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# SUPPORTING A DYNAMIC SME SECTOR: CHALLENGES FACED BY SMES IN SINGAPORE

FAIZAL BIN YAHYA  
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NG YAN HAO  
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Yahya, Faizal; Chang, Zhi Yang; Ng, Yan Hao and Tan, Meng Wah

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## PREFACE

The Economics and Business research cluster at the Institute of Policy Studies (IPS) has a keen interest in small and medium enterprise (SME) development in Singapore, in particular the challenges faced by the sector in the current economic restructuring that started in 2010, a year after the Global Financial Crisis rattled economies across the world.

The cluster believes that the SME sector is key to ensuring the successful transformation of Singapore's economy into one supported by innovation and productivity. The sector hires nearly 70% of the workforce and contributes significantly to the economy. However, it is also true that many SMEs are struggling to overcome the multitude of challenges arising both internally and externally.

The aim of this volume is to act as a primer that provides an updated overview of the SME landscape in Singapore and around the world, laying the groundwork for future research on SME development. The primary source of research for this book is qualitative in nature, and is derived from seven sessions of closed-door discussions (CDDs) held by IPS from end 2013 to early 2015. Each closed-door discussion covered a specific topic of SME development. The events were attended by senior representatives from various sectors including academia, the private sector and public sector. As the discussions were held under Chatham House Rule, it encouraged an open exchange of views, which proved very useful in enhancing our understanding of the SME sector in Singapore.



# Chapter 1

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## Introduction



# CHAPTER 1: INTRODUCTION

## BACKGROUND

Ever since the great recession of 2008, triggered by the collapse of Lehman Brothers and the ensuing Global Financial Crisis (GFC), SMEs have come to the fore of the economy in numerous countries. Traditionally an important part of the economy, SMEs as a group account for more than 95% of total enterprises in most countries, hire a substantial amount of the workforce and contribute significantly to national output. There is also a social aspect to the existence of SMEs. Aside from the obvious social stability that the SME sector brings through the role of job creation, it also contributes to social development by supporting a diversity of jobs and meeting the population's array of societal demands.

In Singapore, while the SME sector has always been recognised as an important part of the economy and society, it is not the main driver of Singapore's economic growth. Instead, Singapore's economy has been driven by multinational companies (MNCs) and government-linked companies (GLCs) at the core, with SMEs providing the ancillary services and support required.

In more recent times though, there is an increasing recognition that SMEs as a group can play a greater role in Singapore's push to become an innovative economy. There are even a growing number of people spanning across various sectors who think that Singapore's restructuring success and longer-term economic sustainability depend on the ability of SMEs to transform their business models and become more productive. In his 2014 budget debate round-up speech, Deputy Prime Minister Tharman Shanmugaratnam said that the three priorities in the next phase of restructuring were: Transforming Singapore's enterprises, especially SMEs; transforming jobs and developing every talent; and transforming Singapore's culture. Economic restructuring would only be successful if Singapore progressed on all three fronts.

One of the goals of the current economic restructuring process is to achieve a long-term annual productivity growth target of 2 to 3% by 2020, as recommended by the Economic Strategies Committee (ESC) in their report submitted to the government in 2010. Given that SMEs in Singapore make up 99% of all the enterprises in the country, and that the average productivity of SMEs is lower than their larger counterparts, it is not



surprising that the government views SMEs to be a crucial stakeholder in the current economic restructuring.

While five years have passed since the government accepted the ESC recommendations and began on the journey of economic restructuring, a quick check on the country's productivity growth shows that not much progress has been achieved. Although productivity grew at a compounded annual rate of 2.5% from 2009 to 2014, most of the productivity gains during that period was realised in 2009 when the economy experienced a sharp recovery from the GFC. Stripping out that effect, the country would have only registered a weak annual productivity growth of 0.3%.

Admittedly, aggregate productivity figures do not give a complete account of the pace of productivity growth and restructuring activities happening within different sectors, but it is clear through the feedback from the business community that the SME sector at large is struggling in the current trying business environment. In addition, a study by the Ministry of Trade and Industry (MTI) released in the second quarter of 2014 Economic Survey of Singapore showed that annual productivity growth for the domestic-oriented sectors — where traditionally most SMEs are — was -0.3% for the period 2010 to 2013. This is despite the government expanding its support to businesses over the past few years and devoting a wide range of resources to help SMEs develop deeper capabilities to move up the value chain of production and internationalise. The top-line figures of many SMEs have been depressed by weak external demand while their bottom line has been driven up over the last few years due to supply side constraints such as land and manpower.

## **OVERVIEW OF CHAPTERS**

The chapters in the book will each cover one topic of the CDDs. The format of each chapter is as follows: A background review of the topic in focus will first be given, followed by an elaboration of the exchanges that took place in the CDD. The final chapter combines the information generated from each chapter to summarise a list of recommendations for policymakers to consider. These points can also be used for follow-up research on SMEs in Singapore.

Against the backdrop of the ESC's recommendation to double the number of Singapore companies with over S\$100 million in turnover to 1,000 by the year 2020, Chapter 2 examines the idea of grooming competitive SMEs so that local companies would take on a more direct role in Singapore's future economic development. In the early post-independence years, the country chose to implement an industrial policy focused on attracting foreign

investment into the country to help develop much-needed infrastructure, create jobs, spur economic growth and uplift the country's standard of living. This resulted in an economic structure centred on the activities of MNCs. As Singapore now attempts to transform into an innovative economy, local companies are an important element to making the transition successful and sustainable. But creating an innovative ecosystem supported by local companies is not an easy task. What strategies should the government take, and is the choice of “cherry-picking” certain groups of SMEs to enable their growth rather than covering the 180,000 or so SMEs in Singapore an approach that is effective or even tenable? The chapter will also explore the linkages between MNCs and SMEs in relation to the model of Singapore's development, and review the challenges face by emerging market multinationals (EMMs) of other East Asian countries in a very competitive and fast-changing global environment.

Chapter 3 will look at the rising business costs in Singapore and their impact on SMEs, with a focus on rental cost. Business costs in Singapore have been on a persistent upward trend over the past few years. For some components, like manpower, this is the result of intentional government policy, while others like imported raw materials are subjected to international developments beyond the country's control. However, a major part of business costs comes from real estate rental, especially in the case of SMEs that usually do not possess the financial means to purchase real estate for their business operations. With the government's push to develop the real estate investment trust (REIT) industry, the country has seen the rise and expansion of several large institutional landlords. Many in the SME community felt that these developments have eroded the bargaining position of businesses and led to an undue acceleration of rental cost as these landlords seek to maximise their profits. The CDD held by IPS in February 2014 discussed the impact on rent prices of increasing presence of institutional landlords in Singapore, and the effects of spiralling rental costs on SMEs.

Chapter 4 will examine the financing issues faced by SMEs. The availability of financing is imperative for the development, survival and expansion of a company. Given Singapore's current backdrop of economic restructuring to boost productivity, many companies require adequate and sustainable financing to carry out the long-term investments needed to transform their businesses. In particular, SMEs often face difficulties in financing their business needs. They tend to be subjected to higher levels of capital rationing due to the existence of informational asymmetries and risks associated to small businesses. The chapter will examine the issues of moral hazard, adverse selection and credit guarantees in the supply of



financing to SMEs. It will also look at models of sustainable financing for SMEs.

Chapter 5 will examine the human capital and labour aspects of SME needs. The government has moderated the inflow of foreign labour as part of the economic restructuring, and several service sectors especially the hospitality and the food and beverage industries have found it challenging to sustain and expand operations due to a lack of manpower. Schemes and programmes to help companies increase productivity and innovation have been rolled out to encourage SMEs to transform their operations and cope with the reduced inflow of foreign labour, by changing their business models and leveraging on more automation, smart technology and better use of human capital. Compounding the business woes of SMEs is the difficulty in attracting and retaining human talent — that is so critically needed to achieve the mentioned business transformation — because of the public's perception of SMEs as less desirable employers. What could be done to tackle these human capital issues?

Chapter 6 discusses the institutional challenges, including bureaucratic hurdles that SMEs have encountered in their business operations. Several companies of varying business profiles had shared their experiences in a closed-door discussion. Their comparative experiences converge in several areas and offer illuminating insights on the kind of challenges SMEs encounter on a day-to-day basis.

Chapter 7 will conclude by highlighting the key concerns of SMEs surfaced in the various chapters and providing some policy recommendations to address the issues SMEs face in order to promote a flourishing SME sector that would undergird the country's future growth. These points could also be key areas for future research on SME development in Singapore.

## **DEFINITION OF SMALL AND MEDIUM ENTERPRISES**

Before proceeding to the following chapters that discuss the specific challenges SMEs face, it is worth paying some attention to the definition of SMEs, understand the group of companies it comprises, and make sense of the potential implications that could arise from this mode of definition. The statistical definition of SMEs varies across countries, and is usually based on the number of employees, value of turnover or value of assets or a combination of the three measurements. As shown in Figure 1.1, while the set of criteria for defining SMEs is broadly the same across countries, there is a great variation in the limits selected. Countries adopt different combination of criteria and different size quantum based on the local context of political, economic and social conditions.

**FIGURE 1.1: DEFINITION OF SMES IN VARIOUS COUNTRIES**

Country	Category of enterprises	Criteria and country's official definition	Measure
Australia	Manufacturing	Manufacturing enterprises with fewer than 100 employees	Employment
	Medium	< 100 employees	
	Small	< 20 employees	
	Services	Non-manufacturing enterprises with fewer than 50 employees	
China	Manufacturing		Employment and turnover
	Medium	300–1,000 employees and CN¥20–40 million	
	Small	20–299 employees and CN¥3–19.99 million	
	Micro	< 20 employees and < CN¥3 million	
	Wholesale		
	Medium	20–200 employees and CN¥50–400 million	
	Small	5–19 employees and CN¥10–49.99 million	
	Micro	< 5 employees and < CN¥10 million	
	Retail		
	Medium	50–300 employees and CN¥5–200 million	
	Small	10–49 employees and CN¥1–4.99 million	
Micro	< 10 employees and < CN¥4.99 million		
Hong Kong	SME	< 100 employees	Employment
India	Manufacturing		Manufacturing enterprises are
	Medium	≤ Rs100 million	

Country	Category of enterprises	Criteria and country's official definition	Measure
	Small	≤ Rs50 million	defined in terms of investment in plant and machinery
	Micro	≤ Rs2.5 million	
	Services		Service enterprises are defined in terms of investment in equipment
	Medium	≤ Rs50 million	
	Small	≤ Rs20 million	
	Micro	≤ Rs1 million	
Indonesia	SME	< 100 employees	Employment
Japan	Manufacturing	< 300 employees or asset capitalisation < ¥100 million	Employment and asset
	Wholesale	< 50 employees or asset capitalisation < ¥30 million	
	Retailing and Services	< 50 employees or asset capitalisation < ¥10 million	
Malaysia	Manufacturing		Employment of annual sales turnover
	Medium	51–150 employees or RM10–25 million	
	Small	5–50 employees or RM250,000–RM10 million	
	Micro	< 5 employees or < RM250,000	
	Services		
	Medium	20–50 employees or RM 1–RM 5 million	
	Small	5–19 employees or RM20,000–RM10 million	
	Micro	< 5 employees or < RM200,000	





Country	Category of enterprises	Criteria and country's official definition	Measure
Republic of Korea	Manufacturing	< 300 employees	Employment
	Services	< 200 employees	
Singapore	SME	< S\$100 million annual sales turnover	Employment or turnover
		< 200 employees	
Taiwan	Manufacturing, mining, and construction	Invested capital ≤ NT\$80 million or employees < 200	Employment, invested capital or turnover
	Other	Sales revenue ≤ NT\$120 million or employment < 50	
	Micro	Employment < 5	
European Union	Medium	< 250 employees; turnover ≤ €50 million or balance sheet total ≤ €43 million	Employment and turnover or balance sheet total
	Small	< 50 employees; turnover ≤ €10 million or balance sheet total ≤ €10 million	
	Micro	< 10 employees; turnover ≤ €2 million or balance sheet total ≤ €2 million	
United States	Medium	100–499 employees	Employment
	Small	20–99 employees	
	Micro	< 20 employees	
World Bank	SME	≤ 300 employees; turnover ≤ US\$15 million; assets ≤ US\$15 million	Employment, turnover, and asset

Source: *Policy Guidebook for SME Development in Asia and the Pacific* (Abe et al., 2012, p. 14–16)

In Singapore, the MTI unveiled its new criteria for the definition of SMEs in April 2011. Under the criteria, an SME is defined as an enterprise with annual sales turnover of under S\$100 million, or an enterprise that employs less than 200 workers. This new definition supersedes the old definition of an SME as an enterprise with no more than S\$15 million in fixed asset investment and no more than 200 employees. Figure 1.2 shows a comparison between the old and new definition for SMEs.

**FIGURE 1.2: OLD AND NEW DEFINITIONS OF SME IN SINGAPORE**

	<b>Prior SME Definition</b>	<b>SME Definition (with effect from 1 April 2011)</b>
Manufacturing or Non-Parameters Component	Net Fixed Asset Investment (FAI) of not more than S\$15 million (for manufacturing enterprises) <i>and</i> employment size of not more than 200 workers (for non-manufacturing enterprises)	Annual sales turnover of not more than S\$100 million <i>or</i> employment size of not more than 200 workers
Manufacturing or Non-Manufacturing Component	Enterprises are bound by the parameters set within the manufacturing and nonmanufacturing sectors	Enterprises qualify as SMEs as long as they satisfy at least one of the two parameters above, regardless of whether they fall under the manufacturing or non-manufacturing sector

Source: SPRING Singapore (2011)

The new definition for SMEs could be argued as an improvement because companies exist primarily to generate value through sales and not to hold assets. The government's rationale that many manufacturing enterprises were increasingly becoming more asset-light due to changes in capital investment strategy — and hence FAI may no longer be an accurate measure of the size of a company — is also valid. Moreover, many countries use sales revenue and employment size as metrics to define SMEs, so the updated definition would make SMEs in Singapore more comparable internationally. Hence, the change in criteria from asset value to revenue reflects a more accurate and timely portrayal of the state of affairs of in the SME landscape.



In addition to the official definition of SMEs, some government agencies including SPRING Singapore internally further categorise SMEs into three subgroups based on their turnover. SMEs with annual turnover smaller than S\$1 million are classified as micro enterprises. SMEs with turnover between S\$1 million and S\$10 million are classified as small enterprises. The rest of the SMEs with turnover exceeding S\$10 million are classified as medium enterprises.

Notwithstanding the changes, classifying SMEs based on revenue and employment size still leaves some inherent issues unresolved. First, these two criteria do not adequately reflect the social vibrancy of SMEs, which is an integral part of any society. Second, the size limit is rather broad, covering more than 180,000 companies in Singapore as of 2014 (Department of Statistics Singapore, 2014), which results in a very heterogeneous population consisting of businesses of very different profiles facing starkly different business needs and concerns. SMEs are found in all sorts of business activities ranging from neighbourhood mom-and-pop retail shops, local designer lifestyle shops and small advanced engineering companies to medium-sized manufacturers servicing large international companies. They face different cash flows; operate in very different market conditions; embody different levels of skills, capital, sophistication and growth orientation; and may be in the formal or the informal economy (OECD, 2004).

It will be seen in the chapters to come that this classification of SME as a framework for policy design and implementation has significant impact on the effectiveness on SME policy and also affects the discourse of SME development. In short, the current classification of SME does not seem to fulfil the function of categorising businesses effectively.



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## **Chapter 2**

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# Grooming Competitive SMEs



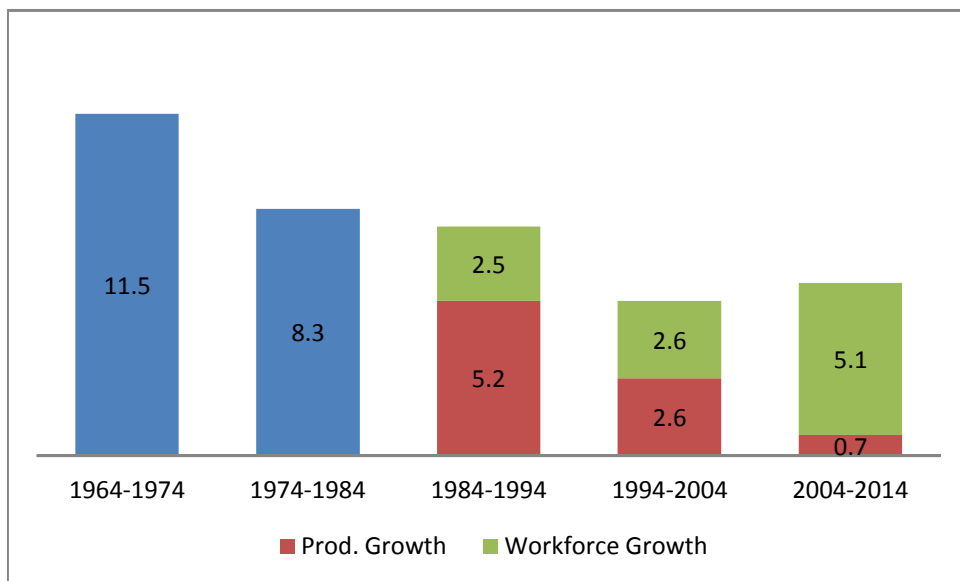
## CHAPTER 2: GROOMING COMPETITIVE SMES

### BACKGROUND

#### **Economic Restructuring in Singapore**

Shortly after the 2008 GFC, followed by a global recession that implicated Singapore, Singapore's Prime Minister Lee Hsien Loong (PM Lee) formed the Economic Strategies Committee (ESC) to study Singapore's economy and develop strategies that would maximise the country's opportunities in a new world environment, by building its capabilities and making the best use of its resources, with the aim of achieving sustained and inclusive growth (MTI, 2011). Led by Finance Minister and Deputy Prime Minister Tharman Shanmugaratnam, the committee consisted of senior members of the public sector, private sector and academia. While the group keenly examined the different aspects of the Singapore economy, it also kept in mind the social needs of the society. On 30 January 2010, the ESC submitted its report to the government, which subsequently accepted the key directions of the ESC recommendations.

The overarching view of the committee was that to ensure that Singapore's future development is sustained and that growth is inclusive, it is necessary to make skills, innovation and productivity the basis for economic growth. Relying on population growth and efficiency to drive the economy could not continue indefinitely, and hence it recommended that the country focus on augmenting the productivity, skills, and innovation of people and businesses in Singapore. It also drew attention to the fact while Singapore's economy grew by more than 5% each year over the last decade, productivity growth in more recent times averaged only about 1% each year. This declining trend was again highlighted in PM Lee's speech at the 2015 Ho Rih Hwa Leadership in Asia Public Lecture Series, where he pointed out that from 2004 to 2014, productivity growth only accounted for 0.7% of the 5.8% annual GDP growth; the rest was achieved through workforce growth (Figure 2.1).

**FIGURE 2.1: GDP GROWTH PER ANNUM, 1964–2014 (%)**

Source: Prime Minister's Office

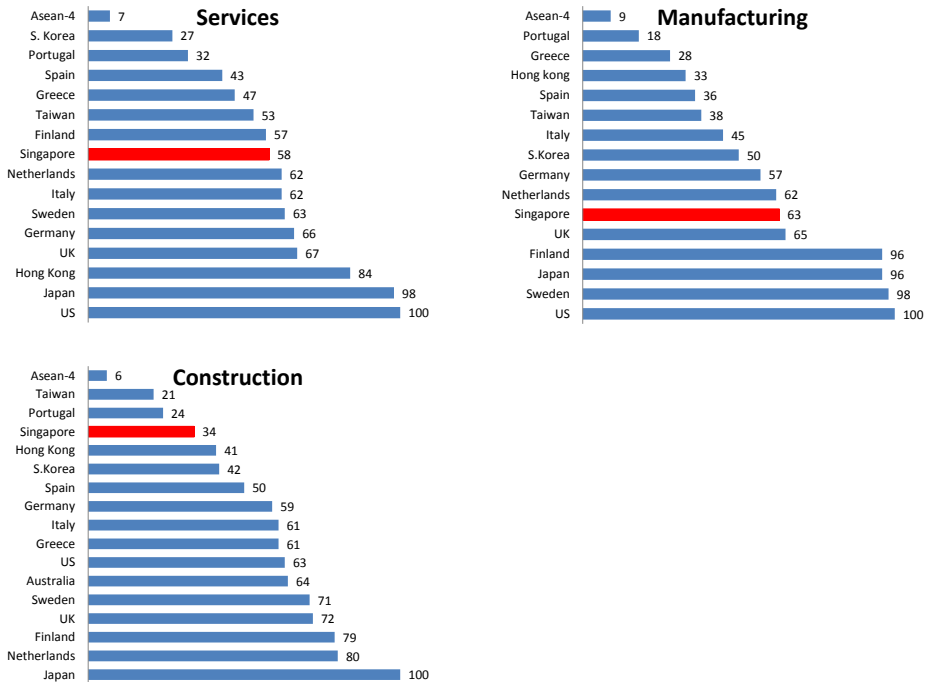
With the current demographic trend of a rapidly ageing population and a need to slow down the inflow of foreigners due to increasingly binding physical and social constraints, annual workforce growth is expected to taper off to 1 to 2% for the rest of the decade (MTI, 2015). As such, the ESC recommended that the long-term productivity growth be increased to 2 to 3% by the next 10 years. This development necessitates a structural reform to the Singapore economy, centring the narrative of the economic restructuring on building up a productivity core. In order to achieve this goal, businesses have been identified as one of the crucial groups of participants. “Restructuring across sectors and across enterprises is as important as improvements and innovation within each enterprise, and within industries,” said DPM Tharman at the ESC press conference.

### **The Need for Business Transformation in Singapore**

Singapore today enjoys one of the highest GDP per capita in the world, but its productivity level lags behind many developed countries including the United States (US), Japan, the United Kingdom (UK) and Germany (Figure 2.2). In particular, the performances of the service and construction sectors are particularly lacklustre compared to other developed economies. The poor productivity levels of Singapore's businesses relative to other developed countries peers are an important reason why productivity growth is identified as the driver for Singapore's future development.



**FIGURE 2.2: RELATIVE PRODUCTIVITY ACROSS COUNTRIES**



Source: *Report of the Economic Strategies Committee (ESC, 2010, p. 4)*

The productivity gap between SMEs and large companies is also huge. In 2014, the average labour productivity of a non-SME at S\$152,250 was twice as high as the labour productivity of an SME (Figure 2.3). The disparity in the manufacturing sector is even greater, with the labour productivity of manufacturing SMEs nearly five times lower than their larger counterparts according to EDB's 2013 manufacturing census data. This stark contrast in performance underscores a reality of putting productivity at the centre of Singapore's economy: Its success is predicated on the ability of the SME sector to make a quantum leap in business transformation; a view subscribed by the ESC too.

The ESC proposed a number of improvements to the local business ecosystem to create a more vibrant SME landscape and to meet a target of doubling the number of local enterprises with turnover of more than S\$100 million to 1,000 by year 2020. Indeed, if the recommended strategies by the ESC are successful in achieving the above goals, this would mean a much more productive SME sector that would not only help bridge the productivity gap across companies and countries, but also result in an

economic paradigm shift from growth driven by workforce expansion to growth undergirded by productivity enhancement.

**Figure 2.3: SMEs and Non-SMEs Comparisons**

	Singapore Economy			Manufacturing Sector		
	Value Add	No. of Employees	Labour Productivity	Value Add	No. of employees	Labour Productivity
SME	S\$168.8 Bil	2.2 Mil	\$76,727	S\$14.3 Bil	243,341	S\$58,765
Non-SME	S\$182.7 Bil	1.2 Mil	\$152,250	S\$45.7 Bil	181,164	S\$252,257

Source: “Singapore economy” (Department of Statistics Singapore, 2015); *Report on the Census of Manufacturing Activities, 2013* (EDB, 2013).

To achieve this leap in productivity, the government decided that it is necessary to help competitive companies seize opportunities and grow much faster than the average company. It is important to provide them with sufficient room to grow and with manpower and land. At the same time, with a slowdown in workforce growth and a moderation in GDP growth to 3 to 5% per annum, less efficient industries and enterprises would either have to upgrade or fail. In other words the more efficient and more dynamic industries would be supported so that they can grow faster (Ministry of Finance, 2010).

Singapore-based companies that could seize emerging business opportunities and leverage the support provided by the government could potentially become globally competitive companies (GCCs). By supporting local companies that exhibit high potential and helping them become GCCs, Singapore could gain its own group of multinational corporations, which would be similar to the growing numbers of emerging market multinationals (EMMs) of rapidly developing mega economies like China and India.

### **The Rise of Emerging Market Multinationals**

For a long time, conventional international business theories dictated that companies internationalising would have to go through the linear stages of first establishing itself in the home market and then exporting their products to overseas markets through foreign distributors before investing directly in major overseas markets to be close to their consumers. This process of incremental internationalisation often took several decades to happen.

Since the 1980s, changes in and the commoditisation of information and communication technologies have allowed new business models underpinned by outsourcing and distributed production networks to



emerge. Companies internationalise not only to capture overseas markets but also to help lower production costs and to seek resources, giving rise to the phenomenon of the global supply chain that is a common strategy today for companies with an international footprint.

More importantly, as MNCs spread their wings around the world, their activities have not only brought capital and technology to the emerging economies but also facilitated the diffusion of management knowhow and best practices to the bright-eyed local managers in these countries. As indigenous companies in these developing countries accumulate more capital and move up the learning curves, they begin to strike out on their own to compete with the MNCs first in the home markets and now increasingly in the global markets. A study by Accenture pointed out that even though multinationals are a defining invention of western economies, rapidly growing emerging economies are beginning to produce business giants of their own at a staggering rate (Nunes & Purdy, 2008).

The number of companies from emerging economies in the 2007 Fortune Global 500 list had increased from 20 in 1995 to 70 in 2008 and 130 by 2013. According to a projection by McKinsey Global Institute, that number will go up from the current 26% to 45% or 230 by 2025 (Dobbs et al., 2013). Currently, three quarters of the world's 8,000 companies with at least US\$1 billion annual revenue are based in developed economies. The authors estimated that another 7,000 would join that rank within a decade, and 70% of those would come from emerging markets where demand for consumer goods and services would be driven by a rising trend of urbanisation and income growth.

Today, EMMs<sup>1</sup> like Samsung, LG, Hyundai, China Mobile, Huawei, Lenovo, Alibaba, Tencent, Haier, Sany, Reliance, Tata and many more from Korea, China, India and Brazil are well-known trailblazers that make good case studies on business models and international competition.

Another remarkable trend is that more Asia-based companies are making the list. In 2012, the number of North America-based companies fell to 132 from 197 a decade ago. During the same period, the share of Europe-based companies increased marginally from 158 to 160, whereas Asia-based companies increased rapidly from 116 to 188. Among the top 10 countries with the most entrants in the 2013 list were three Asian countries.

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<sup>1</sup> The International Monetary Fund includes all “newly industrialized Asian economies” and “other emerging market and developing countries” as emerging markets.



China had the most with 89, followed by Japan's 62 and Korea's 14 ("Fortune Global 500", 2013).

The "growing up" stories of these EMMs are quite different from those of the MNCs. Some ride on the MNCs first as contract manufacturers or joint venture partners but as they move up the learning curve, they also move up the value chain into higher value-add activities by conducting research and development (R&D) and building products with their own branding. After capturing a foothold and building scale in the domestic market, many have expanded outwards. Other EMMs could be indigenous companies that are competing with MNCs within the domestic market. As they mature, they also begin to move up the value-add ladder and compete in the regional and global markets using their own brands. Finally, there are also state-owned enterprises or government-linked companies (GLCs) that enjoy monopolistic power within their domestic market and are earmarked to be groomed into national champions. Many are resource-based companies. Now, with financial support from the government, they are expanding their footprint rapidly in the global market. Of the 70 EMMs in the Fortune Global 500 in 2008, for example, about 20% were state-owned.

By internationalising their operations, EMMs are able to access new markets, achieve efficiency gains from restructuring its production chain to optimally tap on resources which include among others human capital and raw material, and expand their potential by building on existing competitive advantages to move up the value chain. While it is easier for large companies to expand globally because of their extensive pool of resources, SMEs traditionally struggle due to significant investment needed to scale and export. However, the rapid advancement of information and communication technology (ICT) is reshaping the international business environment, lowering the entry barrier to markets so that SMEs have a better chance at internationalising successfully (EIU, 2014).

### **Factors Contributing to the Rise of Emerging Market Multinationals**

The rise of the EMMs has been facilitated by several favourable changes in both the domestic and the external environments.

First, the domestic reforms and economic liberalisation in many emerging economies have helped to jumpstart entrepreneurial development within those countries. The rise of Chinese EMMs, for example, would not have been possible if not for the reforms and opening up measures initiated by Deng Xiaoping in 1978. Similar reforms to embrace a more market-based



economic system were seen in India, Russia and Eastern Europe. The explosion in long suppressed demand and the huge domestic market size in these economies allow local enterprises to grow rapidly to an optimal scale. At the same time, efforts on regional integration as well as multilateral economic liberalisation at the international level allow EMMs easy entry to neighbouring or regional markets and to the wider global economy.

Besides liberalising the economy to move towards a more market-based system, the governments in these emerging economies also play a very important role in catalysing growth by mapping out industrial policies, developing infrastructure needed for economic development, and educating and training a workforce that can help drive economic development.

Next, globalisation has also stimulated the flow of not only goods and services but of capital, labour and technology as well. As foreign direct investments poured in to take advantage of the lower costs, EMMs gained access to production technology, capital and managerial know-how. Competition with MNCs from developed economies in the EMMs home market also helped to hone the capabilities of EMMs and prepare them for challenges in overseas markets.

Finally, many of these emerging economies enjoy large surpluses and high saving rates. These help to improve liquidity for EMMs, without the latter having to borrow foreign currencies at high interest rates overseas. After the 1997 Asian Financial Crisis (AFC), in particular, governments in emerging markets began building up financial reserves and introducing more prudent corporate governance structures and practices. The improvements arising from EMMs' financial rectitude and their more prudent management practices enabled them to survive the 2008 GFC relatively unscathed. Their financial health also allowed them to go on a shopping spree in the aftermath of the crisis, buying up highly prized but debt-ridden foreign enterprises priced at a fraction of the usual market value. In fact, merger and acquisition (M&A) activities on foreign soil had begun long before the advent of the GFC. In 2006 alone, EMMs conducted US\$122.9 billion worth of M&A deals (Nunes & Purdy, 2008).

Many popular brands once owned by western MNCs are now owned by EMMs. India's Tata Group bought Tetley, a famous beverage manufacturer in 2000 and Jaguar Land Rover in 2008. MG Rover has been bought over by Nanjing Automobile in 2006, while China's Geely Automobile bought Volvo in 2010. After acquiring the PC brand Thinkpad from IBM in 2005, China's Lenovo acquired Motorola's handset business from Google in

2014. Dalian Wanda, a Chinese diversified conglomerate with total assets of more than US\$85 billion, acquired the American movie theatre chain AMC Entertainment in 2012. Hot on the acquisition trail, Chinese companies are also buying up German Mittelstand companies known to be hidden global champions in their respective fields of business.

By acquiring these well-established foreign enterprises, EMMs not only broaden their customer base in foreign markets and realise complementary business synergies, more importantly they also gain access to highly valued patents and technological know-how that can help them stand up to foreign competition and expand their production capabilities. At the same time, EMMs also leverage the newly acquired premium brand to bolster their competitive position in home market.

There is no doubt that in many fields, MNCs still command a convincing lead over EMMs, which are lagging far behind in terms of innovation and technology. However, EMMs have been able to stand their ground against the more established MNCs by leveraging their strengths while working hard to beef up other competitive advantages. They are constantly improving their efficiencies, building up their innovative capabilities, seeking new sources of inputs, and searching for new markets.

### **Singapore's Need for Globally Competitive Companies**

To understand the government's case for promoting internationalisation and supporting local companies to nurture GCCs, it is useful to understand the history of Singapore's economic development.

Even though Japan, Korea, Taiwan, China and Singapore practise what is broadly termed as state capitalism, their paths taken and resulting outcomes differ quite fundamentally. Newly industrialised economies (NIEs) such as Korea and Taiwan, for example, began developing their indigenous industrial capacity and capabilities for export-led growth right from the start instead of depending overly on foreign MNCs. Emerging economies such as India, China and Brazil, on the other hand, adopted import-substitution or autarkic policies that entailed shielding their indigenous industries from foreign competition. The protection provided time and space for the emergence of an indigenous industrial infrastructure. Even though many of these local enterprises were unproductive and unprofitable in the past because of disincentive issues and bureaucratic oversights, the inertia to growth was gradually overcome in recent decades with their governments liberating and reforming the economies and subjecting these local enterprises to foreign competition. No doubt, too, the large size of the domestic markets of these countries



also played an important role in enabling success in the import-substitution strategy for some industries.

In contrast, Singapore's export-led developmental model was underpinned right from the beginning by MNCs providing capital, technology, managerial know-how and access to overseas markets. Local participation in economic development, on the other hand, was spearheaded by GLCs whose priorities were the provision of critical services such as utilities, telecommunications, ports, and other infrastructure developments to make Singapore an excellent place for doing business especially for the MNCs. Finally, the third component of Singapore's model is the private sector comprising of mostly SMEs and relatively fewer big companies with revenues exceeding S\$100 million. SMEs were positioned to act mainly as subcontractors and main suppliers to the MNCs, providing them the essential ancillary services.

Overall, this unique model of economic development has served Singapore exceedingly well for the decades following the city-state's independence from the British and its separation from Malaysia. With the help of the MNCs, Singapore economic structure underwent incessant upgrading, moving from being labour-intensive to capital-intensive and then knowledge-based and now innovation-driven. In 1970s, the precision engineering industry was targeted. This was followed by electronics and computer-related industries as well as the chemical industry in the 1980s, and the life sciences in the 1990s.

The increase in value-add from the numerous economic restructuring has helped raise Singapore's GDP per capita and foreign reserves, to become among the highest in the world. However, the overdependence on MNCs for both capital and technology also means that when they uproot and relocate from Singapore, the affected industrial sectors and the skills of the workers would become obsolete overnight.

Singapore has so far avoided the problem of deindustrialisation by attracting more foreign investments in other new sectors, but if the dislocated workers including professionals, managers, executives and technicians (PMETs) are not able to pick up the new skills needed for redeployment, this would lead to rising structural unemployment on one hand and the influx and growing dependence on foreign talent with the right skills and exposure needed for those new sectors on the other. The Economic Development Board (EDB), for example, reported that 21,400 new skilled jobs were created in 2013 from projects it had brought in, led by gains in headquarter location and professional services. However, these new jobs are more likely to benefit not the older unemployed PMETs but

younger Singaporeans and foreign talent with the right skills and global exposures. According to the Ministry of Manpower, 57% of Singaporeans and permanent residents who lose their jobs find a job within six months. For PMETs, this proportion was lower at 49%.

The structural changes in the job market and the capriciousness of MNC business strategy underline an urgent need for a shift from a managed economy, where MNCs and, to a lesser extent, GLCs are the main drivers and capital and labour are the critical success factors, to one that places more emphasis on local companies.

Unfortunately, local companies are still not in a position to take on part of the mantle from the MNCs. Since many past economic policy measures were geared towards meeting the needs of the MNCs and the GLCs, which were groomed to become world-class companies, SMEs were neglected until recently and are therefore at present not in a position to play a significant role in innovation and productivity growth (OECD, 2013).

Through the impetus, which has been mostly from the government, significant progress has been made in promoting the growth of SMEs in recent years. However, the emergence of thousands of new business giants is likely to herald increased competition for not only markets but also resources and talent. In time, it will therefore be increasingly difficult for SMEs to become a champion or to expand overseas without any form of substantive government support.

Chinese companies, for example, have begun to move up the value chain and to expand aggressively across the border, pushed by rising wages at home. Already, Japanese and South Korean firms are wary of the Chinese threats to their high-tech manufacturing industry. Likewise, Singapore will see more competition from Chinese EMMs moving into higher value-add sectors and niches where Singapore companies currently have a competitive edge.

At the same time, given the dominant role of Singapore's state sector, the question remains whether an entrepreneurial economy can thrive within, or at least co-exist with a predominantly managed economy during this transitional phase, so that Singapore can eventually produce its own EMMs or hidden champions.

### **Developing Singapore's External Economic Wing**

Given Singapore's small domestic market, it is also important that SMEs have the ability to recognise and seize opportunities in overseas markets. A recent study by McKinsey found that Singapore SMEs, with their limited



market size, needed to go overseas at a much earlier stage of development, compared with those of other countries (Vinayak et al., 2014). Many SMEs have useful technologies and capabilities that could enable them to continue operating profitably in a country where such costs are lower, whereas their chances of success could be lower if they remained only in Singapore, due to the high local business costs.

There are already efforts by public agencies, such as IE Singapore, to encourage and help Singapore companies expand overseas. However, in terms of priority and resources allocated by the government, this ranks lower than the present dominant strategy of attracting foreign direct investments into Singapore. Hence, a strategic shift of this nature would require a change in mindset, institutions and skills. Mistakes will be made, and the risks will be greater in the short to medium term — but the greater long-term risk is in staying with a strategy that has been largely unchanged for nearly half a century (Teh, 2014).

In some circles, the idea of Singapore creating an external economic wing is already inevitable because some analysts stress that Singapore SMEs have to be “born global” if they are to survive and expand their respective businesses in a highly competitive global environment. What would this entail? Singapore SMEs have to create products or services that are and could be utilised globally. For example, SMEs need to undertake feasibility studies for new markets overseas. One of the schemes that the government has rolled out to help SMEs expand overseas is the Market Readiness Assistance (MRA) Grant that is managed by IE Singapore. In this regard, SMEs surveying potentially lucrative markets overseas can tap the grant to get advice from pre-approved consultants on areas such as market assessment, market entry and business restructuring through internationalisation (Careem, 2013). However, more assistance is required especially in the area of navigating complex Free Trade Agreement (FTA) rules to which Singapore is a signatory, such as with the European Union (EU). SMEs have to understand the country’s political environment as well as the rules and regulations of operating their overseas ventures.

### **Singapore Government Strategy to Nurture Globally Competitive Companies**

With MNCs having more options today in where to locate their operations, Singapore’s future well-being depends increasingly more on forging a more entrepreneurial economy where the domestic private sector play at least an equally important role as the MNCs. To develop corporate giants that can stand up to competition from foreign EMMs, Singapore needs both innovative and internationally competitive indigenous enterprises.

But how should government go about nurturing Singapore companies that are globally competitive? What approach should they employ to achieve the targets that they have set for the country? The government can choose to either intervene passively by making available support — be it financing, advisory or any other forms of help from the state to all companies. Or it could take a more active interventionist approach to achieve the envisioned economic outcome by, for example, identifying companies that seem to exhibit the most potential to become globally competitive, and implementing industry- or sector-specific government support measures so that national resources are channelled to the companies and sectors identified as the most promising or most important to the country's future economy, instead of looking at the 180,000 or so SMEs in Singapore.

Such an approach would sharpen the focus of working towards the ESC recommended target of 1,000 GCCs by 2020. Numerous parties have pointed out that instead of trying to increase the number of SMEs blindly to support job creation, it may be better for Singapore, which is facing increasing binding resource constraints, to nurture more local companies that can compete more effectively against companies from other economies, such as in Germany, Japan and Taiwan. While this is hardly a new proposition, the intensifying competition from SMEs in emerging regional economies does point to the urgent need to re-examine how the competitiveness of local SMEs, especially those in the tradable sector, could be enhanced. However, such a “cherry-picking” strategy risks regulatory capture and market distortion, and therefore stands in contrast with the government's current approach of broad-based support measures instead of favouring specific companies.

It is in this regard that IPS held a CDD on 4 November 2013 to discuss the issue of conceiving an optimal strategy to support SMEs and enable the development of globally competitive companies that would shift some of Singapore's economic reliance on MNCs to the population of indigenous companies.



## **IPS CLOSED-DOOR DISCUSSION ON GROOMING COMPETITIVE SMES: TIME FOR CHERRY-PICKING?**

On 4 November 2013, IPS held a CDD to discuss the approach that the government should take to nurture competitive SMEs and achieve the 1,000 GCCs by 2020 target recommended by the ESC. Some quarters of society had advocated focusing national resources on high-potential enterprises to enable their growth rather than covering the entire spectrum of SMEs. However, this “cherry-picking” strategy risks regulatory capture and market distortions, and therefore stands in contrast with the government’s current approach of providing broad-based support that does not actively favour any specific companies.

### **Singapore’s Economic Development**

During the discussion, one participant said that Singapore built its economy on trade, which accounted for 2.2% of global trade. He added that the focus on innovation-based industries — moving from technology adoption to technology shaping — was timely. This, coupled with the market sensing approach adopted by policymakers, had resulted in the high level of growth experienced by Singapore’s economy over the past few decades.

