

# Strategy to Increase the Competitiveness of SMEs and their Integration into Global Value Chain

**Restia Christiandy<sup>1</sup> dan Ratnaningsih Hidayati<sup>2</sup>**

<sup>1</sup>*Fakultas Ekonomi dan Bisnis Universitas Pattimura Ambon*

<sup>2</sup>*Pusat Pendidikan dan Pelatihan Perdagangan, Jl. Abdul Wahab 8 Cinangka Sawangan Depok, 16516,*

**Abstract:** Small and Medium Enterprises is one of economic pillars in Indonesia. However, Indonesian SMEs has not performed well comparing to other ASEAN countries, particularly in terms of participation in global and regional production networks. This study aimed to identify factors causing the low participation of Indonesia SMEs into the Global Value Chain (GVC). This research is conducted with literatur study and Internal & Eksternal factors analysis. Result shows that the low participation of SMEs and Indonesian companies in GVC is determined by the lack of optimal GVC support factors, namely infrastructure and use of communication and information technology, reliability and efficiency of logistics services, and high trade barriers. The relatively high level of wages is also an obstacle to increasing production efficiency. Likewise, the strict requirements for obtaining access to external financing from banks. Another problem faced by SMEs is that most of them do not know where their position are in the GVC. Increasing SMEs participation into GVC will automatically improve their competitiveness in the global economy. There are internal and external factors that determine the competitiveness of SMEs. Internal are human resources, marketing strategies, and innovation. Meanwhile, external factors are the ease of trying in Indonesia, access to finance and capital, market access and infrastructure.

**Keywords:** SMEs, Global Value Chain, Competitiveness

## I. Introduction

Small and Medium Enterprises are the pillars of the Asian economy. However, this sector in many countries in Asia has not been much developed. This is because of several factors, among them, there is no similar definition of SMEs between developed and developing countries, and the lack of SME access to the financial sector. Whereas about 90% of companies in Asia are SMEs, and 60% of the labor market in Asia works in the SME sector. SMEs become the backbone of the economy. Therefore, SMEs need to be upgraded as an important part of the global trade value chain by gaining proper policy facilitation, effective product marketing, and provision of adequate access to finance. SME development policy is required to be a sector that promotes balanced and inclusive sustainable economic growth.

Some of the challenges faced include the lack of common understanding between developed and developing countries regarding SMEs' "small" and "medium" concepts, barriers to access to financing sources, minimum market access, lack of integrative work programs, and lack of management. Both on a number of SMEs.

SMEs generally have limitations in building industrial and social relationships, resource mobility, access to information, and resource development (Broughton, 2011). The main problem that occurs if SMEs want to be a supplier to multinational companies is how to meet quality standards, supply consistency, and product adaptation. The problem is related to the limited access to capital. SMEs are often unaware that these factors are so important in improving product quality that can hamper SMEs into suppliers of multinational corporations. The capability of business diversification with the support of larger assets makes SMEs at mid-level have flexibility in anticipating demand fluctuations. Meanwhile, small businesses tend to have only one business unit so that a decrease in demand can lead to the termination of the SME's operational activities. Therefore, in general, SMEs have a higher survivability rate than larger companies.

In realizing ASEAN as a single and gradual production and market base, ASEAN member countries shall free import duties and eliminate other non-tariff barriers for ASEAN member countries if the goods to be traded meet the established requirements jointly. In addition, ASEAN countries also reduce barriers to trade services among ASEAN

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countries, among others, by increasing the foreign capital limitations. The issue of globalization is one of the external factors that the impact may vary on SMEs. Globalization, opening up domestic market access for partner country's products so as to have a negative impact on SMEs that have low competitiveness. Conversely, positive impacts can also be felt by SMEs with the opening of opportunities to expand the domestic product market to partner countries. Thus, the characteristics of SMEs that can take advantage of opportunities for access to international markets need to be explored. Such characteristics will be useful and become an ideal benchmark for developing strategies to improve the competitiveness of Indonesian SMEs.

Nicolescu (2009) states that internal factors influence the performance of SMEs rather than external factors by considering the economic scale of the SMEs. The combination of external and internal variables can be an example of how it can affect the survivability of SMEs. Medium or medium enterprises tend to have a higher survival ability than small businesses.

