Entrepreneurship and SMEs in Southeast Asia

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Entrepreneurship and SMEs in Southeast Asia's Economic Development

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First published in Singapore in 2004 by
Institute of Southeast Asian Studies
30 Heng Mui Keng Terrace
Pasir Panjang
Singapore 119614

E-mail: publish@iseas.edu.sg
World Wide Web: http://bookshop.iseas.edu.sg

ISEAS Library Cataloguing-in-Publication Data

Entrepreneurship and SMEs in Southeast Asia / edited by Denis Hew and Loi Wee Nee.
Papers presented at the ASEAN Roundtable 2002, Singapore, 7–8 November 2002, organized by the Institute of Southeast Asian Studies, Singapore and supported by Konrad Adenauer Stiftung.

1. Small business—Asia, Southeastern—Congresses.
2. Business enterprises—Asia, Southeastern—Congresses.
3. Entrepreneurship—Asia, Southeastern—Congresses.

I. Hew, Denis.
II. Loi, Wee Nee.
III. ASEAN Roundtable (2002 : Singapore)
IV. Institute of Southeast Asian Studies.
V. Konrad Adenauer Stiftung.
VI. Title: Entrepreneurship and small-medium enterprises in Southeast Asia

HC441 A843 2002 2004

ISBN 981-230-251-4

Typeset by Superskill Graphics Pte. Ltd.
Printed in Singapore by Seng Lee Press Pte Ltd

Credit: The photo on the cover is by Sinartus Sosrodjojo/JiwaFoto. The Sosro factory in Slawi, Java, is a 100% Indonesian business which started small a few decades ago and has grown since. The company uses locally grown tea-leaves to produce varieties of bottled tea and tea-related beverages for sale all over Indonesia.

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Acknowledgements

The editors would like to thank all the individuals who contributed to the realization of this volume. Our thanks to the paper-writers for their valuable contributions. Their papers were first presented at the ASEAN Roundtable 2002 on 7–8 November 2002, held at the Institute of Southeast Asian Studies (ISEAS) in Singapore.

To Professor Chia Siow Yue, former Director of ISEAS, for her guidance in conceptualizing this project, our sincere thanks. We are grateful to the administrative staff of ISEAS, especially Karthi Nair, who worked tirelessly to ensure that the Roundtable ran smoothly. Our thanks also to Chen Yen Yu for her editorial assistance and to the ISEAS Publications Unit for their valuable input in getting this volume published.

Finally, this project would not have been possible without the generous contribution of the Konrad Adenauer Stiftung. We would like to express our appreciation for their continued support in the many ASEAN Roundtables that ISEAS has organized over the years.

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Foreword

SMEs: A New Role in Economic Growth Strategies

Tharman Shanmugaratnam
Senior Minister of State for Trade & Industry and Education, Singapore

It gives me great pleasure to be here this morning at the ISEAS' ASEAN Roundtable 2002. The topic of this year's Roundtable, Entrepreneurship and SMEs in Southeast Asia's Economic Development, is timely.

Across the region, countries are looking afresh at their economic strategies, to achieve more resilient growth in a less certain environment. There is a fresh focus on the role of SMEs in this regard. Having been generally neglected in past growth strategies, SMEs and entrepreneurship are now viewed as integral to future growth.

Past Growth Strategies — Fostering Large Players

There are a number of reasons for the predominant role of large firms in economic growth strategies in Southeast Asia, and indeed much of East Asia, in the last forty years. First, economic development in the region has centred on export-oriented growth, encouraging firms to look outward and compete with global players. Second, the initial base of entrepreneurship in most countries in the region was not wide. There was especially a shortage of industrial expertise. The region had no more than a rudimentary industrial economy until the 1960s and early 1970s. Countries had to quickly attract or nurture firms capable of competing in world markets and generating jobs. This was quite in contrast to the natural evolution of industrial capabilities in most of the advanced economies, which had taken many decades and in less competitive global markets. Jumpstarting the industrial economy in the region inevitably meant a dose of dirigiste policies, which focused incentives, funding or other resources on the most capable players.

The Southeast Asian economies relied heavily on attracting multinational corporations (MNCs) to build up an export manufacturing capability. The MNCs, first American and European and later Japanese, brought with them capital, technology, know-how in factory and supply chain management, and markets. They allowed new Southeast Asian manufacturing centres to leapfrog established producers, and accelerated the move up the ladder of skills, productivity and wages.