Another participant argued that Singapore had pursued a “growth at all cost” policy over the past few years, which in the process stymied productivity growth. This growth strategy relied on cheap factor inputs like low-skilled foreign labour and an overly relaxed investment environment to drive economic growth. The relaxed investment environment, encouraged by government policy, coupled with a glut in global credit liquidity, pushed up the prices of real estate significantly, he said. Companies, squeezed on every other front of business costs, especially on real estate cost, depended on the access to cheap labour to sustain their businesses. But with the government tightening the foreign manpower supply, companies are now confronted with a new business challenge: Manpower cost is increasing, and in addition many SMEs are facing difficulty retaining and attracting talent. The high cost of business operation threatens to push companies out of Singapore, with a significant number of companies already investing in Iskandar’s industrial real estate in Malaysia, said the participant. But even in Iskandar, companies are expected to face the same labour crunch problem (Singh, 2013).

It was also pointed out that the industries and sectors in Singapore were highly differentiated, and problems faced by SMEs could not be easily addressed through government intervention. In terms of SME growth and



development, there was a large body of work and research undertaken and supported by many different stakeholders and government agencies. However, when it came to evaluating the extent of SME development in Singapore, there was a lack of suitable benchmark metric that could be used for Singapore's unique economy.

### **Rising Business Costs Confronting SMEs**

Companies, especially SMEs, were very much affected by the rising cost of real estate, said one participant. Many SMEs rented their business space because very few could afford to purchase their own property for their business operations. Over the past two years, industrial land prices had jumped by 60% while industrial rent had risen by 30%. As a result, SMEs found themselves in a situation with increasingly limited options for affordable space. Ever since JTC executed its industrial real estate divestment strategy, its market share of multi-user industrial space had shrunk from 18% in 2008 to 3.5% in 2013. In contrast, large institutional private investors like REITs had expanded their market share and regularly increased rentals to maximise their returns. Private developers strategically designed and built more premier industrial spaces to increase their investment returns too. The consequent effect for SMEs was that those that did not own their own business property space faced rapidly increasing rental prices. The participant felt that it was important for JTC to assume a greater role in the industrial real estate segment again to control the pace of rental price increase so that companies operating in Singapore could be competitive against companies operating in other countries like Taiwan or Korea. The government should also introduce measures to thwart speculation in the industrial real estate market because an industrial real estate bubble has a very direct impact on the real economy.

Another participant said that the current economic restructuring was necessary to ensure that sustainable growth for the future. However, he felt that the pace of the productivity drive was too fast, especially when one considered that it is 10 to 20 years of productivity underperformance that the economy is trying to tackle and close the gap on. While it was necessary to moderate the growth of foreign manpower, the inflow should not be reduced too quickly as companies could not realistically restructure their businesses that fast. He suggested that the government adopt a more gradual approach instead, allowing a period of one to two years of low productivity while companies restructure their businesses before the productivity gains begin to materialise. During this period, it is important that ample government support be provided to companies especially SMEs, he said.



## Using Cherry-Picking as a National Strategy

### ***Failures of past attempts to cherry-pick companies***

One participant argued that outright cherry-picking winning SMEs would not work. Pointing to the Promising Local Enterprise (PLE) Programme introduced in 1995 as an example, he said that picking winners was an idea that failed in the past because Singapore did not know how to identify high-potential SMEs. Led by EDB, the programme targeted to produce 100 PLEs with at least S\$100 million sales turnover by 2005. In 1999, a 3C approach comprising of co-investment, collaboration and consolidation was announced to further intensify the PLE programme. But ultimately the PLE programme did not succeed in meeting its target. The participant also pointed out that the World Class Companies Programme, launched in 2000, also failed to meet its target of creating 50 local knowledge-based companies that offer world-class products, services or capabilities by 2010. He questioned how cherry-picking would capture companies with the likes of Breadtalk or even Ya Kun Kaya Toast, which took over 50 years to build their brands and convert from a single outlet to a regional franchise empire.

Nonetheless, the government had done well in its support that does not cherry-pick companies, said the participant. The Startup Enterprise Development Scheme (SEEDs), micro-loan scheme and Local Enterprise Finance Scheme (LEFS) were examples of broad-based schemes that were very effective in helping companies and had delivered some positive outcomes.

### ***Difficulty of cherry-picking successfully***

One participant highlighted that even if the government were to adopt a cherry-picking approach, the approach would be undermined by the nature of the public sector. He explained that given the limited industry knowledge of public servants and the way their performances are evaluated, they would probably channel most resources to larger companies that were already enjoying some level of financial success instead of taking risks with companies that did not have a track record.

Some participants felt that perhaps the government should be looking at encouraging SMEs instead of directing them or cherry-picking them to develop. They argued that a cherry-picking approach would stifle the entrepreneurship culture. A number of participants, especially those from the private sector, called for more broad-based support to give SMEs a shot at growing their business. However, other participants saw the value of more targeted government support for companies although they too were not in favour of outright cherry-picking companies to nurture.

***Combining broad-based support and cherry-picking***

One participant suggested a combination of broad-based support and cherry-picking depending on the stage of company development. He identified three company development stages that would require different sets of support — the incubation stage, the growth stage, and the MNC stage.

During the incubation stage, affordable rentals, access to skilled manpower and financing support are very important. There should be more broad-based government support for companies in the incubation stage. The second stage requires companies to have the ability to grow through productivity and innovation. At this stage, as greater and more customised government support is required, it may be appropriate to narrow down and select clusters (i.e., cherry-pick) that can develop into larger companies. In the third stage, when companies strive to become globally competitive companies, international support and financing support are crucial to help them establish themselves in the overseas markets. The government should not cherry-pick companies at this stage, and instead provide support that can be accessed by any companies that is attempting to venture overseas. This would include newly formed companies that are born global.

Another participant said that he was against cherry-picking companies and instead supported an approach that identifies the various growth stages of companies, and from there provide the help needed. He firmly believed that through policymaking, the government had the ability to foster an even playing field that would benefit any company driven by innovation. However he realised — through his study trips to other countries — that SME policy formation in Singapore was not as sophisticated as other developed countries like the UK and Japan, where the SME sector contributed significantly to value-add and innovative activities. This is an area where policymakers in Singapore had to pay more attention, he said.

***Cherry-picking in the form of industry targeting prevented Singapore from developing deep knowledge***

One participant said that Singapore had a disjointed industrial development strategy whereby the government shifted attention from one industry to another very quickly. For example, industrial development was first focused on semiconductor manufacturing, followed by hard disk production before eventually shifting to wafer fabrication. By changing the focus of industrial development so often, the knowledge that could have created more productive industries and companies was not accumulated, he said. In Taiwan, the semiconductor industry continues to be successful and is at



the frontier of innovation precisely because it has retained technical knowledge and built on it to move up the value-chain. Singapore has never been able to reach that level of specialisation because the government's focus is too short-term, resulting in resources that were constantly diverted to newly identified industries. Chipping in, another participant pointed out the way the government selected and favoured the development of certain industries could be considered as a form of cherry-picking.

### ***Grooming element missing from cherry-picking***

Cherry-picking involves selecting companies and industries and grooming them so that they grow and become competitive. Several participants expressed that the grooming component, which they felt was important for all companies, was lacking. They identified a lack of coordinated effort between government agencies as the reason for the poor grooming support. One participant said that part of the problem was also due to the way policy programmes were evaluated by the public sector, which commonly relied on tangible yardsticks like expected return on investment capital. However, in most instances, the value is intangible and there is a lack of instruments to accurately quantify that value. The same applied for SME support. Effective programmes require public officers to have a deep understanding of the business ecosystem and also to accept some level of risk due to uncertainty.

### ***Are MNCs cherry-picked over SMEs?***

More than one participant felt that the government are cherry-picking MNCs over SMEs. One participant claimed that many government policies and programmes are skewed towards MNCs. In order to attract MNCs to operate in Singapore, MNCs are given an abundance of government support which includes tax incentives among other subsidies. Support for SMEs is notably smaller perhaps because they mainly provide services to support the operations of MNCs, the participant said. Another participant shared his own experience of this treatment disparity, whereby the MNC he worked for received a larger sum of government grant for R&D than the SME he later established, notwithstanding that both companies conducted similar R&D work.

However, a number of participants pointed out that there are government schemes that are exclusive to SMEs. These include the micro-loan programme, capability development grant and local enterprise finance scheme. Nonetheless, they acknowledged that many SMEs lack the scale to reap the productivity enhancement from investments — hence it was important to provide SMEs with some help to reduce the uneven playing field. Otherwise, many SMEs would not even be able to survive, much less grow and become globally competitive.

Participants also pointed out that in Singapore the large companies, mostly MNCs, tend to dominate the economy. This could have resulted in economic policies that tilt in their favour. However, in order to nurture more competitive SMEs so that the SME sector plays a larger role in the economy, the current market rules and economic policies have to be reviewed.

Nonetheless, participants, including those from the business community, recognised that the SME initiatives and policies introduced by the government are well intended. It was also agreed that companies in Singapore received much more government support than many other countries, which could have cultivated a sense of entitlement in companies, and reduced the overall level of competitiveness of the SME sector.

### **Importance of Business Diversity to the Economy**

One participant said that it is important to have a spectrum of high value-add and low-add industries in an economy, for entrepreneurship to flourish. An overly heavy-handed development strategy by the government, whereby it cherry-picks industries and companies to develop and support, would risk institutionalising the entrepreneurial space. As diversity and vibrancy are siphoned from the entrepreneurial space, Singapore could end up with a less nimble economy, he said. The participant pointed to Singapore's real estate market as an example. He said that over the last 15 years, the real estate had consolidated to be dominated by a few large players, many of them private institutions. This was unlike other countries, where a whole range of participants comprising institutional land owners, single land owners and small land owners exist. He believed that it was this market diversity that enabled the property markets of neighbouring countries to recover much faster than Singapore after the 1997 AFC.

### **Job Creation and Performance as Goals of SME Policy**

Responding to a question on the diversity of SMEs and which areas SME policy should focus on, one participant said that like in other countries, 90 to 95% of the SMEs in Singapore were micro enterprises (based on the size of employees). However, the variability among SMEs in terms of sector, growth orientation and other company characteristics was great. While SME policies in many countries focused on job creation, this should not be the case in Singapore given the tight labour conditions. Instead, SME policy in Singapore should focus on boosting the performance and potential of SMEs. The difficulty though was to have an SME policy that provided equal opportunities to all SMEs because of the heterogeneity of the SME sector, he said.



Another participant agreed that in Singapore the area of concern was not so much about job creation but about improving performance in terms of productivity. He said that while SMEs in Singapore hired up to 70% of the total workforce, their productivity was very low. On the policy administration, he felt that many administering public officers lacked the domain expertise that was required to identify a problem, separate it into individual components, and analyse it properly. As a result, while many initiatives have been introduced to help SMEs, very few programmes were truly effective or lasted long.

The view that job creation was not so important for Singapore's case was challenged by one participant. He argued that the low unemployment rate in Singapore belied the fact that a significant proportion of the workforce was employed in low-quality jobs. He said that productivity should not be viewed separately from job creation. Uplifting productivity without improving the quality of jobs created would result in growth that is not evenly distributed across society. Hence, it was important to view job creation and performance as interrelated variables of the same equation.

### **A Comprehensive Growth Strategy for the SME Sector**

On Singapore's growth strategy for SMEs, one participant highlighted that the aspiration of doubling the number of Singapore companies with turnover of S\$100 million from 500 to 1,000 by 2020 was an immensely difficult task and questioned how realistic that target was. He said that even in the US — after scaling its economy to Singapore's GDP — fewer than 10 companies break the US\$100 million turnover mark each year. In order to meet the target recommended by the ESC, an average of 50 new companies have to generate more than S\$100 million of turnover each year. In order to even have a chance of achieving such a high rate of business growth, favourable business environment and support were necessary, he said. However, over the past few years, SMEs in Singapore faced several issues that obstructed their growth and expansion. These issues included high labour cost; slowing sales growth; increasing competition from overseas companies; and an uncertain global economy.

Three key areas were identified by the participant to help ratchet up the pace of SME development in Singapore, to close the current gap from the 1,000 GCCs target.

- Identify and target the most promising international micro-markets: Instead of focusing only on developed markets and the region, Singapore could identify and target international micro-markets that show most promise. On average, two-thirds of a company's growth

comes from “where it is playing”, while only 4% comes from “how to play” or market share. The rest of the 30% comes from M&A.

It was also noted that today’s countries or cities where the “playing” is happening might not be the most promising place for tomorrow’s growth. About 230 emerging markets projected to be middleweight cities by 2025 did not even make it into today’s top 600. Therefore, focusing on the markets that were already developed might not be a very good strategy.

- Move up the technology S-curve from adaptor to creator: In terms of technology development, there is a need to move up from being an adaptor to be a creator. The current technology policies and investment focus in Singapore are in the right direction.

However, a cultural shift in Singapore’s society is needed, such that entrepreneurs would share more and become more willing to help other young and upcoming entrepreneurs. In the Silicon Valley, there is a thriving culture of the pay-it-forward concept. But this culture does not happen overnight. It has to be nurtured slowly, starting from a tender age.

In addition, more focus on smart industry collaborations would enable and accelerate the adoption of innovation and technology in different industries.

- Support competitive SMEs in a systemic but inclusive way: Companies have divergent growth paths. A startup could end up exiting early, become a small owner business (through the lifestyle choice of owner), achieve moderate growth or develop into a highly competitive company. And even within these growth trajectories the needs of individual companies vary greatly. In addition, only around 5% of companies in each cohort of SMEs would become competitive. Hence, to aid SMEs effectively, a systemic approach towards government support should be taken. Figure 2.4 shows the changes that should be made to the approach currently taken.



**FIGURE 2.4: SUGGESTIONS TO APPROACH IN SUPPORTING SMES**

	<i>From...</i>	<i>To...</i>
Policy Goals	<ul style="list-style-type: none"> <li>• Increase number of companies</li> </ul>	<ul style="list-style-type: none"> <li>• Enable high potential companies to grow</li> </ul>
Policy themes	<ul style="list-style-type: none"> <li>• Business planning, productivity tech adoption and broad internationalisation</li> </ul>	<ul style="list-style-type: none"> <li>• Management capacity building</li> <li>• Internationalisation (“micromarket”)</li> <li>• Innovation (“creator”)</li> </ul>
Policy Process	<ul style="list-style-type: none"> <li>• Broad themes, each of which ends up supporting a few promising companies (note: selection and resource prioritisation happens but they done on an ad-hoc basis)</li> </ul>	<ul style="list-style-type: none"> <li>• Define ~ 500-1,000 competitive SMEs</li> <li>• Understand special needs, design policy/initiatives</li> <li>• Track progress</li> <li>• Measure and give feedback on effectiveness of government programmes based on companies’ performance</li> </ul>

Source: IPS CDD on “Grooming Competitive SMEs: Time for Cherry-Picking?”

According to the same participant, a competitive SME approach would dynamically nurture SMEs with good performance through a system of good governance with proper checks and balances. It would also help to scale up successes and shut down failures in a nimble fashion. However, the functioning of this system entails good leadership from both the private sector and public sector that flexibly employ multiple tools to create a market with healthy competition.

### Agency for SME Development

One participant suggested the creation of a single agency that combines the functions of IE Singapore and SPRING Singapore to better support SME development in Singapore. He said that the officers in this agency would be like industrial account managers, providing SMEs dedicated support that cut across different levels from broad-based to targeted forms. This structure would also help the single agency build domain expertise to identify emerging companies, and grant it the capabilities to customise support better based on the needs of companies. While he acknowledged that the government may not have the resources to form such an agency overnight, he felt that as a start, SPRING should at least get a more equitable amount of resources as compared with EDB so that it can perform its duties better. Other participants felt that a rebalancing of resources between EDB, SPRING and IE Singapore was required for the government to be more successful in developing the SME sector.

Another participant added that the SME knowledge and support capabilities built up within the government were fragmented across several



agencies. Creating a single agency with the resources, manpower and mandate to oversee SME development would help institutionalise and accelerate the build-up of that knowledge. Such an agency would also be able to leverage the synergies created to develop a more holistic understanding of the SME sector. It would also reduce bureaucratic inertia and inter-agency coordination problems, thereby improving the efficiency of government efforts to support SMEs. One participant also expressed that it was a bit ironic that there was so much help available to MNCs in Singapore compared to SMEs, when in reality MNCs were more equipped internally than SMEs.

Several participants also questioned the commitment level of the government to support SME development in Singapore. In other Asian countries like Japan and Korea there was a heavy commitment to support their SMEs and it was reflected in the number of public officers and agencies formed to tackle SME-related issues. Compared with these countries, the scale of public resources devoted to the SME sector in Singapore was much smaller. In addition, some of the duties were outsourced to private consulting companies, but their performance was not evaluated properly or tracked regularly, one participant said.

However, others at the discussion observed that the government seemed to be increasingly aware of the need to provide better support to SMEs. A lot of effort had been made in the past few years to provide substantial support to help SMEs grow and internationalise. The government is also working very hard to develop a deeper understanding of the SME sector and comprehend the various factors affecting growth and company decisions.

Another participant said that the government could allocate more public sector procurement opportunities to SMEs as a strategy to groom them to become more competitive. The US passed the Small Business Act, setting a government-wide goal of allocating at least 23% of government procurement contracts to small businesses. Elsewhere, Korea, Taiwan and the Philippines also have policies in place to improve government procurement from SMEs, he said.

### **Lack of Support for Born-Global Companies**

There are a growing number of new companies whose business models are based on serving the global market from day one. One participant pointed out that while substantial government support — in particular support for internationalisation and financing — was important for these companies, there was no government agency to oversee their needs.



Neither IE Singapore nor SPRING was tasked to provide holistic government support to these born-global companies, he argued.

### **Negotiate FTAs that Benefit SME Development**

Participants also highlighted that it was important that Singapore's trade agreements with other countries support the needs of SMEs. One participant pointed out that many existing FTAs benefited MNCs operating in Singapore, but very few components could help SMEs internationalise and acquire the kind of scale required to be globally competitive. This was an area where policymakers should pay closer attention.

### **More M&A Incentives and Support for SMEs**

The push for stronger M&A support was also identified as an important factor to help SMEs gain critical size to enjoy economies of scale, and to free up market resources by consolidating industries that were too fragmented. Moreover, as pointed out by one participant, M&A offered small family businesses — with significant value in terms of existing business operations and internal knowledge but no viable successors — a way out besides shutting their businesses.

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## **Chapter 3**

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# Business Costs and Rent



## CHAPTER 3: BUSINESS COSTS AND RENT

### BACKGROUND

Cost containment is a major issue for Singapore businesses and consumers. According to the Singapore Business Federation's *National Business 2011/2012 Survey*, increasing cost pressures in labour, materials and rent were cited as major challenges for businesses. The EDB *Annual Census of Manufacturing Activities* also reported that growth in total business costs in manufacturing from 2002 to 2013 had averaged 7.56% year-on-year, while growth in materials costs had averaged 7.77%, and growth in remuneration costs had averaged 4.76% over the same period.

SMEs in Singapore are highly vulnerable to increases in business costs. Unit business costs that increase at a relatively faster rate can pose an existential threat to less profitable SMEs, while forcing lower value-added operations in other SMEs to relocate out of Singapore. Given that the SME sector is a buffer in the economy and the largest source of employment, a miscalibrated spiralling of business costs may create long-lasting socioeconomic impacts.

### **Business Costs and Cost Competitiveness**

The business cost structures of major industry groups in 2011 obtained from a 2013 MTI research report is shown in Figure 3.1 and Figure 3.2 (Poh & Lee, 2013, p. 22–24). As of 2011, labour, utilities and trade and transport costs formed the largest cost components in the manufacturing sectors, while labour, premise rentals and other services formed the largest cost components in the service sectors. Of note is the higher share of labour cost as a proportion to total cost for SMEs in most industries, and the higher share of services cost (utilities, trade and transport, rentals, etc.) as a proportion to total cost for large enterprises. Another observation is that renting of premises formed a larger percentage of costs in the retail trade and accommodation and food services industries than in other services industries.

**FIGURE 3.1: BUSINESS COST STRUCTURE OF THE SERVICES SECTOR BY TYPE OF FIRM, 2011**

Per Cent

	Wholesale Trade		Retail Trade		Accommodation & Food Services		Transportation & Storage		Finance & Insurance		Information & Communications		Business Services	
	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs
<b>Labour Cost</b>	<b>24.2</b>	<b>25.8</b>	<b>33.9</b>	<b>36.1</b>	<b>37.7</b>	<b>42.0</b>	<b>11.5</b>	<b>10.3</b>	<b>16.0</b>	<b>12.9</b>	<b>17.7</b>	<b>34.3</b>	<b>22.9</b>	<b>27.8</b>
<b>Services Cost</b>	<b>73.2</b>	<b>71.5</b>	<b>60.1</b>	<b>59.0</b>	<b>53.1</b>	<b>49.8</b>	<b>79.5</b>	<b>84.3</b>	<b>82.5</b>	<b>86.1</b>	<b>76.4</b>	<b>60.3</b>	<b>71.4</b>	<b>65.3</b>
Utilities	0.4	0.6	5.2	2.3	7.9	6.8	0.9	0.3	0.2	0.1	0.8	1.1	0.5	1.9
Freight & Transport	17.7	22.7	0.6	1.4	0.7	0.2	34.4	47.6	–	0.2	–	0.3	–	1.6
Financial Services	0.8	2.1	2.3	2.2	1.3	1.6	0.6	0.8	3.8	4.1	0.1	0.4	0.2	0.8
Communications	0.9	1.2	0.5	0.8	0.5	0.6	0.3	0.4	0.4	0.3	4.3	14.7	0.5	0.6
Renting of Premises	5.5	5.2	31.8	32.0	15.9	20.9	0.7	2.1	1.2	1.3	1.6	3.3	1.1	3.4
Professional Services	4.1	4.6	1.0	1.3	0.7	1.1	0.6	0.5	3.1	2.1	5.4	6.1	6.9	7.3
Other Services	43.7	35.1	18.7	19.1	26.1	18.7	41.9	32.6	73.7	78.0	64.2	34.4	62.2	49.6
Contract labour & work given out	5.7	3.8	1.1	2.0	2.1	2.4	1.1	2.6	0.4	0.3	4.3	6.0	32.9	21.2
Commission & agency fees	7.0	5.6	0.3	3.0	1.2	1.0	3.9	2.4	3.0	5.9	13.0	2.5	0.5	2.5
<b>Government Rates &amp; Fees</b>	<b>0.5</b>	<b>0.5</b>	<b>0.6</b>	<b>0.6</b>	<b>1.4</b>	<b>1.1</b>	<b>0.6</b>	<b>0.5</b>	<b>0.1</b>	<b>0.2</b>	<b>0.6</b>	<b>0.4</b>	<b>1.4</b>	<b>2.0</b>

Source: MTI Economic Survey of Singapore 2013 in Poh & Lee (2013, p. 23)

**FIGURE 3.2: BUSINESS COST STRUCTURE OF THE MANUFACTURING SECTOR BY TYPE OF FIRM, 2011**

Per Cent

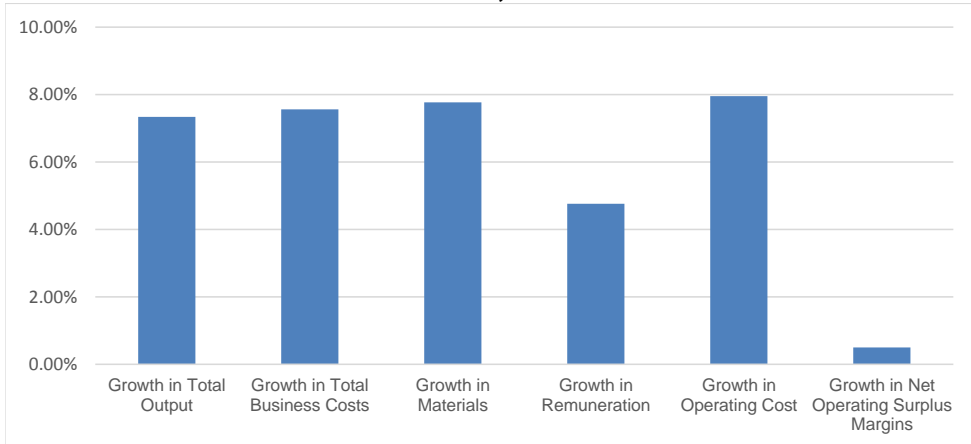
	Total		Electronics		Chemicals		Biomedical Services		Precision Engineering		Transport Engineering		General Manufacturing	
	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs	Large Enterprises	SMEs
<b>Labour Cost</b>	<b>40.7</b>	<b>52.5</b>	<b>52.4</b>	<b>53.6</b>	<b>12.9</b>	<b>28.1</b>	<b>49.1</b>	<b>50.1</b>	<b>60.7</b>	<b>59.2</b>	<b>66.8</b>	<b>65.4</b>	<b>49.3</b>	<b>55.6</b>
<b>Services Cost</b>	<b>58.6</b>	<b>46.1</b>	<b>46.9</b>	<b>45.9</b>	<b>86.5</b>	<b>70.7</b>	<b>50.0</b>	<b>48.6</b>	<b>38.5</b>	<b>38.6</b>	<b>32.4</b>	<b>33.2</b>	<b>50.1</b>	<b>43.4</b>
Utilities	30.1	12.4	19.3	6.6	59.8	36.5	14.0	11.5	5.9	6.3	5.8	3.1	12.7	7.7
Trade & Transport	14.5	12.8	14.4	18.0	16.3	13.3	12.8	14.4	14.7	12.3	12.4	12.0	11.6	12.5
Financial Services	2.7	4.3	3.7	5.4	2.3	5.1	1.5	4.0	2.1	4.7	2.1	3.9	3.3	3.3
Communications	1.2	1.5	1.7	1.9	0.6	1.5	1.4	2.5	2.0	1.5	1.6	1.2	1.1	1.3
Warehousing	0.9	0.9	1.1	1.6	0.7	2.3	0.8	0.4	1.9	0.2	0.4	0.2	0.7	0.9
Real estate, include rental	2.4	5.5	2.0	4.7	1.3	3.2	2.8	4.5	2.8	5.6	4.5	6.3	5.1	7.1
Business & other services	6.7	8.7	4.8	7.6	5.4	8.7	16.7	11.4	9.0	8.1	5.6	6.5	15.5	10.6
<b>Government Rates &amp; Fees</b>	<b>0.7</b>	<b>1.4</b>	<b>0.6</b>	<b>0.5</b>	<b>0.7</b>	<b>1.1</b>	<b>0.9</b>	<b>1.3</b>	<b>0.8</b>	<b>2.2</b>	<b>0.8</b>	<b>1.4</b>	<b>0.5</b>	<b>0.9</b>

Source: MTI Economic Survey of Singapore 2013 in Poh & Lee (2013, p. 23)

Data from the 2012 EDB *Annual Census of Manufacturing Activities* (Figure 3.3) indicates that companies in the manufacturing sector in aggregate were unable to grow their net operating surplus margin in the last decade, as output growth only kept pace with the growth of operating costs. The aggregate growth in total business costs from 2003 to 2012 at 7.56% outpaced the growth in total output at 7.33%. This was offset by relatively lower growth rates in remuneration.



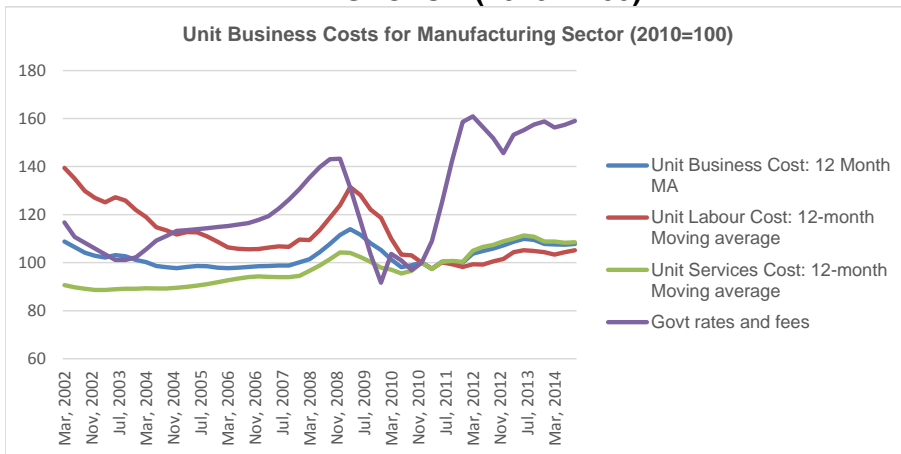
**FIGURE 3.3: CAGR IN MANUFACTURING OUTPUT AND COSTS, 2003–2012**



Source: Annual Census of Manufacturing Activities (EDB, 2012)

Figure 3.4 shows the growth in unit business costs for the manufacturing sector from 2002 to 2014. Of note is the downtrend in unit labour costs alongside a flat-lining of unit business cost over the period, suggesting that nominal wage compression could have subsidised rises in other components in unit business costs. Substantial increases of 58.95% in government rates and fees since 2010 were recorded. Unit business costs increased by 7.83% since 2010, while the sub-components unit service costs and unit labour costs grew by 8.45% and 5.18%, respectively.

**FIGURE 3.4: UNIT BUSINESS COSTS FOR MANUFACTURING SECTOR (2010 = 100)**



Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)



## International Comparison of Cost Competitiveness

The competitiveness of Singapore has come under threat due to increases in business costs. Here it is useful to have a working definition of competitiveness. Competitiveness is most commonly defined as the productivity with which a nation utilises its labour, capital and natural resources — that is, the ratio of the value of total outputs over inputs (Porter, 2005). Productivity depends both on the value of a nation's products and services — measured by the prices they can command in open markets — and by the efficiency with which they can be produced. A growth rate of business costs above a growth rate of real output indicates a decline in the competitiveness of businesses operating in Singapore.

Unit labour costs (ULC) are a common indicator used for international comparison of cost competitiveness. It is defined as the cost of labour input required to produce one unit of output, and is computed as total nominal compensation divided by real output. It is also computed as nominal wage over real output per worker.<sup>2</sup>

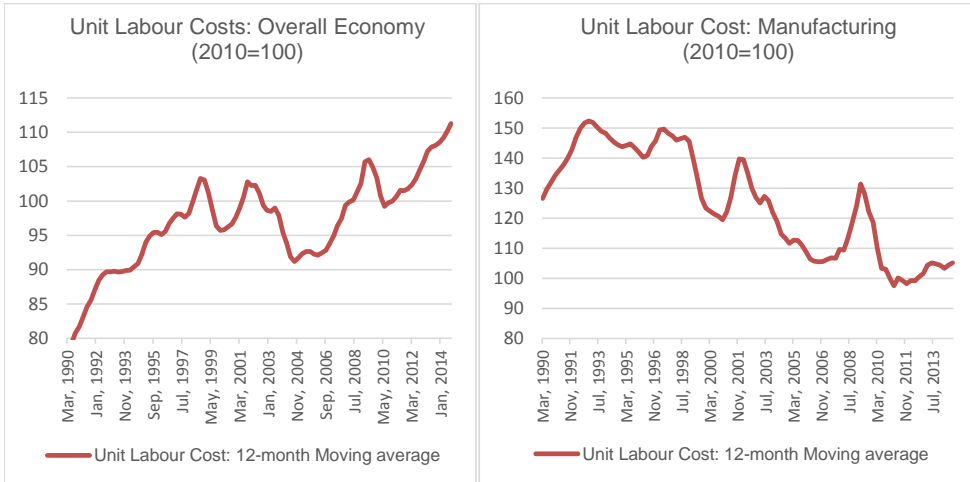
From 1990 to 2013, the ULC of the manufacturing sector has diverged from the overall economy. While ULC for the service sector is not publicly available, it is plausible that wage growth has exceeded productivity growth in the services sector, hence pushing up the ULC of the overall economy. On the other hand, the progressive restructuring into more productive activities by the manufacturing sector has led to a reduction in the sector's ULC (Figure 3.5).

$$^2 \text{ ULC} = \frac{\text{Total nominal compensation}}{\text{Total real output}} = \frac{\text{Average Nominal Wage} \times \text{No of workers}}{\text{Total real output}} = \frac{\text{Average Nominal Wage}}{\frac{\text{Total real output}}{\text{No of workers}}} = \frac{\text{Average Nominal Wage}}{\text{Real output per worker}}$$

Note that the US Bureau of Labor statistics dataset uses real output in the denominator, hence the ULC may be biased upwards in countries with higher CPIs due to nominal wage growth.



**FIGURE 3.5: COMPARING ULC IN MANUFACTURING AGAINST OVERALL ECONOMY**



Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)

An MTI study estimated that the real average wage growth as a ratio of productivity<sup>3</sup> growth in Singapore from 2000 to 2010 was 0.7. This figure, which is lower than that of some developed countries like the US, Hong Kong, Germany and Japan, is indicative of Singapore's flagging relative competitiveness. (Figure 3.6)

<sup>3</sup> Productivity growth (measured by MTI) is growth in value-added per worker.  
$$\text{Value added per worker} = \frac{\text{Total output} - \text{materials} - \text{operating costs}}{\text{No of workers}}$$

**FIGURE 3.6 COMPARING REAL AVERAGE WAGE GROWTH AS RATIO OF PRODUCTIVITY GROWTH**

Country	Productivity	Real Average Wage	Real Average Wage Growth as a Ratio of Productivity Growth
	CAGR, 2000–2010, % p.a.		
Canada	0.4	1.6	3.7
France	0.6	1.1	1.7
Australia	0.8	1.1	1.4
United Kingdom	0.9	0.8	1.0
Korea	2.9	2.1	0.7
Singapore	1.8	1.3	0.7
Hong Kong	3.2	1.3	0.5
United States	1.7	0.5	0.3
Germany	0.6	0.2	0.3
Japan	1.0	0.2	0.2

Source: “Productivity and wage growth in Singapore” (Tan & Guo, 2011)

### Rental Costs in Singapore

In this section, the changes in rental costs and its co-movements with vacancy rate and real estate supply are presented. This presents an aggregate picture of the macro-trends facing the respective markets, bearing in mind that the analysis does not cover the different demand and supply conditions that sub-markets within the respective rental spaces face.

Cost pressures stemming from increase in real estate prices are weighing down significantly on many SMEs. Based on data from the Urban Redevelopment Authority (URA), the rental costs for commercial retail real estate have increased by 20.7% and 12.6% in the Central Area and Fringe Area, respectively, since December 1998. In the office rental markets, suburban and prime office rents have rose 2.68% and 4.17% in compounded annual growth rate (CAGR) terms and 52.8% and 92.3% in absolute growth between 1998 and 2014, with most of the increases occurring during 2005 to 2014. In the industrial space, the median monthly rental rate for multiple-user factory rose by 92.9% from 2005 to 2013, while warehouse space rose by 64.8% over the same period.

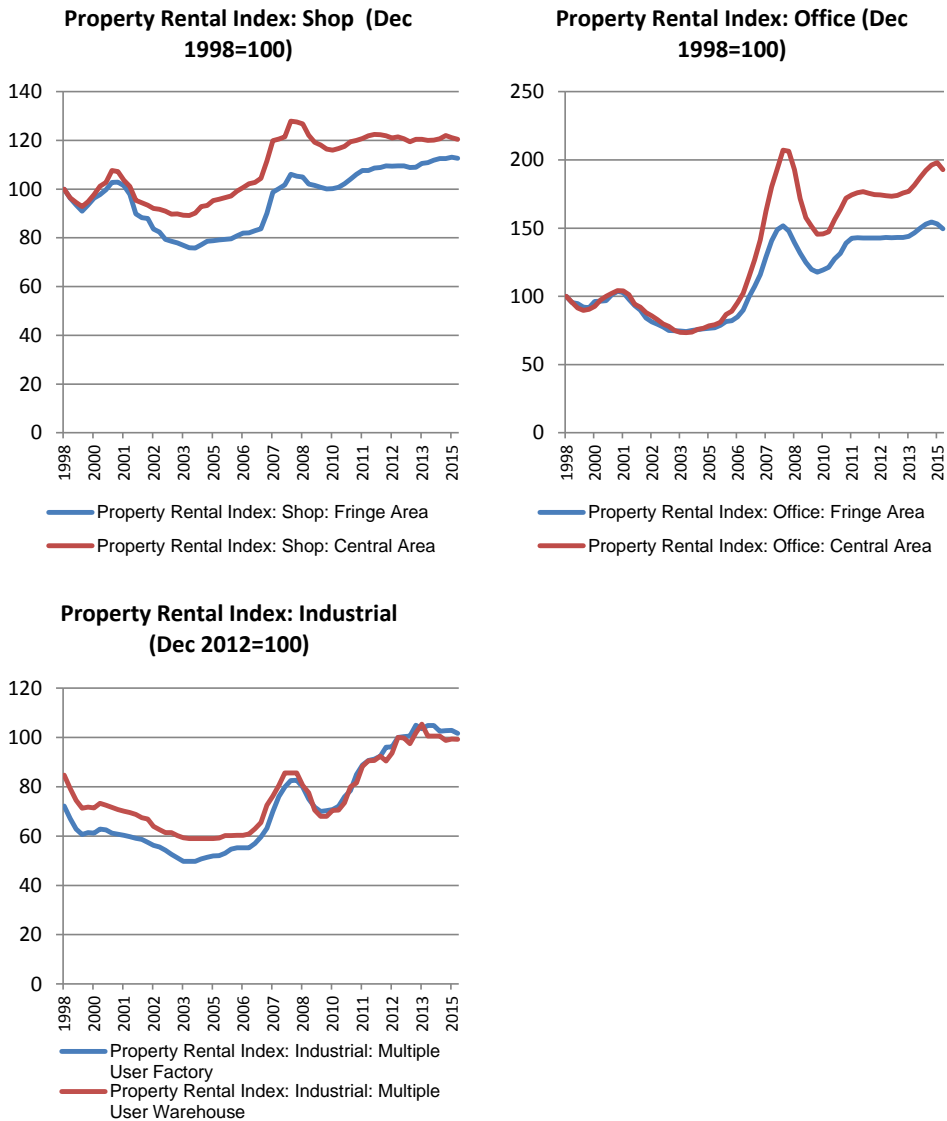
Based on the 2011 MTI Business Costs report, rental costs comprise 5.5% of total business costs for SMEs in the manufacturing sector and 20.9% to



32.0% of total business costs for SMEs in the retail trade and food and beverage (F&B) sector.

The Property Rental Index for shops have increased 20.4% and 12.7% in the Central and Fringe Areas, respectively, from December 1998 to June 2015, while the index for offices in Central and Fringe areas have increased by 92.9% and 49.5%, respectively in the same period. The indices for multiple-user factory and multiple-user warehouse have increased by 40.9% and 17.2%, respectively, over the same period (Figure 3.7).

**FIGURE 3.7: PROPERTY RENTAL INDEX FOR VARIOUS PROPERTY TYPES**



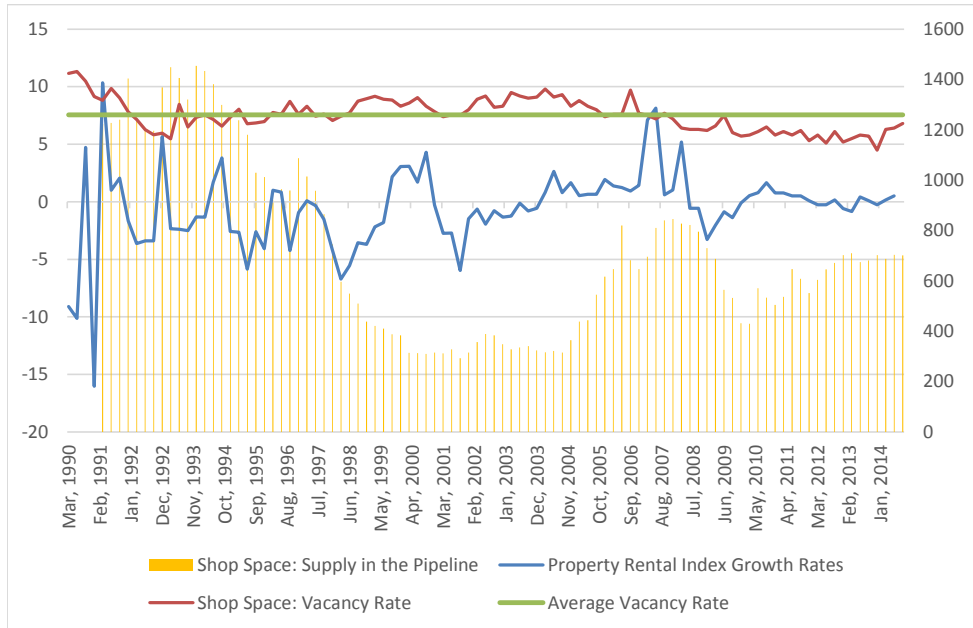
Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)

In the shop rental market (Figure 3.8), a noticeable period of rental growth was registered from 2003 to 2007, which correlated with a slight fall in vacancy rates. However, while vacancy rates have continued to trend downwards from the period from 2008 to 2013, rental growth rates have stabilised post-2008. The vacancy rate has been below the long-term average since 2007, signalling a strong demand growth and a protracted



lack of supply in the markets following the dip in construction pipeline from 1998 to 2004. However, a sequential pick up in supply since 2005 has stabilised the net rental index growth rate.

