POLICY NOTES

Philippine Institute for Development Studies
Surian sa mga Pag-aaral Pangkaunlaran ng Pilipinas

ISSN 2508-0865 (electronic)

No. 2018-11 (October 2018)

Barriers to internationalization of Philippine SMEs

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Despite the large role of small and medium enterprises (SMEs) in the Philippine economy, they remain far less productive than large firms due to several challenges. These include those related to access to finance (Harvie et al. 2013), access to technology (Thong and Yap 1995), access to markets (Rogerson 2013), disruptive regulations (Klapper et al. 2006), and lack of human capital (Bates 1990; Wiklund et al. 2009).

Several factors can help SMEs overcome these challenges, one of which is their internationalization through global value chains (GVCs) (Botelho and Bourguignon 2011; ADB 2015). Linking SMEs to GVCs gives them access to an expanded market, improves their technology, human capital, and access to information, and provides them a platform to develop economies of scale and increase productivity (ADB 2015; Arudchelvan and Wignaraja 2015). However, participating in GVCs is not easy for SMEs as they also face a host of hindrances in doing so.

This *Policy Note* identifies the factors that hinder Philippine SMEs from participating in GVCs. Through a 2017 survey[1] among 530 firms in Metro Manila and a series of key informant interviews (KIIs) among exporting SME owners and managers, it pinpoints policy solutions to improve the integration of Philippine SMEs into GVCs.

Philippine SMEs and GVCs

A mere 1.3 percent of survey respondents had export revenues in 2017. Of this figure, slightly more than half (57%) were from the services sector, while the rest were from the industry sector, particularly manufacturing. Given that only 8.5 percent of the respondents were from the industry sector, a greater proportion of industry compared to services SMEs were exporters (Figure 1).

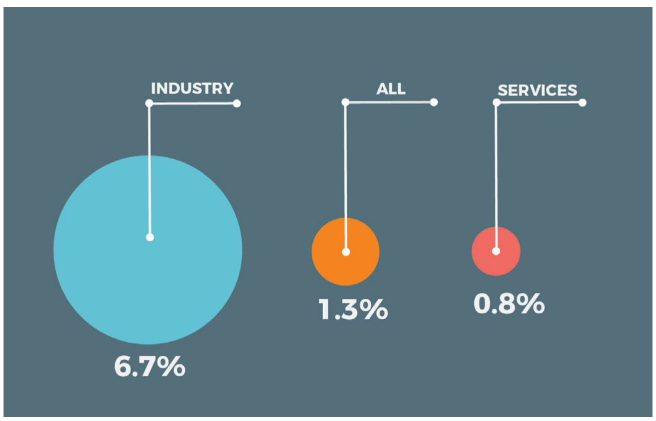
When both direct and indirect exports are included, SMEs accounted for 33.4 percent of Philippine manufacturing exports (Wignaraja 2012), one of the highest in Southeast Asia. However, the Philippines

[1] Conducted by the Asian Institute of Management Rizalino S. Navarro Policy Center for Competitiveness. See Canare et al. (2017) for the survey methodology.

lagged behind in the share of exporting manufacturing SMEs, which was only at 20.1 percent in 2012. This proportion was lower than 46.2 percent in Malaysia, 29.6 percent in Thailand, and 21.4 percent in Viet Nam (Figure 2). This suggests that SMEs in these neighboring countries were, in general, more connected to GVCs.

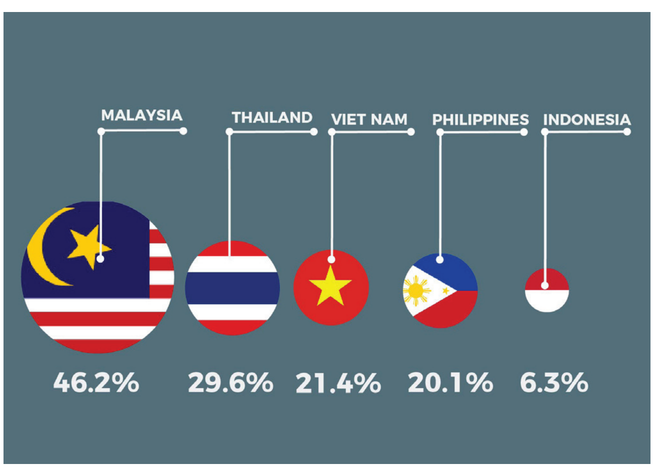
Another way SMEs can connect to GVCs is through linkages with domestic large firms and multinational enterprises (ADB 2015). This is especially true for big businesses that export their products, but may also be applicable to large firms that only sell domestically. These linkages could be through supplying these firms with inputs or through subcontracting and outsourcing arrangements. It could also be through formal partnerships, such as joint ventures, strategic alliances, and consortiums.