Quite apart from expertise, economies of scale and long gestation periods were initially an important deterrent to entry of new entrepreneurs in some industries — especially in capital-intensive industries like steel, shipbuilding or petroleum. In several countries, governments have sought to develop such industries for strategic reasons, either by giving preferential treatment to large local players or setting up state-owned enterprises. But these experiments have met with varying degrees of success. In general, success has been limited in cases where enterprises have been shielded for some time from foreign competition.

There is no doubt a sense in which political economy has also played a role in the favouring of selected entrepreneurs, in a number of countries. This is particularly evident where firms have been protected from competition, or given preferential regulatory treatment, in domestic markets where there is no lack of potential new entrants. This has not been an unmitigated disaster, in economic terms. Large companies led by capable entrepreneurs have in many instances contributed to the development of industrial prowess. However, the granting of domestic subsidies, preferential tariffs or monopoly privileges to selected players has led to an increasingly inefficient allocation of resources over time, and a self-reinforcing pattern of corruption that has had a progressively corrosive effect on both economy and society.

The Asian financial crisis revealed many of these weaknesses. Relationship-based capitalism, as scholars politely describe it, has outlived its usefulness. It has to give way to market-oriented economic policies which aim at providing a level playing field for enterprises, and at allowing resources to be allocated to the most competitive players.

The focus on large enterprises has not been unique to Southeast Asia. In Japan and Korea, which relied much less on foreign MNCs, local conglomerates — the *keiretsu* which followed on the pre-war *zaibatsu* in Japan, and the *chaebols* in Korea — played a decisive role in their industrialization, typically in markets protected for some period from imports. Taiwan and Hong Kong have been the main exceptions, largely on account of the broader base of entrepreneurs they inherited. SMEs were the driving force behind Hong Kong's exports in the years when it had a manufacturing economy. In the case of Taiwan, a vibrant entrepreneurial culture has also allowed the SME sector to successfully compete with large enterprises despite government industrial policies that often favoured larger players.

With the exception of Hong Kong and Taiwan, SMEs have been incidental in the growth of the East Asian economies. Even where they account for a sizeable share of output and employment, they have been mostly in the domestic and informal sectors, and caught in a low-cost, low-productivity activities. The gap in efficiency between SMEs and non-SMEs in the region tends to be wider than in countries like the U.S., Taiwan, Germany and several of the smaller northern European economies, where SMEs are often internationally competitive and the most dynamic sources of growth. For example, small enterprises in the U.S. account for more than half the innovations, and approximately three-quarters of fresh job creation.

Future Growth Strategies: Fostering the Development of SMEs

We have entered a new and more challenging economic environment. It is vastly more competitive than in the last few decades — witness just China — more globalized, and more fast changing. It is also seeing the rapid emergence of the knowledge-based economy. East Asian countries are rethinking their economic strategies, to stay relevant and sustain growth and higher living standards in this new environment.

Foreign MNCs should remain an important source of investments, technology and jobs for Southeast Asia. It is far too early to write-off the role of MNC-centred, export-oriented manufacturing. Similarly, many large local companies, operating without the shelter of monopoly privileges, will continue to play a key role in spearheading exports and economic growth. But increasingly, countries in Southeast Asia need to pay greater attention to the development of SMEs.

First, a strong SME sector will help cluster strategies to work. MNCs are increasingly focusing on their core competencies, and outsourcing non-core work to other companies. An important consideration in their investment decisions is thus the availability of competent and high quality suppliers of components and other supporting parts and services, who are able to adapt quickly to new demands. A nimble base of local SMEs adds strength to such clusters. They can help to anchor MNCs in the region, and improve national competitiveness.

Second, in a rapidly changing economic environment, it will be much more difficult to spot winners and pick potential champions. There is also greater churn, and shorter company life spans, in the knowledge-based economy. While Southeast Asian economies will continue to specialize in sectors in which they have competitive advantage, it will not be possible to bet on which companies will succeed. The markets will produce the winners, oftentimes surprising winners. Having a broad and diverse pool of companies, will improve the chances of economic success, and provide greater resilience to national economies.