**FIGURE 3.8: SHOP SUPPLY, VACANCY AND RENTAL GROWTH RATES**



Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)

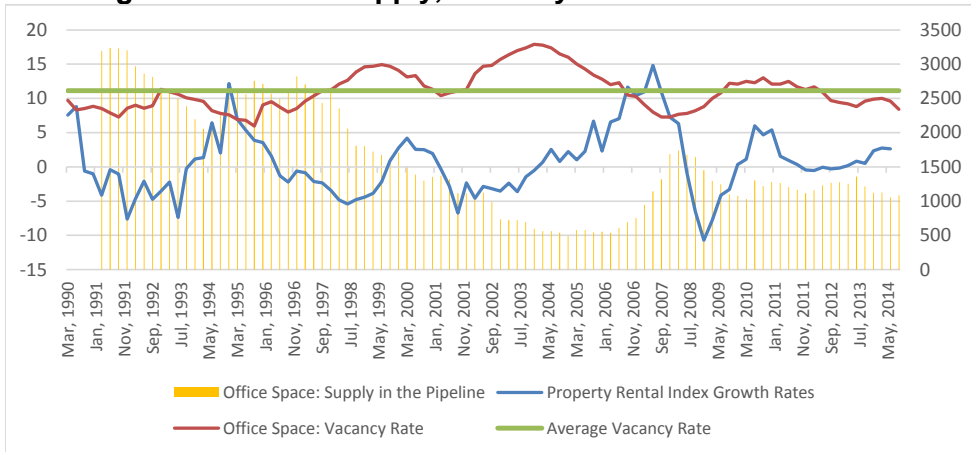
Market segmentation and mall-specific factors, such as mall quality, location and population catchment, quality of tenant services, customer traffic flow, retail concepts and the penetration of high street brands, as well as market pricing power play a key role in the shop rental growth differentials observed in Singapore. While the CAGR of rental prices of properties professionally managed by REITs have grown 20% from 2009 to 2013, shop space rental prices have stabilised over the same period.

A comparative review of retail rents in prime areas around the world reported by CBRE showed that Singapore was ranked 18th in the world. In addition, CBRE third quarter 2013 Asia report noted that Singapore had one of the highest prime retail rents in Asia at US\$465 psf/annum.

In the office rental markets (Figure 3.9), the fall in vacancy rate from 2003 to 2007 correlates negatively with the rental index growth over the period. The rental index growth peaked at 14.83% in June 2007, just before the onset of the GFC. One possible reason for the higher volatility exhibited by

office space rent relative to other rental spaces is because of the higher demand cyclicality and longer construction lags experienced by the office real estate sector.

**Figure 3.9: Office Supply, Vacancy & Rental Growth Rates**

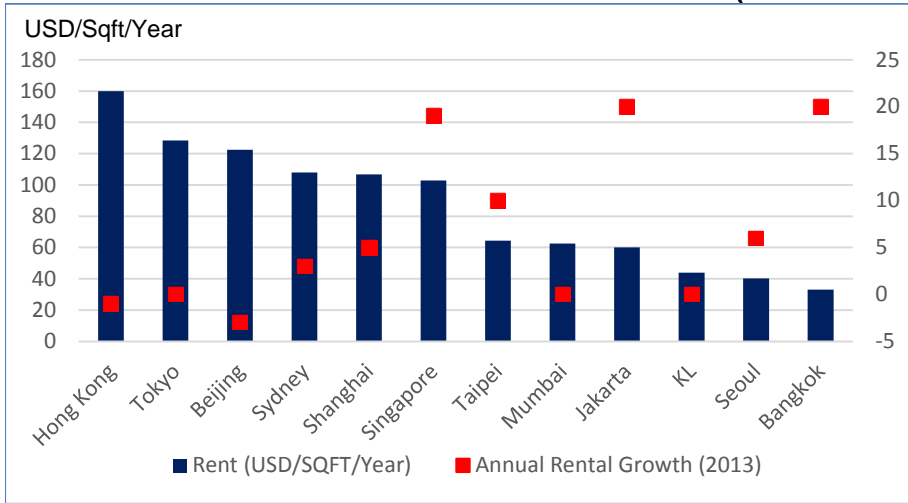


Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)

More recently, the rise in supply coming onstream has reduced volatility in rental movement post-2009. In terms of prices, CBD office rents in Singapore are the fifth highest in Asia (and 11th worldwide) at an average of US\$102.84psf/year, based on a Cushman and Wakefield report (Cushman and Wakefield Research, 2014; Figure 3.10). At 19% after adjusting for exchange rates, the rental price growth in Singapore is one of the highest in the world.



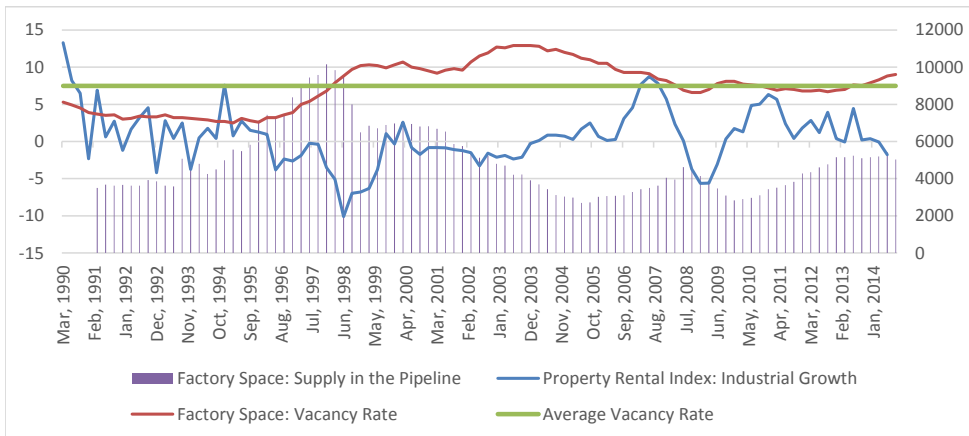
**FIGURE 3.10: CBD AVERAGE OFFICE RENT 2014 (ASIA PACIFIC)**



Source: "Office space across the world" (Cushman & Wakefield Research, 2014, p. 8)

In the industrial space, the rental index has registered increases from December 2004 to December 2013, with the exception of the period from December 2007 to December 2009. This is despite the vacancy rate stabilising at its long-term level since March 2008 on the back of a constant stream of projects completion (Figure 3.11).

**FIGURE 3.11: INDUSTRIAL SUPPLY, VACANCY AND RENTAL GROWTH RATES**



Source: Generated from [www.ceicdata.com](http://www.ceicdata.com)



## The REIT Industry in Singapore

### *Overview of the Industry*

Studies have shown that the increase in rental costs in the industrial and commercial sectors correlates with the institutionalisation of landlords in Singapore after controlling for macroeconomic effects, particularly after 2003 as professionally managed REITs experienced rapid growth to become major players in the commercial and industrial real estate markets. During this period, tenanted business owners have expressed concerns about the lease structures and practices of REITs, citing issues of asymmetric information and unequal bargaining power between small business tenants and institutional landlords. In reply, landlords have cited the substantial value-added services they provide as a justification for cost increases. In addition, a MTI study in 2013 found that rents in REIT-owned malls are not statistically different from rents in single-owner malls after controlling for factors such as location and asset enhancement initiatives, or AEs (Sodhi & Leong, 2014).

REITs began in the US in the 1960s as a means to allow investors to gain exposure to large-scale, diversified portfolios of income generating real estate through liquid trading of securities in the equity markets. Since then, more than 30 countries around the world have established REIT regimes.

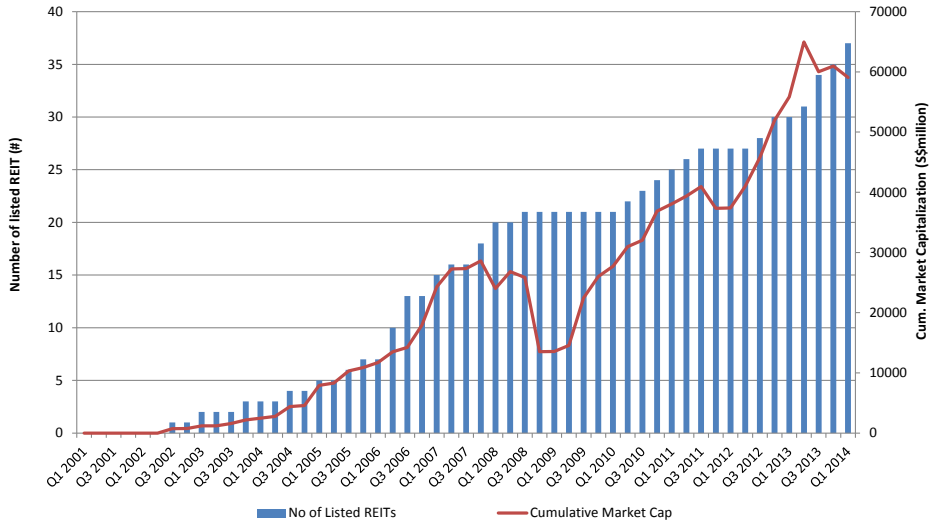
The Monetary Authority of Singapore (MAS) issued the first set of regulations governing REITs in Singapore in 1999. The regulatory framework has undergone several revisions, aimed at promoting Singapore as a regional REIT centre, while protecting the interests of unit holders (Koh et al., 2014). REITs are currently subject to MAS regulations under the Property Funds Appendix of the Code on Collective Investment Schemes, which are designed to ensure that REITs derive revenue mainly from stable sources that are not susceptible to significant fluctuations. REITs in Singapore are regulated on several fronts, including distributable income, performance fee methodologies, development limits, leverage limits, disclosure requirements, and restrictions on investments among other things. Regulatory requirements include: Distribution of at least 90% of taxable income; maximum gearing ratio of 35% or 60% subject to credit ratings; full valuation of real estate annually; and competency requirements and duty guidelines for REIT managers.

Since the first CapitaMall listing in 2002, REITs in Singapore have grown to include more than 33 REITs representing a total market capitalisation exceeding S\$61 billion at the end of September 2014 (MAS, 2014; Figure 3.12), with asset holdings in retail, office blocks, serviced apartments, hospitality, healthcare, industrial and warehousing in Singapore and abroad. Singapore is currently the second largest REIT market in Asia after



Japan and the 7th largest REIT market globally. This is on the back of favourable liquidity conditions, which aided the expansion of REITs.

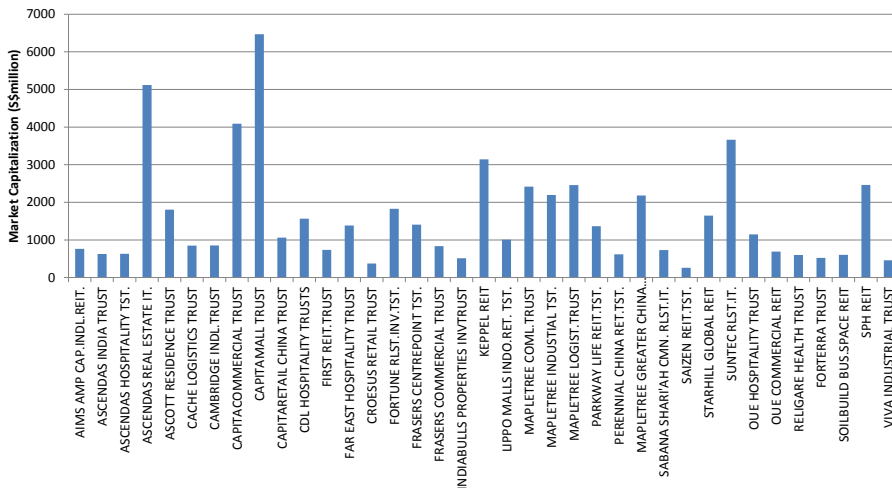
**FIGURE 3.12: MARKET SIZE OF REITS**



Source: IPS Closed-Door Discussion on “The Costs and Benefits of Landlord Institutionalisation”

**FIGURE 3.13: DIFFERENT REITS IN SINGAPORE**

There are 5 REITs with market capitalisation of more than S\$3billion



Source: IPS Closed-Door Discussion on “The Costs and Benefits of Landlord Institutionalisation”

Several impacts of the development of REITs have been cited in the literature. On the positive side, REITs structures provide investors with liquidity, diversification and an inflation hedge (Atchison & Yeung, 2014). It also advances the sophistication of real estate markets by professionalising the real estate value chain, diffusing best practices, increasing transparency and standards of disclosure, initiating real estate innovation, reducing agency conflicts, and attenuating property cycles (Jones Lang Lasalle, 2012; Bauer et al., 2010). It encourages investment in the real estate sector by lowering liquidity and risk premiums as well as expanding market access, hence reducing the cost of capital. Other benefits of REITs include allowing developers to free up capital for infrastructure development; contributing to the breadth and depth of capital markets; providing economies of scale in active property management and value-adding activities; and contributing to GDP and job creation directly and through the employment of ancillary services (PwC, 2012). In addition, as REITs become major stakeholders in communities in which they invest, they are invested in the continuing economic vitality of suburban areas (Dinsmore, 1998).

Several of the benefits have been contested, while other research also noted the adverse impacts of REITs on tenants. For instance, the REIT manager fee structure includes a base fee that is calculated based on a fixed percentage of the value of the properties in the REIT as well as a performance fee pegged to certain metrics such as gross revenue, net property income or the dividends paid out to investors. Fees are also tied to acquisitions and sales, which work out to 0.5 to 1% of the purchase price (Goh, 2015). This creates an incentive for REITs manager to pursue expansion aggressively. In the US, the evidence on the scale efficiency of REITs has been mixed (for a review, see Anderson et al., 2000; Corgel et al., 1995). Evidence of diseconomies of scale in REITs have been found (Willard et al., 1991; Ambrose et al., 2000), suggesting that external factors rather than operational efficiencies contribute to the scaling up of REITs. Other studies show that the best sources of scale economies reside in general and administrative expenses and management fees, both of which are smaller components of total REIT costs (Anderson et al., 2000; Bers and Springer, 1998). Bers and Springer (1998) concluded that REITs experience scale efficiencies differently according to their organisational characteristics such as management structure, capital structure, diversification levels and investment portfolio. Questions were also raised about the amount of value-add generated by REITs. Using revenue data, Brady and Conlin (2004) found that the superior performance of hospitality REIT properties was due to the fact that REITs tend to acquire properties in market segments that performed well; REIT ownership in itself did not appear to have increased performance.



Dinsmore (1998) noted that new forms of financial intermediation through REITs have changed the dynamics of metropolitan growth and urban development — and in ways that are still poorly understood. The changing structure of ownership of real estate — away from smaller private entities to large institutional public and private funds — affects the markets for real estate acquisitions and development. Private and public constituents who are not primarily involved in real estate development or finance continue to seek and pursue strategies that improve the economic, social and environmental welfare of their communities, and these strategies may or may not conflict, complement, or otherwise connect with the strategies being pursued by the emerging property owners and credit intermediaries. Furthermore, added financing considerations, such as desired risk-return profiles of REITs, interact with operational and leasing decisions to affect the markets for retail space (Wheaton, 2000).

In Singapore, the introduction of the REIT business model improved corporate governance and transparency, creating avenues for capital-raising from institutional investors at lower costs, hence allowing for the aggressive expansion of malls in key retail centres. The introduction of suburban prime REITs led the expansion of international high street brands beyond the central districts, and guided the development of major local franchises within the suburban retail space, all of which resulted in further segmentation of market dynamics between strata-titled and professionally managed space.

In the following sections, the pain points that have triggered the concerns of tenants in the retail sector in Singapore are reviewed.

### **Rental Growth**

While fine-grained data on rental growth rates are not publicly available, a study by Sing Tien Foo, Associate Professor from the Department of Real Estate at the National University of Singapore, presented during the CDD showed significant retail rental price increases after 2003, controlling for macroeconomic effects. However, an MTI study in the REIT sector published in the *Economic Survey of Singapore* for the first quarter of 2014 showed that the higher levels and growth rates of rents observed in REIT-owned malls appeared to be largely driven by the better physical characteristics of the REIT-owned malls. After controlling for observable mall characteristics like AElS and distance to the nearest MRT station, the level of rents in REIT-owned malls was not statistically different from that in single-owner malls.

It was found in the report that the cumulative increase in rents upon renewals in 2013 was highly skewed, with median rent increases at 5.5%, while that at the 99th, 90th and 75th percentiles to be 136%, 45% and 14%, respectively. In every year from 2000 to 2013, up to 25% of retailers would either experience no increase or a decline in rent price upon lease renewal. For most of the renewals, annual effective increases in rent per annum amounted to 3.3% and 2.9% for one-year and two-year lease renewal terms, respectively, similar to the rate of inflation of 3.5% per annum. Higher lease renewals rates were generally for leases that were renewed after more than five years, with the median annual rental price increases working out to be 3.6% on an annualised basis, which is in line with the inflation from 2007 to 2013.

### ***Leasing Structures***

Retailers have also voiced concerns about the leasing structure of retail REITs, most of which include a base rent and an additional rate pegged to gross turnover (GTO) that kicks in as turnover exceeds a certain threshold. Studies conducted by Wheaton (2000) suggest that in situations where tenants made specific sunk costs with imperfect long-term contracts, and where there were inter-store externalities and an uncertain tenant mix, the percentage GTO structures aligned the incentives of the landlords with tenants (by aligning mall revenue maximisation with store sale maximisation), ensuring that landlords did not act opportunistically or against the interest of existing tenants when attracting new tenants. Percentage rents have also been explained through risk-sharing among risk-adverse parties (Miceli & Sirmans, 1995), although this may induce risk aversion among landlords (Productivity Commission, Australia, 2008), resulting in a reduced diversity in the retail sector.

### ***Market Concentration***

Based on data taken from CapitaMall's *Annual Report 2014*, CapitaMall Trust is the largest single owner of major retail space, with 14% of market share (Figure 3.14). Tenants have claimed that retail REITs in Singapore operate within an oligopolistic structure, and that high market concentration handled unfair pricing power to REITs landlord, resulting in rapid rental price increases.

**FIGURE 3.14: SHARE OF MAJOR SHOPPING CENTRE FLOOR SPACE (%)**

Owner	2010	2011	2012	2013	2014
Others	40.7	43.7	43.7	38.9	46.3
CapitaMall Trust	16.2	16.6	17.3	16.6	14.3
Pramerica	7.1	6.9	6.8	5.9	5.6
Frasers Centrepont Trust	5.8	6.6	6.5	5.7	5.3
Mapletree Comm Trust	5.7	5.6	5.5	4.8	4.5
Suntec REIT	4.5	4.4	4.3	4.5	3.0
Lend Lease	5.0	4.0	4.0	5.7	5.4
Far East Organisation	3.8	3.7	3.7	3.2	3.0
Marina Centre Holdings	3.2	3.1	3.1	2.7	2.5
City Developments Ltd	3.6	Nil	2.7	2.3	2.2
Singapore Press Holdings	2.8	2.7	2.7	2.3	2.1
Las Vegas Sands	Nil	2.7	2.7	2.4	2.2
Allgreen	Nil	Nil	2.3	2.0	Nil
CapitaMalls Asia	1.5	1.5	2.2	2.8	Nil
CapitaLand	Nil	Nil	Nil	Nil	2.0

Source: CapitaMall Trust Annual Reports (2010–2014)

However, based on calculations made by IPS, market concentration in the retail real estate market remains relatively low, with a modified Herfindahl-Hirschman Index (HHI) of 0.060396, and aggregated market shares of the four and eight largest companies standing at 36.1% and 51.2%, respectively. However, of note is the ratio of the largest company CapitaMall Trust to the second largest company, at 2.54, while the largest company takes up 47.9% of the market share of the four largest firms. It is also important to note that market concentration alone does not account for other factors that influence pricing power, such as local monopoly effects, market segmentation and substitutability of retail space.

**FIGURE 3.15 MARKET CONCENTRATION MEASURES**

	2010	2011	2012
<b>M-HHI<sup>4</sup></b>	0.053301	0.053913	0.060396
<b>CR4</b>	0.348	0.357	0.361
<b>CR8</b>	0.517	0.509	0.512
<b>S1:S2</b>	2.28169	2.405797	2.544118
<b>S1:T4</b>	0.465517	0.464986	0.479224

Source: IPS calculations

Nevertheless, the low vacancy rates in CapitaMall Trust as well as the strong property demand suggest that the effects of market structure on price-setting at present among the REITs is minimal as rent prices have not been set at above market-clearing prices. Vacancy rates have been less than 1% for the majority of CapitaMall Trust malls over the period from 2006 to 2014 (Figure 3.9). A 2008 study by the Competition Commission of Singapore using regulatory market share thresholds also concluded that there was no significant evidence of uncompetitive behaviour in the Singapore retail market. However, the trend towards market consolidation could lead to greater bargaining power for retail REITs.

### ***Relative Bargaining Power***

Several factors create stronger bargaining power for retail REITs, including relatively high entry barriers into the industry, the presence of high switching costs for the tenant (e.g., having invested heavily in a fit-out and stocked shop for the term of the lease as well as building up a customer base at its retail location), a lack of market information and research for the tenant, and an imbalance in negotiating skills between landlord and tenant (Productivity Commission, Australia, 2008). Farrell and Klemperer (2007) noted that switching costs might create lock-in effects that incentivise market-distorting behaviours, such as low rent bargains followed by steep rent increases, and retrofits billed to the tenant that exacerbates tenant lock-ins. In addition, tenants who put themselves in a bad position to walk away from lease renewals (e.g., by taking business loans or signing franchise agreements beyond the terms of the lease) weakened their own bargaining power during lease renewal negotiations.

Furthermore, there have been reports of exclusivity clauses in rental contracts that prevent tenants from concurrently leasing retail space with

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<sup>4</sup> Unlike the conventional HHI, the modified HHI corrects for potential upwards bias by assuming that the market share of firms in the others group is no larger than the smallest share of the documented companies.



competing developers. Such clauses mean that businesses planning to operate at other locations are effectively bound to a single supplier of retail space, thereby increasing the bargaining chip of landlords.

In response to the unequal bargaining power between landlords and tenants, the SBF announced in January 2015 details of the Fair Tenancy Framework developed by its SME Committee (SMEC) Rental Practices Working Group. The framework aims to establish a reference leasing practice and a useful mediating platform for the industry, and helps tenants and landlords of business premises understand the key terms and conditions of a lease agreement, their respective roles and responsibilities, as well as the implications of prevalent industry lease clauses. It consists of three prongs: Rental data transparency, education and awareness (e.g., developing a business leasing guide and a basic reference lease agreement), and a preferred dispute resolution channel. It aims to address some of the existing issues in an equitable manner to all stakeholders.



## **IPS CLOSED-DOOR DISCUSSION ON THE COSTS AND BENEFITS OF LANDLORD INSTITUTIONALISATION**

To understand the views of different stakeholders, a CDD was convened by IPS on 13 February 2014 to examine the issues surrounding the institutionalisation of landlords in greater detail. It involved among others SME owners, real estate trust managers and representatives from the public sector.

Several key themes were explored during the discussion, including significant rent increases during the REITs era; the presence of asymmetric bargaining power between institutional landlords and smaller tenants and its impacts on businesses; the presence of market frictions which may skew bargaining power in favour of larger players; the need for greater collaboration between landlords and tenants to cope with increasing external competition; the role of the government and the effects of government intervention in the real estate markets; broader questions of the role of economic policy in preventing a rentier economy at the expense of a vibrant business environment; as well a clearer set of government objectives in re-allocating resources and initiating social distribution.

### **Literature on the Effects of REIT Regulation**

In Singapore, REITs pay out at least 90% of their earnings as dividends. Borrowing for REITs is limited to 35% or 60% if a credit rating is obtained, and most REITs rely heavily on external sources of funding for new investments. It is also common for REITs to outsource the management of their real estate assets.

Some research literature on REITs was shared. Bauer et al. (2010) argued that the regulated regime in the US REIT markets reduces the reliance on strong internal governance, and limited the scope for agency conflicts in REITs vis-à-vis other public-listed companies in the US, due to limits on capital borrowing and dividend payouts. Sing (2013) found that strong governance in REIT markets, together with strong investors' protection, induce positive risk-taking behaviour in REIT managers, which increases the sector's overall value.

Gyourko and Sinai (1999) estimated the net benefit to US real estate companies of a REIT structure to be at 2% to 5% for US companies, with smaller benefits for larger payout REITs. However, the benefits of tax exemption have to be traded off with the limits to growth through capital borrowing.



## **Landscape of Commercial, Retail and Industrial Markets in Singapore**

It was shared that the retail and commercial real estate markets were dominated by a few large institutional players, while the industrial segment was more diverse, with larger shares owned by mid-sized players and private industrial end users. For example, in a 2008 report by the Competition Commission of Singapore (CCS) on retail space, it was found that developers and REITs owned 64% and 29% of private non-strata retail space, respectively. In a later CCS study in 2012 on industrial space, it was found that end users comprised 60% of ownership of all industrial space, and smaller private market players made up about 28% of the share of investment space.

It was reported that the aggregate growth in rental costs of multi-user factory space, measured by the multi-user factory index, was consistently below the growth in the industrial production index, which meant that as a whole, the costs of rental space as a share of total revenue had fallen, at least at the aggregate level.

Net average demand and net average supply have tracked each other quite closely over the last 10 years, resulting in high occupancy levels and moderate rises in rental prices. Rental prices are likely to adjust downwards due to increasing supply coming onstream combined with low economic growth projections, although future demand from MNCs remains unclear, said one participant.

The industrial real estate markets can be separated into single-user, multi-user space, high-tech space, business park space and warehouse space. Ownership profiles for the different segments were shared at the CDD.

In the single-user market, the ownership profile showed that 80.4% was owned by the end-user, where about 16% was owned by government agencies, and only about 4% was owned by REITs. As a result, the single-user market was a space that remained fairly insulated from market forces.

In the multi-user space, 61.5% was owned by end-users and other private players, and there was a fairly large government representation, with the Housing and Development Board (HDB) and JTC owning 12.5% and 3.9%, respectively. REITs represented 19.8% of market share, with Mapletree Industrial Trust as the largest player accounting for 13%. The bulk of SMEs operated in this space.

The high-tech space showed higher concentration of REITs partly because it covered niched properties. REITs owned 68.1% of the properties in this

segment, with Ascendas-Reit (A-REIT) as the largest player (41.0%), while end-users made up 18.1% of the market share, and private investors/developers accounted for another 13.8%. Tenants in this space tend to be engaged in higher value-added activities and were more resilient to rent price changes.

In the business park space, the market share for REITs, private investors and developers, public agencies and end-users were 43.7%, 22.8%, 18.0% and 15.5%, respectively. The largest player was A-REIT with a market share of 31.5%. The price development in this segment was less of a concern to SMEs, as majority of the space users were MNCs.

In the warehouse space, REITs owned 41.0% of the real estate, with the largest player MLT holding 13.5% of the market share, while end-users owned a significant share of 47.2%. Tenants in this segment were mainly large businesses.

It was also pointed out that there was a large variance among tenants of industrial REITs in their rents as a percentage of operating costs. Lower value-added services companies involved in textiles, wood products and printing had larger rental share of operating costs, while capital-intensive industries like pharmaceuticals and refined petroleum products had lower rental share of operating costs. The average share of rental in overall operating costs for the manufacturing sector, as derived by the EDB census of manufacturing, was 2.2%.

### **Justifying the Case for Increasing Rental Prices**

It was mentioned that real estate rental prices in all sectors, after controlling for various macroeconomic and real estate market factors, have increased significantly since the start of the “REIT era”, from 2003 onwards. One participant also noted anecdotally that rents have increased by up to 300% upon lease renewals, adversely affecting many SMEs. Views were mixed on whether the rental price increases were fully justified by value enhancements provided by professional active managers.

However, it was argued by some participants that under most REIT structures, an asset manager’s compensation is tied to his performance, which incentivises the manager to undertake AEs to increase the value of the property, and offer tenant value-adding services such as advertisement, promotions and marketing workshops. These activities translate to higher customer traffic flow. For example in the case of Illuma which was acquired in February 2011 by CapitaMall Trust, a link bridge connecting it to Bugis Junction was added alongside other AEs, which reportedly increased the number of visitors from 300,000 per month to 1.7



million per month in 2013, bringing substantial value to the mall's tenants. This explained the long queue of retailers to waiting to take up space in the mall. Other examples of value-add services include providing publicity to tenants through a tenant magazine as well as offering sponsorships for news and television showcases to help tenants to reach out to the market more effectively.

An active manager also ensures a balanced tenant mix, and minimises the negative externalities that can accrue to malls without proper oversight, said one participant. Responding to comments about special rent prices offered to more established retailers, one REIT participant explained that large anchor tenants are given lower rent price because they draw in more shoppers, benefiting the other tenants in the process. Good management adds value to a mall by actively fine-tuning these incentives.

Furthermore, some participant argued that the large spike observed in rental renewal rates over the past few years were the result of the privatisation of several real estate properties, and the removal of effective subsidies provided through government ownership, especially under JTC. The relatively higher rental price growth was part of a reversion process to normal market rates as opposed to an exploitation of pricing power. They added that REITs also share a similar business environment of rising costs, and that land rents charged by government agencies have been increasing by up to 5.5% per annum.

Another participant noted that REIT managers took on project risks when they engaged in AEs, adding that these risks were significant because of the costs of the projects. Hence, the increases in rental prices reflected the compensation for these risks on top of the value added from the new facilities and services.

The role of an active manager is to maximise investment returns to shareholders. Some value-adding strategies were noted during the discussion. They include yield accretive acquisitions that enhanced the economies of scale of REITs, cross-border expansion and diversification, organic growth via AEs, and active management of capital structure through debt restructuring and diversification of funding sources.

Some participants argued that the industrial sector benefited from the REIT structure through capital recycling availing the option for end-user owners to sell and lease back their property, enabling capital to be released for redeployment to other business needs. This has particularly benefitted the logistics and light industrial areas. Hence, industrial REITs as an

investment platform contributed meaningfully to the economy, they contended.

### **Long-Term Sustainability of REITs Business Model**

The claim that REITs were like private equity (PE) funds was disputed by some participants. They highlighted that unlike PE funds, REITs were designed to provide sustainable returns to unit trust holders by building up long-term value in their assets. The approach was to manage the properties with a long-term strategy. Although REITs managers increased rents, it had to be done in a sustainable manner.

### **Asymmetric Bargaining Power**

Several participants noted that the supply constraints of retail spaces in malls, as well as the low entry barriers to the retail industry, resulted in an asymmetric bargaining power situation, in which landlords enjoyed an advantageous position in the bargaining process.

Such problems included the escalation of rent prices during lease renewals, one-sided penalties for breaking lease before expiry, short notice period for exterminating lease, rental deposits that were only payable in cash, and tenants being expensed for retrofits and renovations on terms dictated by landlords. To this, one participant suggested that businesses, especially SMEs, engaged in collective negotiation efforts to boost their bargaining position with landlords.

### **High Rental Prices Reduce Business Diversity**

It was felt that high rental prices in Singapore affected the diversity and level of innovation of the retail sector. Retailers in other countries were more willing to take on bigger spaces, spend more on renovations and be more creative improving the customer experience because lower occupancy costs free up resources for other uses. In addition, some participants felt that tenant diversity in Singapore was compromised as a result of landlord institutionalisation, as only the best-performing and most profitable tenants were shortlisted for offerings in other properties of the landlord's portfolio.

One participant pointed to Hong Kong as juxtaposition to Singapore. Despite being as land-constrained as Singapore, there existed a broader range of rent distribution in Hong Kong, providing businesses with more occupancy options, which in turn brought about a greater diversity of goods and services to the market. The participant suggested that the different outcomes between the two countries could be a result of government policies, and called for more studies to be conducted to uncover the underlying factors.



### **Factor Driving Rental Prices**

Some participants noted that rental prices were largely driven by supply and demand forces, and interventions from the government might introduce undesirable distortions to the markets.

However, other participants argued that government intervention in the real estate markets is necessary due to a few reasons. First, the assumption of perfect substitutability does not hold. Rental space is not a homogeneous product, and tenants may not be able to find an acceptable alternative location. Imperfect substitution and switching costs due to unrecoverable investments like retrofits can tilt the bargaining position substantially in favour of the landlord. Second, the real estate markets are relatively price inelastic, with substantial time lags needed for supply to adjust in reaction to price changes. For example, a typical shopping mall takes an average of five years to be built and operational. Third, market structure imbalances are a significant factor contributing to upward rent growth, and so government intervention is required to address the problem.

### **Real Estate Rental Markets are Becoming More Concentrated**

One participant said that as of the third quarter of 2013, in terms of market capitalisation, Singapore had five REITs that were larger than S\$3 billion in market value and 10 REITs that were larger than S\$2 billion, which was a sign of market concentration. In addition, he noted that while the larger REITs were growing rapidly, the smaller REITs were shrinking in size.

He added that the trend towards greater market institutionalisation and the scaling up of landlords was expected to continue due to the benefits from economies of scale, as well as from industry consolidation. This would further weaken the bargaining power of tenants against landlords in the future. Some other participants added that an oligopolistic market structure within a given real estate subspace might lead to a situation of rents that are exploitative and permanently marked up.

### **Lack of Transparency From Landlords**

Some participants were also concerned about the inequitable practices by landlords. They complained of cases where tenants received inadequate tenancy extermination notice periods when their leases were not renewed. This creates operational problems for businesses, especially if they have been operating in a particular location for years and have built up a pool of regular customers. It is also common in the retail real estate segment for landlords to include exclusivity clauses in their contract that prohibit their tenants from renting concurrently from other landlords. These unfair terms are restrictive and damaging to business vibrancy.

### **Correlation between REITs Growth and Rent Price Growth**

A study presented at the discussion found that there was a positive correlation between REITs formation and rental price growth. However, the study was not able to conclude that lagged REITs returns significantly cause rental price to increase. It was noted that more data was needed to undertake more conclusive analysis.

### **The Use of Gross Turnover in Lease Structure**

The common use of GTO information to determine rental price was also highlighted at the discussion. In principle, using GTO as a variable rental price component is expected to align tenant and landlord business interests as it creates an incentive for landlords to help tenants drive higher sales in return for higher rent proceeds. However, many tenants felt that this did not happen in practice. Instead, they felt that the use of GTO information seemed to unilaterally benefit landlords.

The point-of-sales (POS) systems used to track the GTO provided landlords with complete information on the revenue of tenants. It was claimed that by providing this information to the landlord, the GTO system has worsened the asymmetric bargaining power between tenant and landlord.

Several participants mooted the idea of reciprocal transparency from landlords to publish effective rental prices and not contracted rental prices. More information on the different rental prices charged by landlords should also be available to tenants. This would help tenants make more informed decisions and not be misled by low basic rents.

However, there were participants who felt that the use of POS system and variable rent component was contractually fair and beneficial to the tenant. First, the variable rent component rate was kept constant throughout the whole lease period. Second, the variable rent component would only take effect when the GTO exceeded a certain amount that was pre-agreed by both parties. Moreover, it was argued that mall operators usually provided regularly reports using data from the POS system for their tenants. These reports allowed businesses to benchmark their performance against the industry average, and encouraged tenants to work with their mall operators to improve their performance.

### **Introducing a Price Cap**

It was reported that in South Korea, although rental price reviews were still based on market or inflation rates, the landlords of Prime Grade A properties have accepted a cap of 5% or 7% in fixing rental price reviews. In Australia, there were also fixed increase of 3.5% to 4.5%, or increased



based on consumer price index. Some participants suggested that Singapore adopt similar controls on rental price growth.

However, other participants expressed doubts over the suggestion, and questioned who would ultimately benefit from this regulation — the tenants or consumers. If most of the savings were not passed down to consumers, this would effectively be a transfer of wealth from one profit-seeking entity to another. How could such a subsidy be justified, they argued.

A few landlord participants also defended REITs for using the land more efficiently than smaller private landlords, transforming them into more productive spaces. The economy on the whole benefited from this more efficient use of capital, they said. Rental price increases were justified because of the new value added to the properties. They also claimed that many businesses appreciated the value-adding activities that REITs carry out on their properties.

One participant remarked that landlords, like their tenants, faced increasing business costs too. For example, land rental price from JTC or HDB typically increase about 5.5% each year. In addition, certain government relief measures (e.g., tax rebate for vacant space) have been removed recently. All of these factors had an impact on rental prices. Moreover, the retail sector typically had low barriers to entry, and rental prices were driven up as more people were attracted to enter the retail business.

Another participant acknowledged that some government regulation to control rental price growth could help correct for market externalities. However, he cautioned against retrospectively applying such regulations because landlords would find it difficult to recalibrate their business operations. It was added that the introduction of a cap on rental price increase could potentially impede future real estate development as investors were turned away by the lack of ample returns. Instead, he preferred the use of collective bargaining as suggested by some participants for businesses, especially SMEs, to strengthen their bargaining position.

Finally, one participant pointed out that the main objective of government intervention in the real estate sector was to reduce market distortions and not to provide handouts to businesses. He added that even market economies required some form of regulation to correct for certain externalities. The question was finding the optimal level of regulation to support a smooth running market.



## **The Role of Government in Allocating Resources and Regulation**

Taking a whole-of-economy perspective, questions were raised about the optimal levels of public ownership of the rental space and the regulation of the real estate markets, as well as the role of government intervention in the sector.

Issues regarding finding the right balance between the allocative efficiency of free markets and addressing distributive concerns through public policy were raised in connection to possible policies to protect small tenants through a tenancy framework. Participants noted that the upholding of legal contracts was a key reason for Singapore's economic growth and that government intervention in this area might not send positive signals to the markets. Some participants also noted that land scarcity in Singapore remained a problem, and the rental price caps as well as government subsidy through ownership of retail and industrial space could distort the market allocation of rental space to higher value-added businesses.

However, other participants argued that the long-run appropriation of profits by landlords in Singapore had adversely affected the incentives to develop capabilities to create value through innovation in manufacturing and services that would support export competitiveness. One participant noted that manufacturing firms that owned their own properties — essentially locking up capital in property assets and hedging against rises in rents — were more profitable in the long run than companies that rented their business space. Participants questioned the long-term desirability or sustainability of an economy where the investment returns from property assets outweighed returns of other forms of productive capital.

## **Balancing Between Business Vibrancy and Business Sustainability**

One participant said that if businesses in Singapore continued to experience margin compression, eventually they would be forced to raise the price of their goods. This would lead to higher costs of living, which was detrimental to society. Besides, SMEs acted as a sponge to the economy, protecting it from adverse shocks. While a free market was always touted as imperative to attract MNCs into Singapore, during an economic downturn, MNCs did not provide the type of job stability that the SME sector offered. Hence, in order to retain this layer of diversity and social stabiliser, it was necessary for some government intervention to support a vibrant SME sector.



While several participants acknowledged the need for government intervention to support business vibrancy and protect the interests of the SME sector, they preferred the government to extend its support directly to businesses that needed help, instead of intervening through regulation of the real estate markets. This would reduce the distortion of market allocation of resources. Some landlord participants also said that they were willing to help business improve their cost structure so that they were more competitive.

One participant opined that the focus on rental prices detracted from the real problem, which was a lack of market demand. SMEs, especially those in the F&B sector, urgently needed to restructure and be more productive in order to cope with rising competition. In addition, businesses with strong brands tend to have greater influence of the traffic flow in a location, and hence would have more bargaining power over rental contracts. In contrast, businesses that did not have strong market presence relied heavily on the landlord's ability to attract shoppers to the location. Naturally, they would be subjected to the conditions set by landlords.

Adding on, he said that although ensuring business vibrancy was important, one could not ignore the land constraints in Singapore, and that 80% of the land stock earmarked until 2030 have already been allocated for use.

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## Chapter 4

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# Financing Challenges of SMEs



## CHAPTER 4: FINANCING CHALLENGES OF SMES

### BACKGROUND

The financing of micro enterprises and SMEs has long been a subject of immense interest because of their growing importance as economic drivers and job providers. A lack of access to formal funding can severely limit SMEs' ability to become more productive and to expand in order to reap the economies from scale. Studies have shown, for example, that SMEs that are financially constrained have the tendency of keeping operational profits as precautionary savings against unexpected events rather than investing those profits. The low investment in turn hampers their efforts to raise productivity and capacity to grow. The implication is that increasing the depth of credit available to SMEs may help raise domestic investments, which would eventually lead to higher productivity and economic growth (Shinozaki, 2012). For an economy to be competitive, it is imperative that the SME sector is also vibrant.