Along with the development of free trade agreements in East Asia since 2000, the final product trade in the region has decreased and vice versa has grown intermediate goods trading trend. This is triggered by the growth of production patterns that several stages of production are done separately in some countries so that the pattern of regional production network chain, or even global, to produce a product. The literature calls it a regional production network or GVC. ADB (2015) mentions that two factors for success in GVC are company competitiveness and corporate connectivity. Both are a means for companies to connect with the value chain. Companies that have competitiveness and connect will be able to join and benefit from GVC.

Competitiveness is a concept that refers to a company's ability to compete with other companies to create value. There is no single indicator that can be used to measure competitiveness which is very difficult to measure (Markovics, 2005). Competitiveness can be created or enhanced by applying the right competitive strategy, one of them with effective and efficient resource management. In addition, the determination of the right strategy must be tailored to all activities of the company function, so that will create the company's performance as expected even more and can produce value.

To engage in GVC There are some factors that challenge SMEs to benefit from cooperation with multinational corporations (Yuhua and Bayhaqi, 2013). First, SMEs need to improve their technical and operational capabilities to achieve the global standards of multinational companies. Related to this, SMEs need to get adequate capital access in order to invest in the production process. The next challenge is human resources (HR). With the culture and informal working structure and lack of a clear career plan, SMEs are very difficult in improving the quality of human resources or attracting professional human resources. Meanwhile, a change in business practices is the latest challenge that SMEs must face to enhance competitiveness in the global value chain (GVC). These challenges include efficiency in company operations as well as consideration of the social and environmental impacts of the production process. There are two positive impacts that can be gained if SMEs are part of GVC, which is profit for SMEs themselves and benefits to the national economy. Positive impact on SME sector is obtained by increasing technical capability. Involvement in GVC requires high quality standards that automatically increase productivity with technological mastery and production efficiency. Another positive impact of participation is improved access to information and the latest business models. They can improve the image of SMEs so that other positive impacts, such as ease of access to external funding sources (Yuhua and Bayhaqi, 2013).

Furthermore, participation in GVC enhances the contribution of the SME sector to economic growth and employment. Thus, involvement in GVC will assist SMEs in exploiting opportunities in other countries and competing in the domestic market by increasing competitiveness.

In order to get involved in GVC, will Indonesian SMEs compete with other ASEAN member countries? SMEs Indonesia have been able to take advantage of more open market access, better access to more affordable and cheaper inputs and greater consumer access? Therefore this study aims to: identify Indonesia's SME strategy to improve competitiveness in GVC and provide recommendations on strategies to enhance the competitiveness of SMEs in GVC.

## **II. Methods**

Data analysis method in this research using qualitative method, that is research procedure that produce descriptive data. The type of qualitative research used in this research is Action research. Action research is one form of research design in which the researcher describes, interprets and explains a social situation at the same time by making changes or interventions for the purpose of improvement or participation.

## **III. Result and Discussion**

The result of the research is explained by the exposure on the analysis of internal and external factors of SMEs and the recommendation of competitiveness improvement strategy. Internal factors include strengths and weaknesses that can

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determine the competitiveness of SMEs such as productivity and innovation. Some other factors are also very influential on the level of productivity and innovation companies, namely the quality of human resources (human resources), corporate culture, educational background of owners and workers, as well as the character of stakeholders in the company. Meanwhile, various external factors also affect and support the competitiveness of SMEs. These factors, among others, are ease of doing business, access to finance and capital, market access, infrastructure, and macroeconomic conditions in general.

### **1). Internal factors**

Currently, the human resources of Indonesian SMEs is one of the factors that hamper the performance of SMEs. Some aspects that may reflect the weakness of human resources in the SME sector include the following:

- a. Low technological mastery, especially for micro and small enterprises. Use of the website and e-mail utilization can improve the operational efficiency and sales volume of SMEs through a wider market coverage.
- b. Awareness to expand the reach of marketing through e-commerce. The marketing outreach of the majority SMEs is limited to the domestic sphere of its own environment, which is limited by the region and the environment of friendship or family. Limitations on the mastery of technology to reach new potential buyers environments can be helped through e-commerce. This has been done by some e-commerce websites that already exist. Many products that are marketed are SME products. Therefore, an introduction to this method is necessary to expand the reach of product marketing.
- c. Low ownership of international or national certification (SNI). Certification is generally related to the production process and packaging of a product. The existence of standardization in accordance with the certification can increase productivity and encourage SME innovation. In addition, there is a low level of expertise between the demand for SMEs and the supply of Vocational High School is still weak. Non-compliance with labor criteria is much complained by SMEs, especially those that require special skills to run their business. Generally, SMEs should provide its own training so that SMK graduates can be directly involved in the production process and company operations. Giving curriculum related to soft-skills also needs to be done related to direct and indirect communication as well as expertise on product marketing strategy.

