CDE **INSIGHT**

Global lessons for small business promotion

This CDE report presents a summary of lessons learnt from attempts to promote small business in both developed and developing countries. It is based on a CDE commissioned paper by **Dr Ross Brown**, School of Management, University of St Andrews, Scotland.

Introduction

A stronger, more dynamic small business sector is essential for achieving inclusive growth in South Africa. Unfortunately, in spite of a number of promising-sounding interventions, and the creation of the Department of Small Business Development in 2014, South Africa's small business sector has experienced little growth. Nor does it contribute sufficiently to generating the employment opportunities our country desperately needs. What can we learn from global experiences about the most effective way to reverse these trends and grow the small business sector? Is there something that various levels of the state (national, provincial and local) and other national government agencies such as SEDA should be doing differently? To find out CDE commissioned international expert Dr Ross Brown to provide an overview of the key lessons to learn from attempts to promote small businesses in both developed and developing countries.

Dr Brown is a lecturer in the School of Management, University of St Andrews, Scotland. His main research interests lie in the areas of entrepreneurship, entrepreneurial ecosystems, the funding of small businesses, innovation policy, and regional development. He recently advised the OECD on policies to support high growth entrepreneurship.

This CDE report presents a summary of the most important insights from Brown's commissioned paper.[1]

May 2020

The state of small business in South Africa

According to a report commissioned by the Small Enterprise Development Agency (SEDA), between 2008 to 2015, the proportion of employed workers who were working in small businesses fell from 15% to 14%.[1] The most recent Global Entrepreneurship Monitor (GEM) similarly reveals stagnation and decline, showing that levels of early-stage entrepreneurial activity fell by 30% in 2016/17 compared to the previous year, while the rate at which new businesses were being formed fell by 26%, the lowest level since 2011.[2]

Research undertaken by Professor Neil Rankin of Stellenbosch University shows that companies with 50 or fewer employees account for far less employment share than is commonly believed. Using South African Revenue Service data for the 2015 tax year, Rankin shows that these companies accounted for just 21% of formal sector jobs.[3] Similarly, a 2013 paper by UCT's Andrew Kerr, Martin Wittenberg and Jairo Arrow finds that smaller companies were shedding more jobs than they were creating between 2005 and 2011. Only companies with 500 or more employees generated net job gains. Reflecting the vulnerability of the sector, most jobs losses among small businesses resulted from companies going out of business.

Different ways to promote small businesses

Governments use many different approaches to try to assist small businesses. They can strengthen and improve the business environment so it becomes easier or increases the returns to investing in one; they can encourage entrepreneurship through broad education initiatives; they can provide better access to finance and/or subsidise credit; they can provide business training to aspirant entrepreneurs and/or existing business owners. A less established but increasingly popular approach is to enhance interactions and knowledge sharing between peers, small firms and industry leaders or between business-owners and various levels of the state in order to increase mutual understanding and strengthen the networks that business-owners can then access.

One way to categorise interventions is according to what and whom they are targeting, as well as the scale of their ambition. In this respect it is possible to identify three levels:

1. National or regional initiatives to stimulate entrepreneurship in general and to expand the number of startups;
2. Targeted initiatives that identify existing businesses with potential, and then find ways to help them grow;
3. An 'economic gardening' approach implemented at the local level that works with a cross section of usinesses to improve entrepreneurial ecosystems.

The report looks at how effective these different levels of small-business support have been across many countries. Within each of the three categories, we summarise the relative effectiveness of different forms of support, i.e. access to credit, training; business environment interventions, etc.

The findings are based on a broad review of all the policy instruments that have been examined within the academic literature as well as consultant reports, internal papers and similar sources. The research covered 68 broadly representative, small-business and entrepreneurship programmes – approximately a third of which

[1] Bureau for Economic Research (BER), 'The Small, Medium and Micro Enterprise Sector of South Africa', Report Commissioned by the Small Enterprise Development Agency (SEDA), 2016, p. 13.

[2] M. Herrington, P. Kew, A. Mwanga for Global Entrepreneurship Monitor (GEM), 'South Africa Report 2016/2017: Can Small Businesses Survive in South Africa?', p.7

[3] S. Timm, 'Doubts cast on the role small business in creating jobs', PressReader, 27 Febrary 2017, [Accessed 25 June 2018] https://www.pressreader.com/south-africa/business-day/20170227/281668254752647

were from emerging economies, with the remainder largely drawn from OECD economies (especially the US and the EU).

Level 1: Startup programmes

In many developing countries promoting small business startups is viewed as a powerful driver of structural change to absorb unemployment, overcome resource dependency, and catalyse economic development. Policy makers in many parts of the developing world have embraced the idea of entrepreneurship as a way to provide employment for the growing labour force. The programmes launched in these countries usually take the form of marketing campaigns, business advice services, seed finance schemes and provision of subsidised property. Startup India is a good example of this.The report looks at how effective these different levels of small-business support have been across many countries. Within each of the three categories, we summarise the relative effectiveness of different forms of support, i.e. access to credit, training; business environment interventions, etc.

The findings are based on a broad review of all the policy instruments that have been examined within the academic literature as well as consultant reports, internal papers and similar sources. The research covered 68 broadly representative, small-business and entrepreneurship programmes – approximately a third of which were from emerging economies, with the remainder largely drawn from OECD economies (especially the US and the EU).