A third reason for promoting SMEs has to do with the importance of domestic enterprise in general, in capturing value in the knowledge based economy. Many of you would be familiar with the “smile curve”, which illustrates that most value accrues to upstream activities like R&D or product development, and downstream activities like branding and marketing. Production, in the centre of the curve, is increasingly characterized by narrow margins. This is exacerbated in industries where there is an overcrowding of players in the production segment, as improvements in production machinery and processes have lowered entry barriers. On the other hand, ideas and intellectual property are commanding higher rents and a growing portion of the value pie.

While MNCs play a critical part in moving economies up the value creation curve, we need a complementary strategy of growing domestic enterprises that can capture more of the value, by developing their own products and owning the associated intellectual property.

Countries in Southeast Asia are recognizing the importance of developing the SME sector and putting more effort into it. For example, Thailand has embarked on a range of schemes to help small businesses and widen its base of entrepreneurs. Malaysia has in its recent Budget reaffirmed its focus on the development of SMEs, and has lowered the effective corporate tax rate for SMEs. In Singapore, across the board corporate tax cuts and the partial exemption from tax of the first $100,000 of a company’s income, will mean an effective tax rate for SMEs of 5.5 per cent to 10.5 per cent from Year of Assessment 2003. SMEs will benefit from the planned further cuts in corporate taxes (to 20 per cent within three years).

A Case for Government Intervention

Let me next address the question of why governments have to play an active role in SME development, or why this cannot be left to market forces.

One reason for government intervention is that markets do not always provide a level playing field for small companies. Even companies with good business ideas and strong growth potential often face impediments at the growth stage, especially in obtaining financing. This is partly due to the intrinsically higher risks of funding new businesses, but may also reflect incomplete markets. Traditional financial intermediaries are often reluctant to engage in the higher costs of obtaining and assessing information on SMEs, and of monitoring their risks. In addition, early stage financing through private equity markets is at a nascent stage of development in Asia. Indeed, the private equity markets are a relatively recent phenomenon anywhere outside of the U.S.

Without a well functioning capital market for small enterprises, there is a need for governments to catalyse market funding of SMEs, and to even share some of the risks.

There are also important economic externalities in promoting entrepreneurship and facilitating the start-up and growth of small companies. A vibrant landscape of start-ups and up-starts produces an environment of constant experimentation and innovation. Government support for SMEs can thus lead to greater economic dynamism all around.

Finally, governments need to ensure that incumbents do not abuse the power of incumbency, to stifle new entrants and potential challengers. Regulations aimed at ensuring a level playing field are essential to a healthy market economy.

There are therefore good reasons for government assistance programmes to develop SMEs. Even the U.S., well known for its free markets, has a long history of government help for its SMEs. The Small Business Administration (SBA), established in 1953 to champion small businesses, provides them with financial, technical and management assistance. Last year alone, the SBA backed more than US$12.3 billion in loans to small businesses.[1] In addition, Small Business Investment Companies (SBICs) licensed by the SBA also provide equity capital, long-term loans, debt-equity investments and management assistance to small businesses. Many big businesses which are now household names, such as FedEx, Intel, Nike, Apple, Ben & Jerry and AOL, just to name a few, received help from SBA as they grew.

SINGAPORE'S STRATEGY FOR GROWING SMEs

Let me share with you the Singapore Government's approach and basic strategy for developing local SMEs.

Providing a Pro-Business Environment

There are two broad prongs to our strategy to help grow SMEs. The first, and more important, prong is to provide an overall business environment conducive to the growth of enterprise, big or small.

When some of our trade officials visited Sweden about two years ago to learn from their experience in enterprise development, the Swedish Trade Council (STC) pointed out that a business environment that is good for big companies may not necessarily be favourable for small companies. However, the converse is always true, that is, a business environment that is conducive for small businesses will also be good for large companies. This comment held much relevance for Singapore.

In our first few decades of development, the emphasis of economic policy was on providing incentives aimed at attracting and encouraging the growth of large, established players. Some incentivization of new activities remains important even as we go forward. But we are seeking to regear our policies, focusing on improving the business environment for small and large companies alike by cutting red tape, reducing income taxes, encouraging risk taking and fostering competition.

We are seeking to remove regulatory impediments that stifle businesses, acting on feedback from the public. We are systematically reviewing and streamlining the number of licences and licensing requirements for setting up businesses. To encourage enterprise, we have lowered corporate and top-tier personal income tax rates to 22 per cent, with plans to further reduce them to 20 per cent within three years.