### **2). External Factors**

#### **a. Ease of Doing Business**

In addition to in the form of individual informal enterprises, to conduct business in Indonesia, SMEs can choose some form of business entity (legal entity), such as individual business entities, limited partnership (CV), firms or limited companies (PT), for example, SMEs in Indonesia is a business or a sole proprietorship in the form of trading business (UD). However, the majority of SMEs owners in Indonesia prefer not to formalize or legalize their business. Simple organization, ease of running a business, and complicated taxation procedures are the main reasons for maintaining status as an informal business. These considerations can be spelled out as follows:

- ). The number of procedures and time that must be passed. To start a business, from the establishment of a business entity to registration of operational permit (Corporate Registration Certificate and Trading License), it takes more than 10 procedures with a total time required of more than 1 month on average. This is certainly a barrier for the SME sector that has limited resources.
- ). Limited capital to establish a formal business entity. If the SME wants to improve the status of a limited liability company (PT), there is a minimum capital requirement of 50 million rupiah and a paid up capital requirement of 25 percent of the authorized capital.
- ). Concerns about tax reporting and payments. Many SME owners are not willing to legalize their business due to the complicated tax payment reporting and tax payment procedures. The large number of taxes to be paid is also considered to significantly reduce the operating margin. Although some ministries have facilitated licensing arrangements, the proportion of formal informal enterprises is still low.

#### **b. Access to Finance**

Many research on SMEs shows that in starting a business, SMEs rely on their own capital or from loans / assistance of their closest people. External sources of funds are needed when SMEs expand.

##### **-). Banking**

Although banks are still the largest source of funding, in addition to the feasibility of the business itself, many statements from banks that must be met by SMEs to get funding from banks, especially related to prudential banking aspects such as the following:

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**Additional collateral for loans disbursed.** This assurance may be a fixed asset such as land, buildings, and vehicles or assets of the business itself, which is a good operating cash flow.

**The legality of the company.** This aspect is important to see the prospects of SMEs business and compliance in accordance with the laws and regulations.

Currently the government also has a community business credit program (KUR) to encourage SME lending without requiring a guarantee. KUR is channeled by several banks that have been set by the government with interest rates that have been subsidized, which is equal to 12 percent per year. Although KUR is available at low interest rate and guaranteed by the government, there are some things that still need to be concerned with banking funding, which are as follows:

**Limited resources of KUR.** Currently the source of KUR funds comes from the banking itself. The government only provides the amount of interest subsidy fund, which is equal to the difference between the general interest rate less the KUR interest rate. Therefore, the banking capacity to channel subsidized KUR is limited by the availability of funds in designated government banks.

The absence of an integrated SME information system that every bank can access. The banking sector needs potential SME data to be credited. However, there is currently no database (information system) that can be used by banks as the basis for assessment.

### -). Other Financing

In addition to banking, alternative financing through non-bank financial institutions also still need to be improved. Venture capital is an alternative source of financing for new businesses / entrepreneurs who have no collateral, but have a potential business. Venture capital is a financing with risk to investors so investors (venture capital firms) must understand and understand the business run by the company to be financed. The difficulty of accessing banking and the relatively limited amount of venture capital prompted the government to establish the National Capital of Madani (PNM) with the aim of assisting the funding of SMEs. However, PNM requires a good track record for SMEs to be financed. Various other new financing models also arise in the difficult conditions of accessing financing sources for SMEs. Financing models such as crowd-funding and other micro-financing are already available. SMEs also have access to capital for export financing through banks and the Indonesian Export Financing Institution (LPEI). However, the percentage of bank credit for exports is very low. Likewise with LPEI, the agency only allocates 10 percent of the funding portfolio for SMEs. Funding is more done indirectly, namely through venture capital financing. Crowd funding also began to develop as an alternative nonbank financing in Indonesia although still very limited. However, the growth of crowd funding is not as fast in the United States as there is still a lack of 'trust' between investors and borrowers as well as fears of online fraud.