In the aftermath of the GFC, as banks deleveraged to clean up their books, falling liquidity caused bank credit to businesses, especially SMEs, to contract. Looking ahead, bank lending is likely to be further constrained when provisions of the Basel III regulatory framework, introduced in 2013, are fully implemented by 2019. Aimed to curb future financial instability by regulating bank capital, liquidity and leverage, the provisions are expected to drive up borrowing costs. Loans to SMEs were also assigned a relatively high risk weighting under Basel III. Against the backdrop of rising capital requirements and higher cost of capital in more turbulent capital markets, there is a risk that banks may choose eventually to shift its business models away from SME lending (Schizas, 2012).

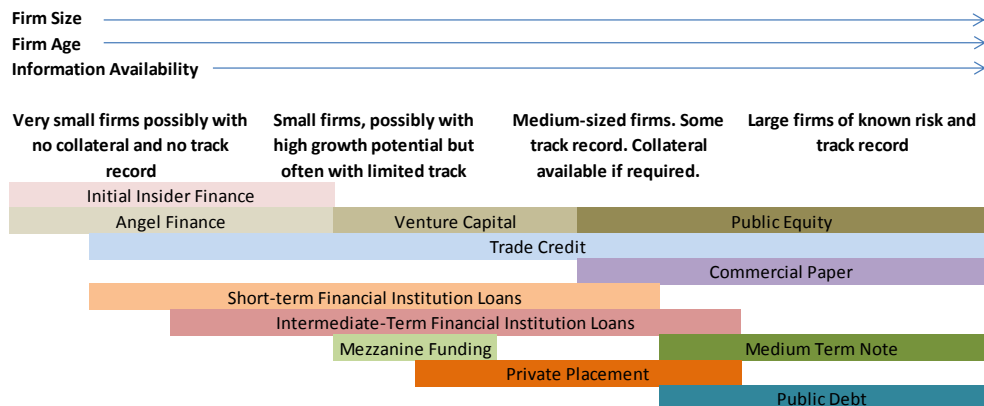
An efficient financial system ensures effective pooling, management and transfer of risks through effective intermediation and pricing of risk (OECD, 2010). Lenders are well matched to borrowers, and investor preferences in terms of the risk and maturity of the credit extended within the portfolio is matched to the requirements of the borrower for financing, while the effects of information gaps and asymmetries are minimised.

Companies have different business needs that evolve at different stages of development. They include working capital requirements (inventory, receivables) fixed capital requirements (land, long-lived assets), trade credit, guarantees and other structured finance products. These needs are addressed through specific forms of financing. Figure 4.1 gives a brief



overview of the forms of financing that are commonly used by businesses in different stages of growth.

**FIGURE 4.1: OVERVIEW OF FINANCING FOR BUSINESSES AT DIFFERENT GROWTH STAGES**



Source: “The Economics of Small Business” (Berger & Udell, 1998)

### Share of Financing for SMEs

As a result of the government’s efforts to promote entrepreneurship and to support the growth of domestic SMEs, the number of SMEs increased from 128,000 in 2005 to 171,000 in 2014. Their contribution to total enterprise value rose from about 30% in the late 1990s to about 46% in 2004, and had risen further to 58% in 2010 (OECD, 2013). The number of workers employed by SMEs also increased from 56% in 2006 to 67% in 2010.

Despite their growing contributions, however, SMEs still received a smaller share of the financial credit compared to larger enterprises. Parliamentary debates in 2014 revealed that only about a third of all business credit in Singapore has been extended to SMEs even though they account for 99% of all enterprises, 70% of employment and 50% of GDP. That figure is on par with the US, but is lower than places like Taiwan and South Korea, where the number is half of the overall (Lim, 2014).

A similar conclusion can also be drawn from an earlier study conducted by ADB in 2012 on the extent of SMEs’ access to finance across countries in Asia. Figure 4.2 shows SMEs’ contributions in different countries to employment and GDP as well as the amount of financing they enjoyed as a percentage of their respective country’s GDP. In low middle-income countries such as India and Indonesia, the value of SME loans as a percentage of GDP was small possibly because of the differing structures and maturity levels of financial systems in these countries. In contrast, in countries with high and upper-middle income, that share ranged from



30.7% to 48.7%, except for Singapore and Malaysia, whose outstanding value of SME loans as a percentage of GDP was only 15.0% and 17.4%, respectively. Singapore's 15.0% was less than half of that of Japan and Korea which, like Singapore, are also high-income countries (Shinozaki, 2014). The low figures indicate that SMEs in Singapore enjoyed lower accessibility to credit than those in Korea and Japan even though their contribution to respective country's GDP was comparable.

**FIGURE 4.2: SMES' CONTRIBUTION TO EMPLOYMENT AND GDP AND THE OUTSTANDING VALUE OF SME LOANS AS % OF GDP**

Country	SME as % of total companies	Contribution to Jobs	Contribution to GDP	Outstanding Value of SME loans as % of GDP *
<b>High Income</b>				
Japan	99.7	68.0 [12]	54.0 [12]	35.9 [10]
S. Korea	99.9	87.0 [12]	48.0 [12]	37.4 [10]
<b>Singapore</b>	<b>99.4</b>	<b>70.0 [12]</b>	<b>50.0 [12]</b>	<b>15.0 [10]</b>
<b>Upper Middle Income</b>				
Malaysia	99.2	59.0 [10]	31.9 [10]	17.4 [10]
Thailand	99.8	80.0 [12]	37.0 [12]	30.7 [10]
PR. China	99	80.0 [12]	60.0 [12]	48.7 [10]
<b>Lower Middle Income</b>				
India				4.3 [10]
Indonesia	99.9	97.0 [12]	58.0 [12]	0.7 [10]

\* [ ] = year of data used

Sources: Shinozaki (2012); Vinayak et al. (2014); CGAP (2010).

In another local study conducted in 2012, which tracked 700 applications by SMEs for financing, it was found that more than 55% of the applications were rejected (Singapore Business Review, 2013). Many SMEs were also reportedly caught off-guard when their credit facilities were cancelled by their banks due to high economic uncertainties. Finally, a report in May 2014 by McKinsey revealed that Singapore only spent about 0.4% of its GDP on SME financing support (Vinayak et al., 2014). This is considerably lower than the 2.7%, 3.7% and 6.0%, spent by Germany, Korea and

Taiwan, respectively. Various studies point collectively to the difficulties faced by Singapore SMEs in accessing credit, especially in times of extreme economic conditions when liquidity shrinks and banks turn cautious in their lending. It also suggests the government is underspending in providing financing support to SMEs.

### **Stability-Oriented vs Growth-Oriented SMEs**

The term SMEs is too narrow to describe a broad range of firms in terms of sector, scale, management style and history. In reality, each SME has differing funding needs depending on various factors including its stage of enterprise growth and the level of the country's economic development. To determine where financing gaps exist, SMEs can first be categorised based on two factors that drive their funding needs, i.e., size and growth orientation.

Size is more an extrinsic and measurable indicator pointing to SMEs' current state. Officially, as of April 2011, MTI defines an SME as an enterprise with an annual sales turnover of under S\$100 million, or that employs less than 200 workers<sup>5</sup>. This new definition, however, is still too broad for it to afford a more detailed look at the SMEs in Singapore. Another more functional definition proffered by McKinsey classifies all Singapore businesses into globally competitive companies and large corporations (numbering about 1,000 or 0.6% of total companies) with revenues of more than S\$100 million; medium enterprises numbering about 2,000 or 1.2% of total companies with revenue between S\$30 million and S\$100 million; 22,000 small enterprises with revenues between S\$1 million and S\$30 million; and micro-enterprises numbering about 146,000 with revenue less than S\$1 million (Vinayak et al., 2014).

Growth orientation, on the other hand, is an intrinsic and unquantifiable indicator pointing to SMEs' future state. In a study on SME financing, the Asian Development Bank (ADB) classifies SMEs as either stability-oriented or growth-oriented (Shinozaki, 2012). A stability-oriented SME is typically a self-employed micro firm or small family business created by a business owner whose main concern is survival. Since there is little impetus for expansion and rapid growth, little financial leverage is required and financing needs are restricted mainly to startup and working capital.

A growth-oriented SME, on the other hand, is one that aims to capitalise on emerging opportunities using innovative technology and ideas that are

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<sup>5</sup> This new definition superseded the old definition of an SME as an enterprise with no more than S\$15 million in fixed asset investment and no more than 200 employees.



often scalable and can therefore grow rapidly. It can also be one that begins as a stability-oriented enterprise but expands rapidly under the able leadership of its entrepreneurial business owner. In either case, because the business is likely to be pushing boundaries, substantial investment is needed for strategic expansion and growth. The resultant high financial leverage makes such businesses high risk but also high return and their financing needs are correspondingly more complex.

While stability-oriented SMEs help to maintain social stability and reduce poverty, growth-oriented SMEs enhance a country's economic competitiveness, raise its productivity and provide new impetus for sustainable economic growth. In the longer term, growth-oriented SMEs have the makings of world-class companies similar to the middle-sized companies in the EU and the US and the *Mittelstand* in Germany. Supporting stability-oriented SMEs helps to achieve the socio-political goal of providing jobs to structurally displaced workers. Supporting growth-oriented SMEs, on the other hand, helps to put Singapore one step closer to the economic goal of upgrading Singapore economic structure.

A sustainable SME financing policy framework should therefore be inclusive enough to include a microfinance industry aimed at supporting stability-oriented SMEs and startups while at the same time comprehensive enough to offer a full range of scalable funding opportunities (including both debt and equity and exchange-and non-exchange based) for growth-oriented SMEs, ranging from innovative startups to competitive medium-sized firms at different phases of their growth cycle (Shinozaki, 2012).

### **Overdependence on State Funding for SME Development**

Strong actions by the government in recent years have indeed moderated the pains of SMEs having difficulties accessing credit. The dominant role played by the state, however, brings to fore not only issues of moral hazards and adverse selection but also whether the use of state funds are efficiently allocated and best serve the overall economy in the long term.

While the optimal level depends on the state's goals in implementing the subsidies, two objectives noted in the literature, are to capture the positive externalities accruing from investment in new research-intensive enterprises, and to correct the market bias towards underinvestment in new enterprises due to information asymmetries, agency problems, incomplete contracting and insufficient depth of capital markets (Botazzi & Da Rin, 2002). Hence the optimal level of state subsidy would depend on the marginal effect of an additional unit of subsidy on the overall return of the investment including the positive external effects.

In Bauer and Burghof (2007), it is argued that subsidies in financing of small enterprises generate the highest overall marginal benefits because the markets in these sectors remain highly inefficient. Negative effects of crowding out are minimised, while significant positive externalities are generated if the subsidy facilitates the accumulation of knowledge in the early stage financing and venture capital markets (Schertler, 2003), thereby generating as much additional private investment as possible. In Singapore, this is reflected in the success of the Micro-Loans Programme in accelerating the development of SME banking units in the respective local banks. Furthermore, small and risky firms suffer most from the costs associated with incomplete contracting (assuming equal risks), which state co-financing may address. It was also shown that direct investment could generate the same combinations of investment levels at lower costs than a refinancing subsidy, while state guarantees should be avoided due to its stronger bias in favour of bad investments.

Japan's compensatory SME financing policies offer important lessons for Singapore because of several similarities between the two countries' socio-economic development models. While Japan focused on developing big businesses at its early stage of development, Singapore's growth was underpinned by MNCs. Like Japan, the Singapore government also plays an active role in enhancing SMEs' access to credit, not only in regulating and facilitating but also in directly funding or by co-sharing of risks with financial intermediaries. Finally, Singapore also spends cautiously little on social welfare as in the case of Japan. SMEs in both countries therefore serve an important social role providing jobs for older displaced workers thus reducing their dependence on the state for welfare payouts.

Japanese experience, however, shows that using SME policies as a substitute for social safety net not only results in moral hazard and fiscal sustainability issues but also impede economic restructuring when inefficient SMEs kept on life-support depress competitive SMEs' profitability and hence also their own ability and willingness to reinvest and expand (Shinozaki, 2014). Similarly, financial support given to stability-oriented SMEs in Singapore may have also prop up otherwise inefficient SMEs and prevented their exits. Their continued existence takes up resources, drives up costs and depresses profit for efficient SMEs. During the process, productivity and wage growth are also depressed for all workers in SME sector.

It is not that the government is unaware of the adverse effects of use of state funds to promote the growth of SME sector. The issues have been debated in the parliament (Chua, 2014). Based on the government's past *modus operandi*, counter-cyclical SME support measures are usually



withdrawn when recovery sets in. Indeed with the improvements of economic conditions and the recovery of SME bank financing revenues after the GFC, the government terminated the Bridging Loan Programme in February 2011 and also rolled back support schemes, reducing the Internationalisation Finance Scheme (IFS) from S\$50 million to S\$15 million per loan, and the Loan Insurance Scheme Plus (LIS+) from S\$15 million to S\$5 million per borrower group. As a result of the roll-back, the value of government funding declined by 75% from S\$6 billion provided to about 14,000 SMEs (8% of SMEs) in 2009 to S\$1.4 billion to 5,000 SMEs (or 3% of SMEs) in 2011 (Vinayak et al., 2014). Furthermore, to mitigate moral hazards associated with use of public funds, debt financing from the government will only come in after financial institutions have done its due diligence and have approved a loan. For equity financing, the government only takes a stake to match private sector investment (OECD, 2013). Despite the various mitigating efforts, the roles played by the government in providing financing still remain unmistakably dominant.

Another common feature associated with financing of both stability and growth-oriented SMEs is the heavy dependence on the banking sector for credit supply. The European experience shows that the overdependence raises systemic risks arising from widespread bank failures due to non-performing loans in times of financial shock. The credit crunch that follows when surviving banks deleverage to mitigate associated risks also impedes the process of overall economic recovery when even healthy SMEs are deprived of working capital and investment financing (Wolf, 2014). In the EU, the overdraft rejection rates, for example, rose from an average of 8% in 2005 to 2007 to 19% in 2012, while those for term loans rose from an average of 6% in the period 2005 to 2007 to 23% in 2012 (Armstrong et al., 2013). European countries are therefore moving beyond the banking sector into the capital market to develop longer term financing instruments to help finance the growth of innovative startups and SMEs.

Similar contraction of bank credit was also seen in Singapore during the recent GFC and recession. The number of SMEs with bank financing in Singapore dropped from 61% to 52% in the course of just a single year from 2009 to 2010. Correspondingly, the percentage of SMEs taking up government funding grew from 7% in 2008 to 26% in 2012 (Vinayak et al., 2014). Meanwhile, concerns over systemic risk also rose as corporate debt to GDP ratio hit 78% in the second quarter of 2014, up significantly from just 52% in the second quarter of 2008. In an event of an interest rate hike, the high debt combined with declining profitability could result in spike in non-performing loans (Singapore Business Review, 2014).

The issue for Singapore is therefore not only whether SMEs still face a crippling shortage of financing but also of whether the current approach,

underpinned by an overdependence on both the government and the banking sector in providing financing, is efficient and prudent so that it best serves the overall economy in the long run.

For stability-oriented SMEs, Singapore needs a financing framework that is inclusive enough to take care of the financing needs of all deserving SMEs but still discerning enough to avoid the trappings of moral hazards and adverse selection in the long run. The ideal outcome is that the financial support provided to the inefficient SMEs help to buy time for restructuring efforts to bear fruit and to create more meaningful jobs for even the older Singaporeans. In due course, support for inefficient SMEs can be gradually withdrawn to render a more productive and innovative SME sector. Given that banks are less likely to extend credit without the government assuming most of the risks, the government's role in providing credit support for stability-oriented SMEs, including the inefficient ones, may have to remain dominant.

As for growth-oriented SMEs, the experience of the US and the EU points to the potential benefits of developing more diverse financing modalities that is beyond the banking sector. With the target set at doubling the number of local SMEs with revenues of over S\$100 million to 1,000 by 2020, the need for growth capital by medium-sized businesses to fund their expansion will only rise<sup>6</sup>. The policy challenge is therefore to develop robust capital markets to provide alternative channels of supplying growth capital especially to fund longer-term and higher-risk strategic investments of high-tech startups and growth-oriented small and medium-sized businesses. Indeed, recent policy actions indicate that to be the path taken by policymakers.

### **Micro-Financing in Singapore**

The lack of track records and tangible collaterals creates obstacles for financing. A study by McKinsey in 2014 showed that the 146,000 micro businesses in Singapore tend to rely more on equity financing and retained earnings. They typically had lending relationships with one or two banks for only small secured or unsecured working capital loans.

Efforts to help close the financing gap for micro businesses began as early as 2001 as a support for those who were structurally displaced by the departure of MNCs to start their own businesses. To address the issue of

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<sup>6</sup> The target was set in 2010 by the Economic Strategies Committee set up by the government to provide strategic direction for the economy.



information asymmetry, an SME Credit Bureau was also set up as a depository of credit information in 2005.

Under the Enhanced Micro-Loan Programme (MLP), the government co-shares 70% of the risk of bank loans of up to S\$100,000 for SMEs with 10 or fewer employees or annual sales of under S\$1 million<sup>7</sup>. The Local Enterprise Finance Scheme (LEFS) provides loans of up to S\$15 million through participating financial institutions for automation and upgrading of factory and equipment.

As the economy went into restructuring mode in 2010, more incentives were provided to drive innovation and raise productivity. For example, the Productivity and Innovation Credit (PIC) was launched in 2011 to encourage SMEs to invest in order to raise productivity. To aid lower-income workers while restructuring is in progress, the government also supplements their wages by introducing Workfare and the Wage Credit Scheme (WCS). Meanwhile, incentives are also provided through the Skill Development Fund and Workforce Development Authority to help businesses upgrade the skills of their workers.

UOB, which claimed that it had a 50% market share among SMEs that make less than S\$20 million a year, reported double-digit growth of SME revenue over the past few years. Meanwhile, DBS said its SME revenue grew to a record S\$375 million in the first quarter of 2014. With the help of an online facility launched to enable the opening of accounts within 15 minutes, the bank managed to sign up 150,000 new customers in the SME space. Foreign banks such as Standard Chartered and MayBank have also jumped onto the SME financing bandwagon.

To compensate for the higher transaction costs, banks have remodelled their business to earn not only interests but also fees from services provided. Today, DBS is also reaping the benefits of cross-selling from a pickup in capital market and treasury activities from the larger SMEs (Lim, 2014).

Amid an increasingly competitive SME lending landscape, business owners have more choices with offers often coming from more than one bank. This has led to higher approval in banks in Singapore. Concerns were raised about the risk of moral hazard due to risk-sharing by the

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<sup>7</sup> The two-year enhanced scheme, launched in 2014, replaced the Micro-Loan Programme (MLP) introduced in 2001 under which the government co-shared 50% of the risk of bank loans.



government. Moving forward, lending models as well as government policy needs to be fine-tuned to balance accessibility and risk.

The financing gap for many micro and small businesses has indeed narrowed in recent years as a result of strong government interventions, which help to leverage lending from the banking sector. Notwithstanding, the lending environment could still turn adverse in the event of extreme economic conditions. Furthermore, the financing gap still exists especially for many micro and small businesses that do not meet funding criteria set by the government and therefore still face funding hurdles<sup>8</sup>.

### **Gaps in Financing for Internationalisation**

Internationalisation refers to the expansion into export markets as well as investments in overseas assets. Export entry presents particular problems for SMEs, involving high upfront sunk costs from activities such as identifying foreign customers and new export markets, creating distributor networks, and meeting foreign product standards. Export transactions incur higher shipping, logistics and trade compliance cost, with each day in transit adding to shipping costs, while additional risks include customer non-payment, exchange rate instability, and cash flow problems (Grover & Suominen, 2014).

Typical sources of financing and risk management for international expansion include commercial credit facilities, such as export/import loans, loan guarantees and insurance products, project financing and industry-specific collateral-backed loans and leases, in addition to the sources of equity and debt financing provided for expansion.

Growth-oriented SMEs in Singapore seeking to expand overseas currently face difficulties raising growth capital. In particular, shortfalls are encountered by businesses engaging in trade with emerging markets outside Asia and services companies exporting their services with limited tangible assets to offer as collaterals. Strategic investment activities in these foreign markets constitute higher lending risks. Banks may therefore be reluctant to extend credit especially in the absence of collaterals and of trust derived from long-term banking relationships. The financing constraints these startups and SMEs face put them at a disadvantage compared to their foreign competitors who enjoy state financial support through credit guarantees and/or export-import (EXIM) banks or have more

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<sup>8</sup> Credit guarantee under the 2014 Enhance Micro-Loan Programme, for example, are only available for businesses that are less than three years old and employ 10 or fewer employees.



alternative funding options from deeper and more established capital markets.

Based on the 2013 ADB Trade Finance Gap Survey, the global trade finance gap was estimated at US\$1.9 trillion. In advanced Asia, the trade finance gap was estimated at US\$519 billion or 26% of the world's figure. Global rejection rates of trade finance applications are highest for SMEs with 50% of proposals for trade finance being rejected in 2013, as compared to only 7% for MNCs. The default rates on trade credit financing were very low at 0.05% on more than 11 million trade finance transactions, which suggests high rates of credit rationing and bank conservatism in trade finance. The main impediments in Asia for the bank provision of trade finance include anti-money laundering and know-your-client requirements, low country credit ratings, and issuing bank's poor credit ratings, while the main impediments to businesses obtaining trade financing include high interest rates, insufficient collaterals and long processing time.

On the demand side, there is a lack of financial awareness of financial instruments available for trade credit financing. From the same ADB survey, as many as 78% of companies reported that they would benefit from greater financial education. Familiarity with traditional forms of trade financing such as letter of credit, working capital financing and credit insurance were low. Familiarity with non-traditional forms of financing such as supply chain financing, factoring and forfaiting were very low. The lack of familiarity with finance options may contribute to the high proportion (68%) of companies, which did not seek alternative forms for rejected transactions.

To plug the financing gaps, the government has stepped up its involvement through various financing schemes administered by different government agencies including IE Singapore, SPRING and Temasek Holdings. To provide better trade finance solutions for SMEs and to help them mitigate non-payment and other risks when venturing abroad, the government has also revamped its risk assessment procedures. IE Singapore has also worked with various partners to help design schemes that offer SMEs more affordable insurance coverage for risks in overseas markets.

The IFS administered by IE Singapore provides funding through participating financial institutions of up to S\$30 million for additional asset investments or working capital in overseas projects. The LIS+ helps companies secure short-term trade financing lines from banks by insuring the banks against insolvency risks of the borrowers. The Trade Credit Insurance (TCI) enables qualifying Singapore companies to receive premium support of up to 50% of the minimum premium for TCI policies

held with Singapore-registered credit insurers, subject to a maximum amount of S\$100,000 per company. IE Singapore also offers other support such as political risk insurance and double tax deduction schemes. Notwithstanding, given the complexity of their funding needs, which cannot be fully met by risk-averse banks, financing gaps for internationalisation are likely to persist.

## **Different Types of Financing**

### ***Equity Financing***

The gaps in equity financing include a lack of technology companies committing to high capital investments with long gestation periods of at least three to five years; and promising startups that have gone through early stage funding but fail to attract new funding because their business models, though viable, do not offer the high return within the time span expected by venture capitalists (VCs). Hence, high-tech companies are finding it difficult to obtain financing to scale up production. For high-tech innovative startups, only 19 VC funds in Singapore have invested in technology companies' first-round financing since 2006. Between 2006 and 2012, only US\$33 million was invested with the average per year falling below US\$4 million since 2008 (Vinayak et al., 2014).

In addition, it is noted in the literature that innovation and research and design in small high-tech SMEs have special features that make external debt-based financing especially difficult, such as the high degree of uncertainty combined with a fixed interest rate return, the lack of tangible assets which limits collateral availability, the lack of options in diversifying risk by pursuing several innovation projects, and unfavourable ratios between transaction costs and returns (Zimmermann, 2014). It was found that the level of external financing in SMEs fall as R&D intensity increases, and as the degree of uncertainty represented by the kind of research (e.g., basic research, market novelties) increases.

Dealflow Connection was established in 2007 to match SMEs with individuals or entities that have funds to offer, and SPRING has an investment division managing two funds to help start-ups and established SMEs with growth capital. Promising medium and large companies with revenues of up to S\$500 million and at a more advanced stage of growth can tap the SME Co-Investment Fund II and SME Mezzanine Growth Fund — both managed by the state-owned investment company Temasek Holdings' Heliconia Capital Management.

To meet specialised financing needs, Temasek Holdings set up a new project finance company called Clifford Capital in 2012 with a consortium of financial institutions that counts banks and insurance corporations. Clifford Capital provides long-term financing for local companies pursuing



overseas infrastructure (power, waste and water treatment, transport, etc.) and marine sector-related projects. These are sectors where Singapore enjoys a strong competitive advantage. In total, about S\$400 million of credit was set to be disbursed annually to finance S\$23 billion of offshore projects. Hence, as in the case of stability-oriented micro and small businesses, the financing gaps for growth-oriented small and medium enterprises have also narrowed in recent years as a result of strong government involvements both in debt-and equity-financing.

However, due to the risks of regulatory capture and moral hazards, as well as the limits of government funding, the development of deep capital markets remains an important long-term solution to financing of growth SMEs.

### ***Angel Investing***

Angel investing is a new and growing form of financing in Singapore. A “business angel” is defined as an individual who has in the past three years invested his personal wealth in an entrepreneurial venture started by someone else with whom he or she has no family ties, excluding the purchase of publicly traded shares or mutual funds (Wong & Ho, 2007).

Data on the growth rates of angel investing is not available, but based on the Global Entrepreneurship Monitor (GEM) surveys, the prevalence of informal investment<sup>9</sup> in Singapore appears to have increased from 2000 to 2006, with the informal investment rate rising from 1.3% of the adult population to a high of 3.5% in 2005. While informal investment is on the rise in Singapore, Singapore’s participation rate is still below that of countries such as the US and other Asian countries like Taiwan, China, Korea and Thailand (Wong, 2011).

Studies have found that informal investing in Singapore appeared to be less influenced by demographic factors and more by entrepreneurial networks, experience and skills. Business angel investment in Singapore was largely familiarity-driven, with 80% of angels having known their entrepreneur for at least a year prior to investing, and 52% having known them for more than five years. There were also relatively small differences in the average size of investments made by family investors (S\$14,750) and by business angels (S\$16,666), suggesting that informal investing in Singapore was largely undeveloped in terms of professionalism and the

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<sup>9</sup> Informal investors are defined as those who have in the past three years invested in an entrepreneurial business venture started by someone else, excluding the purchase of publicly traded shares or mutual funds.

ability to make higher-risk investments. Some of the identified bottlenecks include the rate of informal investing being constrained by the lack of entrepreneurial activity, and the need to boost the level of professional expertise in the business angel community in Singapore (Wong & Ho, 2007).

Among other things, good angel investors possess the relevant technical and consultancy capabilities to advise their investment companies, have strong sales experience to pitch and market their investment companies to potential stakeholders and customers, and are able to leverage their networks to the companies' benefit (Mirabile, 2014.). In the US, the growth in angel investing is due to an expanding community of previous generations of startup founders who acquired resources through successful initial public offerings (IPOs) and acquisitions, and who sought to reinvest capital and knowledge into the industry.

The development of major angel investor networks and support systems is a key catalyst for the professionalisation of angel investors. Business angel networks contain well-developed channels to share information, and provide a means of introduction and contact between SMEs and potential investors. Singapore has seen an explosion of business angel networks in recent years.

### ***Crowdfunding***

New funding avenues have been made possible by the advent of Internet and social media. Smaller companies can now benefit from, for example, peer-to-peer equity and debt financing platforms, which allow SMEs and startups to attract many investors that contribute small amounts of money instead of selling their ideas to a few wealthy venture capitalists. Established US-based crowdfunding platforms such as Kickstarter and Indiegogo have emerged to become important sources of finance for entrepreneurs in the US and Europe.

In Asia, however, the concept of crowdfunding is still in its early stages of development. ToGather.Asia, which pioneered crowdfunding in Singapore, started only in March 2012. Since then, other local sites like Crowdonomic and Cliquefund have also appeared. In addition, Singapore's status as a financial centre and its high penetration of social media and technology has attracted foreign-based sites such as Kickstarter, Indiegogo and Swedish FundedByMe to also establish a presence here.

Unlike in the US where restrictions on companies selling shares to the general public via crowdfunding platform have been lifted in April 2012, equity crowdfunding in Singapore may be deemed as a security offering which makes it governable by the Securities and Futures Act (Cap. 289).



Among other things, the Act stipulates that entities that make an offer of securities to investors in Singapore are required to lodge and register a prospectus with the Monetary Authority of Singapore (MAS).

Because of these legal uncertainties, money received by companies in Singapore through crowdfunding platforms has been treated as not investments but goodwill donations. In return, funders are given rewards or “perks” which are non-monetary incentives that startups offer in exchange for the contribution received. As a result, the amounts raised in Singapore are typically small.

In February 2015, the Malaysian Securities Commission became the first in Southeast Asia to have issued equity crowdfunding guidelines allowing businesses to raise growth capital capped at RM5 million from crowdfunding platform. The MAS also released a consultation paper in February 2015 setting out its proposals and clarifications on setting up an equity crowdfunding platform (ECP) by mid-2015 in a joint venture between SGX and high-tech venture capital firm Clearbridge Accelerator (Goh, 2014).

Unlike the other foreign ECPs, MAS proposal restricts investments to only accredited investors and institutions, to protect unaccredited investors from the significant risks associated with such investments. In addition, the ECPs, as intermediaries, are not allowed to handle or hold customer monies, assets or positions and act as principal in customer transactions. To allay fears over risks, ECPs could accept only companies with revenue streams that are in the black or near profitability. By limiting exposures to a closed group of investors, MAS proposed to ease the current financial requirements for ECPs so that operators with lower financial resources could also apply for a licence. Besides lowering the minimum base capital requirement for such intermediaries to S\$50,000 from the current S\$250,000, MAS also dropped the need for them to lodge a security deposit of S\$100,000.

The equity crowdfunding initiative by MAS is viewed as timely for many high-tech startups founded in the recent years. They are maturing and are seeking post-Series A investments to fund expansion<sup>10</sup>. However, MAS' efforts in ensuring investor protection by limiting participation to only a small group of privileged investors have drawn criticisms and concerns as

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<sup>10</sup> PostSeries A funding refers to multimillion-dollar investments by VC firms in companies that have commercially viable products and services, but require funds to expand quickly. See Chng (2015b).

to whether small investors, who are already facing a dearth of investment opportunities, are shut out of another potentially highly lucrative set of investments (Chng, 2015a). More importantly, the main attraction of crowdfunding is its use of Internet technology and social media to raise a small sum each from a global audience instead of a large sum from one or two venture capitalists looking for extraordinary high yields. The restriction against mass outreach not only goes against the very spirit of crowdfunding as its name implies but also greatly diminishes the effectiveness of crowdfunding as a tool for SMEs and startups to raise funds.

Finally, crowdfunding can also be debt-based. In Singapore, platforms offering crowdfunding include MoolahSense and FundedByMe. MoolahSense, for example, began its operation in 2013 to help connect small businesses in Singapore with prospective investors by allowing a borrower to specify the loan amount and the interest rate the borrower is prepared to pay. In response, potential investors looking for higher yield than bank deposits but do not have enough capital for corporate bonds, nominate the interest rate at which they are prepared to lend for amount starting from S\$1,000. In a fundraising exercise for an education centre in Singapore, S\$100,000 was raised at an annual interest rate of 9.9%, a rate that is higher than the 5 to 6% charged by banks for micro loan but considerably lower than the 13 to 20% charged by money lenders depending on whether the loan is secured.

### ***Catalist — The Junior Equity Market***

In 2008, Singapore set up Catalist through SGX to replace the secondary board SESDAQ. The new junior board is designed to allow fast and low-cost entry for fast-growing companies with well-defined business models but still in their conceptualisation phase. Unlike its predecessor, Catalist replicated London's Alternative Investment Market approach of setting less stringent listing requirements in order to try to attract less mature companies with no track record from around the region to list here. There is no restriction on size of companies wishing to list, for example. Neither do they have to show a business track record nor to pass any profits or asset test. To cut down listing costs and time, companies are only required to lodge an Offer Document on the Catalist website for at least two weeks for public comment instead of the past SESDAQ practice of lodging a prospectus with the MAS. Typically, it takes only five or six weeks for companies to go to market instead of the two to three months under SESDAQ. Once they are listed, they also have a freer hand to raise funds more readily to undertake acquisitions or disposals of assets in respond to emerging business opportunities.



In 2014, Catalist raised S\$318 million for 18 companies, up from S\$253 million from 12 listings in 2013. The average IPO size was S\$120 million in 2014 and S\$230 million in 2013. It used to be that companies seeking listings on the Catalist board were mostly from the property and construction sector. Interests have since spread to companies from other industries including oil and gas, chemicals, medical, entertainment, luxury cars and watches, defence, healthcare and furniture. In December 2014, for example, Singapore movie producer mm2 Asia, which produced local blockbusters such as the *Ah Boys To Men*, and *Lion Men* films raised S\$5.7 million (Leong, 2014a).

Trading interest in Catalist-listed companies has risen considerably in recent years in tandem with more listings. According to SGX data, turnover value on the Catalist board accounted for 5.5% of total market turnover value in 2013, more than double the 2.4% from 2012. The total value of Catalist-listed shares traded in 2013 jumped 147% from 2012, compared to a 5.7% rise on the Mainboard.

Despite the increase in market interests and activities, however, Catalist has not really taken off in a significant way. As of January 2014, there were 141 stocks listed on the Catalist with a combined market capitalisation of S\$9.4 billion or 1% of all stocks listed on the SGX (SGX, 2014). That was not far off from SESDAQ's market capitalisation of S\$10 billion in 2007.

Furthermore, unlike SESDAQ, which incubated many successful mainboard listings such as Venture Corp and Datapulse Technology, only three of the 48 businesses that started out with Catalist made the leap to the main board. One reason could be that the junior board has managed to attract mostly only small companies making less than S\$10 million in pre-tax profit but not medium-sized ones earning S\$20 million or more. The dearth of bigger companies seeking listing could be attributed to image problems that come with the less stringent listing requirements as well as a high-profile warning on the Offer Document that companies listed on Catalist may carry higher investment risk (Goh, 2013).

As for investors, one factor that douses their interests in Catalist market is that, typically, companies that seek listings do not make value investments in the short term because their operations are either unprofitable in their current phase of growth or any profit is more likely to be reinvested to drive growth rather than paid out as dividends (Leong, 2014b).



**FIGURE 4.3: BRIEF OVERVIEW OF FINANCING SCHEMES AVAILABLE FOR EARLY-STAGE AND TRADE FINANCING IN VARIOUS COUNTRIES (NON-EXHAUSTIVE)**

<b>Country</b>	<b>Bank lending and SME loan programmes</b>	<b>Angel Investing Schemes</b>	<b>Grants and Credit Insurance</b>
Singapore	Micro Loan Programme; Local Enterprise Finance Scheme	Business Angel Scheme; Angel Investor Tax Deduction Scheme	ACE startups grant; Spring Incubator Development Programme; Technology Enterprise Commercialisation Scheme; Patent Application Fund plus; Youth Social Entrepreneurship Programme for Start Ups; PIC; ICV vouchers; IDA iSprint
Australia	-	-	Business Growth Grants (Entrepreneur's Programme)
Germany	KfW (State Development Bank) provides: ERP Startup Loans (Risk-sharing with commercial banks of up to 80%); ERP Capital for startups including subordinated loans and equity; Micro Loan Programme; Entrepreneur Loan Programme; ERP innovation programme	European Angels Fund; INVEST grants	KfW Startup coaching grants; Roundtable and Turnaround; consulting grants; cash grants for R&D projects awarded on per-project basis
Japan	Japan Financial Corporation's (JFC) Micro Business and Individual Unit provides: Direct loans to business startups and micro-businesses; safety-net financing; Managerial Improvement (MARUKEI) Loans;	Tax-deductible angel investments	JFC provides: National credit guarantee scheme; SME Agency provides: Credit guarantees; subsidies to startups



	Collaborative Loans; subordinated capital loans; loans for overseas expansion; educational loans that Shoko Chukin Bank provides: SME loans		
South Korea	Loans to micro and small enterprises; SMBA policy financing for long term investments, high-tech SMEs; SMBA provides special guarantees and sunshine loans for less developed sectors of the economy	Angel investment matching fund (1-1); tax-deductible angel investments	Subsidised credit guarantees; no-collateral guarantee insurance for licensing; M&A guarantees; account receivables insurance
Taiwan	Loans are provided by the National Development Fund. Examples include Youth Business Startup Loans and Micro-Entrepreneur loans. The Industrial Development Bureau provides industrial R&D promotional loans. Additional loans to micro-enterprises and SMEs are provided at the municipal level, as well as for investment in technology parks.	-	SME credit guarantee fund of Taiwan (SMEG) provides regular and special guarantees across a wide range of loans; Cost subsidies (e.g., rentals, labour, training) and tax-deductions are provided on a county/city basis by the municipal government agencies; land-lease payment incentive (exemptions) in industrial parks
UK	British Business Bank provides startup loans. Regional Enterprise funds and Business Centers provide business loans for micro businesses and SMEs; Bank of England provides funding for Lending Scheme aimed at increasing	Co-Fund NI; Enterprise Investment Scheme; Seed Enterprise Investment	Various regional enterprise funds provide: Grants for businesses as well as subsidised rentals of workspaces



	credit availability to small businesses. Other loans include regional Loan Funds and regional Catalyst funds.	Scheme	
US	US Small Business Administration (SBA) provides MicroLoan Programmes and Certified Development Company Programmes. US Dept. of Treasury provides capital to financial intermediaries to encourage lending through the Small Business Lending Fund.	Qualified Small Business Stock permits reductions on taxable capital gains; Income deduction on capital losses	SBA provides small business loan guarantee through the SBA Basic 7(a) loans; US Department of Treasury provides funding to state support programmes through the State Small Business Credit Initiative; US Economic Development Association provides competitive innovation grants; state and local programmes provide business grants for specialised business sectors.

Sources: SMEG (2012); InvestinTaiwan; SMBA; PwC (2015); Deloitte (2014); Ernst & Young (2013); Japan Federation of Credit Guarantee Corporation (2014); SME Agency (2013)



**FIGURE 4.4: BRIEF OVERVIEW OF FINANCING SCHEMES AVAILABLE FOR EARLY-STAGE AND TRADE FINANCING IN VARIOUS COUNTRIES (NON-EXHAUSTIVE)**

Country	Equity Co-investment Schemes	Tax Deductions	Trade Financing and Products
Singapore	Spring Seeds; NRF Technology Incubator scheme; Enterprise Fund; Entrepreneurial Talent Development Fund; Sector-Specific Accelerator Programme; Heliconia Capital	Tax deductions on R&D expenditures; Tax exemptions for startups; Pioneer Incentives; Development and Expansion Incentives	IE Singapore provides co-sharing of default risks (Internationalisation Finance Scheme), co-sharing of credit guarantee risks (Trade Facilitation Scheme), insurance premium support (Loan Insurance Scheme, Political risk insurance scheme, Trade Credit Insurance Scheme). IRAS has a Major Exporter Scheme.
Australia	Regional Innovation Funds: Australian Government Innovation and Investment Fund Tasmania; Geelong Region Fund; Melbourne North Fund	Tax liability offset of 40 to 45% for eligible R&D entities; Early Stage Venture Capital Limited Partnerships; Venture Capital Limited Partnerships; Accelerated Depreciation for small businesses; Additional 5% tax discounts for unincorporated businesses.	Efic (Export credit agency) provides overseas investment guarantees, working capital guarantees, exchange rate guarantees, foreign exchange facility guarantees, bonds for collateral, export contract loans, medium-term export payments insurance.
Germany	KfW ERP Startup Fund; ERP Participation Programme	-	Kfw-DEG provides subsidy (up to 50% or €200,000) for feasibility studies. Kfw-IPEX provides export credit guarantees and sector-specific financing products across basic industries (e.g., basic industries receive medium- to



			long-term loans, project financing, structured financing; manufacturing industries receive export finance, acquisition finance, corporate finance solutions, interest and currency derivatives; aviation industries receive direct loans and finance leases, operating leases, derivatives and trade finance products).
Japan	Innovation Network Corporation of Japan funds; SMRJ Venture Funds; Regional SME support funds; JFC Stock subscription rights loans	Tax credits for R&D costs; accelerated depreciation for new investment in equipment, employment insurance, regional areas	Japan Bank for International Cooperation provides overseas investment loans, EXIM loans; untied loans; equity participation; loan guarantees; energy and natural resource financing; bridging loans; purchase of loan assets and corporate bonds issued for overseas expansion; securitisation (guarantees for SPCs, acquisition of securities, guarantees for receivables and other monetary claims). JFC provides financing support to SMEs (e.g., Loans for Overseas Investment Programme)
South Korea	SMBA: Korea Fund; Future Creation Fund; Growth Ladder Fund; startup funds (e.g., technology development	Deferred capital gains tax on reinvested VC; tax benefits for technology M&A; 30% tax credit for R&D expenditures for SMEs; tax credits for	EXIM Bank provides primary services (e.g., export loans, trade finance, loan guarantees); overseas investment credit; natural resources development credit; import credit; information



	and commercialisation funds); incubators	intellectual property purchase; investment in R&D equipment	services related to business opportunities abroad. SMBA provides operation financing support; export financing; preferential support for selected promising SMEs for exports (Global Highway Programme, Hidden Champions Programme)
Taiwan	Executive Yuan National Development Fund; SME Development Fund; Taiwan Silicon Valley Technology Fund; crowdfunding facilitation services (provided by TPex)	Cost subsidies and tax-deductions (provided on a county/city basis by the municipal government agencies); tax credits of 15% on R&D expenditure; tax incentives for biotech investments, infrastructure investment, acquisition of technology, M&As	EXIM Bank of ROC provides credit services (e.g., import-export credit, overseas investment credit, technology export credit, international accounts receivable factoring); guarantee services (import-export guarantee, overseas construction guarantee); export credit insurance support
UK	Various regional equity funds provide early stage funding; loans and equity investment for social enterprise (e.g., Big Issue Invest)	Tax deductions for R&D (e.g., super deduction scheme on expenses; (225%) cash credits	UK Export Finance (Export credit agency) provides trade credit insurance; export-import financing
US	SBA Impact Investment Funds; Early-Stage Innovation Funds	17 tax-cutting measures enacted specifically for SMEs through ARRA, SBJA, HIRE Act and Affordable Care Act (e.g., 50% exclusion on capital	SBA provides export working capital loans; export development financing; facilities development financing OPIC provides medium- to long-term direct loans and loan guarantees to



		<p>gains; accelerated depreciation for tax expensing; health care tax credit for health insurance)</p>	<p>eligible investment projects in developing countries and emerging markets, providing opportunities for US firms.</p> <p>EXIM Bank (authority expired in 1 July 2015) provided working capital guarantee; term financing; lease financing; direct fixed-rate loans to buyers of US exports; export credit insurance policy programs; political risk insurance.</p> <p>USTDA provides funding for infrastructure projects overseas that provide overseas opportunities for US firms.</p>
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Sources: SMEG (2012); InvestinTaiwan; SMBA; PwC (2015); Deloitte (2014); Ernst & Young (2013); Japan Federation of Credit Guarantee Corporation (2014); SME Agency (2013)





## **IPS CLOSED-DOOR DISCUSSION ON FINANCING TO SUPPORT SME DEVELOPMENT IN SINGAPORE**

To better understand the SME financing landscape in Singapore, identify areas of financing gaps, and explore possible solutions to address those gaps, IPS held a CDD on 30 July 2014 that included participants from the public and private sectors.

