poor families is expected to possess better human resource qualities, thus eventually they can break the chain of poverty.

Micro and small enterprises have a significant role in the first course above. A micro enterprise (with maximum labor of five workers) is the most probable type of enterprise for poor families to establish. The informal business type, in urban or rural areas, are usually individual or family businesses. On the other hand, the type of business possibly accessed by poor groups are micro or small enterprises. There is very limited possibility for labor from poor families to work in a medium or large enterprise that requires higher quality of human capital.

Therefore, a set of efforts to nurture micro enterprises are required. As described previously, the main problem encountered by micro and small enterprises is capital. The government should provide support to the poor to open businesses. The business

assistance through banking will be hindered by bank prudence principles, where banks must follow certain requirements in order to grant initial capital loans. Direct capital aid (revenue transfer) disbursed to the community is an alternative. Unfortunately, experience shows that direct assistance in the form of revolving capital is generally not effective. This must be realized early on so that negative impacts can be minimized. Nevertheless, capital aid distributed to poor communities can be linked to the conditional cash transfers program that the government started to implement in 2007.

Capital aid for poor communities will be more effective if distributed to those who already have a micro or small enterprise. This type of capital aid is not used to start a business, but more for business expansion. The capital aid for micro and small enterprises also usually is restricted by banking regulations. Therefore, other efforts are necessary. One option is non-banking financing assistance managed directly by the government. Another option is cooperation with the banking sector to assist small and micro enterprises that wish to request a loan from the bank. Assistance will mainly be in the form of cash management and book keeping. Thus, at a certain point, after the micro and small enterprises have improved their administration, they can meet the standards set by the banking sector. This assistance can be disbursed through government banks as well.

An important dimension is the collateral - one of the obstacles encountered by small and micro enterprises in requesting a bank loan. This is due to the fact that usually the small and micro enterprises do not possess any assets formally acknowledged. If they do possess assets, these do usually not come with legal documents that makes the asset eligible as collateral. In this context, a comprehensive land certification program, especially in rural areas, will be the first step in creating collateral for the poor.

In the long term, micro and small enterprises can hopefully be 'upgraded' into larger enterprise groups. Micro enterprises are expected to upgrade into small enterprises, small enterprises into medium enterprises, and so forth. This upgrading must also be based on increased productivity, and not merely based on subsidies. The government should provide special incentives to informal businesses to encourage them to change into formal ones. This incentive can be in the form of simpler licensing and the possible wider access to the banking sector. On the other hand, the advantages of a formal business form are better labor protection and eventually higher state revenue.

Another policy that supports MSME development, especially the medium enterprise group, is promotion of entrepreneurship oriented to technology and exports; strengthening of the MSME role as goods and service supplier to the domestic market, especially to fulfill public demand. One method is to provide business opportunities for MSMEs in allocating space for MSMEs promotion, e.g. in public places with many visitors, such as in malls and shopping centers. Providing free or inexpensive space can greatly assist the MSME in promoting their products and services.

Micro and small enterprises are significant for poor communities because this type of business has the potential to provide jobs. These enterprises also produce outputs that the poor consume. Therefore micro and small enterprises must be efficient in order to produce inexpensive goods and services for consumption of the poor. Currently, the poor have been greatly impacted by the expensive price of soy, which is a basic ingredient for various foods. This issue has constrained the micro and small enterprise production in

regions that process *tempe* (fermented soy bean cake) and tofu, and eventually impacts poor community group consumption patterns.

## 7. Closing

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This paper has presented the profile of Indonesian MSMEs. The close link between MSMEs and the poor community makes this enterprise group, especially the micro and small enterprises, central in poverty alleviation efforts. MSME is the group that is most intimate with the poor.

MSME development is an important factor in the economy, especially in terms of creating job opportunities, exports, and poverty reduction. Therefore the Government should promote the development of MSMEs by creating more conducive and predictable policy environment, simplifying laws and regulations, encouraging establishment of best practices among MSMEs, and designing a tailored assistance program for MSME groups with various sizes and capabilities.

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