Figure 1. Share of respondents with export revenue, by sector



Source: Asian Institute of Management [AIM] (2017)

Figure 2. Share of exporting (direct and indirect) manufacturing SMEs, selected Southeast Asian countries



SMEs = small and medium enteprises
Source: Wignaraja (2012)

Among the surveyed firms, only 23.4 percent sold to large firms, with the remaining firms selling primarily to fellow SMEs and retail clients. In terms of the other formal linkages, 14.5 percent of respondents were subcontracted, outsourced, and licensed to manufacture a product, or engaged in a joint venture, strategic alliance, or consortium with a large domestic business or a foreign firm (Figure 3).

Another indicator of GVC linkage is firm's participation in the global production networks (GPNs). Sturgeon (2000) provides a simple definition of a production network—at least two value chains with at least one common actor. From this definition, being part of a GPN implies being part of at least one GVC.

More formally, Coe et al. (2008) define a production network as the set of interconnected functions and transactions used to produce, distribute, and consume the product or service. A production network is a GPN if one of the interconnections extends across countries.

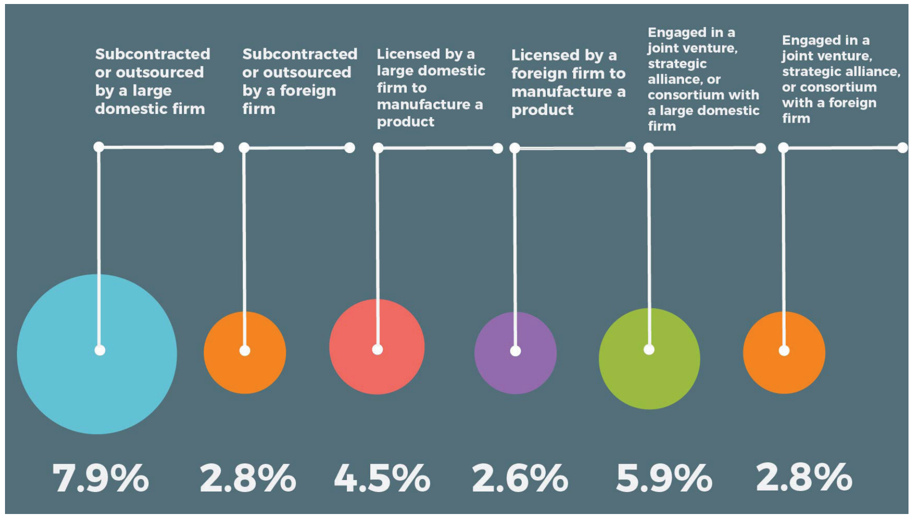
As in the previous indicators, only a small share of firms—15.1 percent—identified themselves to be part of a GPN (Figure 4).

Challenges to SME participation in GVCs

Through the survey, this study found that the leading obstacles faced by SMEs in penetrating the international market were corruption and high tariff rates, both of which were raised by 8 in every 10 of the firms. Aside from these, respondents also raised the poor quality of infrastructure relevant to trade (48%), unstable foreign currency exchange rate (46%), and difficulty in meeting international products and services standards (44%) (Figure 5).

The Asian Development Bank (2015), in another survey, also identified five primary impediments in connecting SMEs to GVCs, namely, lack of access to finance, unavailability of skilled labor, labor market rigidity, weak institutional support, and disadvantages of the sector.

Figure 3. Share of respondents engaged in selected partnerships with a domestic large business or foreign firm

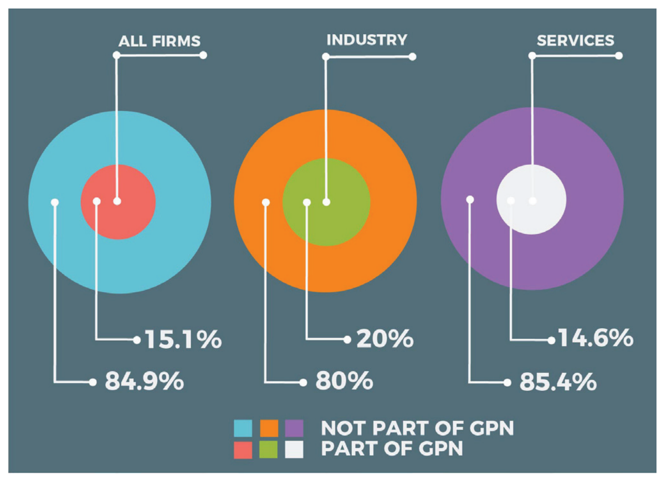


Source: AIM (2017)

While these surveys provided evidence on the challenges in linking SMEs to GVC, they did not show how these factors affected the capability of SMEs to link to GVCs.