From the CDD, there was an urgent need to speed up regionalisation of Singapore SMEs as the country's economic model changes. Financing gaps existed in both the growth stage and internationalisation stage of the SME life-cycle. In addition, there are also sector-specific financing gaps that have to be bridged. On the debate of having a SME or EXIM bank in Singapore, the appropriate decision was unclear partly due to the overly broad definition of SME that included a wide range of companies with varying needs and at different growth stages.

### **Three Key SME Financing Gaps in Singapore**

Three main SME financing gaps in Singapore were identified in the discussion:

- Financing for startups and young businesses: Conventionally, banks require companies to have two to three years of operating experience before they would consider providing financing. There is a gap between the time a company first begin operation and the time it can get its first loan.
- Financing for internationalisation: Given that more companies are expanding overseas, sufficient internationalisation support is very important.
- Equity funding: There is a lack of equity financing options for middle of life-cycle SMEs, especially those in post-seed and growth stages.

### **Financing Options for Young and Micro Enterprises**

It was shared in the discussion that micro enterprises usually had access only to term loans, which were designated three- to four-year unsecured loans. As they grow into small and medium companies, the banking services would expand to include typical short-term revolvers, working capital-type facilities and trade financing. Available secured facilities include commercial property loans, equipment and machinery loans, and receivables financing — especially pertinent to companies in



manufacturing and building and construction. To a lesser extent, SMEs may be able to access private equity, venture capital and mezzanine financing.

Micro enterprises in Singapore face several impediments to obtaining business loans. A large majority of them in Singapore seeking to obtain loans are in asset-light general commerce and services industries such as retail, cleaning, F&B, trading and wholesale, as well as business services, which restrict access to credit facilities, said one participant. For companies in the high-tech sector, most of their assets are intangibles, which require officers equipped with highly specialised skills to properly conduct credit assessments. Other problems that hinder micro enterprises from securing bank financing based on traditional banking credit assessment metrics include difficulty in establishing their credit-worthiness due to a lack of established cash flows; a lack of track record; and high levels of growth uncertainty and risks. This has resulted in lower bank lending volume and higher interest rates charged.

Young enterprises are typically companies that are less than three years old with turnover of less than S\$1 million. Within this segment there are seed stage and post-seed stage companies. One participant said that a high demand coupled with high risks and uncertainties in micro-financing resulted in an underserved market. It was noted that in the typical business models of bank lending, the provision of a new SME credit facility typically requires banks to consider if the client meets the credit acceptance requirements, which involves at least two years of track record and financial statements. Hence, young companies largely obtain their financing from internal or non-bank sources. One participant shared that a survey on young businesses found that 11% of young businesses obtained bank financing, mostly in the form of personal loans.

### **Challenges for Banks in Pricing Risk**

One participant said that young companies in Singapore faced relatively high failure rates, with around half failing within the first four years. The annual failure rate of SMEs in Singapore, at 12.5%, was also higher than that of South Korea and Taiwan, at 6.25% and 6%, respectively. He added that around 20% of Singapore SMEs were not profitable, and another 39% of them had profit margins below 5%. Banks manage the higher business risks of SME lending by charging higher borrowing costs.

The sensitivity of default risks to changes in approval rates differ across the life-cycle, product and territories. Small changes in approval rates may create large swings in non-performing loans (NPLs). Banks benchmark against norms in the region and try to stay within the range of peers,



shared one participant. He said that it was important for banks to be proactive in engaging SMEs to find out their needs, to educate them on good credit behaviours, and to identify early warning signals of loan default as part of their credit risk management.

One participant said that other financial entities play an important role in SME financing by offering more financing options. Notwithstanding, he added that more financing options did not necessarily bring about more benefits, especially if these options were transient and died out after a short period of time. The inconsistency and unsustainability of many novel financing ideas could be quite disruptive for the development of businesses.

### **Enhancing the Credit Assessment Framework for SMEs**

Several participants raised the need for banks to enhance their credit assessment framework to incorporate more qualitative assessment elements so that more accurate credit appraisals could be made for SMEs. One participant added that the micro-loan scheme and other risk sharing schemes introduced by the government reduced the business risks to banks, so that they could afford to explore inventive ways to improve their credit assessment frameworks for SMEs. Several participants agreed with this and acknowledged that government loan schemes have served as an important catalyst for the growth of commercial unsecured micro loans in Singapore. Banks in Singapore have leveraged on the experience gained and SME information collected through these risk-sharing loans to improve their credit assessment framework.

One potential innovation suggested at the discussion was to leverage behavioural models to enhance the credit assessment process of SMEs loan applicants. For example, in identifying behavioural patterns, qualitative factors such as how a company handles business problems provide a good insight in establishing the company's credit worthiness.

### **Growing Competition Among Banks Have led to Higher Approval Rates**

It was pointed out that amid an increasingly competitive SME lending landscape, SMEs now have more financing options with multiple offers from different banks. This has led to higher approval rates and lower interest rates, with some banks reporting approval rates as high as 75%. However, one participant cautioned against placing too much value on the figure, as very often bank officers would pre-screen customers even before they apply for loan, hence pushing up the official approval rates.

## **The Importance of Business Aspirations**

One participant said that ultimately the ability of a business to move up the life-cycle and graduate as an SME hinged not just on the availability of financing but also on the aspirations of its business owner. While many startups had huge aspirations to grow, a lot of the existing middle-sized SMEs were more concerned about wealth preservation and maintaining status quo.

For those SMEs with aspirations to grow, the main challenge was in internationalisation. Many of them found it very challenging to expand their businesses overseas, he said. More internationalisation support was thus required.

## **Financing for Internationalisation**

It was noted that there was a rising demand for internationalisation related financing as businesses expand overseas due to push factors (e.g., rising business costs, limited space and labour), and pull factors (e.g. growing overseas markets). It was pointed out that around 50% of Singapore-based SMEs derived more than 30% of their revenue from overseas, and over 70% of SMEs were looking into overseas expansion.

One participant added that SMEs needed to expand overseas rapidly if they wanted to tap emerging economic growth opportunities in the region. Moreover, some SMEs that were struggling domestically may in fact perform much better if they were to expand overseas. Hence, he believed that a supportive internationalisation programme was crucial to the success of businesses.

Companies engaged in overseas businesses needed substantial financing for their working capital and fixed capital investments. While IE Singapore offers several internationalisation schemes, one participant noted that they were not easily accessible to SMEs. He suggested that more education in the schemes to be conducted, and that rethinking and improving the distribution channels of schemes should be done.

In addition, several participants said that many SMEs found it challenging to expand their business activities beyond Singapore substantially. One area of consideration suggested by them was to provide more coordinated support that encourages overseas project that involves a consortium of local companies led by a few big principal companies. A number of SMEs had feedback that when they venture overseas, they sometimes found themselves competing even harder than native companies to win jobs from large Singapore companies.



Another suggestion was to introduce more schemes that encouraged M&A activities, because they incentivise companies to consolidate and attain scale, which would then improve their capacity to expand overseas. Other participants expressed an urgent need for Singapore SMEs to expand regional market share over the next two years, as many of them would become increasingly vulnerable to takeover by larger regional players.

Due to the growing middle class in Asia, there has been an upsurge of acquisition interest to expand distribution networks and acquire new capabilities in the region. Singapore companies are increasingly vulnerable to takeover. Participants have seen Singapore companies with strong brands, good operating model and a high growth potential acquired by EMMs. Using their large cash pile, these EMMs tap the capabilities and sophistication of Singapore companies and their networks to further grow their businesses. Singapore SMEs would find it increasingly difficult to break into the regional markets if they continued to delay internationalisation, said one participant.

### **Risk of Moral Hazard**

Concerns were raised about the risk of moral hazard from risk-sharing schemes between the government and banks. Several local banks had experienced double-digit growth rates in their micro-SME lending, and some participants are worried about a deterioration in the credit quality of SME loans. However, other participants felt that the risk-sharing loan schemes were necessary for improving the SME financing capabilities of banks in Singapore. Moreover, they argued that this was a better model than the government granting loans to SMEs directly, because the duty of credit assessment resides with the banks, which can better assess the credit worthiness of loan applicants.

### **Special Financial Institutions to Support SME Financing**

Specialised financial institutions for SMEs such as SME banks and export credit agencies in Japan, Taiwan and South Korea play an important part in supporting the business operations of SMEs. One common concern was whether the existence of an SME Bank would crowd out private credit providers. On this subject, one participant said that the business operations of an SME bank need not necessarily overlap that of private credit providers, adding further that the SME bank in Malaysia generally did not crowd out commercial banks as the degree of business overlap was not high. However, he also cautioned against generalising Malaysia's experience to Singapore because every country was different and each SME bank had its own set of mandates.

Another participant noted that while many countries had their own SME bank or EX-IM bank, not all of them were profitable or sustainable. Germany's SME banking model was held in high regard precisely because of its success in achieving national goals while remaining financially sustainable. In Singapore, it might be difficult to sustain the operations of an EX-IM bank because there might not be sufficient overseas projects to finance. More generally, given the state's objectives, was there a role for an SME bank, EXIM bank or other forms of state related financing institution to fulfil in Singapore, he asked.

In terms of funding of government supported financing programmes, it was suggested that Singapore could consider the approach used by the German government-owned development bank KfW Bankengruppe, which funds itself mainly through the capital markets. The government financing programmes in Singapore were currently funded through the national budget. The capital markets could be a more effective and efficient way of funding.

It was also noted that adequate financing was not the only necessary condition for a business's development, and most participants also agreed that it was not a major obstacle preventing SMEs from growing in Singapore. In particular, a number of participants felt that there might be more value in creating a government agency that oversees the development of SME instead of an SME bank.

### **A Dedicated SME Government Agency**

Several participants felt that SPRING lacked the capability to manage business assistance on a sector-by-sector basis. In addition, the design and delivery of government schemes for SMEs were uncoordinated and distributed through many government agencies. It was added that there was insufficient evaluation of existing SME schemes and policies.

They appealed for the creation of a government agency that would oversee all aspects of SME development. In addition to coordinating SME policy, planning the sector's development, and conducting policy and programme evaluation, the agency would also accumulate SME-related knowledge and technical expertise. This would help build up institutional knowledge on SME development in the public sector, which was difficult to achieve under a multi-agency approach.

Some participants held a different view. They pointed out that the small and micro companies were very different in characteristic from the medium companies. Instead of creating an SME bank or SME development agency, it might be more useful to create institutions or agencies that



looked after the development and needs of small and micro enterprises. Unlike their medium-sized peers, this group of enterprises was most in need of business assistance.

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## Chapter 5

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# Addressing the Manpower Challenge



## **CHAPTER 5: ADDRESSING THE MANPOWER CHALLENGE**

### **BACKGROUND**

Nobel laureate and economist Gary Becker once said that the basic resource in any company was its people, and that the most successful companies and the most successful countries would be those that manage human capital in the most effective and efficient manner. This statement has gained credit among top management of companies around the world, which recognise that a top-notch workforce is crucial for business survival and growth as the knowledge found in any company starts and ends with its employees. According to Boudreau and Ramstad (2007), whether it is called “people,” “labour,” “intellectual capital,” “human capital,” “human resources,” “talent” or some other term, the resource that lies within employees and how they were organised was increasingly recognised as critical to achieving strategic success and competitive advantage. Employees form the core of a business as they are the foundation that supports a business and its performance, enabling it to be more than just an idea.

With this realisation, companies of all sizes are beginning to appreciate how important it is to invest in their employees to build up their core competencies and job knowledge in order to remain competitive in a globalised economy. The urgency is accentuated by the breakthroughs in technology, whereby new processes and disruptive technology emerge at an exponential rate, such that for a company to remain at the frontier of technology and ahead of the competition, it must possess a team of people with the level of skills and ability to envision and execute business strategies.

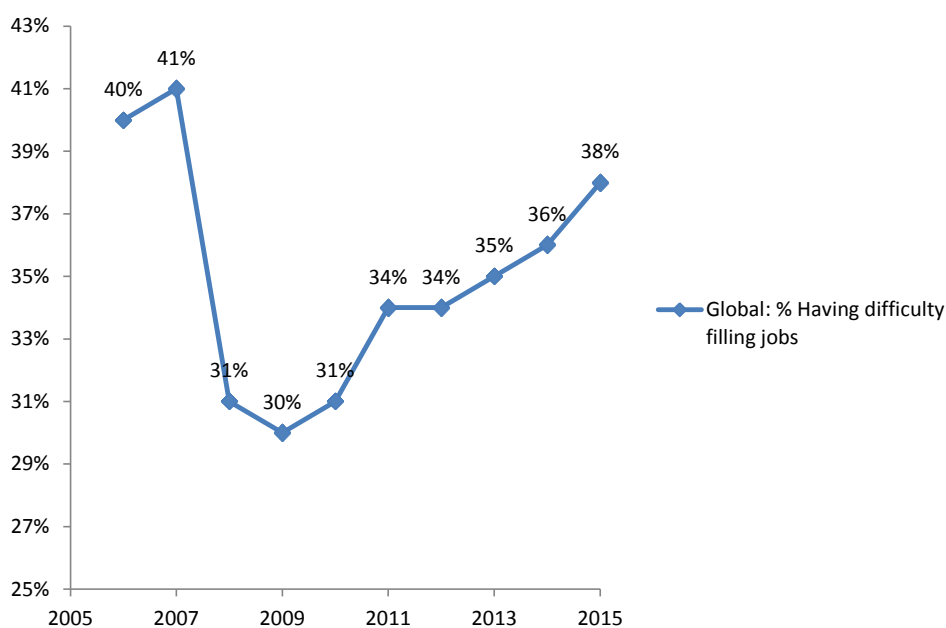
### **Widening Skills Mismatch in the Labour Markets**

But securing or retaining the necessary manpower is by no means an easy feat. At present, the labour markets in many developed countries are suffering from a persistently widening mismatch between the needs of companies and the skills and knowledge of the workforce. In the US, the growing mismatch is attributed to structural changes of the economy since the 1970s. A 2014 Economist Intelligence Unit (EIU, 2014a) report “Closing the Skills Gap” noted that the US economy which was once dominated by manufacturing had shifted to an increasingly service-based economy that required more collaboration rather than routine work. This change in nature of the economy resulted in the rise of demand for soft

skills like critical thinking, teamwork and effective communication. The report also added that there was a shortage of workers who were equipped with the competencies required of emerging middle-skilled jobs in the fields of information-technology, healthcare, high-skilled manufacturing and the service industry.

The same phenomenon is also observed in other countries. In the ManpowerGroup 2015 Talent Shortage survey of 41,700 employers around the world, 38% reported that they had difficulty filling up jobs due to a lack of available talent. In fact, the global measure of manpower shortage has been on an incremental but persistent upward trend since 2009, indicating that employers around the world are finding it more difficult to secure the talent they need (Figure 5.1).

**FIGURE 5.1: % FACING DIFFICULTY IN FILLING JOBS (GLOBAL)**



Source: “2015 Talent Shortage Survey” (ManpowerGroup, 2015)

Of the jobs employers were experiencing difficulty filling, the shortage of skilled trade workers posed the greatest challenge. This view among employers is in line with the impact of technology advancement on the changing nature of work and innovation. Increasingly, the jobs of the future would call for specific technical competencies while an increasing number of routine-based jobs and even some generalist jobs would be automated fully or partially. Even among jobs that demanded specific technical



competencies, the rapid pace of technology advancement would result in a job environment that was more dynamic, disruptive and fast-paced.

### **Destructive Technology Trends?**

Ironically, there is also a growing concern that technology would eventually obliterate a swathe of jobs and leave a huge proportion of the existing workforce redundant. Global sales of industrial robots grew by 27% to 225,000 units in 2014 after surging by 12% the year before (IFR Statistical Department, 2015). A study conducted by Frey and Osborne (2013) into the jobs in US that were at risk due to computerisation estimated that 47% of the existing jobs had a high chance of being destroyed by computerisation. Ray Kurzweil (2005) even went so far to project that the “singularity” — the point at which computer learning enables machines to become integrated in all facets of society and become more intelligent than humans — would happen in the next 20 to 30 years.

However, while it is true that many of these jobs could be computerised with the proliferation of robotics technology, this does not necessarily point to a parlous state of mass unemployment. Instead, the advancement of technology actually offers a chance of uplifting the whole of society under the realisation of substantial productivity improvements through human-machine collaboration. This would however require the right structural reforms to be made to the labour market. The bleak scenario of massive unemployment may transpire only if a significant breakthrough in artificial intelligence happens, and even then the dynamism of society offers myriad possibilities of outcomes.

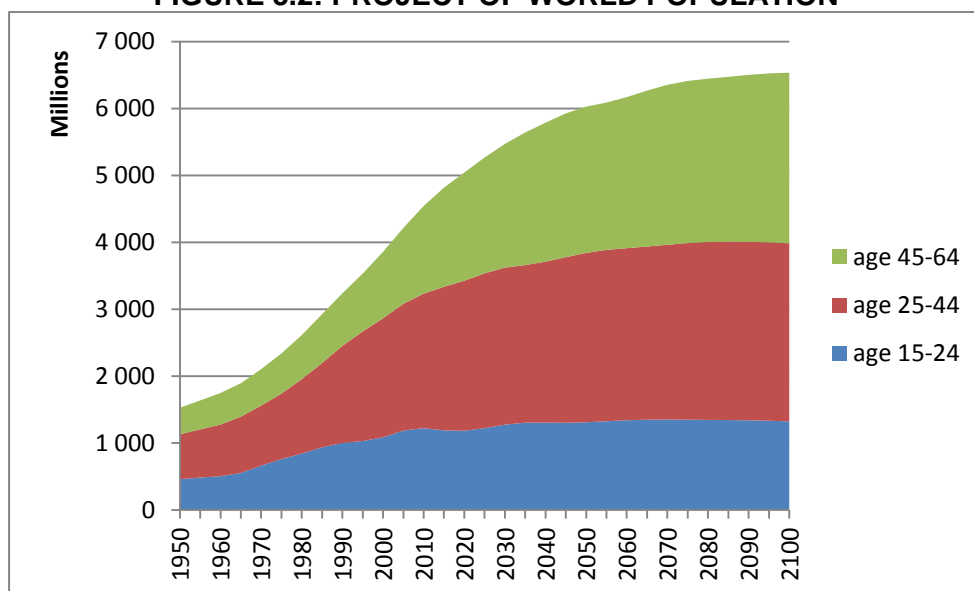
Bringing the focus back to today, human capital is still needed to achieve almost everything in the world. Technology today takes on a complementary role in production, enhancing the productivity of the human worker. However, with economies becoming progressively knowledge-based and interlinked, winning the competition for a limited pool of high skilled human capital that is globally mobile will be a paramount factor that could make or break companies.

### **Changing Profile of the Global Workforce**

In 2012, there were 810 million person aged 60 or over in the world. This figure is projected to more than double by 2050, topping 2 billion (UNFPA, 2012). The demographics of the global population are also expected to change significantly. Across the world, countries are struggling with total fertility rates (TFR) below replacement level, with OECD member countries recording an average of 1.70 in 2011 (OECD, 2014). The global phenomenon of declining TFR and rising life expectancy will transform the age profile structure, bringing about a profound impact on the future

workforce. Based on data from the *World Population Prospects: The 2012 Revision*, by 2050 a sizeable proportion of the global workforce will be in the middle age (Figure 5.2). The significant slowdown in workforce growth across countries will inevitably place a premium on labour for years to come, presenting companies a new set of challenge to effectively manage their manpower.

**FIGURE 5.2: PROJECT OF WORLD POPULATION**



Source: *World Population Prospectus* (UNESA, 2013)

At the same time, reforms in the labour markets have not kept pace with the rapid advancement of technology and the way it is transforming society and business needs; hence widening the skillsets mismatch and resulting in inefficiencies that are exerting a heavy burden in terms of unemployment and lost potential. This coupling effect has resulted in 30 to 40% of the working-age population in the world being unemployed, inactive or working part-time (Manyika et al., 2015).

With labour markets operating sub-optimally, being able to attract ready talent is only one half of the equation. Equally importantly is a company's ability to successfully retain and nurture existing employees. Companies that are able execute human resource (HR) strategies to make strides on these two fronts will find themselves in an advantageous position over their peers. On the national level, commitment from both the government and the employers are needed to push through structural reforms in order to close this labour market gap.



## **Value of Human Resource Management**

The manpower challenges arising from the above-mentioned demographic and technological shifts are huge. Ever-evolving technology, a multi-generational workforce, growing cultural diversity and increased labour mobility will confront the way companies manage their human resource. Companies around the world grappling with manpower challenges are most concerned about the lack of technical skills and the lack of soft skills such as creativity, adaptability and good interpersonal communication. In particular, the Asia Pacific region appears to be suffering most acutely from the lack of soft skills. The EIU Global Talent Index (2011) found that 52% of Asia Pacific respondents felt that “limited creativity in overcoming challenges” was a primary shortcoming among candidates, compared to 41% worldwide.

In a 2013 survey of 636 senior management executives, people management was cited to be the most pressing challenge facing companies both today and in the next five to 10 years (EIU, 2014b). What is happening is that demography, technology and globalisation trends are upheaving the tradition constructs of the workforce, sharpening the complexities of hiring and managing employees in the process. And this is where technology can play a role. More companies are turning to HR analytics to understand the evolving characteristics of the workforce and aid workforce planning. In addition, digital platforms such as social media networks offer access to an international pool of potential employees. For instance, Randstad reported that 49% of job seekers worldwide used social media networks (Randstad, 2015).

But the challenge is to align these new technology-augmented recruitment strategies with business goals, as highlighted by Aberdeen Group (Laurano, 2013). The report noted that companies that took a holistic approach to recruitment and human resource planning were most likely to be successful in tackling skill shortages and achieving company growth objectives. Therefore, paying attention to human resource management and developing a people-centric approach to business development is of utmost importance, in order to tackle the manpower challenges of today and the future.

## **Collaboration Between the Government, Companies and Education Institutions**

Addressing the labour market issues would also require a multi-stakeholder effort. It is imperative that companies communicate and work more closely with the government and education institutions to ensure that the right skills and knowledge are imparted. Companies, as the producer of



goods and services and as employer of the workforce, are in the immediate position to identify the skillsets in demand.

The government plays the pivotal role of addressing inefficiencies in the labour market by introducing policies and programmes based on the feedback from companies. For example, by engaging the business community, the government would be able to form a better understanding of the challenges and needs of companies, which would then allow the formulation of policies that support the development of creative solutions to tackle the manpower gaps. The government also acts as a catalyst for creating an ecosystem ideal for business-university interactions.

The education institutions, which in this case refer to both schools and training providers, will take cue from the feedback of the business community and policy climate set by the government to redesign curricula that will equip the workforce with the most appropriate skills and competencies.

This multi-stakeholder approach is essential to mitigate the labour market frictions that occur as a result of changing demographics and disruptive technology advancement. But it is also important that the government avoid being captured by the narrow self-interests of the private market. It has to balance short-term business needs with longer-term strategic planning for the country so that the labour market will evolve alongside the development of the economy. This calls for discerning stewardship on the part of the government.

Traditionally, education institutions, especially those of higher education, are structured around academic disciplines. The conventional system is not designed with a focus on making students job-ready. However, with the growing skills mismatch in the workforce, there is an emerging interest in companies to be more involved in education programmes in recognition of the potential benefits of increased cooperation with higher education institutions.

Take for example in the US, there has been a growing number of companies forming partnerships directly with institutions of higher education. According to an EIU survey (EIU, 2014a), two-thirds of the companies interviewed had some experience working with higher-education providers. These companies were keen to be more involved in designing the syllabus, and they were more committed in forging long-term relationships to help close the skills gap. Moreover, companies were not just doing it individually but also collectively with other companies and



through the help of organisations such as trade associations and industry groups.

While companies are keen to be more involved in higher education, they tend to prefer working with community colleges than with universities. This is partly because community colleges have goals that are more complementary to the needs of companies. One of the main goals of community colleges is to ensure that their students have the right skillsets to be employable. Universities on the other hand, have a very different pedagogy based on a more broad-based syllabus that does not focus narrowly on equipping their students with the hard skills of the day demanded by the job market. As a result, they appear to be less willing and slower to accept education suggestions from the business community. It is this reluctance that forms a major barrier preventing stronger and deeper engagement between companies and universities, despite the desire of the business community for greater partnership.

The UK is one country that has seen much progress in the area of business-university collaboration. For many of its higher education institutions, company involvement has penetrated deeply into the academic culture, helping to update curriculum-based approaches to improve graduate employability. This has been achieved through innovation in teaching and learning, in-company programmes, industry-designed courses, and placement and internships for students. Foundation degrees, designed in association with employers to provide employer-relevant qualifications, spiked from 4,300 enrolments in 2001 to 103,000 by 2010 (Wilson, 2012).

Notwithstanding the rising trend of business-university collaboration around the world, several studies have found that cooperation practices are still highly fragmented and uncoordinated, particularly when it comes to designing education programmes. In addition, there is very limited literature assessing the benefits of cooperation activity on designing education programmes, with most of the attention focusing on cooperation and collaboration in the field of research and innovation (Healy et al., 2012).

### **Growing Prominence of Apprenticeship**

Germany has a strong tradition of apprenticeship as part of its business culture. Roughly half of all students in Germany are under a dual programme of on-the-job training and education. Despite the fact that companies are not required to offer apprenticeships, around 60% of the German workforce across all industries began as apprentices. This is most likely because companies do not tend to view investment in trainees who

leave as a loss, since they also benefit from the investment in the training that other firms have made. This is an important perspective because training an apprentice does not come cheap. In fact, it is estimated that the cost spent on each apprentice averaged US\$25,000 to US\$80,000 in Germany. In other countries that do not have a strong culture of apprenticeship this amount is likely to be even higher. For example, the apprenticeship programme of Siemens US plant in Charlotte, North Carolina reportedly cost US\$170,000 per apprentice, a figure that is nearly twice the upper boundary cost estimated for an apprenticeship in Germany (Jacoby, 2014).

Nonetheless, the value of and need for apprenticeship is growing in recognition. Apprenticeship programmes offer a way for companies to meet their manpower demands. In Europe, many employers have embraced dual training because it allows apprentices to reinforce the theories picked up in schools, thus resulting in a more prepared workforce. In the US, traditionally only around 5% of young people undergo apprenticeship as employees and employers tend to view the college education system more favourable. However, as more large German companies like BMW and Siemens expand their operations in the US, they bring along the German model of apprenticeship to the US, raising the visibility of vocational training among companies and improving its image as a highly respected career path among the population.

### **Meeting the Expectations of Employees**

As the workforce demographics change and cultural diversity of the workforce expands, the motivations and expectations of the workforce change too. Hence, companies should constantly review their HR practices and introduce necessary changes to ensure that their HR management is effective. Employers have to constantly ask themselves what their workers truly desire.

Companies around the world are realising that it is not enough to just be able to hire workers. It is also important to have the right HR policies and programmes to retain, motivate and improve the existing workforce in the company. Financial compensation alone is not sufficient to attract new talent or even retain existing ones as individuals place more value on non-monetary qualities when it comes to making job decisions. And employers are beginning to understand this. For example, many respondents of a survey conducted by EIU believed that the power of their own company's brand, and to a lesser extent the pay and benefits it offered, helped to fight off competition for the limited number of experienced workers (EIU, 2011). As seen in Figure 5.3, Cisco found in its 2011 survey that the top driver of



employee retention across various countries and globally was opportunities for career development, while pay and rewards came in third.

**FIGURE 5.3: TOP DRIVERS OF EMPLOYEE RETENTION**

Top Drivers of Retention	Global Overall	Brazil	Canada	China	Germany	India	Mexico	UK	US
Career Development	1	1	1	1	3	1	1	1	1
Leadership	2	3	2	2	1	2	4	3	2
Pay and Rewards	3	2	4	3	2	3	2	2	5
Empowerment	4	4	3					4	3
Supervision	5			4		4	5		
Efficiency				5					
Performance Appraisal		5			4	5		5	
Benefits					5				
Diversity									
Competitiveness			5						
Stress, Balance and Workload							3		

Source: “Transitioning to workforce 2020” (Cisco, 2011, p. 17)

Experienced hire is also in high demand as companies, especially those that are trying to expand their presence in existing markets or break into new markets, seek to hire employees who are able to instantly take on managerial roles or high-level, specialised work. However, with the widening skills mismatch in the labour market, companies are forced to change their manpower staffing approach. As many come to accept the reality of a tight labour market and the dearth of experienced talent, they are shifting their focus to recruiting workers with no experience but exhibit high potential, and training them internally for specialised job roles including managerial positions.

Increasingly, staff training for both new hires and existing staff are becoming a crucial part of a corporate’s business strategy. As a result, companies are pouring massive amount of resources to develop their staff training capabilities. According to the EIU’s *Global Talent Index* (2011) report, one in two companies indicated that they were investing more time and money bringing managers and specialised workers up to speed compared to two years ago.

This heightened commitment to staff training also fit well with a growing desire of employees to acquire new skills, hence improving the chances of a company to attract, motivate and retain their workforce. Employees value training because they recognise that they need to be engaged in continuous education and training in order to survive and prosper in a knowledge-based world where skills are likely to become quickly redundant under constant technology breakthroughs.



## Improving Employee Engagement

Closely linked to workforce retention and training is workforce engagement. Very often, the importance of maintaining employee engagement is overlooked. But what is employee engagement?

Using MacLeod and Clarke's (2009) definition, employee engagement could be viewed as a workplace approach designed to ensure that employees are committed to their organisation's goals and values, motivated to contribute to organisational success, and are able at the same time to enhance their own sense of well-being. Their report also summarised a list of studies on employee engagement that all pointed unequivocally to a clear correlation between engagement and performance. These studies include: Towers-Perrin's 2006 global survey that found that companies with highly engaged employees performed 52% better than companies with poorly engaged employees; the Corporate Leadership Council (2004) reported that engaged employees were 87% less likely to leave the organisation than disengaged employees; and a Hay Group study (2001) that concluded that engaged employees generated 43% more revenue than disengaged ones.

Similar results were derived in Gallup's 2013 *State of the Global Workforce* report that analysed the data of 192 organisations in 49 industries and 34 countries. It found that companies with engaged employees exhibited higher productivity, higher profitability, lower employee turnover rate, and fewer safety incidents than companies with employees who were not engaged. Aon Hewitt (2014) arrived at the same results in their global survey as well. The message from these studies is clear: Employee engagement if properly practised could not only alleviate the manpower issues plaguing companies, but could also impact positively on profit and competitiveness.

The converse holds true too. The same Gallup report noted that employees who were actively disengaged<sup>11</sup> from work were more likely to steal from their companies, negatively influence their co-workers, miss workdays, and drive customers away. It was estimated that these employees cost the US between US\$450 billion to US\$550 billion of foregone productivity each year. With 63% of the global workforce currently not engaged and another 24% actively disengaged (Figure 5.4), the human capital crunch plaguing companies could be greatly reduced with better HR management to engage employees.

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<sup>11</sup> The report defined actively disengaged employees as unhappy workers who undermined the work of their engaged co-workers.

**FIGURE 5.4: GLOBAL ENGAGEMENT AMONG EMPLOYEES**

	Engaged	Not Engaged	Actively Disengaged
<b>Global</b>	<b>13%</b>	<b>63%</b>	<b>24%</b>
Philippines	29%	63%	8%
Thailand	14%	84%	2%
Malaysia	11%	81%	8%
South Korea	11%	67%	23%
Singapore	9%	76%	15%
Taiwan	9%	60%	32%
Indonesia	8%	77%	15%
Japan	7%	69%	24%
China (Including Hong Kong)	6%	68%	26%
US	30%	52%	18%
Spain	18%	62%	20%
UK	17%	57%	26%
Canada	16%	70%	14%
Germany	15%	61%	24%
Italy	14%	68%	18%
France	9%	65%	26%

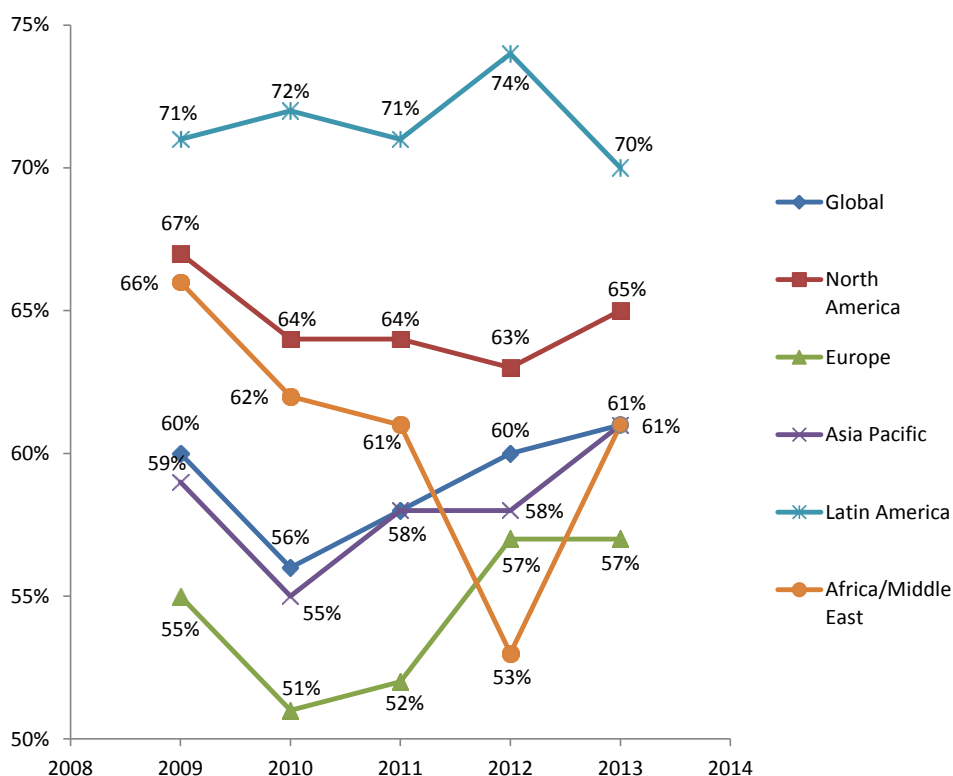
Source: "State of the global workplace" (Gallup, 2013, p. 112–113)

It is therefore not surprising to find that employee engagement is emerging to be a leading priority for companies. According to a survey conducted by the Harvard Business Review (2013) with managers from companies around the world, 71% of the respondents ranked employee engagement as very important to achieving overall organisational success. They were also conscious that there was an engagement gap to bridge, with only 24% of them saying that the employees in their companies were highly engaged. More interestingly, the survey uncovered a divergence in views between executive management and middle-management respondents. Senior managers were far more likely to be optimistic than their middle-management colleagues in their perceptions of engagement levels. The report suggested that as middle managers handled more day-to-day employee issues, their assessment was likely to be more accurate. As a result, there is value for senior management to relook engagement levels in their companies.

Finally, much variation in the level of employee engagement exists across countries and company size. For company size, Gallup (2013) found that the level of employee engagement was highest in small companies with

fewer than 10 people. Region-wise, Aon Hewitt (2014) found in their survey that Latin America performed the best while Europe lagged behind the pack (Figure 5.6).

**FIGURE 5.6: EMPLOYMENT ENGAGEMENT, 2009–2013**



Source: “2014 trends in global employee engagement” (Aon Hewitt, 2014)

## The SME Sector

### *Public image of the SME sector*

The above sections have covered in breadth the human capital issues — arising from demographic changes, technology breakthroughs and increased globalisation — that confront companies across the globe. These companies include SMEs. A global research into SME conducted by Oxford Economics in 2013 found that 39% of SMEs were finding it increasingly difficult to hire skilled workers to match their business needs. In fact, very often many of these issues are more acutely felt by SMEs because they lack the resources that bigger companies have, be it financial girth or extensive market networks.



One major difficulty that SMEs struggle with is the image of them as less desirable employers than large companies. Many studies have found that majority of university students prefer to work for large companies. Scott and Twomey (1988) found that university students in the US, UK and Ireland perceived SMEs to provide more opportunities to be creative and involved in the company's decisions. However, SMEs were also thought to offer lower salary and few career prospects than large companies.

Teo and Poon (1994) conducted a similar study on Singapore undergraduates and arrived at similar results. On the whole, SMEs were generally perceived less favourably than MNCs as employers. Subsequent on undergraduates in other countries also had the same findings (Moy & Lee, 2002; Jariangprasert & Kantabutra, 2012). While students agreed that they could access higher managerial relationships and had more involvement in decision-making working with an SME, they felt that large companies would be able to offer better remuneration, long-term career prospects and job security.

However, this perception may not reflect the truth on the ground. Using data from the WERS 2011, Dromey (2014) reported that employee engagement decreased with the size of the company. In addition, employees in larger companies were also less loyal to their employers than their counterparts in smaller companies. So while students, who have yet to enter the workforce, seemed to think that large companies would be a better employer, this perception could in fact be misinformed. Providing students with more information on and exposure to SMEs are crucial to dispelling this preconception of SMEs as inferior employers. This is important since students would form part of the future workforce as existing workers retire and leave the workforce.

A good place to start is to widen the support for apprenticeship. A culture of apprenticeship system among SMEs is already appearing in many countries. In the UK, the government has cemented its commitment to drive a culture of apprenticeship by announcing that it would enshrine in law its commitment to create three million apprenticeships by 2020. In addition, apprenticeship would be given equal legal treatment as degrees.

### ***Employee training in the SME sector***

Employee training is another big problem that SMEs grapple with. As found in most research, SMEs devote less attention to formal employee training than larger companies. Even at the managerial level, the attention to training — which is important given the key roles these employees hold — is lacking. The UK Department for Business Enterprise and Regulatory



Reform's 2007/2008 Annual Small Business Survey found that only 28% of SMEs provided training for their management team (Williams & Cowling, 2009). This could be due to several reasons, ranging from a lack of financial resources to a lack of structured HR management, and not knowing what training is available or what training is appropriate. Another major impediment to providing more training is SMEs' inability in allowing their employees to be away from the workplace for an extensive period of time. All these reasons are attributable to the fact that SMEs are smaller than large companies and lack the resource bandwidth to have a holistic employee training. Unfortunately, this initiates a vicious cycle; because little employee training is provided, the company struggles with attracting, retaining and improving its employees, which then feeds itself into inferior performance and competitiveness.