### c. Market Access

The ease of market access, both domestic and international, strongly supports the increasing competitiveness of Indonesian SMEs. Due to the weak characteristics of SMEs in the use of technology and innovation, the scope of marketing of SME products in the domestic market is generally limited to the area of SMEs and the scope of marketing also tends to be localized in certain areas. Programs that greatly assist SME market access are often small scale so that the impact is less than optimal. The challenge for the government is to create a larger scale program to have a broad impact. Online programs such as e-catalog and e-marketing need to be the focus of attention. When entering the global market, SMEs must have other challenges because doing export, not as easy and as cheap as entering the domestic market due to risk factors and higher costs. The cost to obtain the export market is sunk cost, which is the cost to be incurred but cannot be withdrawn if the export is not realized. The Government through the Ambassador, Trade Attaché, and Indonesia Trade Promotion Center (ITPC) have been trying to get information and connect exporters with buyers abroad. The government also established the Directorate General of National Export Development to help the business world to export. However, the effectiveness of programs and activities undertaken by these institutions is often not maximized. The challenge for governments is how to improve the effectiveness of these institutions in increasing export market access to potential markets.

### d. Infrastructure Support

The limited availability of infrastructure (hard and soft infrastructure) and the quality and high cost of logistics services have been the obstacle to overall business growth in Indonesia. The impact of the quality of infrastructure and logistics on the transaction costs of SMEs will be greater than the big business because the scale of SME business transactions is relatively smaller. Furthermore, Indonesia does not yet have an industrial cluster that can effectively synergize with

SME development strategies. The development of the cluster needs to be supported with adequate infrastructure and facilities. Support in the form of regulations, regulations, or support from institutions that effectively implement the cluster is a prerequisite for synergizing SMEs with larger scale industries. The industrial cluster development model in Indonesia currently focuses more on Special Economic Zone by prioritizing large companies. It still needs to be done simultaneously because it has the potential to increase the GVC of SME sector in the future.

#### **IV. Discussion**

##### **1. Internal Factors**

When compared to countries such as Malaysia, Singapore, and Thailand, it appears that the productivity of Indonesian SMEs is still relatively lower. Improvements in the level of education and managerial skills are very influential in increasing SMEs productivity. Education in this case includes formal and non-formal education that can improve the skills of SMEs workers. Meanwhile, managerial expertise is essential so that resources can be utilized efficiently and also help to increase the scale of business. Equally important is the facilitation of standard and certification management required by SMEs in order to enter the export market. Knowledge of the standard in the target country and the cost of standardization and certification are relatively expensive if borne by micro and small businesses individually and the cost is sunk cost so that if the government can facilitate SMEs it will lower the transaction costs of SMEs. Besides, assistance to micro and small enterprises is needed so that the operational of the business can run efficiently and its productivity increases. Some banks and foundations that specifically distribute micro business loans and provide micro business assistance as a form of corporate social responsibility (CSR) recognize that the provision of credit and / or financial assistance for micro and small enterprises will be better for business growth if there is assistance. This is because businesses / micro and small entrepreneurs get help finding solutions if there are problems encountered in the business, for example creating a business plan when applying for a loan to the bank, making financial statements, understand simple contracts, and export.

##### **2. External Factors**

That SMEs are reluctant to become a formal business entity is a problem that needs to be prioritized to be noticed by the government. Based on empirical studies the legality aspect is very helpful in accessing external funding sources. Therefore, the licensing arrangements for SMEs need to be facilitated and free of charge (cost free). The granting of access and special facilities for SMEs for licensing arrangements throughout the One Stop Service Integrated Agency throughout Indonesia needs to be initiated by the government. However, such facilities need to be followed by other policies, such as ease and tax incentives to encourage SMEs to become formal business entities. For SMEs that have been established for more than two years, the provision of incentives or reduction of income tax for a certain period of time accompanied by compliance tax assistance may be considered to enhance the competitiveness of SMEs. The ease and incentives of such taxation are expected to encourage increased legalization of SME entities the government also needs to treat specifically the SME sector with regard to the process and the amount of costs that must be incurred in the legalization process. The government can provide an investment permit registration facility that cuts the number of procedures and reduces the number of days required for a given SMEs.