The KIIs allowed the current study to dig deeper into the results. Five themes emerged from which challenges can be identified and enablers can be suggested. These include the (1) competition in Association of Southeast Asian Nations (ASEAN) and East Asia; (2) international standards, regulatory requirements, and local institutions; (3) role of the government; (4) international market demand and inputs supply; and (5) entrepreneurial mindset.

Figure 4. Share of respondents that are part of a global production network



GPN = global production network
Source: AIM (2017)

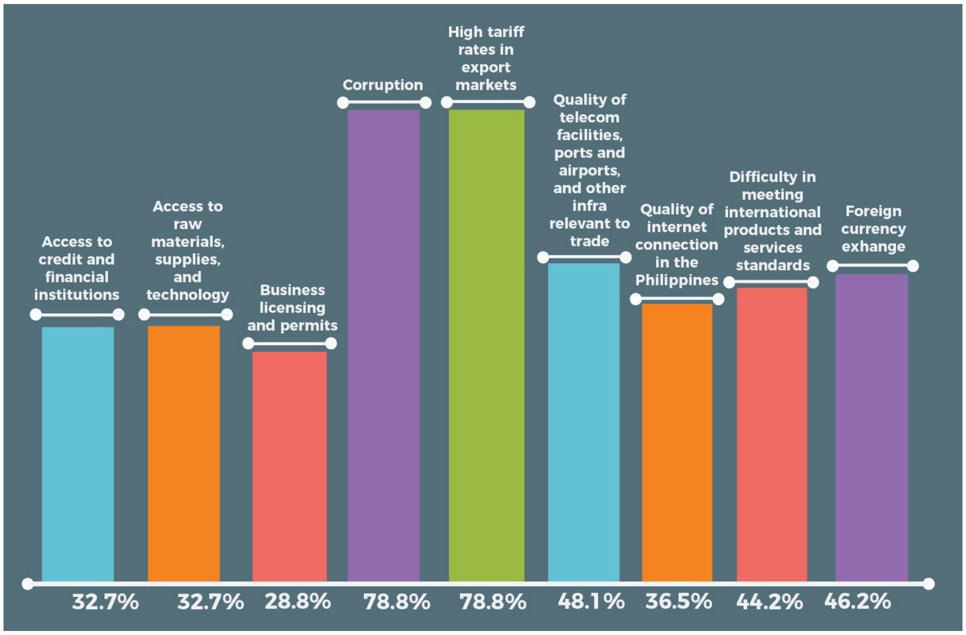
Competition in ASEAN and East Asia

Exporting Philippine SMEs find it hard to compete abroad because of their lack of capacity to mass produce. This problem leads to high per unit cost and inability to take bulk orders, lower labor cost in most competitor countries, and participating at the lower-value part of the GVC (i.e., exporting mostly raw rather than processed, higher value, products). While competition is a problem for most respondents, some of them were able to adapt to it by looking for certain market niches not yet highly competitive and in the higher-value section of the chain.

International standards, regulatory requirements, and local institutions

Compliance with regulatory requirements and quality standards, both in local and potential export markets, also poses challenges to the entry of Philippines SMEs to export market.

Figure 5. Perceived obstacles of SMEs to participating in GVCs



SMEs = small and mediium enterprises; GVCs = global value chains
Source: AIM (2017)

These standards have two benefits. First, they improve the quality of the product, making them more likely to penetrate the international market. Some countries also have regulations on the use of certain inputs, and imported products require compliance certifications. Second, compliance to certain nonregulatory standards, such as organic production, allows the producer to participate in the higher-value part of the GVC.

Several reasons explain the difficulty of Philippine SMEs to comply with these standards and regulations. One is lack of access to finance and credit. And even when credit is available, SMEs are averse to obtaining it due to risk aversion, lack of entrepreneurial orientation, and lack of willingness to expand and invest. Other reasons include lack of access to skilled labor and entrepreneurial mind-set.