An encouraging point is that the advancement of technology and the intensifying of cloud computing have led to a significant lowering of costs for IT-empowered business solutions. This has a potential to uplift the SME sector's HR management capabilities. Enterprise technology solutions like business management software and analytics that were once confined to the use by large companies due to their exorbitant price tag, is increasingly being adopted by SMEs as technology costs continue to tumble.

While factors such as a lack of employee skills, company system legacy issues and a nascent understanding of the benefits of deeper technology adoption still pose an obstacle to more widespread adoption of technology-based HR solutions among SMEs, there are strong signs indicating that the sector is already on the cusp of change. Oxford Economics found that among SMEs, a significant number believed that creating a culture of innovation was crucial to their transformation efforts. In addition, the research also found that SMEs were nearly three times more likely to be early adopters of technology than reluctant ones (Oxford Economics, n.d.).

Hence, although SMEs are struggling to hire to support their business expansion, they are no doubt leveraging newfound access to technology to meet their business needs and level the playing field with larger companies. This, with the right kind of support from the government, should help the SME sector overcome the barriers of human capital.

### ***“Leasing” of human capital***

In order to overcome the inherent scale disadvantage that magnifies most problems that companies face, SMEs and policymakers overseeing the SME sector must dare to be creative and conceive novel solutions too. For example, in Japan, an economy with an ageing population and declining TFR, some SMEs have close links with larger companies in the production



chain. These ties can be leveraged to develop human capital. During cyclical economic downturns, bigger Japanese companies may “lease out” workers in a practice known as *Shukko*. This enables Japanese SMEs to have access to talent who may have previously rejected them for larger companies. The Japanese SMEs under the *Shukko* system pay only a fraction of the leased workers salary with the rest paid for by the bigger company. Kimijima Heat Treatment, a Japanese SME in metal processing, does the following to maintain a high level of craftsmanship among its workforce: It attracts young interns, invests heavily in the training of existing workers and sources for non-manual senior workers through “leasing” arrangements from larger companies (EIU, 2010).

## **Singapore’s Case**

### ***Tightening foreign manpower policy in Singapore***

Singapore, as a maturing economy, is already facing land and labour constraints. The city-state’s total labour force was 3.62 million in March 2015, expanding at an average rate of 4.3% per annum from 2004. Experiencing a tight labour market, the total employment vacancies in early 2015 was 67,400, the largest number since 2009. The inflow of foreign labour was reduced from 60,000 in 2011 to 16,000 in 2014, as the government tightened the inflow of foreign manpower to restructure the economy. Politically, this was a response to growing concerns from its citizens as foreign labour and migration into Singapore turned out to be a key issue in the general election of 2011 and has maintained its prominence ever since.

Over the decade, since 2004, Singapore’s workforce has grown at 4.3% yearly to 3.53 million in June 2014. The growth rate was faster for the period from 2004 to 2009 compared to the period from 2009 to 2014 for both residents and non-residents (Ministry of Manpower, 2015). The annual non-resident workforce growth decreased from 11.4% to 5.2% between the two periods because of tightening foreign manpower measures that were implemented progressively since 2010. Over the same two periods, the resident workforce growth slowed down from 3.2% per annum to 1.9% per annum (Figure 5.7). In July 2011, the Ministry of Manpower (MOM) increased the minimum wage for the S pass category of work permits (WP) from S\$2,000 to S\$2,200. For Employment Pass (EP) holders, which include professionals, managers and executives, they have to earn at least S\$3,300 per month. These measures made it more costly to employ foreign labour. Projections by MOM show that resident workforce growth will taper off to an average of 20,000 per year towards 2020 as a result of Singapore’s long-term low TFR, a sharp decline from the average growth of 60,000 from 2010.

**FIGURE 5.7 ANNUALISED CHANGE IN LABOUR FORCE (% P.A.)**

	2004–2014 (10 Years)	2004–2009 (5 Years)	2009–2014 (5 Years)
Total	4.3	5.6	3.1
Residents	2.6	3.2	1.9
Non-residents	8.3	11.4	5.2

Source: “Labour force in Singapore, 2014” (MOM, 2015)

While reducing the inflow of foreign labour to more sustainable levels made sense socio-politically, it does impact economic growth trajectory, at least in the short term while the economy adjusts structurally. By 2014, the staggered restrictions on foreign manpower had stoked a manpower crunch with the unemployment rate dipping to 1.9%. This indicated that the economy was running at full employment. With increasingly tight restrictions on the hiring of foreign labour, many employers, especially SMEs, are finding it difficult to fill their vacancies. At times, even the offer of higher pay is not enough to attract locals to fill these vacancies because they are jobs that simply do not interest locals.

### ***Increasing labour force participation in Singapore***

The increase in labour force participation rate (LFPR) to a high of 67% in Q2 2014 helped relieve some of the pressure from the foreign labour tightening measures. The increase was due to more women and older residents returning to employment. The female LFPR increased from 51.3% in 2004 to 58.6% in 2014 due to the rise of employment opportunities in the services sector. The LFPR for older residents across all age groups saw yearly increases from 2011 to 2014 (Figure 5.8). Some of the reasons could be the increase of flexible work arrangements, the on-going tripartite efforts to enhance the employability of older workers and the improving educational profile of older workers. Notwithstanding, there is a limit to how much the workforce size can be boosted through increasing LFPR.

**FIGURE 5.8: LABOUR FORCE PARTICIPATION, 2011–2014 (%)**

Age Group	2014	2013	2012	2011
55 – 59	74.3	73.2	72.4	70.2
60 – 64	61.2	59.7	58.1	54.7
65 – 69	41.2	40.2	38.6	36.2
70 – 74	25.7	24.2	21.9	20.4

Source: “Labour force in Singapore, 2014” (MOM, 2015)

### ***Labour market shortage in Singapore***

Another manpower concern is the mismatch between the expectations and skills of the local workforce and what companies demand. In this regard,



the government has placed heavy emphasis on the need for having in-demand skills for workers instead of chasing for degree qualifications. Within the services industry, the shortage of manpower is likely to be exacerbated with the expansion of childcare and pre-schools, healthcare and tertiary institutes. Together with the opening of new shopping malls, vacancies also increased in the wholesale and retail trade, accommodation, food services, administrative and support services (Soh, 2015).

Singapore also appears to be running short of local civil, mechanical and electronics engineers. Mechanical engineering technicians are also scarce with regard to the demand for onsite work operations. For these jobs, the biggest obstacle for companies is in finding local candidates with suitable work experience.

While Singapore is seen to be shifting towards a services-driven economy, it has also been attracting the world's best manufacturers since its independence to industrialise its economy. Some critics may have questioned the continued need of a manufacturing sector. However, the manufacturing sector can contribute tremendously to the economy through innovation for higher-value products, and it is also the key for supporting wider service-related activities.

Prime Minister Lee Hsien Loong has acknowledged that the economic restructuring had hurt companies, especially SMEs, and many were struggling while some had moved their operations to Malaysia. He added, "If we squeeze them too hard, they may not survive — and that will mean that many jobs will be at risk" (Chuang, 2014).

Nonetheless, there will be no reversal in government policies regarding tightening of the foreign labour inflow. The government's intention is to pace the growth of the foreign labour force at a sustainable level and enable it to grow at a tight pace. In this regard, the government has signalled its intent to companies that with the slowdown in the local workforce together with the reduced inflow of foreign labour, going forward, companies will experience a significant tightening of labour. Businesses including SMEs were advised to become manpower lean and if they did not become productive, this would impact their ability to find adequate manpower (Tay, 2015).

### ***Preparing for an older workforce in Singapore***

Given Singapore's persistently low TFR and a drastic tightening of foreign manpower inflow, the labour market is expected to remain tight for considerable time. From 2015 onwards, the local workforce is expected to

grow at a slower pace of around 20,000 per year over the next few years, compared to 95,000 in 2014, according to then Minister for Manpower Tan Chuan-Jin at the ministry's Committee of Supply debate. One way to alleviate the tight labour market is to tap the pool of older workers, especially those aged 65 and above. Although the labour force participation rates for residents aged 65 and above have been growing over the years as shown in the, they are still significantly lower than that of other age groups.

With Singapore's life expectancy today at around 82 years and expected to edge higher in future, the older resident population will grow larger as the baby boomer generation retires. Hence, more policy measures to encourage the employment of older workers are desirable. First, it unlocks a pool of available manpower supply that also offers value from their wealth of working experience. Second, the additional years of employment support active and meaningful ageing, and help individuals accumulate more financial resources for old-age needs.

To encourage employment of older workers among companies including SMEs, the government has announced in the 2015 Budget that it will provide additional special employment credit of up to 3% of wages for workers aged 65 years and above in 2015. This is in addition to the existing 8.5% offset that employers will receive in 2015. Hopefully this subsidy, by making it less costly for companies to hire older workers, would improve the general perception towards older workers and get companies to appreciate the value that these veterans bring to the organisation.

### ***Lifelong learning in Singapore***

At the same time, the new Minister for Manpower Lim Swee Say has highlighted the need for workers to pick up relevant skills and for businesses to transform existing jobs at a faster pace. Two key programmes to be implemented are SkillsFuture and JobsFuture, both aimed at equipping workers with the necessary skills for employment and helping businesses transform jobs to enhance competitiveness. Every Singaporean aged 25 and above will receive an initial S\$500 in SkillsFuture Credit, which will be topped up at regular intervals and will not expire. The credit can be used on a range of government-supported courses.

SkillsFuture will pour over S\$1 billion annually from 2015 to 2020, on initiatives such as career guidance for students, enhanced internships and subsidies for mid-career learning, among others. About S\$600 million a year over the last five years have already been spent on continuing



education and training. More attention will also be paid to career development even before one enters the workforce. Polytechnics and Institutes of Technical Education (ITEs) will house professional career counsellors while making internships more structured for two-thirds of polytechnic courses and half of ITE courses over the next two years. In addition, fresh graduates from polytechnics and ITEs can work and study for an industry-recognised qualification at the same time. Under the Earn and Learn programme, they are matched to suitable employers where they undergo on-the-job training (Chong, 2015).

There are also several ongoing collaborative efforts. For example, industry partners will be tapped to support the SkillsFuture initiative. Sectoral manpower plans for all key industries are expected to be drafted by 2020. This would include a shared pool of people with specialised skills known as SkillsFuture Mentors, on which SMEs can also leverage. The Ministry of Education will provide multiple subsidies for workers balancing families, careers and learning responsibilities. The government will establish a tripartite committee to develop an “integrated system”, of education, training and career progression for Singaporeans.

### ***Changing profile of the workforce in Singapore***

The educational profile of the local labour force has improved as the younger cohort joining the labour force tends to be better educated, replacing the retiring older cohort that has a lower-educated profile. In 2014, the tertiary-educated resident labour force comprised 51% of the total labour force, an increase from 36% in 2004 (MOM, 2015). This increase was mainly due to degree holders, whose share of the labour force increased to 32% from 22% in 2004.

While better-qualified applicants would be welcome news for employers, it is also likely that the younger cohort would be aspiring for better-paid and more illustrious jobs. Jobs that involve shift work, “blue-collar”, onsite presence or other “grungy” requirements would still be hard to fill. Hence, it is not surprising that UOB Group (2014) found in their small business survey that one in two SMEs reported that the loss of key personnel would take a company at least nine months to find the right candidate as replacement.

Businesses with older employees making up a large proportion of their workforce, especially those that are non-PMET now, such as food manufacturers, ought to think about the changing profile of the local workforce of the future too. As their older workers retire, such companies may find it harder to find replacements. Only a third of Singaporean workers will hold non-PMET jobs by 2030, down from half in 2013.

***Manpower challenges faced by the SME sector in Singapore***

The ASME, in its *SME Business and Budget 2013 Sentiments Survey Report*, said that 87.9% of SMEs reported an increase in current cost operation for the year 2012. This increase was attributed to rising manpower costs, followed by rental costs and foreign worker levy. In its efforts to examine various sources of alternative workforce, ASME has looked at ex-offenders, undischarged bankrupts, back-to-work mothers and problem youths (Teh & Ramchandani, 2013). ASME in collaboration with SPRING Singapore has a Max Talent Programme, which is supported by the Workfare Development Agency (WDA).

Difficulty in hiring has consistently been cited in SBF-DP's "SME Quarterly Index" as a factor hampering SMEs' capacity to grow. In Q2 2014, manpower constraints prevented SMEs from seizing expansion opportunities to grow their revenue. More recently, the same manpower shortage is weighing down on SMEs' bottom line amidst a tepid period of global growth.

One of the weaknesses that SMEs face in relation to attracting human capital is the inability to maintain an active database of potential hires that result in SMEs having to place advertisements each time there is a vacancy. This means that SMEs are not able to harness the use of a database effectively. In addition, few SMEs are able to leverage hiring channels such as referrals, graduate recruitment, internal transfers, etc. The lack of detailed job analysis translates to ineffective recruitment in which the key criteria for hiring personnel and key success factors on the job have not been framed. Coupled with weak or no employer branding, job applicants do not have effective understanding of the overall organisation or do not have good experience during the recruitment exercise.

There is an imbalance in terms of pay between sectors. For example, in the services sector, the medical and law professions have the highest starting salaries. Employees in the financial and insurance services sector have the highest growth rate for compensation since 2004, when bonuses are factored in. In this regard, sectors such as manufacturing that are not able to match the compensation of the financial and insurance sectors are starved of good engineering graduates who are attracted to the latter. In 2014, there were more than 100 foreign banks in Singapore, and even then the local labour pool could not support them all (Singh, 2014).

The services sector, which is the most stable engine of economic growth, has become the biggest risk to the economy according to a research piece by DBS (2014). The report stated that the existing labour crunch due to



curbs in foreign manpower has taken its toll in this relatively labour-intensive sector. If the services sector continues to slow, there is a downside risk to the medium-term prospects for the economy given its relatively large share in GDP and employment. The DBS research group is of the view that as Singapore is midway into its 10-year programme of restructuring the economy, broad-based measures such as hikes in foreign workers' levies will no longer be required. Moreover, as the Productivity & Innovation Credit (PIC) scheme will expire in 2018, possible reduction in levies may need to be considered.

In addition, instead of the carrot-and-stick approach of “starving” companies of foreign workers and subsidising the costs of investment in technology, the focus could be towards assisting companies to improve their revenues. One of the key methods to undertake this is to help SMEs internationalise.

### ***Singapore SMEs venturing abroad***

Besides venturing abroad to seek new business opportunities, the impact of foreign labour restrictions on companies have inevitably forced many SMEs to consider relocating their operations overseas. However, not only is the cost of relocation overseas to other countries high and unpredictable, local customs and culture and the competition from native companies are some of the other factors the SMEs venturing abroad have to take into consideration. One method for SMEs is to use M&A to achieve sufficient scale to compete internationally. Notwithstanding the M&A tax incentives provided by the government, few SMEs have embraced this strategy as part of their internationalisation plan.

Scale aside, the lack of suitable human capital poses a challenge when venturing abroad into regional markets. Besides a shortage of experienced employees suitable for leading overseas ventures, there is a general reluctance in Singaporeans to take on overseas regional postings. What are the reasons for Singaporeans' reluctance to move abroad? Family commitments were one of the key reasons for unwillingness to move overseas for job postings among Singaporeans. To elaborate, the difficulty of settling in a new environment — for example, finding spousal employment and schooling availability for children — contributes to the reluctance to move overseas by Singaporeans, especially for those with young children and older parents. Younger employees with no dependents tend to be more mobile and willing to move overseas for job postings. But even then they prefer to be posted to leading cities like London and New York instead of cities in emerging countries, like Ho Chi Minh and Yangon. But it is in these up-and-coming cities where the greatest opportunities lie for companies that venture in early.



### ***Existing government support for SMEs in Singapore***

Aside from the newly initiated, nationwide SkillsFuture movement, there are already several existing schemes that SMEs can tap for human capital development. The enhanced Workfare Training Support (WTS) scheme provides course-fee funding and cash to all workers including PMEs (professionals, managers and executives) to upgrade their skills and hone their expertise. The Wage Credit Scheme (WCS) helps SMEs retain and motivate staff through higher wages. The government will co-fund 40% of wage increases for Singaporean employees earning a gross monthly income of up to S\$4,000 over the three-year period between 2013 to 2015. SPRING Singapore has also launched the SME Talent Programme to help SMEs attract and recruit ITE and polytechnic students through study awards.

The WTS is especially useful because it encourages both companies and employee to embrace life-long learning, which is necessary in a changing economic landscape. The WCS is scheduled to end in 2015, after which companies are expected to shoulder the portion of the remuneration that was subsidised. The intention was to give companies time to improve labour productivity, which would then pay for the wage increase. However, for most SMEs, productivity has yet to materialise significantly. Hence, SMEs are understandably worried about having to stomach the spike in expected labour costs when the scheme is rolled back.

The SME Talent Programme has helped to match SMEs with prospective young employees, but on its own, it cannot address the “image problem” that plagues the SME sector. Singaporeans, especially those who are younger and better educated, are not keen to work for SMEs. They believe that a smaller company cannot guarantee satisfactory career progression and work-life balance. As the government encourages Singaporeans to appreciate different educational paths to success, a similar mindset change is needed, so that SME jobs are not viewed as the poorer cousins of employment with large companies or the government. To this end, the SkillsFuture movement plays an important part in realising this shift in culture.

### ***Forming consortiums and alliances to help SMEs in Singapore***

Singapore SMEs in the same sector are more likely to be competing instead of collaborating. Encouraging alliances and consortiums between SMEs will allow them to pool talent and achieve more. For example, in specialised sectors such as the aerospace industry, a consortium of businesses of different engineering expertise could offer integrated manufacturing solutions and services, especially in overseas markets. Combining forces could encourage SME staff to be more entrepreneurial,



creative and efficient. Recent government efforts to encourage this include JTC Launchpad @ one-north, a new cluster for startups, and the A\*STAR Aerospace Programme, an attempt to get players in the aviation industry to take on pre-competitive research work together. However, while the level of collaboration for Singapore projects is high, Singapore consortiums have not displayed the same intensity in venturing into the realm of overseas business projects. Here is where larger companies can help. They can be the crucial cog in a consortium submitting its bid for major overseas projects, acting as the anchor companies to which SMEs will provide their services.

In tackling the human capital challenge, SMEs in Singapore have to reassess their aims and reinvent themselves to be more sustainable for the long term. At the same time, the government have to identify the specific human capital issues affecting SMEs and provide the right kind and amount of support to the SME sector.

## **IPS CLOSED-DOOR DISCUSSION ON HUMAN CAPITAL FOR SMES IN SINGAPORE**

IPS held a CDD on 30 September 2014 to discuss the human capital issues that SMEs in Singapore faced. Participants from the business community, academia and the public sector shared their perspectives and offered suggestions to tackle the problems raised at the discussion.

In summary, the CDD found that when defining the problems and challenges that SMEs faced in the space of human capital, it was evident that the challenges went beyond just the difficulties posed by changes in manpower policies. There were complex issues at play, which must be properly grasped in order to overcome the human capital issues. For example, industry fragmentation limits the capacity to exploit scale and so reduces the industry's competitiveness and ability to invest in human capital, grow productivity and raise wages. One implication is that policies in the SME sphere should encourage consolidation in some industries.

Second, policies must be calibrated and targeted according to the different profiles of SMEs. This calls for a deep consideration of a new type of classification that goes beyond the parameters of size because it does not adequately capture the nuances of the varying characteristics of SMEs.

Third, the proposal for an expanded system of apprenticeships subsidised by the government merits further consideration.

### **Top Human Capital Issues That SMEs in Singapore Face**

It was highlighted at the CDD that the top three human capital challenges faced by companies in Singapore were:

- Increasing workplace performance and productivity
- Retaining top performers
- Attracting new talent for the next phase of growth

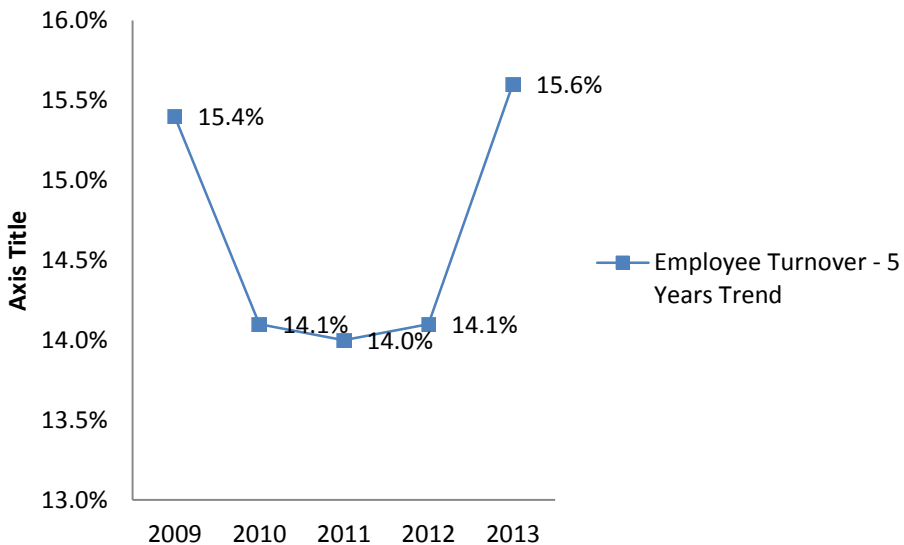
One of the main goals of the current economic restructuring exercise is to uplift productivity. Improving productivity is still a work-in-progress for most SMEs, and is especially challenging for labour-intensive industries like the F&B and retail sectors which have to grapple with the twin challenges of attracting and retaining employees, said one participant.



In addition, it was noted that many companies felt that the pace of restructuring was too fast. Companies also gave the feedback that increases in wages have been outstripping productivity growth — an unsustainable trend that reflected the need to recalibrate the pace of economic restructuring.

It was noted that rising employee turnover rate (Figure 5.9) and shrinking employee length of stay were driving up manpower costs. The average length of stay of an employee had dropped to around two to five years. In the banking sector, this period was even shorter at around six months to 18 months.

**FIGURE 5.9: EMPLOYEE TURNOVER (5-YEAR TREND)**



Source: “Singapore employees looking for the exit as economic growth returns” (Hay Group, 2013)

One participant said that the government measures to tighten foreign labour inflow due to socio-political considerations have a significant negative impact on companies, especially SMEs. In particular, industries at both ends of the skill spectrum encountered the most acute manpower shortage. Skills shortage and wage premium were the most severe in high skilled industries like engineering and information and technology (IT). Upward wage pressure was also strong for low-skilled workers because foreign labour was a traditional source for these types of workers. The SME sector was also more seriously affected by labour shortages because wages tend to form a larger proportion of their overall costs.

Appropriate incentives in the form of remuneration and proper career paths are essential to attract the younger workforce to join companies. Unfortunately many SMEs do not have the right mindset and tools to provide these incentives, said one participant. Moreover, employment branding among SMEs is also weak. Further compounding the problem are the complacent attitude and unrealistic job expectations that many younger workers have.

It was highlighted that more collaboration between the government, business associations and SMEs to improve HR practices (e.g., wage structure, strong HR policies, proper succession planning) is needed. There is an urgent need for SMEs to adopt proper HR practices in order to attract and retain talent, especially from the younger workforce. In addition, more government support on improving employer branding, strengthening job redesign and improving recruitment competitiveness could be given to SMEs.

In order to improve the public perception of SME as an employer, it is important to provide more recognition, said one participant. In particular, cases of SMEs that invested in training staff, embraced good HR practices and yielded positive results from these adoptions should be highlighted on a regular basis. National campaigns promoting positive work attitudes should also be introduced to tackle the issue of complacency and unrealistic expectations in the workforce.

### **Employee's Reluctance to Accept Overseas Posting**

It was pointed out that SMEs and other big companies shared certain similarities when it came to human capital. One major problem companies often faced was convincing their brightest talent to accept overseas postings. Working in a different part of the world exposes employees to different cultures and business environments, preparing them for future leadership roles, said one participant. Because of their unwillingness to be posted overseas, employers cannot promote these employees even though they were talented and fully capable. Many of these employees, having high career aspirations, are in turn frustrated by what they perceive as a career ceiling.

It was also posited that the reluctance of employees in Singapore to accept overseas postings could be attributed to a lack of clear career paths, family considerations, comfort zone and, to some extent, Singapore's tremendous economic success.

One participant said that companies and the government could help lower employees' opportunity cost of working overseas by addressing their social



and family concerns of being overseas for an extended period of time. For example, the government could introduce policies to support the seamless reintegration of the employee's children education upon returning to the home country. He added that companies should manage the job concerns of their employees upfront and provide clear re-entry planning for those who are returning from their overseas postings. This includes ensuring that there are suitable job positions available for returning employees.

### **Engineer Local Jobs That were Global in Nature**

One participant argued that it was not always necessary to post an employee overseas in order for the employee to pick up the required skills and experience to take on more senior or global roles. He felt that local jobs that are global in nature could emulate to a great extent the experience of an overseas posting. Such jobs would entail a global context with multiple touch points, allowing employees to build the skillset required for taking on more global or senior roles without having to work abroad.

He also highlighted that the age window whereby employees were most open to overseas posting was short, and closes by the time they are in their mid-30s. After this time, family commitments usually take priority. Hence it makes sense to provide more overseas job posting opportunities to younger employees.

### **Expand the Workforce to Tackle the Manpower Crunch**

One participant suggested that Singapore could consider tackling the manpower crunch by tapping the pool of older workers and through apprenticeship. However, he noted that most companies were reluctant to pay older workers equitably because of their age. The benefits of apprenticeship were also not apparent to companies because apprentices were not able to contribute much in their early stages and there was a chance that they would leave for other companies after completing their training programme.

The government could catalyse these two practices by subsidising companies that hire older workers and apprentices, he said. The public financing of this programme could come from the revenue collected from foreign worker levies, amounting to a double dividend effect of taxation.

Other suggestions to expand the workforce base by tapping readily available human resources were given. More incentives for mothers returning to work could be introduced, for example. The employment rules of foreigners on dependency passes and foreign students could also be modified to help ease the manpower crunch. Part-time employee sharing

programmes could be encouraged as an innovative way of tackling the manpower shortage.

### **Promote More Student Internships with SMEs**

One participant suggested extending internship programmes with SMEs to younger students as a way for students to understand SMEs better and to dispel the image of SMEs as inferior employers. He added that the structure of this internship programme could depend on how important the government deemed SMEs to be, and could even mirror the structure of Singapore's national service. However, considering the fact that many SMEs did not even have a basic HR management system, student internships could work against the SME sector, if students are put off by their negative internship experience with badly managed SMEs. Hence, he said that it was important that both employers and employees changed their mindsets. Otherwise, national efforts such as internship programmes would be not be very effective.

### **Adopt Longer-Term View on Employee Skill Acquisition**

One participant said that while in the past the same set of skills could last an entire career, employees today had to constantly re-skill and retool to stay relevant in the face of changing technology and business needs. However, many companies continue to seek employees with ready skills to meet their needs. This is compounding the manpower shortage.

Companies should instead adopt a longer-term view and provide training for existing employees to acquire the skills required. Employees in turn would have to be willing to participate in continued education and training so that they can remain valuable.

### **Encourage Company Consolidation in Some Industries**

Several participants felt that SMEs were disadvantaged against large companies because they lacked size. Certain business operation systems and processes (e.g., HR management system) were only practical to implement if the company was beyond a certain size. Consolidation in fragmented industries in the form of merger and acquisition or collaboration between companies could help SMEs overcome that size barrier. Moreover, it was pointed out that employees are more likely to join growing companies because of better career prospects.

### **Better Alignment of Education, SME and Manpower Policies**

One participant said that the education policy, SME policy and manpower policy in Singapore could be better aligned to unlock hidden synergies. For example, the recent decline in foreign student population growth in



Singapore could be attributed to shrinking employment prospects. This in turn dampens Singapore's ambition to be an education hub. Concurrently, SMEs are facing a growing human capital crisis. These problems could be resolved if there are policies to better match foreign students studying in Singapore to SMEs.

### **Introduce More Targeted Government Policies**

While participants accepted that the tighter foreign labour policy was necessary, some of them felt that the policy approach should be reviewed. For instance, certain measures could be targeted at the sectoral level. It was suggested that depending on the requirements and constraints of each sector, different levies and quotas could be allocated.

One participant shared that his IT business faced difficulty employing suitable people simply because most people preferred sales jobs over engineering jobs. In a situation where few locals wanted to take on the job, introducing a levy on foreign employment only served to drive up wage costs.

Another employer shared his own personal experience of not being able to attract a single graduate in the first three years of his company's inception. In fact, he constantly had to make presentation pitches to his interviewees. His peers in other industries like hospitality also encountered difficulty in hiring middle management employees.

Responding to the argument that people would be attracted to the job if the salary were competitive enough, the participant said that many people do not recognise career building as a long-term effort, and that starting salary should not be the only factor when considering a job. Singaporeans are too present-anchored and failed to consider the long-term career prospects of a job. In addition, the media spotlight on top fresh graduates with high starting pay raises the wage expectations of other fresh graduates.

### **Importance of HR Management to Meet the Evolving Needs of Companies**

It was noted that as the profile of Singapore's workforce was becoming more diverse as population demographics change. A one-size-fits-all HR policy is no longer adequate. Hence, there is a need for more specific HR management to meet the needs of different profiles of employees. One participant highlighted that investing in and grooming quality HR talent could have a multiplier effect on a company's performance. Moreover, as productivity is a function of both company processes and employee effort, proper HR management is very crucial.



It was noted that the government recognised the importance of HR management for a company, and was trying to change the common perception of HR as a mainly administrative work. For example, government-sponsored HR scholarships have been introduced to attract talent to the profession.

However, it was noted that good HR practices alone were not sufficient to attract employees to a company. Employees were drawn to aspiring and growing companies because of the better career prospects they offered. SMEs that possess the right business mentality would naturally stand a better chance of attracting the talent they need.

### **Debate Over the Right Level of Government Support**

One participant questioned whether the amount of government support to companies had stifled competition so much that it has retarded the creative destruction process necessary to produce successful companies. Many successful US companies were born from very competitive business environments. Are the effects of the government support in Singapore akin to a command economy in the sense that resources are used inefficiently, the participant asked.

Others disagreed with this view and contended that more incentives could be made available to nudge SMEs from their current status quo into expansion either through internal growth or M&A.

The question on industry fragmentation was raised at the CDD. It was asked whether the state of fragmentation observed in some industries was a result of market distortions due to excessive government support or simply an outcome of industry dynamics that would benefit from more government regulation. One participant called for the government to conduct a detailed examination of the matter to understand the causes of industry fragmentation.

However, others argued that it is difficult for the government to draw a clear conclusion on the right level of government support even with the use of various analysis metrics, like company formation and cessation, profit margin and business sentiment. In addition, overly rigid government policies could result in more inefficiency in the system.

Besides, it was pointed out that much of the government support were in the form of targeted schemes that required companies to make some form of capability investments. Directly subsidising operating costs was avoided because it amounted to a direct transfer, which encourages little behavioural change. In this sense, support was not given indiscriminately.



However, it was true that government support to businesses might have resulted in some level of excessive employment and fragmentation in certain industries. This was something worth studying, said one participant.

Several participants from the business community cautioned against taking the view that the government, through “spoon-feeding” SMEs, has prevented the natural process of creative destruction. While they agreed that there were many available government support schemes, and also commended SPRING’s proactive efforts to help SMEs, they pointed out that the decision to implement business changes and the burden of carrying out the restructuring ultimately still fell on companies. Providing SMEs some support to ease the pains of business restructuring should not be misconstrued as spoon-feeding, they argued.

### **Offer More Subsidy Schemes Based on Upfront Reimbursement**

It was highlighted that cash flow management was a major problem for many SMEs. Most of the government schemes operated on a reimbursement basis. Given that many SMEs faced cash flow constraints, the government should consider offering more upfront subsidy options. Although this might result in higher wastage of public finances or misuse of subsidies, the overall returns to the economy was likely to outweigh the costs as long as national productivity level could be boosted.

### **Reframe the Process of Productivity Improvement**

One participant posited that companies should change the way they viewed productivity fundamentally. The right approach to rising productivity should be closely tied to practical business considerations and framed in a systemic manner, he said. First, a company has to identify its core competency and understand the landscape it is operating in. It should then develop a business strategy based on these two factors. Such an approach would have a higher chance of achieving productivity gains.

However, it was noted that in many labour-intensive industries, there was a limit to how fast productivity could grow. Ultimately, these industries still require a significant amount of manpower.

### **Better Classification for SMEs Needed**

One participant was of the view that the current definition of SMEs was not useful for policymaking. He argued that there were so many different kinds of SMEs, and that each group required a different set of policies and treatment.

In response, it was noted that most government agencies further segmented SMEs by their size, growth rate and type of industry they were in, to capture a more granular picture. It was also explained that the government, recognising that different strategies were needed for different types of SMEs, was working with HR diagnostic service providers to help more SMEs conduct assessments to identify the kind of HR capabilities and solutions that suit their businesses.



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## **Chapter 6**

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# The Red Tape Challenge



## CHAPTER 6: THE RED TAPE CHALLENGE

### BACKGROUND

Bureaucracy, a term used to describe the administrative system of large and complex organisations, is often associated with layered and rigid procedures of governance that hinder effective change and progress. The obstacles that originate from government bureaucracy are often referred to as red tape, which describes the excessive and unnecessary government requirements that weigh heavily on businesses and people.

More formally, red tape can be defined as the rules and regulations — encompassing administrative and management procedures and systems — that are not effective in achieving their intended objectives, and which therefore generate sub-optimal and undesired social outcomes (Wegmann & Cunningham, 2010). It falls into at least one of the three broad categories:

- Red tape which is created by rules and regulations that are designed to achieve a specific policy objective and that are thus policy-related
- Red tape which is created by procedures and systems that do not function in an efficient and effective way due to administrative and management issues
- Red tape which is created when stakeholders from different sub-systems exchange information or interact

Examples of red tape plaguing businesses include the requirement to complete copious amount of repetitive paperwork, having to obtain numerous licences for business operations, and the presence of a complicated and layered regulatory structure that stymie the ability of the government to response timely and appropriately to evolving business needs and issues. While the intentions underpinning the rules, regulations and systems introduced by the government are to shape desirable behaviour and policy outcomes, the unintended burden that they create can be debilitating to businesses, especially SMEs, causing significant disruptions in terms of time, money and ability to conduct their business operations. Hence is it importance to remember to following basic fact: That every regulation represents a restriction of liberty, and every regulation has a cost. That is why, like marriage, regulation should not, to



quote Margaret Thatcher, “be enterprised, nor taken in hand, unadvisedly, lightly, or wantonly.”

### **Benefits of Good Rules and Regulations**

Good rules and regulations are the basis of a well-functioning society and economy. By targeting market externalities and ensuring fairness, it promotes the interests of consumers, businesses and society at large. In fact, the primary motivation of regulation is to meet socially desirable goals like promoting equity and uplifting the population’s well-being. As a core agent of nation-building, the government is accountable for protecting the well-being of the public. Naturally then, it has to play the important role of the nation’s regulator. The regulatory environment that it designs and puts in place is key to determining the economic competitiveness and prosperity of the country. Hence, it is integral that the government maintains a dynamic regulatory environment that is responsive to the population’s needs and reactive to emerging trends in order to preserve the well-being of its stakeholders.

Granted that the rules and regulations introduced by the government on businesses are meant to benefit society and the economy, it is important for the business community and the government to work together to create a conducive, fair and vibrant business environment, that would in turn generate societal benefits in the form of better employment opportunities, remunerations and a more resilient economy. While there is no doubt that the business community and the government have different reasons for wanting to reduce red tape, the existence of a common desire should incentivises both parties to work together to simultaneously achieve their respective interests and improve the overall well-being of society.

Hence, when designed carefully and implemented effectively, rules and regulations help to monitor and address the risks in society. Well-designed and purposeful rules and regulations should not exert unnecessary burden on businesses; rather, they protect the rights of consumers and promote a level playing field for businesses, reinforcing the framework of governance for a stronger and more productive economy.

Without some form of governance, there could be friction between various stakeholders in the economy and society, and the well-being of some stakeholders could be marginalised. The role of business legislation and regulation is to: Supervise and regulate markets to address market inefficiencies; safeguard the rights of businesses, consumers and other market stakeholders including employees; and promote a fair playing field for all businesses.

## Cost of Poor Rules and Regulations

But even as the importance of well-designed rules and regulations cannot be discounted, it must be recognised that poorly designed and ineffective rules and regulations can be regressive and destructive for the economy and society. Governments run the risk of introducing poor rules and regulations that impede innovation or create inefficiencies to trade, investment and economic activities, and even threaten the legitimacy of regulation (OECD, 2003).

In most countries, the amount of regulation — and with it the red tape — tends to accumulate over time and different terms of government. This expansion of red tape, if left unchecked, has detrimental implications to the economy and society. The unnecessary burden it imposes on businesses stifles vibrancy of the business environment, which crimps the overall growth potential of the economy. To the society, it could undermine civic participation as individuals are overwhelmed by the amount of regulation whenever they want to volunteer or participate more in the community.

One example is how excessive and overly rigid regulation can snuff out innovation and reduce the pace SMEs adopt new production technology. This happens when the application processes to use new technology and to get government grants are long and arduous, and involve dealing with many government agencies. These delays and uncertainties are a significant strain on businesses, and discourage many SMEs from engaging in innovative activities that are important to push forward the development of the economy.

In Canada, it was estimated that the cost of red tape to businesses in 2014 was a whopping CA\$37.1 billion (Cruz et al., 2015). In the EU-27, based on figures calculated by the OECD, the cost of red tape was equivalent to 3.7% of the region's GDP (Cody, 2013), not an insignificant amount. The cost of excessive rules and regulation can come in the form of direct and indirect costs. Direct administrative and compliance costs include time and money spent on formalities and paperwork necessary to comply with regulations. Examples include completing forms, applying for permits and licences, reporting business information and notifying changes. Indirect costs arise when rules and regulations reduce the productivity and innovativeness of businesses (OECD, 2003).

These costs not only affect those that are forced to comply with red tape at first instance. Ultimately, unnecessary regulatory costs imposed by poor regulation can ripple out to other sectors of the economy in the form of higher prices and fewer opportunities for businesses and consumers (Commonwealth of Australia, 2014). In short, red tape is costly, not just in



terms of the resources wasted on adhering to regulatory requirements but also in terms of the stymied performance of the economy.

The cumulative effect of myriad government rules and regulations from multiple layers of government bureaucracy is to slow down business responsiveness, divert resources away from productive investments, reduce transparency and accountability, hamper entry to markets, reduce innovation and job creation, and discourage entrepreneurship (OECD, 2003).

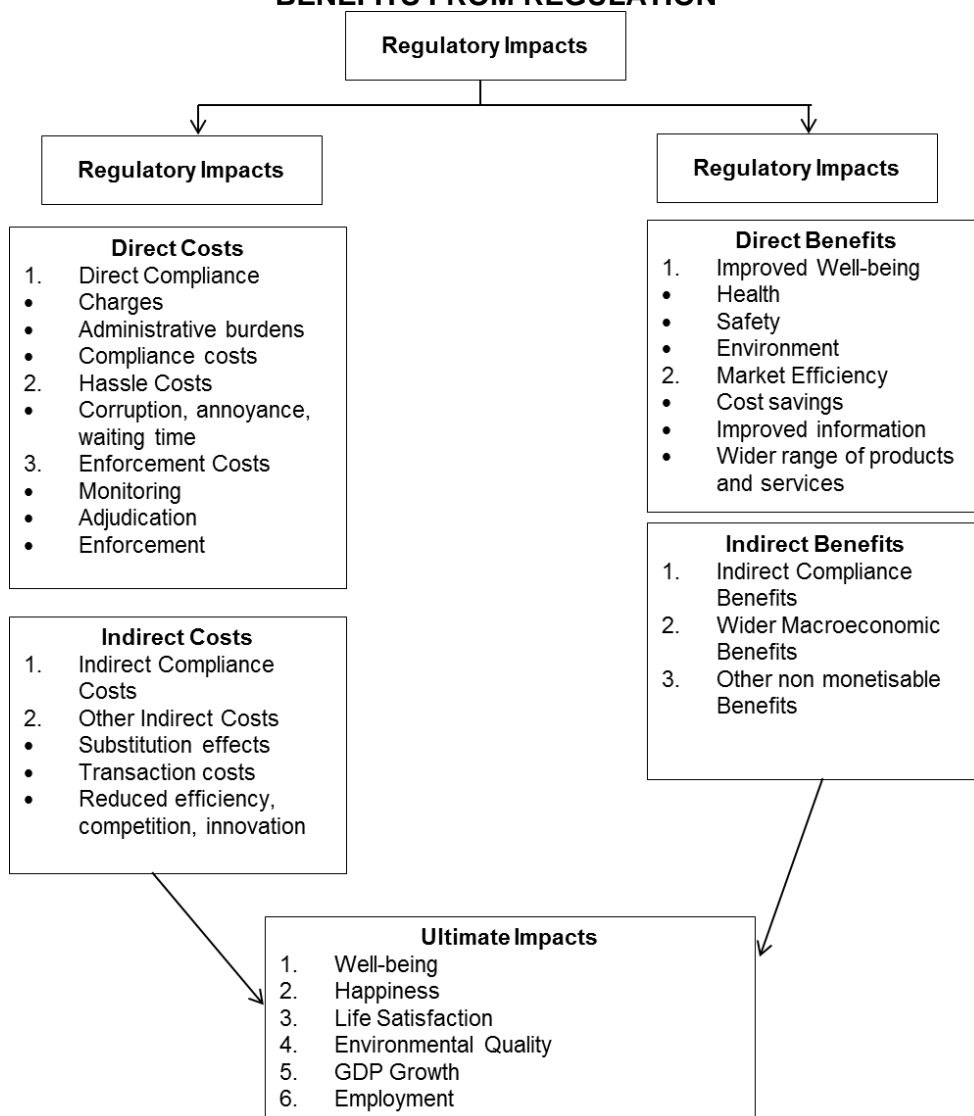
Excessive regulation is always a concern for all businesses, but it has the greatest impact on SMEs because of their limited resources. Hence, it is important for the government to regularly examine existing rules and regulations, to identify and eliminate the regulatory burden that poor regulation imposes on companies. Many countries are well aware of the need for regular review of rules and regulations and their impacts on business, the economy and societal well-being. Otherwise, there is a danger of red tape becoming so entrenched that growth is being choked off for businesses and the overall economy.