We have also revised our bankruptcy laws as part of an effort to foster a culture more tolerant to risk-taking and failure.[2] In addition, to safeguard competition and help forestall any abuse of dominance, we plan to enact a competition law within two to three years.

Strengthening the Competitiveness of SMEs

Besides working on a pro-business environment across the board, the government also seeks to boost the growth of the SME sector by helping SMEs themselves to build capabilities, so they can better compete. There are three guiding principles underlying government's help to SMEs. They are: provide a leg-up and not a crutch; help them build capabilities, i.e., help on the supply side rather than the demand side; and leverage on market mechanisms rather than substitute for the market. I shall elaborate on each in turn.

First, provide a leg-up and not a crutch. The government's assistance programmes for SMEs are designed to help companies who take the initiative to upgrade themselves. We have to reward the competitive spirit, and discourage over-reliance on government support. Grants under the Local Enterprise Technical Assistance Scheme (LETAS), which helps the company acquire external advice to improve its operations in areas such as financial management, IT usage and quality control, are limited by a funding cap of 70 per cent. This co-funding approach ensures that the companies receiving assistance assume ownership and responsibility for their upgrading projects.

Second, help on the supply side rather than the demand side. We believe that we should help SMEs by strengthening their capabilities — by improving their access to critical resources such as training, technology and finance. This is a better and more effective approach than giving SMEs preferential access to demand, e.g. in government procurement policies. SMEs that compete for contracts in the marketplace will ultimately be more resilient.

Third, leverage on market mechanisms rather than substitute for the market. Our assistance schemes for SMEs are designed to rely and leverage on market players. For instance, in the Local Enterprise Finance Scheme (LEFS), credit assessment and judgements on loan worthiness are left to participating financial institutions, with the government stepping in to co-share default risks. Similarly, instead of using a public agency to provide training or advice on capability upgrading for SMEs, the government provides partial funding for companies to engage private sector training providers or consultants.

Shifting the Focus in SME Assistance — Creating Synergies

These guiding principles underlying government's help to strengthen the competitiveness of SMEs remain relevant to the future. However, the focus of Government assistance for SMEs has evolved from one catering to individual companies to one centred on cluster development.

When we started out, our SME developmental assistance was targeted mainly at individual companies, each looked at in its own right. Loans and grants were provided to small companies to improve their business operations and manpower capabilities. The scope of this firm-level assistance has broadened with time, from a focus on finance and technical skills to fostering the acquisition of softer capabilities such as financial management, quality assurance, and branding.

While a firm-based approach has helped individual SMEs strengthen their internal capabilities, this approach by itself was sub-optimal. We were not creating the synergies, and exploiting positive externalities, that could be derived from a more integrated approach involving other industry players. We thus began to embark on a cluster development approach, which aims to strengthen linkages between suppliers, complementary players and supporting firms within various industry sectors by fostering greater collaboration and co-operation. Government assistance programmes such as the Local Industry Upgrading Programme (LIUP) and Business Upgrading through Inter-linkages Development (BUILD) encourage MNCs and large local enterprises to share their expertise with their smaller supply chain partners. The larger companies also benefit from having more reliable and efficient suppliers and distributors, creating a win-win situation. The Industry Productivity Fund encourages players in an industry to work together to raise the productivity of the cluster. One successful example of this approach is the National Productivity and Quality Specifications (NPQS) project. Through the standardization of building design specifications and the creation of a web-based application to enhance information exchange, the construction industry is expected to save $370 million annually upon the project's full adoption.

CHALLENGES

It will take some time for us to develop a more entrepreneurial culture, and build a vibrant SME sector. We have achieved some progress, but there are challenges that we need to overcome. I will highlight three of our current priorities: (1) improving the availability of finance; (2) taking SMEs international; and (3) providing a springboard for foreign SMEs.

Availability of Finance

Financing is arguably the number one problem faced by SMEs in any country. In Singapore, the problem is exacerbated by our small market, which makes it less viable for financial institutions to devote resources to building expertise on SME financing.