Role of the government

While the respondent firms argued that government support to SMEs is greater in competitor countries, various government agencies have already implemented programs that can help SMEs connect to GVCs. Examples of these are mentoring programs that teach the basics of entrepreneurship and trade fairs that help connect SMEs to markets, suppliers, and service providers. Aside from these, the government may also implement policy reforms that will create an enabling environment for SMEs to prosper, such as those pertaining to ease of doing business.

International market demand

Some of the SMEs' market-related challenges are their inability to adapt to changing market conditions and consumer preferences in export markets, as well as their inability for mass production. Specifically, small firms do not have the capacity to produce in bulk quantities, thus failing to serve international markets requiring a certain quantity to be profitable. Other challenges are lack of access to market information in terms of preferences, tastes, and capacity to pay of consumers; lack of access to inputs; and lack of skilled labor especially for newly developed products and industries.

Entrepreneurial mind-set and skills

The importance of mind-set cannot be undermined. According to resource persons from the government, SMEs have an adverse reaction to endeavors that require substantial capital. Fernandez and Nieto (2006) documented this risk aversion of SMEs. With fewer assets and lack of safety nets, these firms have no fallback in case an investment does not produce positive returns. If the mind-set of Philippine entrepreneurs is to change, the underlying cause of their risk aversion should be tackled. Aside from mind-set, the lack of entrepreneurial skills is another obstacle for SMEs' participation in GVCs.

Policy recommendations

This section discusses some policy implications that can help promote SME participation in GVCs.

Enhance ports and customs operations

Inefficiencies in ports and customs processes unnecessarily increase the cost of trading. Simplifying these processes and reducing the incentives for corruption through automation may facilitate the exporting and importing activities of SMEs.

Improve credit terms of SME loans

Many SMEs are reluctant to invest and take out a loan because of risk aversion brought by the absence of safety nets in case the investment produces negative returns. While insurance may be a good safety net, market for it is often incomplete.

Better credit terms may be provided for in an SME law. This need not be lower-than-market interest rates as this may cause the lender to lose money. It may be longer repayment, acceptance of high-value collateral usually not accepted, among others.

Incentivize exporting of higher-value products

One way to do this is through the provision of incentives on the purchase of equipment that processes raw materials into higher-value products. This could be in the form of tax breaks for purchase of equipment or for equipment financing.

Promote linkages between SMEs and foreign or large firms

Connecting SMEs to GVCs is not only through exporting but can also be through the provision of supplies or services to firms already connected to the value chain. Information dissemination may also facilitate linkages between SMEs and foreign or large firms. This may be through the establishment of a platform where SMEs can post the services that they offer and their qualifications while large firms can post their outsourcing/subcontracting requirements.

Reduce the cost of participating in trade fairs

One way to encourage SMEs to join is to waive or reduce the entrance fee during trade fairs. Nonetheless, it is reasonable to charge a transaction fee if a firm is successful in contracting with a buyer during the event.

Expand entrepreneurial skills training

There is probably no proven way to improve entrepreneurial mind-set. However, it is too important to be ignored. Exposure to entrepreneurial skills training would be one way to do it. Owners of SMEs should be exposed to the successful practices of entrepreneurs in running their businesses.

Recognize no one-size-fits-all solution exists

Survey findings suggest that SMEs from different sectors could be facing different obstacles in connecting to GVCs. As such, the government must implement an efficient and effective program targeted to the specific needs and challenges faced by firms.

Aside from the said recommendations, this study also urges the SMEs to also consider the following:

- Find new market niches where competition is not yet too tough. SMEs may target the right markets where they can establish early mover advantages.
- Avoid purchasing equipment with high asset specificity. With a fluid international market, tastes, preferences, and market conditions quickly change. A firm should be ready to adapt to these changes. High asset specificity means an asset has only one or few purposes, such as when a machine can only produce

one type of clothing. When the demand for such type of clothing declines, the SME will find it difficult to adjust because it may be expensive to invest again in other equipment.

- Consider indirect exporting. Many potential exporters do not have the capacity to produce in quantities that would make exporting profitable. Moreover, many potential exporters do not have access to market information in export-destination countries. Indirect exporting can help address these obstacles. This means the SME itself is not the one who does the actual exporting. It sells its products to a third party who, in turn, exports the product or uses it as input for a product that it exports.
- Take advantage of government support and network. SMEs should participate in available programs, such as *Negosyo* Centers and the *Kapatid* Mentor Me Program.

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