But despite the harmfulness of excessive red tape, many businesses actually demand for red tape in the form of entry barriers like tariffs and industry standards to safeguard their investment interest. The private hire transport industry provides an ongoing example where licensed taxi drivers in many countries have staged massive protests against private-car hailing applications like Uber<sup>12</sup>. They complain that the “new entrants” are eroding their livelihoods, and highlighted that these new players are not held accountable to the same stringent standards of the taxi industry. The fact is that red tape in the business environment is critical for companies (and other stakeholders) as it provides a governing framework for society. Therefore, while companies may complain about rules and regulations, they would not want rules and regulations that protect their interests to be eliminated. Figure 6.1 by Harries & Sawyer (2014) maps out the network of direct and indirect costs and benefits arising from regulation.

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<sup>12</sup> Uber is an American international transportation network company that allows consumers to make trip requests on their smartphones through Uber’s application, which is then routed to Uber drivers who use their own cars. As of 2015, the service is available in more than 58 countries and 300 cities worldwide.

**FIGURE 6.1: DIRECT AND INDIRECT COSTS AND BENEFITS FROM REGULATION**



Source: “How to Run a Country” (Harries & Sawyer, 2014, p. 7)

In reality, many of the rules and regulations are necessary for the proper functioning of society and economy, and to support efficient and effective markets. Without any government regulation, a country would very likely be in a state of dysfunctional chaos. Hence, the debate should not be on whether to regulate, but how to regulate and in whose interest. Equally important is finding the appropriate level of regulation, so as to maintain as



light a touch as possible to allow the economy and society the room to flourish.

The objective of red tape reduction is therefore not to eliminate all red tape. Instead, the aim is to have “smart tape”, i.e., to remove redundant red tape and ensure that only the important rules and regulations exist. Ensuring that all stakeholders (e.g., individuals or companies affected by the red tape) can interact with the policies and procedures in a fair and transparent way is also important.

### **Disproportionate Burden of Red Tape on SMEs**

The SME sector contributes significantly to the economy in terms of employment and output. SMEs are also identified as drivers of innovation and change. Given that they make up the majority of all enterprises and play an important role in the economy, one would expect government policies to be designed with SMEs as a leading factor of consideration. However, in reality, larger companies often hold more sway over government policies because they have more resources — both monetary and non-monetary — to push through their agendas, and they have greater visibility in the economy than SMEs due to their larger size. As a result, there is a tendency for policies and bureaucratic structures to overlook the needs of SMEs, resulting in a disproportionate amount of red tape burden placed on SMEs. This in turn runs the risk of impeding the sector’s ability to innovate, compete and even survive.

In a 2007 enterprise survey conducted by Gallup, it was found that more than a third (36%) of the SMEs surveyed faced difficulties caused by stringent administrative regulations. In addition, those that were facing difficulties in coping with administrative regulations felt that the problem was worsening, while at the EU-27 level, some 44% of SME respondents thought that the business environment was too overregulated. Similar findings were reported in a more recent SME survey (SME 2013/2014 review) conducted by the European Commission. The burden arising from managing the pile of administrative requirements and requests from various authorities was found to be exerting a significant burden on SMEs (Muller et al., 2014). The report also revealed that a high and significant negative correlation existed between SME performance and regulation, suggesting that SMEs are forced to compromise on their business performance in order to cope with red tape.

EU SMEs on average spent 69 man-days or 8% of their total time each year satisfying regulatory requirements (Gallup, 2007). As with many other forces in the business environment, red tape weighs more heavily on SMEs than on larger companies. While the benefits of red tape tend to be

evenly enjoyed by companies of different sizes, the cost of red tape is greater to SMEs than to larger companies. There is a clear trend indicating that larger companies are able to more efficiently manage the administrative tasks created by bureaucracy. While micro enterprises employing only one to nine people reported spending 8% of their time complying with administrative requirements, the estimated time burden dropped progressively as the size of the company increases. For companies hiring more than 250 employees, this burden was smaller than 1% (Figure 6.2). In Canada (Cruz et al., 2015), it was estimated that employees in the smallest companies spent up to 185 hours each year attending to issues relating to rules and regulations. In terms of cost, Canadian SMEs spent four times more than larger companies on complying with regulation requirements. In Europe, this cost disparity was even higher for micro enterprises, where it was estimated that for every €1 spent by a large enterprise on regulatory duty, a medium enterprise spends up to €4 and a micro enterprise spends €10 (European Commission, 2007).

**FIGURE 6.2: TIME BURDEN OF ADMINISTRATIVE TASKS**

	Estimated relative time-burden of government administrative tasks (%)
<b>By Size</b>	
EU 27 SME	8
1-9 persons employed	9
10-49 persons employed	2
50-249 persons employed	1
250+ persons employed	0
<b>By Sector</b>	
Manufacturing	5
Construction	9
Wholesale and retail	8
Hotels and restaurants	6
Transport, storage and communication	10
Financial intermediation	10
Real estate, renting and business activities	9
Health and social work	9
Other community, social and personal service	8

Source: "SME observatory survey: Summary" (Gallup, 2007, p. 14)



Unlike larger companies, SMEs have fewer internal resources to draw upon to deal with business issues. The small size of SMEs often implies that they are not able to benefit from economies of scale to reduce the cost of complying with rules and regulations. For instance, regulation that requires fixed cost outlays could be more expensive to SMEs than for larger companies in terms of per unit usage. Moreover, SMEs have more difficulty accessing financing than larger companies, and they also have smaller ability to pass on the increase in cost from abiding to rules and regulations to consumers.

Moreover, many SMEs are too small to have enough employees who possess the knowledge and expertise to navigate all the rules and regulations implemented by the government. In order for them to satisfy the regulatory demands, some of them could be compelled to pay for external consulting to address the lack of internal know-how. Other SMEs facing cost constraints may try to cope internally with the red tape. In contrast, larger companies can easily absorb this extra work into their existing operations without incurring substantial addition costs. In a survey conducted by the Federation of Small Businesses (FSB), more than 50% of SME respondents said that the most challenging aspect of complying with regulatory requirements was the “sheer time” involved in coping with new and amended regulations (Harries & Sawyer, 2014).

But despite the fact that SMEs have less resource bandwidth and therefore are less capable of dealing with red tape, they are still subjected to the same rules and regulations as larger companies most of the time. Where red tape introduce minor inconveniences to larger companies, forcing them to divert negligible resources to comply with government requirements, the same set of red tape impose an inequitable demand on the limited resources of SMEs.

Beside, a lot of the burden inflicted by red tape is not easily measured. The cost generated from the uncertainty over a new regulation, worry about potentially violating rules, and the stress from having to cope with the pace of regulatory changes on top of juggling routine business challenges are all not easily quantifiable. Yet, these issues have an undeniable real impact on the performance of businesses and the well-being of their personnel. Again, SMEs are nearly always disproportionately burdened by these non-tangible effects of red tape due to their limited size and resources.

This burden is even more acute for owner-managed SMEs or newly minted businesses, whereby personal life and work are often conflated. The owner is responsible for every aspect of his business, making decisions on all matters ranging from business development to HR matters and complying



with regulatory requirements. This means that a greater burden must be borne by the owner on both personal and financial levels. Moreover, the barrage of regulatory requirements reduces the owner's "downtime" to recharge and prepare for new challenges, in the process weakening the competitive advantage that SMEs enjoy as being more flexible and innovative than larger companies.

In Canada, one in three SME owners surveyed said that they would have reconsidered venturing into business had they known about the burden of regulation (Cruz et al., 2015). As many as 42% of small business owners said that they would not advise their children to start a business. While this survey reflects only the sentiments of SMEs in Canada, it is likely that SMEs in other countries weighed down by onerous red tape would feel the same way to some extent. Granted that the SME sector is an important contributor to growth the potential of the economy, it is crucial that the government fosters a SME orientated culture within the public service to provide the necessary support to drive the development of the SME sector.

### **Common Tools and Practices to Manage Red Tape**

In view of the adverse impact excessive red tape has on businesses and the economy, governments across the world are doubling their efforts to review and trim red tape. While different countries may rely on different red tape reduction strategies, the following are some forms of tools and practices that are commonly used by countries to manage red tape burden (OECD, 2003):

- Organisational and structural approaches to administrative simplification
- Simplification of licensing procedures
- Methods to measure administrative burdens
- One-stop shops (physical and digital)
- Time-limits of decision making
- Assistance to SMEs in implementing regulation
- The use of ICT-driven solutions



### ***Organisational and structural approaches to administrative simplification***

In the past, it was common for red tape issues to be dealt in an ad-hoc and narrow “silo” manner. A huge amount of effort was required to overcome the inertia of the bureaucratic system just to draw the government’s attention to a particular red tape irritant. Second, there was rarely an efficient structure for coordinating and monitoring the process of red tape reduction programmes. Instead, it was common to assign the duty to government departments where the red tape issue seemed to arise from or to senior public officials who showed the most keenness in carrying out the reform. This resulted in a disorganised framework that lacked transparency, accountability and efficiency.

In recent years however, a more systematic and comprehensive approach is being adopted to deal with red tape. Such whole-of-government approach improves coordination between different regulatory authorities, which helps to reduce the incidence of competing policies and duplication of regulatory requirements. On a broader level, it aligns the goals within the entire public sector so that everyone is working towards a common outcome.

There are four basic organisational bodies used in OECD countries to reduce red tape. One of them is single-purpose entities that focus on specific agendas of simplification, such as plain language or cutting red tape. Then there are administrative agencies that drive simplification processes across the whole environment — for companies, citizens and the public sector, rather than focus on delivering in one particular area. Another important entity is regulatory reform agencies that count cutting red tape as part of their objectives on improving the quality of rules and regulations. The last group is external committees, which is usually made up of a majority of non-government representatives such as academia and business organisations, established by the government to cut red tape (OECD, 2007). External committees are important because they allow non-government stakeholders to point out the faults in the bureaucratic system, and offer them the chance to be involved and consulted right from the beginning to ensure that the reforms made are addressing the right concerns. In particular, it is an important platform for the SME sector to participate and voice their views.

### ***Methods to measure administrative burdens***

Measuring the burden of regulatory procedures is an integral part of red tape reduction programmes. As governments are aware of the disproportionate burden of red tape on SMEs, many cost measurement

exercises — both ex-ante and post-ante to red tape reduction programmes — are conducted with SMEs as a key consideration.

While different countries may use different types of measurement system, the measurement techniques used have to be sufficiently advanced to perform a detailed analysis of red tape burden. In addition to measuring the burden of regulatory procedures in their red tape reduction programmes, governments are also likely to set specific quantitative reduction targets to be achieved within a certain time frame.

Several countries in the EU use measuring models that are based on the Standard Cost Model (SCM) developed in the Netherlands. The SCM consists of breaking down legislation into “information obligations” to measure the burden that a single obligation imposes on businesses. The strength of the model is not only in its high level of measurement detail of administrative costs, but also the fact that the numbers obtained are consistent across policy areas. Moreover, the model allows governments to set numerical targets for burden reduction and to measure progress towards these targets over time (OECD, 2007).

In a bid to improve rule-making, some governments also place emphasis on estimating the potential regulatory burden of new rules and regulations before deciding on implementation. This exercise is known as a regulatory impact assessment (RIA). However, the cost estimated by the RIA could deviate widely from the actual burden of the regulation. Hence, it is important to follow up after a regulation is introduced with an exercise to measure the actual burden it induces. Some governments have in place an automatic review process, under which it is mandatory to review new regulations to ensure that they achieve the intended effect.

In addition, many countries pay special attention to the impact of regulation on SMEs in their regulatory cost assessments. The cost assessment would include studying whether alternative approaches that exert lower regulatory burden on SMEs are available.

### ***One-stop shops (physical and digital)***

Businesses, especially SMEs, have to grapple with the frustration of toiling through the complex bureaucratic system on a regular basis. They have to deal with multiple agencies to obtain approvals, permits and licences for their business operations. In most cases, there is no mechanism for regular review of the relevance or effectiveness of regulatory requirements. There is no proper process to eliminate dated, irrelevant regulatory requirements. As a result, the list of business regulation tends to increase



over time, adding to the burden on companies (Red Tape Reduction Task Force, 2007).

Another inefficient aspect of the public sector is the difficulty in accessing government programmes and services. Notwithstanding the generous government support available in many countries to help companies develop their businesses, navigating the complex web of government services and programmes continues to be a challenge for SMEs. As much as people within the system know how to navigate it, the majority of SMEs do not. SMEs have to invest an inordinate amount of time and effort just to “shop around” the system to find out what support is available and how to access them. Very often, this discourages SMEs — which are already struggling with a limited resource bandwidth — to tap otherwise very useful government support programmes (Red Tape Reduction Task Force, 2007).

What is needed is a simplified and transparent system that can allow businesses to easily find out the services that most suit their needs and access those services easily. Equally important is the need to provide public officers with the suitable tools to carry out their duties effectively to help businesses.

The use of one-stop shops as a single access point to government authorities is one of the mechanisms used in several countries to help SMEs access government services and complete regulatory requirements. One-stop shops are an integrated government service platform equipped with the capabilities to allow businesses to obtain from one place the different licenses and approvals demanded by various government agencies. They are also a destination for businesses to seek advice on government related business formalities and issues, which include obtaining customised information on government support programmes based on their business needs.

One-stop shops can exist in both physical and digital forms. In Canada, businesses can use the web-based service BizPal for help and this includes obtaining instantly a customised list of the permits and licences required from all levels of government (federal, provincial/territorial, and municipal). Different countries use different forms of one-stop shops. In addition, some countries have both physical and digital one-stop shops that may offer different but complementary services to improve the breadth and depth of support to businesses coping with bureaucratic demands (Martini, 2013).

### ***The use of ICT-driven solutions***

The use of ICT to manage regulation is becoming increasingly prevalent. The rapid advancement of technology has opened up possibilities of applying new technologies to achieve intelligent regulation, where the government leverages the power of technology to automate processes and introduce new elements like behavioural economics and big data analytics to strengthen the overall regulatory framework and minimise the red tape burden placed on businesses (Harries & Sawyer, 2014).

One use of ICT is to digitalise government services so that individuals and companies can access them anywhere and anytime. As seen above, one-stop shops do not have to be a physical office and can be in a digital form. Digital one-stop shops can offer an equally comprehensive suite of E-government services that are easy for companies to access and at a much lower cost to the government.

Another use of ICT is to share data within the public sector by using standardised databases that can be accessed by different government agencies. Businesses often have to submit the same information to different government agencies in different formats and by various means. By tapping ICT solutions to create data networks that allow for the sharing of data, the administrative burden on businesses can be greatly reduced. This is particularly helpful to resource-constrained companies like SMEs, freeing up valuable bandwidth for them to devote to developing their businesses.

Take for example the post office in Finland, which offers an electronic client service through which companies only have to make declarations to the authorities just once to collect statutory data. In the Netherlands, companies only have to submit information to the tax authority, which will then share it with other government agencies (OECD, 2007).

It is undeniable that the use of ICT is an important component of achieving administrative simplification and reducing regulatory burden. In particular, the use of ICT could significantly reduce the costs that SMEs incur for complying with government requirements (OECD et al., 2012). Nonetheless, if IT-driven solutions are introduced in a piecemeal manner without proper coordination between government agencies, then they would most likely be ineffective in improving overall bureaucratic efficiency and effectiveness. However, if technology is leveraged smartly, it can offer innovative solutions to cut through onerous red tape (OCED, 2007).



### ***Time-limits of decision making***

Placing a time limit on decision making is a simple but effective way to improve bureaucratic administration. For companies, the slow pace in which decisions emerge from the bureaucratic system — be it license application, reporting process or general enquiry into government formalities — is potentially debilitating for businesses, and even fatal for SMEs. Unlike the complex and unwieldy bureaucratic system, the landscape in which businesses operate is ever-evolving with opportunities appearing only momentarily and threats creeping up without notice. A related frustration is the seemingly lack of appreciation on the part of public officers that waiting for decision outcomes costs precious time and money to businesses. Hence, it is absolutely critical to ensure that administrative decisions are conducted within a clearly defined and acceptable timeframe to give companies a sense of certainty so that they can plan for their other business activities (Red Tape Reduction Task Force, 2007).

Another issue that companies grapple with is the lack of information pertaining to changes to rules and regulations. Often, the announcements of changes perfunctorily conducted without a proper effort to ensure that information on the changes is conveyed thorough to the stakeholders by various communication channels. While larger companies may have the capacity and expertise to deal with changes on a short notice, SMEs on the other hand tend to be already operating at their maximum bandwidth, and could be severely hamstrung by any sudden unexpected changes to rules and regulations.

Hence, some countries alleviate this problem by adopting common commencement dates for new legislation affecting businesses. This helps to reduce the chances of businesses overlooking or misunderstanding the changes to rules and regulations, and also simplify the communication outreach to parties that would be affected by the changes. The European Commission encourages member states to adopt common commencement dates for new legislation affecting businesses. In the UK, for example, all rules concerning businesses operating in the country can only come to effect on two pre-determined dates, 6 April and 1 October (European Commission, 2007).

### ***Assistance to SMEs in implementing regulation***

Lastly, regulation management and reform should take special consideration for SMEs. SMEs tend to bear a disproportionate burden of the regulatory requirements because of their small size and limited resource bandwidth. The use of special procedural measures to assess the impact of regulation on SMEs can help the government arrive at better-designed rules and regulations that achieve their objectives but minimise

the regulatory burden on SMEs. These measures should include consultation sessions with the SME sector to comment and advise on the likely impacts of proposed regulatory changes, to ensure that the sector's views are adequately represented in the decision-making process.

In addition, regulatory burden on SMEs can be reduced by granting them exemption from non-critical regulatory requirements that would not compromise the underlying policy objectives, and providing them with special simplified procedures for adhering to regulatory requirements. SMEs could also benefit from simple and accessible guidelines and other tailor-made information related to regulatory issues affecting them (UNIDO & UNODC, 2012).

### **Regulatory Systems of Different Countries**

Different countries have their own choice of system consisting of institutions, legislations and tools to help guide and manage policy decisions on government rules and regulations. This section provides a snapshot of the systems used by governments in the US, UK, Canada and Singapore to manage their country's regulatory environment and keep regulatory burden on SMEs in check.

#### ***The US approach***

The US has a strong institutional structure that protects SMEs from unnecessary regulatory burden. Central to this framework is the Regulatory Flexibility Act (RFA), which was first enacted in 1980 and subsequently amended in 1996 by the Small Business Regulatory Enforcement Fairness Act to strengthen the support to SMEs for regulatory fairness (United States Environmental Protection Agency, n.d.).

The purpose of the RFA is to fit regulatory requirements to the scale of the businesses, organisations and governmental jurisdictions subject to the regulation, ensuring that the regulation does not create a disproportionate burden on any one stakeholder. The RFA requires that government agencies assess the rule's economic impact on small businesses, explore regulatory options for reducing any significant economic impact on a substantial number of such businesses, and explain their ultimate choice of regulatory approach. In addition, government agencies are required to ensure that they publish a year in advance all of the possible regulations that they are considering to introduce. They are also required to consult a board representing small businesses on possible future proposals to ensure that they do not disproportionately affect small businesses.

Acting as an Ombudsman for the RFA is the Office of Advocacy located within the US Small Business Administration (SBA), which is part of the



federal government. Created by Congress in 1976, the Office of Advocacy is an independent voice for small businesses. The Office of Advocacy gives small firm owners and their representatives the opportunity to have their views heard about rules that affect their interests (US Small Business Administration, n.d.). If a small business or representative body wishes to challenge a regulation on the basis because it imposes an undue burden on small firms, they are able to call for a judicial review of the regulation and the agency's possible failure to comply with the Act through the Office of Advocacy (Federation of Small Businesses, 2012). Besides being a supervisor for the RFA, the Office of Advocacy also works with policymakers at a state and local level to strengthen regulatory flexibility for SMEs.

Separate from the Office of Advocacy is the Office of Information and Regulatory Affairs, located in the White House. It provides advice to government agencies on the regulatory reform agenda and is responsible for managing the regulatory agenda, including reviewing draft regulations and returning them to agencies if they are not satisfactory. It also works with other agencies to achieve the necessary improvements that the Office for Advocacy is unable to do so (Federation of Small Businesses, 2012).

Individual state or local governments may also introduce their initiatives to manage the regulatory environment of the areas under their charge. For example, in New York City, Mayor Bill de Blasio implemented the Small Business First initiative, a five-year plan to reduce regulatory obstacles to local businesses. Among other objectives, the US\$27 million initiative aims to streamline licensing and permitting for small businesses operating in New York City. It will create a one-stop shop where business owners can take care of administrative issues and settle most fines and violations (Kasperkevic, 2015).

### ***The UK approach***

In the UK, the Better Regulation Executive, which is a directorate in the ministerial Department for Business, Innovation and Skills (BIS), is in charge of regulatory reform across the government. The Better Regulation Executive advises the government on ways to eliminate unnecessary regulatory burden, and ensure that regulation and its enforcement are proportionate, accountable, consistent, transparent and targeted (Harries & Sawyer, 2014). Another important administrator of regulation is the Better Regulation Unit, which are department teams located in different government agencies responsible for promoting the principles of good regulation and advising departmental policy makers.



Another important actor in the UK regulatory system is the Regulatory Policy Committee (RPC), an independent advisory non-departmental public body composed of economists, business leaders and civil society representatives created in 2009 with duties similar to the Office of Advocacy in the US. The RPC conducts independent impact assessments on new regulatory and deregulatory proposals, and validates the net cost<sup>13</sup> to business of new regulations under the mandatory “one in, two out” (OITO) rule stated in the better regulation framework manual<sup>14</sup>. Since 2009, the RPC has reviewed more than 1,200 regulation proposals. In addition, one of the core priorities of the committee is to represent the needs of small and micro companies to the government. Recognising the disproportionate burden regulatory requirements exerts on SMEs, the RPC takes special consideration for SMEs when conducting their impact assessment.

In terms of policy, the UK government introduced the above-mentioned OITO rule in 2013. Under this rule, any new regulatory measure that is expected to result in a direct net cost — calculated using the EANCB formula — to businesses and civil society organisations must be offset by compensatory deregulatory measures providing savings to business of at least double that amount. The UK government also adheres to a common commencement dates rule that requires new domestic measures (both regulatory and deregulatory) to come in force either on 6 April or 1 October each year. One of the main reasons for this rule is to provide certainty to companies about forthcoming regulatory changes so that they can better plan for their businesses to minimise additional burden.

Over the course of two years, from 2011 to 2013, the UK government conducted a consultation exercise known as The Red Tape Challenge. The core objective of the initiative was to eliminate rules and regulations that are redundant, and improve existing regulations to reduce the overall red tape burden. It is estimated that the total annual savings to businesses from this exercise would exceed £850 million.

Lastly, the UK government is one of the frontrunners of intelligent regulation — incorporating technology and frontier concepts to improve the

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<sup>13</sup> This cost is calculated based on a formula known as the Equivalent Annual Net Cost to Business (EANCB), which is explained in the Better Regulation Framework manual.

<sup>14</sup> The Better Regulation Framework manual is a guide released by the government that provides advice on how to put into practice the UK Government’s Principle of Regulation.



efficiency of governance. The Behavioural Insights Team (BIT), created by the UK government, is the world's first government institution that applies behavioural sciences to provide public policy solutions. Part of its work involves searching for non-regulatory solutions to achieve government objectives for the economy and society. The BIT has expanded its operations to other countries like the US, Australia and Singapore.

### ***The Canadian approach***

In Canada, the regulatory system underwent a massive transformation after the Red Tape Reduction Commission<sup>15</sup> conducted their study into the regulatory environment and submitted their report to the Canadian government. The Red Tape Reduction Action Plan, launched in 2012 to act on the recommendations of the Commission, outlines a comprehensive framework of measures to ensure efficient regulation.

The plan mandates government agencies to apply the one-for-one rule and follow the Small Business Lens measure. The one-for-one rule is similar to UK's OITO rule, but differs in the sense that the rule requires government agencies to offset the increase in regulatory burden on businesses by a new or amended regulation by an equal amount. The Small Business Lens measure mandates regulators to demonstrate to ministers when designing regulations that they have done what they could to minimise the impact on small businesses. This includes completing a checklist that drives consultation with small businesses to understand their realities at the earliest stages of design. In addition, the plan also calls for all government agencies to publish interpretation policies that clarify their regulatory requirements so that companies can comply with regulatory requirements more easily.

Another initiative introduced in the plan is the Annual Scorecard Report. The Scorecard Report provides an assessment of public agencies' compliance to the commitments outlined by the Red Tape Reduction Action Plan. This report is reviewed by the Regulatory Advisory Committee, a team comprising external experts from business and a consumer group. The Committee considers and comments on the reported progress on the implementation of the Red Tape Reduction Action Plan's systemic regulatory reforms. It then provides its consensus-based views to the President of the Treasury Board and the Auditor General on the

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<sup>15</sup> The Red Tape Reduction Commission was created by the Government of Canada in 2010 to identify regulatory irritants to companies, and recommend options to address the irritants are reduce the regulatory burden on companies without compromising on the government's objectives.

government's performance as reported in the scorecard. Both the scorecard report and the committee's views are made public.

The systemic reforms introduced by the government in its Red Tape Reduction Action Plan address a broad range of irritants to businesses, as well as the systemic barriers that unnecessarily frustrate and burden businesses with additional delays, costs and bureaucracy (Government of Canada, 2015).

### ***The Singapore experience***

Unlike countries like the US, UK and Canada, Singapore does not have an explicit whole-of-government action plan for managing and reforming rules and regulations. Notwithstanding, the country is recognised to have one of the most conducive business environments in world. The Doing Business 2015 study by the World Bank ranks Singapore as the most business-friendly place in the world, reflecting the country's favourable regulatory environment. Similarly, the 2015 Global Competitive Report prepared by the World Economic Forum rated Singapore second out of 144 countries for having the least burden of government regulation. This is a testament of the public sector's effort to gather feedback from the public and to introduce new measures to cut down red tape burden for businesses, especially SMEs.

In Singapore, the Pro-Enterprise Panel (PEP), chaired by the Head of Civil Service, helps to review feedback on laws and processes so that businesses spend less time, effort and money complying with them. The panel is first created in 2000 to help businesses overcome rules and regulations that hinder them unnecessarily. It comprises mainly business leaders from the private sector to ensure that sufficient consideration is taken from the business community's perspective when reviewing suggestions. The panel is in turn supported by a network of high-level public officers across the Singapore public sector (MTI, n.d.).

In addition to gathering feedback from the private sector on rules and regulations imposed by the government, the PEP also oversees the Public Sector Pro-Enterprise Initiative, a programme where public officers are encouraged to submit pro-enterprise ideas to the PEP for their consideration. The quarterly *PEP Bulletin* announces the latest Public Sector Pro-Enterprise initiatives that have been implemented.

Each year, a Pro-Enterprise Ranking (PER) survey is also conducted with the business community to measure the perceptions and expectations of businesses that have interacted with government regulatory agencies. The survey focuses on five areas of a public agency's pro-enterprise



performance: Review of rules; compliance cost; transparency; customer responsiveness; and pro-enterprise orientation.

Numerous moves have also been made to reduce red tape, streamline grant processes, and develop portals and platforms for SMEs. For example, the government maintains the EnterpriseOne portal, which provides businesses a comprehensive network of online help and answers to issues pertaining to their businesses. For SMEs experiencing difficulty navigating the website or require more customised help, they can visit one of the physical SME advisory centres set up across the country, to seek expert advice on government services ranging from productivity and financial to technology innovation and overseas expansion. More recently, the government announced that it would be rolling out the first phase of the Business Grants Portal, which would streamline existing business grants into three key areas (capability development, internationalisation and training) within the portal. The goal is to make grants and government schemes more accessible to businesses, especially SMEs (EnterpriseOne, 2015).

## **IPS CLOSED-DOOR DISCUSSION ON BUREAUCRATIC HURDLES CHALLENGING SMES**

On 9 February 2015, IPS organised a CDD on “Bureaucratic Hurdles Challenging SMEs” to examine the bureaucratic challenges that confront SMEs in Singapore. Participants from the public sector, SME sector and trade associations engaged in an open discussion that surfaced issues impeding SMEs’ business operations and offered some recommendations for policy consideration. The issues raised and ideas generated from the discussion, which extended far beyond the usual bureaucratic challenges, reflected the multitude of challenges SMEs face in the current demanding economic climate and the interconnections of these challenges.

### **Overview of Concerns About Bureaucracy in Singapore**

Participants acknowledged that the government was trying to help SMEs survive and develop because of their importance to the society and economy. One participant said that the challenge for the government has always been to cascade top management thinking and policy directives effectively to the frontline civil servants. It is this bureaucratic structure that affects SMEs.

Bureaucratic hurdles exist in the areas of legislation, compliance, administrative requirements and government procurement. The ground sentiments gathered from surveys conducted by several organisations including ASME, SBF and KPMG show one recurring theme: The desire for simplification. Be it government rules and regulations or the application of government incentives, a majority of the survey respondents felt that many areas could be simplified and made more understandable to SMEs.

The annual SME development survey conducted by DP Information Group shows that government charges is one of the top five cost components affecting businesses. In fact, the proportion of respondents who had ranked government charges as a top cost affecting component has been increasing each year since 2012.

ASME’s Business Sentiment Survey findings also point to government compliance as a key contributor to business costs. The start up costs for a typical restaurant attributed to government licensing according to a study carried out in 2011 averaged S\$7,300 for 15 licences across nine government agencies.

Nonetheless, it was pointed out that Singapore was still one of the best places in the world to conduct business. Singapore was ranked by the



PERC Survey as the country least bogged down by bureaucracy in Asia. The Pro-Enterprise Panel, a public-private partnership set up in 2000 to help businesses overcome rules and regulations that hinder them unnecessarily, keeps an effective check on bureaucratic impediments. One example of the product of panel's work is the Online Business Licensing Service.

However, it was felt that bureaucratic burdens on SMEs could be further reduced. Government agencies should shorten the processing time for permits, licenses and approvals, and also look at simplifying the process. In situations where several agencies are involved, processes should be streamlined further to reduce complexity and compliance costs for licensing, and lessen the burden on businesses with multiple inspections by different agencies.

### **Administrative Burden on SMEs**

It was suggested that the government study the feasibility of redesigning and consolidating government surveys to reduce the administrative burden of completing the forms on companies. Many government agencies conduct surveys with companies on a regularly basis, and sometimes the surveys require very specific details. MOM and the Infocomm Development Authority of Singapore (IDA), for example, require companies to complete two very long surveys annually, one participant said.

Another participant felt that while the government had a fiduciary duty to protect public funds and interests, it had to be aware that overly tedious grant application process and a long reimbursement turnaround time impeded SMEs' innovation endeavours.

He categorised the reimbursement process of government grants into three groups:

- Company pays first and waits for reimbursement
- Company applies first, then pays for product/service, reports to the authority and waits for reimbursement
- Company pays first, then applies for grant and waits for reimbursement

One participant shared that nearly all the schemes he had applied for required the company to first make payment and wait for reimbursement. He waited between three months to 18 months for the reimbursements.

This arrangement was onerous for the SME sector because many of them faced very tight cash flow conditions.

In addition, schemes that required application and reporting further delayed the process of receiving the government grants. As a result, companies with tight cash flow and limited financing resources were unlikely to apply for government grants. These companies were usually SMEs.

The participant added that grant application forms were often tedious to complete. Many of them required very detailed information, and some even asked for clear measurable deliverables, a component that many SMEs lacked the skills to report.

Many SMEs were preoccupied with operational matters, spending a huge amount of their time on “firefighting”. The current tight labour market exacerbates the situation. One participant said that he would spend around 30% of his time dealing with HR and cash flow matters. Speaking to many of his SME peers, he concluded that in the end it was the medium SMEs that benefitted most from government grants because they had more resources to spare.

It was pointed out that a huge amount of the disbursed PIC grants were diverted to undeserving consultants, which was a significant waste of public resources. Anecdotal examples of consultants offering small business owners PIC grant application services, and taking a large slice of the grant disbursement (e.g., the business gets S\$3,000 while the consultant takes S\$12,000) were brought up in the discussion.

### **Equitable Procurement Arrangements for SMEs**

Several participants felt that the government could take the lead in adopting fair contracts, ensuring that smaller companies with less negotiating power were not forced into contracts with unfair terms. One participant said that some government agencies entered into unfair contracts with SMEs, in which the contracts contained an unlimited liquidated damage clause and a one-way exit clause. He knew of cases where companies were forced to shut their business because they had to pay liquidated damages beyond their revenue indefinitely. This practice extends to some MNCs and GLCs, he said.

One suggestion made by a participant was to conduct internal audits on the procurement contracts and transactions of government agencies and GLCs with SMEs, and implement best practices that treat SMEs equitably.



Cases of big companies including GLCs delaying service or product payment to SMEs are common given favourable bargaining position that the former group enjoys. Untimely payment can exert tremendous cash flow pressures on companies, especially SMEs. Encouraging prompt payment to SMEs will help ease their cash flow woes.

One participant claimed that the current participation rate of SME in high-impact public procurement was low. One way to increase SME participation was to change the rules to allow for more procurement of complex goods and services from SMEs. Nonetheless, it was argued that the low SME participation was also partly due to the fragmented SME landscape in many industries. Hence, SMEs may need to partner each other and bid for government procurements as consortiums.

Other suggestions were also made. One of them is to introduce more robust tender evaluation structures to address the tendency of rewarding government procurements to the lowest bidder (e.g., two envelope system). Another suggestion is to reduce the amount of bulk purchases in public procurement so that SMEs can bid for more jobs.

### **Introduce More Targeted Policy Measures to Achieve Productivity Goals**

The balance between broad-based support and targeted support was discussed. Broad-based support schemes like the PIC and Innovation & Capability Voucher (ICV) reach out to many companies and are easy to administer, but they may not be very effective at increasing productivity. Conversely, targeted assistance requires more case management and manpower resources but may have a greater impact to businesses. At present, SPRING has around 70 business advisors who provided customised support to businesses that faced difficulty understanding the various government support schemes.

One participant suggested that the government could try out what he called a “surgical” PIC scheme, which uses business consultants to monitor the returns of the PIC scheme. A dedicated consultant attached to an SME can help it achieve specific business goals. The personal consultant could be tasked at the same time to track and report the company’s progress, and measure the benefits of the PIC scheme to the company, allowing the government to evaluate the efficacy of the PIC scheme on a case-by-case basis, and providing it with more information to design better policies and programmes to help SMEs increase their productivity.



He described this approach as a “sure eat durian”. While the entire process may be slow, it will definitely realise productivity gains. Moreover, this “surgical” PIC approach may help change the current situation of using PIC to mainly offset operational costs, he said.

It was felt that the wage credit scheme (WCS) should be extended beyond its original timeline to help companies cope with the restructuring process. One participant expressed that he hoped that the WCS could be extended longer. He explained that the original time frame of three years was based on the key assumption that productivity growth would occur within that period of time. Over the past three years, many SMEs participated in the scheme. They have taken drastic actions to try to raise productivity and in the process incur higher costs. But these investments, including the participation in WCS, have yet to reap higher productivity.

### **Using Informative SME Case Studies**

One participant commented that entrepreneurs and SMEs have little resources to study the different application procedures and requirements of government support programmes.

He felt that it would be very useful to showcase success stories of companies and how they have used government schemes for their businesses. In addition, the case studies could be categorised into different stage of development, highlighting the different kinds of government support used by companies at different growth stages. By doing so, SMEs could quickly identify the kind of government support programmes that might be relevant to them, and also have actual examples showing them ways to use those programmes. The “surgical” PIC approach that was suggested earlier could provide many candidates for case study.

### **Adequate Internationalisation Support for SMEs**

One participant identified IE Singapore’s internationalisation support as a crucial factor that helped his company expand into the region. When the company first ventured overseas, it incurred more than S\$300,000 of overseas-related costs each year without much success of breaking into the overseas markets. Without IE Singapore’s help to defray some of the setup costs and business development costs, he reckoned that his company would have called off the venture.

He suggested that the government provide more financial support to offset the initial costs of venturing overseas such as operation costs and business development costs. Expanding into overseas markets requires a



company to spend significant time, money and effort to learn the local business culture and seek out opportunities.

Several participants pointed out that given the small size of Singapore's domestic market, even small companies might need to internationalise. While there was increasing recognition of "born global companies", more support should be provided to help small SMEs move first and break into the fast-growing regional markets before companies from other parts of the world capture most of the emerging market opportunities. The government could also do more to encourage large local companies, including GLCs, to partner SMEs for overseas projects so that SMEs can develop deeper capabilities and build their business track records.

### **Placing Local Enterprise Development at the Heart of Singapore's Economic Strategy**

The government should use its plans for infrastructural development to strengthen the core capabilities of the SME sector, said one participant. He said that when the development plan of the Jurong Island Version 2.0 initiative was presented to him, he noticed that the SME component was missing from it.

He went on to elaborate that although Singapore has always managed to carry out complex infrastructure developments, the engineering capabilities of the local SMEs remained low because they have always only been providing low-value ancillary services to the large foreign companies. Instead of importing engineering capabilities entirely for Singapore's infrastructure projects, the government should involve more local SMEs so that they could expand their technology capabilities, said the participant.

This requires a shift in the paradigm of policy thinking, and necessitates policymakers to conceive innovative ways to involve groups of SMEs meaningfully so that they would acquire new technical knowledge and build up indigenous capabilities. By doing so, the economy would benefit too.

One participant recounted how he was rejected from participating in the construction of Singapore's LNG terminal because of he did not have LNG development experience. In order to convince the Singapore LNG Corporation (SLNG) management team, he convinced a leading Japanese developer with very strong engineering, procurement and construction (EPC) capabilities to support him, and even engaged a minister to help write a recommendation letter. However, his request to participate in the SLNG development project was still rejected.

He felt that it was a lack of confidence in his company's (which was at that time an SME) ability to deliver the requirements of the project that led to its exclusion from participating in the SLNG project. He argued that this was an example of the impediments local SMEs faced in growing their businesses.

### **Information Sharing by the Government**

Some participants felt that information-sharing by the government with the public is lacking. One participant said that manpower information like the number of workers by industry, worker skill profile and worker demographics could markedly improve the manpower planning of companies. Used together with other information such as expected sectoral investment flows, companies would be able to plan better for their business needs.

It was also pointed out that a lot of data existed but there was a need for better inter-agency coordination to consolidate the information. Another participant said that his organisation has been trying to get SME data on manpower, financing and internationalisation from the government without much success. The creation of an SME authority could help resolve this issue.

### **Single SME Authority to Push the SME Agenda**

One participant said that the government should study the need for a single SME authority empowered to carry out SME development strategy across the whole-of-government. While SPRING is the de facto SME coordinating agency in Singapore and was doing an exemplary job in carrying out its duties, there was a need to approach SME development in a more holistic manner.

Such an authority would synergise the SME activities conducted by various government ministries and agencies. However, it should not be expected to implement all SMEs-related activities. These responsibilities should be retained by the different agencies.

### **Improve Clarity, Inclusiveness and Flexibility of Government Rules and Regulations**

Some government officers were not able to answer enquiries from companies on specific policy measures, noted one participant. He said that officers from MOM were unavailable to answer questions made by his company on certain manpower policy measures. Although some of these questions may be complex, they were asked because the company needed advice on areas of policy measures where it was unsure, he



explained. Therefore, it is important for government officers to be familiar with existing policies and programmes, and be responsive to enquiries from the public.

One participant agreed that skills upgrading would improve productivity, and said his company participated in the Enterprise Training Support programme. But implementing a training programme that required him to deliver 200,000 training hours a year as part of the criteria for the grant was immensely difficult in a tight labour market. While he managed to meet the requirements, his encounter highlighted how access to government grants only addressed one aspect of business restructuring. Administering the intent of grant is not an easy task.