We have to continue to plug the gaps in funding at the early and mezzanine stages of a company's growth. The Start-Up Enterprise Development Scheme (SEEDS) was launched in October 2001 to help embryonic companies with innovative ideas to raise funds through matched equity financing by the government.[3] In addition, we have to find ways to spur the availability of "angel" funds. We also need to explore mechanisms to strengthen the private equity market for early and mezzanine stage companies, especially in view of the shift seen over the last two years in the focus of VC funds to later stage, lower risk ventures.

SMEs at the expansion stage, where loan financing is more typically obtained, also face difficulties in getting funding. A key problem faced by SMEs is that banks traditionally lend on the basis of balance sheets rather than cash flows. Many expansion stage SMEs, who have a track record and have made gains in market share, still find it hard to meet the banks' requirements for collateral. This problem is compounded in times of economic downturn because of falling asset values.

Government assistance schemes such as LEFS, the Micro-Loan Programme and the latest Loan Insurance Scheme that we have introduced will make loans more accessible to SMEs. However, we need to see how we can encourage either existing or new financial players to develop other forms of debt financing. One option is cash flow financing, which will require banks to build up the expertise to make cashflow projections and monitor companies' positions on an ongoing basis. We will also need to help our SMEs to improve their financial management and accounting transparency in order to make them more loan worthy.

Taking SMEs International

The next challenge we are focusing on is that of taking SMEs international.

Globalization has opened up new opportunities for small companies. SMEs with good products and services can tap demand worldwide, expand their markets and grow quickly. This is especially pertinent for SMEs in Singapore. Given the limited size of our domestic market, our SMEs can only sustain their growth if they eventually go abroad. However, this is not an easy task. On their own, SMEs usually lack the networks and resources, and the skill-sets, to venture abroad.

International Enterprise (IE) Singapore (previously the Trade Development Board) was reoriented in April this year to focus on helping local companies grow and internationalize. IE Singapore offers a range of services to help them shorten the internationalization learning curve, develop marketing and distribution channels, and make the right connections. It is building up its network of overseas centres and business support offices to provide market intelligence, advice, and on-the-ground facilitation. There is a lot of work ahead in this area.

Providing a Springboard for Foreign SMEs

Finally, the challenge of fostering cross-border SME alliances and collaboration in today's globalized markets. We want to attract SMEs from all over the world set up business here, and use Singapore as a springboard into the region and beyond. The presence of foreign SMEs will encourage the cross-fertilization of ideas, expertise and best practices, and help our own local SMEs gain competitive strengths. Foreign SMEs can benefit from our strong economic ties with the region and the major markets, a growing pool of venture capital, and our advanced logistics and communication networks.

China's Ministry of Science and Technology has decided to base its first overseas high-tech enterprises innovation centre in Singapore, with further plans for a national-level trade promotion office here. This is a significant move, and offers great potential. It complements several other foreign enterprise incubators operating in Singapore, including a French, a German, a Korea and a Japan Centre.

To make things convenient for foreign SMEs, IE Singapore has set up an International SME Business Centre (ISBC), which provides ready facilities at affordable prices and flexible terms for them to set up a presence in Singapore quickly. It also offers business matching services to help them form partnerships with local SMEs through the PartnerSingapore programme.

CONCLUSION

SMEs play an integral role in supporting the next stage of growth in Southeast Asian countries. This requires bold policy changes to foster a more conducive environment for all businesses, and competitive markets. It also requires innovative programmes to help SMEs develop capabilities and compete effectively on a level field.

This will not be an easy process, and there are challenges and issues remain to be resolved. Governments cannot do it alone, but will need to work hand in hand with the markets. There will also be benefit in getting insights and analysis from the academic and research community. I am therefore glad that ISEAS has organized this roundtable to improve the understanding on entrepreneurship and SMEs in the region. I wish you a fruitful discussion and hope that the forum will provide further ideas in our efforts to build a more vibrant SME sector.

NOTES

1 While the SBA has no funds for direct loans, grants or low interest rate loans for business start-up or expansion, it can guarantee as much as 85 per cent on loans of up to $150,000 and 75 per cent on loans of more than $150,000. In most cases, the maximum guarantee is $1 million.

2 Since 1999, the minimum amount of debt that must be incurred before a winding up petition can be brought against a company has been raised from \$2,000 to \$10,000.
3 For every dollar raised from an independent third party investor by the start-up, the government will invest a matching dollar, up to maximum of \$300,000. Fifty companies have since benefited under this scheme with \$28 million of funds raised.