With regards to capital, the government-run KUR program is a significant facility to help SMEs access capital. However, based on the experience of banks that distribute microcredit, assistance is needed by the recipients of KUR so that the utilization of KUR is more effective. The limited capacity of banks to channel credit needs to be sustained by opening access to capital markets for SMEs as well as removing barriers to the development of nonbank financial institutions, such as venture capital and crowd funding. As for market access, the government has facilitated SMEs to get the market in the country. However, the scale of assistance that can be provided is very limited. Governments need to use innovative new methods to help SMEs get the market so that with the same budget more SMEs can be facilitated. For example, synergize with local government (cost-sharing) and activate e-catalog and other online promotions.

In terms of facilitation of promotion to the international market, the government also needs to further enhance the role of Indonesian representatives abroad as a market intelligent to obtain information on potential markets (potential demand, trade barriers, including required standards and certification, as well as procedures for entry into the country). In addition, good cooperation with technical ministries is needed to match-making market intelligent information on potential markets with the ability of producers to meet the market, including facilitation to obtain certification and standard management so as to be accepted in the destination market.

## **V. CONCLUSION AND POLICY RECOMMENDATION**

### **Conclusion**

Based on the results and discussion above can be concluded several things as follows:

1. The development of SMEs is an integral part of the economic unification among ASEAN member countries. Various cooperative initiatives for improving the performance of SMEs still need to be done even though Indonesia is late or not optimally utilize the initiative, especially in the implementation of domestic policy.
2. In general, the performance of Indonesian SMEs is still relatively low compared to countries with relatively similar levels of development, especially in terms of productivity, contribution to exports, participation in global and regional production networks, and contribution to added value.
3. The current government approach to SME development is more towards social welfare by promoting social justice objectives as well as the balance of development between cities and villages as well as between regions. SMEs are seen as vulnerable entities that need to be protected. As a result, many policies and programs that are developed and implemented are not based on business orientation, but are more social. The social approach will not result in competitive Indonesian SMEs.
4. The ability of SMEs to compete in the global era depends on several things, namely internal factors such as business scale, stakeholders personality, educational background and corporate culture that can be reflected from the level of productivity and innovation of the company, as well as external factors that factors outside the company such as Access to capital and the policy environment.

### **Recommendation**

Increasing the involvement of SMEs in GVC provides great benefits for SMEs in terms of quality improvement and product innovation, human resources, and especially sales. Other sectors can also feel the impact as a result of spillover economic effect.

As in improving domestic market access, the first step to be taken is the availability of funding to support SMEs in GVC. Public Investment, either from government or other parties, is needed to implement policy that can increase SME linkage in GVC. Specifically there are five policy recommendations that can be submitted to increase the participation of Indonesian SMEs in the global production network:

1. GVC is a phenomenon of new production system that has not been much experienced by Indonesian entrepreneurs. Therefore, it is important for the government to introduce and disseminate information about this GVC.
2. Policies that can encourage business actors to improve their business productivity need to be applied, such as incentives to improve production technology. Issues related to connectivity, logistics and licensing need to be addressed so as not to become an obstacle to the performance and efficiency of Indonesian companies. The government also needs to encourage SMEs to be export-oriented to overseas markets. Coordinated and unidirectional policies are also important to increase Indonesia's participation in global production networks.
3. Trade barriers such as the quality of public infrastructure and special trade such as ports and customs and logistics services that have not been efficient and reliable need to be addressed. Equally important, trade barriers in the form of tariffs and non-tariffs need to be considered as well. GVC shows that international trade is no longer merely an end-product trade but also intermediate goods that support domestic production.
4. Mapping of the capacity of SMEs that can be suppliers in a global production network; And the need for raw materials (input) in the production process of SMEs medium scale and large companies (multinational). Mapping needs to be done to identify factors that can increase MSME involvement in GVC.
5. Establishing a specific industry cluster for SMEs can significantly improve competitiveness and increase SME growth. Meanwhile, the facility of one-stop services for SMEs provides incentives to occupy the area. Such integration can indirectly serve as a driver to improve the quality of SME human resources products and capacities. The development of nonphysical infrastructure in the cluster also needs to be developed by the government. Facilitating dialogue and communication within clusters, between large and SMEs is another important factor for improving efficiency and aligning the quality and standards of SME products required by large enterprises.
6. Develop partnerships with government / private / universities / other institutions for SME development programs, such as business management, HR, entrepreneurship, business plan, product development, financial management, IT mastery, etc.
7. Providing training, especially about basic skills in the rapidly evolving digital age of today and entrepreneurship skills for efficient business operations.
8. Increase the reach and quality of telecommunication infrastructure, especially the fast internet needed for business in the digital age, including the linkage in GVC.

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