His experience should urge policymakers to think laterally about the methods used to push through economic restructuring. In particular, more attention should be given to the interaction effects of separate policy measures. For instance, would a less restrictive foreign manpower policy in the interim for certain sectors encourage more companies at the margin to participate in the WTS or other productivity enhancing activities? In this regard, more targeted manpower policy measures might aid Singapore's economic restructuring.

One participant said that companies should be consulted more often by the government, especially on new rules and regulations in order to mitigate create unnecessary burden on companies from ill-designed rules and regulations. One example is URA's approval of the construction of certain ramp-up factory units that have only around 400 square feet of approved usable production. Most businesses occupying these units flout the rules set by URA because the production space is simply too small. These units are not practical for many of the occupants.

He added that URA also rejected proposals from occupants of B1 factory units who were willing to pay development fees to build a mezzanine floor because the agency said that it had not planned for the additional flow of traffic that could arise from the modifications. The participant argued that the rules and regulation set for these B1 units were based on the assumption that the growth of technology industries would be rapid. This was unlikely to happen any time soon in the current economic environment. In fact, at present the occupants of industrial units are mainly distributors or in the fabrication business, said the participant.

He contended that the government should be more flexible to updating its rules and regulation according to the latest developments. In the above case, allowing companies to build a mezzanine floor would reduce their

rental cost and would not affect the overall economic development strategy significantly.

Another issue brought up during the discussion involved EDB. A senior executive of a local company said that the process industry association that he was a member of received a letter from EDB recently requesting an action plan to address a list of problems regarding the productivity of local process contractors. He was upset that the local process industry was not represented when EDB engaged the plant owners, mostly MNCs, to identify problems in the industry affecting productivity. While he acknowledged the importance of foreign investment to Singapore's economy, he felt other stakeholders were equally important, and that their views should be taken into consideration.

### **Human Capital for SME Development**

Participants said that SMEs were aware of the need to develop their human capital, but it was challenging for them to cope under the current economic climate, with managing their business operations and restructuring their businesses at the same time.

Moreover, even if SMEs improved their HR management, they would still face difficulty attracting and retaining human talent because they could not compete financially with larger companies to attract employees. Hence, the policies introduced under the ASPIRE initiative were important for SME talent development. These policies were instrumental in helping SMEs overcome their manpower challenges. However, if the policies were not properly designed, they could saddle SMEs with even more bureaucratic burden.

The tight manpower situation in Singapore could be holding back the country's economic restructuring process. One participant said that because unemployment was so low now, he had difficulty motivating his workers to work harder or acquire new skills to improve productivity, for fear of losing them.



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# Chapter 7

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## Recommendations



## CHAPTER 7: RECOMMENDATIONS

### RECOMMENDATIONS

The earlier chapters have shown that SMEs face a whole spectrum of challenges in their business operations and growth that often overlap each other. The local contexts of these challenges are captured in the accompanying CDDs. This ranges from unsustainable rental growth to manpower shortage, financing gaps, restructuring struggles and bureaucratic related problems.

Chapter 7 will conclude by highlighting the key concerns for SMEs surfaced in the various chapters. In addition, a list of policy recommendations — some built directly on comments of the CDDs — to address the issues SMEs face in order to promote a flourishing SME sector is provided. These points could also be key areas for future research on SME development in Singapore.

#### **A. Reclassify SMEs into more meaningful categories**

In the introduction chapter, it was stated that the definition of SMEs covers a wide range of companies that are found in all sorts of business activities ranging from neighbourhood mom and pop retail shops, local designer lifestyle shops, small advanced engineering companies to medium-sized manufacturers servicing large international companies. These companies face different cash flows challenges. They operate in very different market conditions; embody different levels of skills, capital, sophistication and growth orientation; and may be in the formal or the informal economy (OECD, 2004).

In addition, in the CDD segments of the subsequent chapters, it was repeatedly highlighted the prevailing way of classifying SMEs based on employee size and sales turnover is too narrow to describe a broad range of firms in terms of sector, scale, management style, history, business orientation and needs — which leads to a reduction in the effectiveness of SME policies and impedes the focus of SME research. For example, in the CDD on Grooming Competitive SMEs (Chapter 2), it was pointed out that the variability among SMEs in terms of sector, growth orientation and other company characteristics is huge. As a result, because of the heterogeneity of the SME sector, it was difficult to design SME policies that provide equal opportunities to all SMEs. In the CDD on Financing to Support SME Development in Singapore (Chapter 4), the broad definition of SMEs was identified to have clouded the debate for an SME bank. In short, all the

comments point to the fact that the definition of SMEs, and the current way SMEs are classified in Singapore by size and sales turnover is not optimal for effective SME policy making.

A better way of classification would be to incorporate other factors like growth orientation and type of industry to provide a more multifaceted definition. Growth orientation is an intrinsic indicator pointing to SMEs' future state. In a study on SME financing, the ADB classifies SMEs as either stability-oriented or growth-oriented (Shinozaki, 2012). A stability-oriented SME is typically a self-employed micro-firm or small family business created by a business owner whose main concern is survival, with little impetus for expansion and rapid growth. A growth-oriented SME, on the other hand, is one that aims to capitalise on emerging opportunities using innovative technology and ideas that are often scalable and can therefore grow rapidly. It can also be one that begins as a stability-oriented enterprise but expands rapidly under the able leadership of its entrepreneurial business owner.

While stability-oriented SMEs help to maintain social stability and reduce poverty, growth-oriented SMEs enhance a country's economic competitiveness, raise its productivity and provide new impetus for sustainable economic growth. In the longer term, growth-oriented SMEs have the makings of world-class companies similar to the middle-sized companies in the EU and the US and the Mittelstand in Germany. Supporting stability-oriented SMEs helps to achieve the socio-political goal of providing jobs to structurally displaced workers. Supporting growth-oriented SMEs, on the other hand, helps to put Singapore one step closer to the economic goal of transforming the country's economic structure.

A well-designed SME policy framework should therefore be inclusive enough to support stability-oriented SMEs and startups while at the same time comprehensive enough to offer a full range of programmes for growth-oriented SMEs ranging from innovative startups to competitive medium-sized firms at different phases of their growth cycle. It must also recognise the hard to quantify socioeconomic vibrancy and stability that the SME sector contributes to the country. In order to achieve these goals, SME classification must go beyond the usual metrics of turnover and size.

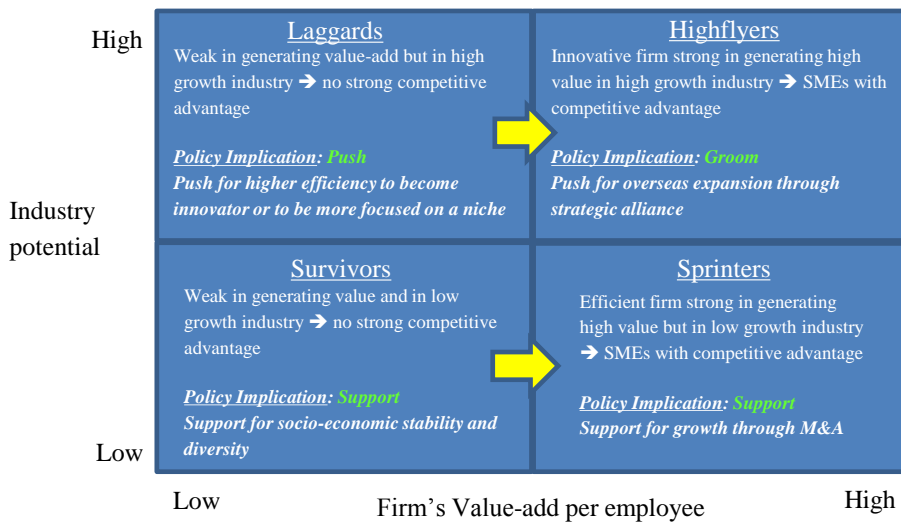
### ***A proposed SME classification system***

In general, businesses face two constraints in terms of the amount of revenue they can generate. The first constraint is the company's capabilities. Companies that possess more and better capabilities generate more sales. The second constraint is the performance of the industry where the company is located. If the company is in a low value-

add industry, the company’s potential performance will be limited to the value-add of the industry.

A better way of classifying SMEs may therefore be to look at their potential value-add contribution, based on the industry they are in, and the capabilities that the SMEs possess to fully exploit the value-add the industry has to offer. Since it is difficult to measure the capabilities that the company possesses, we can use its productivity results as a proxy, on the assumption that companies with higher capabilities are more productive. In this context, Figure 7.1 shows the classification of SMEs under a Value-Add vs. Productivity Matrix.

**FIGURE 7.1: CLASSIFYING SMES USING A VALUE-ADD VS. PRODUCTIVITY MATRIX**



Credit: Tan Meng Wah

Based on these two dimensions, a matrix comprising the following four quadrants can be created and explained as follows:

**Highflyers:** In this quadrant, the SMEs are innovative companies that possess very strong and sustainable unique competitive advantages. They are therefore able to generate high value-add from the high growth industry they are in. These “highflyers” are highly competitive companies that make good candidates to be groomed for cross-border expansion. Note that what they do need not be high in technology content. The industry may experience high growth because of strong emerging consumer demands. Hence, SMEs in processed food industry, for example, can be deemed as highflyers, if they possess strong competitive

advantages (e.g., in the form of branding or other intellectual property) to allow them to capture the rising consumer demand that comes with rising income, in particular, within the region.

**Sprinters:** In this quadrant, the SMEs are efficient firms that possess strong competitive advantages and are therefore able to generate high value-add from their operations. However, the amount of value-add they can generate is limited by the low growth potential of the industry they are in. These SMEs are likely to be in traditional but important service-based industries. They are profitable because they are productive (e.g., through innovation in work processes) which helps to keep their costs lower than their competitors. Because the services they provide are still needed, their growth should be supported. One way for these SMEs to grow is by M&A so that they can enjoy greater economies of scale. By absorbing the smaller or inefficient players, the consolidation will lead to more efficient allocation of resources for the industry and the overall economy and is therefore good for them, for the industry, and for the economy.

**Laggards:** These are inefficient SMEs in a high-growth industry. Even though they are operating in a high-growth industry, they may not possess the competitive advantage that can enable them to realise the high value-add. They should be pushed to raise their efficiency and productivity to become highflyers or to exit the industry totally so that resources can be better reallocated. Alternatively, they can refocus to become a niche player in the industry value-chain so that they can be part of a consortium led by highflyers.

**Survivors:** These are inefficient SMEs in a low-growth industry. They possess no strong competitive advantage and some might be taking up precious resources that can be better utilised by their competitors. Despite their poor productivity performance, many SMEs in this category contribute to the socioeconomic stability and diversity of the country in terms of providing employment, choice of work and potential for future innovation. While support to this group should not be overly generous to induce moral hazard behaviour and delay economic restructuring, it is still important to provide a basic level of assistance.

### ***Using the proposed SME classification system***

Potentially, there are many ways the matrix can be used. For example, the proposed Value-Add vs. Productivity Matrix offers a more effective way of differentiating high performance and competitive SMEs from the uncompetitive and unproductive ones. It not only provides a more accurate picture of how well SMEs are doing now, compared to the current definition system which looks at revenue and size of workforce, but also points to



their potential future contribution to the economy based on their capabilities. The matrix therefore allows policymakers to move away from quantitative measurements to more dynamic qualitative criteria when defining SMEs while drawing up policies. Over a longer run, it may help to reinstate the rule of survival of the fittest and enhance Singapore's competitiveness against fast-rising and highly competitive foreign SMEs from emerging economies at a level of development similar to that of Singapore.

It is also critical to note that all businesses, regardless of their value-add, have different but important contributions to the development of Singapore. The matrix is not a tool meant to discriminate against low value-add firms. Broadly, all businesses can be classified as job creators or wealth creators.

High value-add industries are wealth creators. These are typically export-oriented industries that contribute to the country's balance of payments and create new wealth for the economy as a whole. Because of their high value-add, they provide financially more rewarding jobs for workers that are more skilled. In contrast, low value-add firms, such as food and beverage outlets, cleaning firms, and security agencies, produce non-tradable goods and services more for the domestic market. Even though they may not be creating much net new wealth for the country, they provide valuable goods and services that are needed by all Singaporeans. More importantly, as job creators, they play a major social role in providing employment opportunities, especially to less-skilled workers.

Both job creators and wealth creators therefore play mutually supportive roles for national development. What is more important is for companies in both high value-add (i.e., the wealth creators) and low value-add industries (i.e., the job creators) to be efficient and productive so that they are able to exploit the full value offered by the industries they are in and contribute to productivity growth for the overall economy.

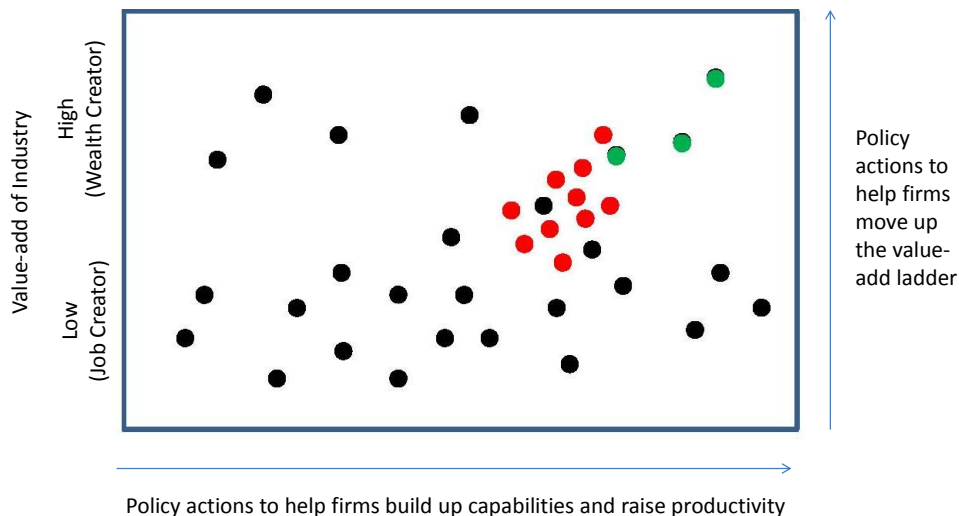
If a mapping exercise of SMEs is carried out, it will be good for the overall economy to see more companies in the two quadrants on the right. Regardless of whether a company is low or high value-add, it has to be productive for the good of the overall economy. Unproductive companies (the dots on the left of the matrix) should not be supported extensively perpetuated. By allowing them to exit or be acquired, resources that they take up can be reallocated for use by new or more efficient firms.

Therefore, the more wealth creators Singapore has, the richer the country and its people will eventually be. Special efforts therefor need to be made

to nurture more “innovators” (green dots in Figure 7.2) that can eventually turn into regional or global leading companies. These high performance and competitive companies may provide leadership to help grow supporting or related industries (red dots in Figure 7.2), forming verticals and clusters to not only create more wealth for the country but also provide meaningful and rewarding jobs to young and able Singaporeans.

In brief, the proposed way of classifying SMEs helps to dynamically differentiate SMEs based on their actual value contribution and capabilities. This way, more efficient and effective allocation of resources can be achieved to facilitate the restructuring of the overall economy towards higher productivity and higher value-add. At the same time, it takes into account the social dimension of the SME sector.

**FIGURE 7.2: A SIMULATED MAPPING OF FIRMS USING THE VALUE-ADD VS. PRODUCTIVITY MATRIX**



Credit: Tan Meng Wah

Alternatively, the Value-Add vs. Productivity Matrix could be used as the base layer of a SME classification system. In this case, another set of categories is identified to explicitly account for contributions to socio-economic stability and diversity. However, with so many factors to consider, it is impractical to build these categories around clear and structured parameters. Instead, some level professional judgement incorporating a range of factors like company size, age and aspirations is used to conceive the following highly differentiated categories.



- Unincorporated micro-enterprises like sole proprietorships and partnerships in low-value, consumer-serving niches (e.g., mom and pop shops)
- Single outlet enterprises in consumer-serving niches (e.g., hair dresser/other personal services, food & beverage, tuition centres, childcare)
- Small professional service enterprises in high-value areas (e.g., general medical practitioner, financial advisory, consulting, professional engineering, small accounting/law/architect/etc. firms, home services such as plumbing/electrician)
- Small firms with physical assets, staffing, largely self-funding, and have little need for banking/capital markets (e.g., manufacturing, logistics/transportation, construction)
- Medium firms with larger amounts of physical assets, large staff, high volume of turnover, and have greater need for banking relationships
- Highly regulated firms (e.g., small private equity or fund management houses, other small financial institutions, small healthcare institutions)
- Entrepreneurial enterprises

By using these two set of categories to classify SMEs, more relevant and effective policies can be designed to help SMEs grow, and to achieve the economic outcomes targeted on a national level.

## **B. Creating a Dedicated Financial Institution to Support SME Financing**

The creation of a government-owned and dedicated financial institution that supports the financing needs of SMEs deserves serious consideration. Participants in several of the CDDs have mooted the idea of an SME bank, EXIM bank or development bank with a strong SME mandate to help address the SME financing gap that is preventing SMEs from growing and expanding overseas. The creation of an SME bank is not a new idea; it was one of the recommendations submitted by the Economic Strategies Committee.

One major concern of such dedicated financing institutions is their commercial viability given the small market size of Singapore. Although



this concern is understandable, an in-depth study should at least be conducted to relook and measure the net benefit to the economy and society of having such institutions. It is apparent from the CDDs, especially the CDD on financing (Chapter 4), that SMEs face limited access to financing that not only affects their daily operations, but also impede their investment plans to carry out business process changes or expand overseas. Although the small size of Singapore's market may reduce the commercial viability of having an SME-dedicated financial institution, its potential importance to Singapore's economy may warrant the government to subsidise the existence of such an entity.

Many other countries, including those with strong, competitive and innovative SME sectors, have dedicated financial institutions supporting local businesses such as development banks, SME banks and EXIM banks. Some of them are: KfW in Germany, SME Bank in Malaysia, Business Development Bank of Canada in Canada, Korea Development Bank in Korea, and Development Bank of Japan in Japan. Singapore can learn from the business structures and best practices of these government financial institutions to develop an optimal working solution that is acceptable in Singapore's context.

Another concern is the competition that such government-owned banks bring to commercial banks. This is not necessarily true as most existing development banks follow a policy of not competing with private financial institutions. Instead, their operations aim to facilitate businesses within its mandate, and to serve neglected segments or areas of national strategic interests. This is reaffirmed in the CDD (Chapter 4) by a participant from the financial sector, who said that he did not think that the SME bank in Malaysia competes with commercial banks as most of its activities do not overlap with theirs.

### **C. Encourage Consolidation in Industries**

Consolidation in certain industries, especially those with a small market size but crowded with many players, could improve individual firm performance and lead to a more nimble and innovative industry. While competition is beneficial for the economy, too many small businesses competing over a small market pie could stymie the development of an industry. This was being experienced by the security service industry in Singapore, where — shared by a participant at one of the CDDs (Chapter 5) — there were more than 250 security guard services companies. He said that the quality and sophistication of the average service offered have remained low because intense price competition among companies in the industry has reduced the incentive and resources of companies to innovate and offer better services.



The consolidation of these overcrowded industries will enable the remaining companies to gain scale advantages such as cost reduction and improved efficiency. It would also improve the business environment for innovation and encourage companies to compete more on the grounds of product offering instead of product pricing.

More attractive and accessible M&A support, stronger awareness campaigns and more frequent events to facilitate business-to-business interaction will help boost the pace and volume of industry consolidation. In particular, special attention should be given to creating effective programmes that would encourage more M&A activities among local SMEs. A detailed study on M&A with SMEs as the focus should be conducted by the government.

Besides catalysing industry consolidation so that the remaining businesses can gain scale advantages and undertake greater innovation activities, M&A among local businesses enable the passing down of valuable internal knowledge and expertise that would otherwise be lost if a company decides to shut down or is bought over by overseas businesses. This knowledge pool is critical for Singapore to become value creators and not merely value adders, a point keenly articulated by the government in the current economic restructuring.

#### **D. Forming Consortiums and Alliances**

Singapore SMEs in the same sector are more likely to be competing instead of collaborating. Encouraging alliances and consortiums between SMEs will allow them to pool talent and achieve more. For example, in specialised sectors such as the aerospace industry, a consortium of businesses of different engineering expertise could offer integrated manufacturing solutions and services, especially in overseas markets. Combining forces could encourage SME staff to be more entrepreneurial, creative and efficient. Recent government efforts to encourage this include JTC Launchpad @ one-north, a new cluster for startups, and the A\*STAR Aerospace Programme, an attempt to get players in the aviation industry to take on pre-competitive research work together. However, while the level of collaboration for Singapore projects is high, Singapore consortiums have not displayed the same intensity in venturing into the realm of overseas business projects. Here is where larger companies can help. They can be the crucial cog in a consortium submitting its bid for major overseas projects, acting as the anchor companies to which SMEs will provide their services.

## **E. Deepen Internationalisation Support to SMEs**

Trade in Singapore is roughly 2.5 times the country's GDP. For many businesses in Singapore, the small size of the domestic market limits how big they can grow. By expanding their businesses, SMEs can benefit more economies of scale, enjoying cost advantages from a larger scale of operation. The confluence of resource constraints, emerging regional economic opportunities, as well as growing competition overseas counterparts warrants internationalisation to be a core priority for businesses in Singapore.

IE Singapore has done an encouraging job at promoting Singapore companies overseas and assisting them in their attempts to venture abroad under their Market Readiness Assistance and Global Company Partnership, regular overseas missions and trade shows. According to IE Singapore, more than 28,000 Singapore companies benefited from its help in 2014. Companies in Singapore have not sat still either. In SBF's 2014/2015 Annual Business Survey, 72% of the respondents indicated that they have overseas presence, a 10% increase from the previous year. 70% of the companies generated more than 30% of their revenue from overseas.

Notwithstanding, the pace of internationalisation of SMEs should increase. In the CDDs, participants acknowledged that most SMEs have to expand beyond Singapore's small market to survive long term and grow. However, the difficulty of expanding abroad — which the current subdued economic climate has further accentuated — is greater for SMEs because they have limited resources. The government can seek ways to make it easier for SMEs to venture abroad by refining existing programmes, introducing new programmes, and consolidating existing internationalisation related government programmes into a single connected framework to unlock synergies and improve the efficiencies of the programmes.

Equally important is a proactive approach by the government to reach out and engage the SME sector aggressively to definitively pull and push the country's SMEs from their comfort zone into the international playing field. SMEs in countries like Japan and Korea are known to come together as consortiums to venture overseas. This method of internationalisation can be used in Singapore too. The government, through its influence on the private sector, close connections with various trade associations and control over internationally competitive GLCs, should study how it can use the consortium approach to help Singapore SMEs internationalise.

All of the suggestions above require significant public investment outlay. However, the extra cost and effort are justified by the importance of



internationalisation in anchoring Singapore's economic growth on productivity and innovation. In addition, having in place a comprehensive and coherent system of internationalisation support is extremely vital. Hence, the government should start by conducting a thorough examination of the existing and potential overseas opportunities, and form a complete understanding what support SMEs need to internationalise.

## **F. Create an SME Agency**

If the SME sector is considered as an important component of Singapore's economy and a critical source of future growth, then it is worth seriously considering the establishment of a single SME agency with both the mandate and the authority to drive the development of the sector. In most of the CDDs, calls for a single SME agency with the authority to oversee the SME sector development were made. The relentless effort by the government to help SMEs was acknowledged, but participants felt that it could be more coordinated and more cognisant to challenges of the SME sector.

Government agencies like SPRING and IE Singapore actively assist SMEs with their businesses, but it is not their directive to drive the development of the SME sector. In addition, none of them have the authority to plan, coordinate and manage SME related policies and programmes that are not under their purview. While there is also SBF that acts as the apex business chamber that champions the interests of the Singapore business community in trade, investment and industrial relations, it lacks the clout that its US counterpart, the Small Business Administration (SBA), possesses. SBA is an influential organ that protects the interest and spearheads developments of SMEs in the US. Its function is to "aid, counsel, assist and protect, insofar as is possible, the interests of small business concerns." Created by Congress in 1953, it has great influence in the areas of policies and research pertaining to small businesses. It also provides strong support to small businesses.

Hence, what is needed is an "SME government agency" with the mandate to oversee the development of the SME sector and the authority to make executive decisions on all or most SME-related national matters. This government agency would be in charge of creating the strategy and policies for SME development. It would also supervise SME-related programmes and initiatives, and have the authority to amend them if necessary. In addition, it can and should convene regular review of existing policies and programmes to assess their effectiveness and to ensure that they are aligned to the overall SME development strategy. On some level, such an agency would be similar to the EDB, which has great authority over matters relating to foreign companies operating Singapore.

For example, EDB has the power to approve the waiver of the condition that the ultimate holding company for the group must be incorporated and tax resident in Singapore under its M&A scheme.

### **G. Review the SME Development Strategy; Create Policies that Aligns with the Strategy**

The government should review its development strategy for the SME sector, especially the target of doubling the number of Singapore companies with sales turnover over S\$100 million from 500 to 1,000 by 2020, as ESC had recommended. As pointed out in Chapter 2's CDD, after weighting the US economy to Singapore's GDP, fewer than 10 companies in the US break the US\$100 million turnover barrier each year. SMEs in Singapore are further obstructed by multiple headwinds stemming from high labour cost, intensifying competition from overseas and slowing sales growth due to weak and certain global economic outlook. Establishing a clear and achievable strategy is the first step to the successful development of the SME sector.

Once the strategy is established, appropriate policies and procedures should be carefully designed and implemented to deliver the targeted outcomes. All relevant stakeholders, including the SME sector, should be consulted on the formulation of policies and procedure. In light of a constantly evolving business environment, these policies and procedures should also be reviewed on a regular basis to check that they are still effective and relevant.

Policies that are introduced to achieve specific national objectives can have unintended effects that undermine other national objectives. For example, well-intended initiatives to encourage better work-life balance and promote childbearing amongst Singaporeans at this junction of tight labour market could further burden the development of the SME sector if they are not designed and or implemented delicately. Hence, it is important to view all government policies as part of an interconnected system, and assess the potential impact of each policy comprehensively. It is also important to ensure that policies are calibrated and targeted according to the different profiles of SMEs.

In addition, involving the SME sector in the country's national development plans, be it local infrastructural projects or overseas projects, should be part of the SME sector development strategy. These projects provide SMEs hard to come by opportunities to rapidly gain technical know-how, project experience and important business connections that would all contribute to their growth. One participant in Chapter 6's CDD pointed out that although Singapore has no problem carrying out complex



infrastructural development projects, the engineering capabilities of Singapore SMEs remained very low. This is due to the fact that Singapore SMEs have mostly been providing low value ancillary services to larger established foreign engineering companies. He argued that the government should actively try to involve more Singapore SMEs in national development projects like the Jurong Island version 2.0 to help them deepen their technology capabilities.

## **H. Improve Data Availability**

The lack of publically available data has been consistently raised as an issue by participants of the CDDs. There is evidently a need to improve the availability of data to the public so that more in-depth research can be conducted. This extends beyond the research on SME development into other fields of public policy. Currently, academic researchers are limited in the work they can do because of the lack of fine grain data. For example, for research into the market structures of the real estate sector in Singapore, academic researchers require more granular data from the government so that they can find out whether there is indeed oligopolistic pricing in the commercial and industrial real estate markets. The knowledge generated from such academic research with a local context is important for the progress of Singapore's public policy and the development of the economy.

Enhancing the flow of data to the private sector can also help reduce mismatches in supply and demand and aid the development of industries. As mentioned by a participant at one of the CDDs (Chapter 6), manpower information like number of workers by industry, worker skill profile and worker demographics can markedly improve the manpower planning of companies. Used together with other information such as expected sectoral investment flows, companies will be able to plan better for their business needs.

Hence, the government should examine ways to improve the availability of public data for research purposes. It should also increase the communication of data in actionable form to businesses, especially SMEs. With the advancement of analytic technology, the power of data analytics could be a game changer for Singapore businesses and industries. However, most SMEs, unlike their larger counterparts, do not have the resources to collect and analyse data for their businesses. There is significant value for the provision of SME friendly data as a public good.

## **I. Promote Fair Business Treatment to SMEs**

SMEs often receive the short end of the stick when they engage in business activity with larger companies, including GLCs and the public

sector. The government and its affiliated companies, being the largest procurer of goods and services in Singapore, should set and uphold best practices that protect the rights of SMEs and are sensitive to the business constraints of SMEs.

It was shared at one of the CDDs (Chapter 6) that there are cases of SMEs entering into contracts with government agencies that contained unequal terms such as unlimited liquidity damage clause and one-sided exit clause. When these SMEs failed to deliver in these projects, they were liable to make indefinite liquidity damage payment, and as a result some of them were forced to shut down.

Another common experience of SMEs when conducting business with larger companies is the delay of payment after goods and services are delivered. While payment delay is a common part of business, it could have a large impact on the cash flow of SMEs. Several SME participants shared that they had experienced significant delays in payment from GLCs, which in turn affected their business operations.

The government should review its procurement contracts regularly to ensure that the terms and conditions do not exert unnecessary burden on SMEs. Unlike larger companies, most SMEs do not have the resources to protect themselves from unequal clauses. The government should also encourage all government agencies and GLCs to accelerate their payments to SMEs. If required, a policy to provide accelerated payment to SMEs could be introduced. This suggestion is not novel as the US government also has a policy to provide accelerated payment to small business subcontractors. The central UK government has also set a target since 2008 to pay at least 80% of its invoices within five days (Young, 2015).

Lastly, there should be a government channel for SMEs to feedback about unfair business treatment from the government and its affiliates. In the UK, this is conducted through the Mystery Shopper scheme, the government's complaint service for suppliers about procurement practices. These feedbacks should be handled and addressed promptly. By taking the lead in promoting fair business treatment to SMEs, the government can bring about a national cultural shift.

## **J. Help SMEs Cope with Manpower Issues**

The tight labour market due to slower foreign manpower growth and changing demographics is weighing heavily on businesses operating in Singapore, especially SMEs. In order to help the SME sector overcome



this major challenge, a concerted effort consisting of policy changes, HR capability building and cultural shift must take place.

***Tweak manpower measures to be more targeted***

Foreign manpower tightening measures should be more calibrated and targeted according to the conditions of different industries and the plans that the government has for industrial development — a point raised in most of the CDDs. It is also important to articulate these plans to companies clearly so that they can properly plan their businesses.

SMEs are already facing headwinds from a weak global economic growth and rising business costs. While limiting foreign manpower inflow to wean companies off cheap labour inputs is important, a miscalibrated approach could run the risk of making Singapore businesses uncompetitive or even crimp the growth prospect of the SME sector. Foreign manpower tightening measures should be calibrated according to existing economic conditions and projected risk scenarios to mitigate the unintended adverse effects on businesses.

In addition, it is worth adopting a more targeted approach towards foreign manpower measures that takes into consideration factors such as the manpower conditions facing different industries and the government's industrial development plans for different sectors. A targeted approach is justified on several grounds.

First, the domestic workforce profile is very different from the foreign workforce profile. Industries and sectors that are not popular among the domestic workforce will find it more difficult to cope with foreign manpower tightening measures.

Second, some industries, by the nature of their business models, need to put in more effort than other industries to become less reliant on manpower. For example, restructuring to become more manpower lean is particularly challenging for the retail service sector. Profit margins are low, making large capital investments in reducing manpower needs significantly riskier. Moreover, there is also a cultural preference for attended service, which slows the pace of adopting more automated service solutions.

Third, key sectors and industries earmarked by the government for strategic development will require manpower, many of which will have to come from overseas at least in the interim. They will also inevitably compete for workers with other industries, including new job entrants, who may be more likely to choose to enter these industries for the promising economic opportunities.



Manpower policies and measures in Singapore should account for all these factors, which also include the fact that undertaking economic restructuring is more difficult for SMEs. Granted, only targeted manpower policies and measures that differentiate among industries, sectors and the size of companies can achieve this. These targeted manpower policies and measures should in turn be carefully calibrated and tweaked based on new developments locally and globally to ensure their relevance. The recently announced Lean Enterprise Development scheme and SkillsFuture's manpower sectoral planning are two promising initiatives introduced by the government. Notwithstanding, there must be sufficient will and steadfastness to ensure that these two programmes and others are delivered properly.

### ***Improve the HR capabilities of SMEs***

The HR capabilities of most SMEs are low compared to their larger counterparts. The government should continue its efforts to augment the sector's HR capabilities because it is an important element in solving manpower issues. First, the awareness among SMEs on the importance of HR should be raised, and this requires a push on the front of education led by government and supported by the chambers of commerce and trade associations. Second, programmes aimed at shoring up the HR capabilities of SMEs should be introduced and actively promoted. This includes the laudable HR Shared Services initiative rolled out by SPRING Singapore, in which a common pool of HR service providers is formed to provide SMEs shared access to HR systems and services. SMEs can receive up to 70% qualifying cost subsidy capped at one year under the programme. More of such HR enabling programmes should be actively introduced in conjunction with awareness programmes to get SMEs to appreciate the importance of HR in growing their businesses.

### ***Raise the image of the SME sector: Leverage on SkillsFuture initiatives***

The workforce, especially the young and higher-educated workers, tend to prefer to work with larger companies. The SME sector is viewed to be lower-paying, less illustrious and offer fewer career opportunities. As the SME sector undergoes restructuring to transform itself, it is also important to dispel the existing image of SMEs as lesser employers compared to their bigger counterparts. This would require strong image campaigns promoting the SME sector, engagement sessions and more job attachment opportunities. The government should work together with other stakeholders like trade associations, education institutions and employers to raise the image of the SME sector as desirable employers offering dynamic career opportunities. The national SkillsFuture initiative should be



capitalised to push for this mindset shift that is required to destigmatise the workforce's current bias against the SME sector.

## **K. Monitor and Review Government Support Programmes Regularly**

The government has done a tremendous job supporting the growth of businesses including SMEs. A significant amount of public resources has already been mobilised, and even more will be spent, to make productivity and innovation the main drivers of the economy. With so much at stake, in terms of money spent and the future of the economy, there is a strong case to have a proper management system to regularly monitor, review and reform government programmes to account the use of public funds, and to measure the efficiency and effectiveness of government support programmes.

Under this system, a standardised methodology consisting of both qualitative and quantitative components should be used to assess the performance of government support programmes. One very important qualitative element of this assessment framework is the consultation with different stakeholders, including the SME sector. As businesses are the end-users of the programmes, it is important to obtain their feedback as part of the programme evaluation process. Dedicated taskforce teams should be formed to evaluate the programmes using this assessment framework. These teams should be part of a cross-ministerial department or the Prime Minister's Office to mitigate cross-ministries coordination issues and to build up institutional knowledge.

A review committee with senior representation from all the stakeholders like the public sector, the business community and academia, could review the assessment reports prepared by the taskforce. This committee will endorse the report, and submit their feedback and recommendations to the government for its consideration and further action. Both the assessment report and committee feedback report should be available to the public in the spirit of accountability and transparency.

The proposed systemic approach towards monitoring, reviewing and reforming programmes is part of good governance. It is also important to augment the public sector's programme management capabilities. Programme management consists of not only planning and implementation, but also entails programme analysis and evaluation. The two latter qualities will come to the fore of public policy in Singapore as the economy continues to mature, and the industries in Singapore become increasingly complex. It requires public officers to be able to act as

administrators equipped with a deep understanding of the industries that they are involved in.

### **L. Study the Factors Driving the Growth of Cost Deeply**

Chapter 3 (on business costs and rent) has shown that the accelerating pace of business costs growth has a debilitating effect on SMEs. It is important to have a thorough understanding of the dynamics of business cost growth and the factors underpinning it. Business costs growth is a natural process in market economies; it can push companies to innovate and scale the value chain, helping Singapore maintain its competitive edge over other countries. But uncontrolled, exploitative business costs growth or runaway business costs growth due to structural issues could be destructive to businesses, especially the more vulnerable SME sector.

Granted the impact of business costs growth on the economy, it is important to look into the issue comprehensively by identifying the factors driving costs, understanding the dynamics of business costs growth, and keep track of business costs growth. Only then would policymakers in Singapore be best equipped to tackle the issues driving undesirable business costs growth.



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## CONCLUDING REMARKS

Singapore has come a long way since independence to become a leading economy with one of the highest income per capita in the world. Nonetheless, it cannot rest on its laurels as the future of the country lies in its ability to stay relevant in the face of emerging global trends and fast rising mega economies like China and India. To achieve this, the Singapore government has presciently committed itself, since 2010, to a long-term plan to restructure the economy to place innovation and productivity at the centre of future growth — for growth that is inclusive and sustainable.

As Singapore restructures to transform its economy towards productivity-led growth, it is important to keep in mind that key to the success of this transformation of the economy is the performance of the SME sector in Singapore, which hires 70% of the workforce and contributes significantly to the economy. In particular, more local SMEs have to venture beyond the small domestic market to capture opportunities arising from emerging global trends and regional developments. On its part, the government has been proactive and steadfast in supporting businesses in Singapore to restructure, move up the value chain and develop a mindset of innovation.

But SMEs face many challenges, both internal and external, in restructuring and priming themselves for growth. The chapters in this volume have outlined the main challenges that confront SMEs, and contextualised those challenges to the local setting. While the issues of growth and internationalisation, business costs, financing, manpower and bureaucracy are discussed separately in this report, it is important to note that these issues do not act in isolation; they act collectively to place a great weight on SMEs. Government support has to be cognisant of this when addressing the needs and constraints of SMEs.

More local research on SME development should also be conducted to deepen the technical knowledge and expertise on the SME sector in Singapore. For research to flourish, sufficient access to data is a prerequisite. This will lay the foundation for building a robust research ecosystem that supports the accumulation of knowledge and encourages meaningful discussions among various stakeholders. In this regard, we hope to continue our research efforts into SME development in Singapore, to help inform policymaking so that the sector can contribute more strongly to the country's future growth.



# Appendix

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## APPENDIX

### ABBREVIATIONS

ADB	Asian Development Bank
AEI	Asset Enhancement Initiative
AFC	Asian Financial Crisis
A-REIT	Ascendas-Reit
ASME	Association of Small and Medium Enterprises
BIT	Behavioural Insights Team
CAGR	Compounded Annual Growth Rate
CCS	Competition Commission of Singapore
CDD	Closed-Door Discussion
CFIB	Canadian Federation of Independent Business
DPM	Deputy Prime Minister
EANCB	Equivalent Annual Net Cost to Business
ECP	Equity Crowdfunding Platform
EDB	Economic Development Board
EIU	Economist Intelligence Unit
EMM	Emerging Market Multinational
EP	Employment Pass
ESC	Economic Strategies Committee
ETS	Enterprise Training Support
EU	European Union
EXIM	Export-Import
FAI	Fixed Asset Investment
FTA	Free Trade Agreement
FSB	Federation of Small Businesses
F&B	Food and Beverage
GCC	Globally Competitive Company
GDP	Gross Domestic Product
GEM	Global Entrepreneurship Monitor
GFC	Global Financial Crisis
GLC	Government-Linked Company
GTO	Gross Turnover
HDB	Housing and Development Board
HR	Human Resource
ICT	Information and Communication Technology
ICV	Innovation and Capability Voucher
IPO	Initial Public Offering
IPS	Institute of Policy Studies
IT	Information Technology



ITE	Institute of Technical Education
LEFS	Local Enterprise Finance Scheme
LFPR	Labour Force Participation Rate
LIS+	Loan Insurance Scheme Plus
MAS	Monetary Authority of Singapore
MLP	Micro-Loan Programme
MNC	Multinational Company
MOM	Ministry of Manpower
MRA	Market Readiness Assistance
MTI	Ministry of Trade and Industry
M&A	Merger and Acquisition
NIE	Newly Industrialised Economy
OECD	Organisation for Economic Co-operation and Development
OITO	One-in, two out
PE	Private Equity
PEP	Pro-Enterprise Panel
PER	Pro-Enterprise Ranking
PIC	Productivity & Innovation Credit
PLE	Promising Local Enterprise
PMO	Prime Minister's Office
PMETs	Professionals, Managers, Executives and Technicians
POS	Point-of-Sales
REIT	Real Estate Investment Trust
RFA	Regulatory Flexibility Act
RIA	Regulatory Impact Assessment
RPC	Regulatory Policy Committee
R&D	Research and Development
SBA	Small Business Administration
SBF	Singapore Business Federation
SCM	Standard Cost Model
SEEDs	Startup Enterprise Development Scheme
SME	Small and Medium Enterprise
SMEC	SME Committee
TCI	Trade Credit Insurance
TFR	Total Fertility Rate
UK	United Kingdom
ULC	Unit Labour Costs
US	United States
URA	Urban Redevelopment Authority
VC	Venture capitalist
WCS	Wage Credit Scheme
WDA	Workfare Development Agency
WTS	Workfare Training Support



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