The ambiguous benefits of small business proliferation

There are other reasons why generalised startup programmes may not be a good idea. One of them relates to the ambiguous benefits of a proliferation of small businesses.

Many economists who have subjected this issue to scrutiny conclude that there is no convincing evidence that having a high level of self-employment produces any positive macroeconomic effects, and there may even be evidence of a negative effect in that high levels of self-employment are detrimental for economic growth. This implies that subsidies to encourage more market entry could be perverse.

Most small businesses fail to generate many jobs

In the 1980s, research by David Birch suggested that small firms generated the majority of new employment in the United States (US). However, his later work complicated the idea that any country's jobs strategy should be based on small business promotion when it became clear that only a tiny proportion of firms, which he famously labelled "gazelles", accounted for the overwhelming majority of new jobs. Subsequent research confirmed the finding that only high-growth firms had a significant impact on growth and jobs. This would imply that general entrepreneurship promotion or startup programmes may be ineffective and wasteful, and it would be better to encourage only those firms that are able to grow quickly.

Startup India

Startup India is a flagship initiative of the Government of India, intended to build a strong eco-system for nurturing innovation and new firms to drive economic growth and generate large scale employment opportunities. Its Action Plan is based on the following three pillars:

1. Simplification and handholding

Regulatory formalities requiring compliance with various labour and environment laws can be onerous. Many new firms are unaware of nuances of the issues and can be subjected to intrusive action by regulatory agencies. Startup India therefore simplifies compliance for startups, for example by permitting startups to self-certify compliance (through the startup mobile app) with nine labour and environment laws. In the case of labour laws, no inspections are conducted for a period of three years. Startups may be inspected on receipt of credible and verifiable complaint of violation, filed in writing and approved by at least one level senior to the inspecting officer.

In order to commence operations, startups require registration with relevant regulatory authorities. Delays or lack of clarity in the registration process may lead to delays in establishment and operations of startups, thereby reducing the ability of the business to get bank loans, employ workers and generate incomes. Startups often suffer from uncertainty regarding the exact regulatory requirements to set up operations. In order to ensure that such information is readily available, it is intended that a checklist of required licenses covering labour licensing, environmental clearances etc. be made available.

2. Funding support and incentives

Due to their high risk nature, startups are not able to attract investment in their initial stage. In order to provide funding support to startups, the government of India set up a fund with an initial amount of about R500 million and a total of R2 000 million over a period of four years (i.e. about R500 million per year). The Fund will be in the nature of Fund of Funds, which means that it will not invest directly into startups, but shall participate in the capital of existing Venture Funds. To provide further assistance, tax exemption shall be given to persons who enjoy capital gains if they have invested those gains in the Fund of Funds recognised by the Government.

3. Industry-academia partnership and incubation

An effective startup ecosystem can't be created by the startups alone, and doing so requires regular communication and collaboration within the startup community. It is dependent on active participation of academia, investors, industry and other stakeholders. To bolster the startup ecosystem in India, government is proposing to introduce startup fests at national and international stages. These would provide a platform to showcase their ideas and work with a larger audience of potential investors, mentors and fellow startups.

While this is not a specific criticism of Startup India, which has some noteworthy features, on the whole startup programmes have been found to have quite limited levels of success and represent an inefficient way to utilise public resources. The evidence on this point seems quite unambiguous. Evaluations reveal that encouraging people across the board to become entrepreneurs is unlikely to foster economic growth within the economy. Furthermore, many developing countries with these startup programmes already have a high proportion of small and micro businesses many of whom are entrepreneurs by necessity, i.e. they would prefer to find formal employment and have gone into business as a way to avoid unemployment and total destitution. These kinds of entrepreneurs will start up and run small enterprises whether they are encouraged to do so or not.

This is not to suggest that necessity entrepreneurship is meaningless: it can clearly help reduce unemployment in some circumstances and in some cases lead to upskilling. However, in the main, this form of entrepreneurship will occur without the intervention of public policy.

Not everyone can be an entrepreneur

Studies across the globe have found that it is common for entrepreneurs to have family members who are also entrepreneurs and that family and the social environment in which children grow up play a crucial role in pre-determining entrepreneurial orientation. Previous work-related experiences and previous employment in entrepreneurial firms increases entrepreneurial awareness. Work comparing entrepreneurship in different parts of Asia with Latin American countries found that, across the two continents, entrepreneurs were typically 30-35 year old graduates, and most had previous work experience that acted as the main source of their motivation, skills and contacts. It makes little sense, therefore, to promote entrepreneurship amongst young people who have never worked and live in homes where no one has any experience of running a business. Even with the subsidies and training provided for them to set up their own business, they are likely to fail quickly.

There are many reasons to be cautious about launching wide, untargeted programmes to encourage or subsidise people into becoming small business owners. At the same time, in South Africa it is imperative to raise entrepreneurship levels, get innovative and high growth ventures off the ground, and generally expand and diversify both the economy and the business sector. What then should government do to achieve these essential goals? The best approach is for government policies to focus on creating a less burdensome regulatory environment in which small businesses have to operate.

Lower the cost of doing business

For newly forming organizations the institutional environment defines, creates, and limits entrepreneurial opportunities, and thus affects the speed and scope of entrepreneurial entry and exit rates.

A survey of new firms in post-communist countries found that weak property rights discourage firms from reinvesting their profits, even when bank loans are available. Where property rights are relatively strong, firms reinvest their profits; where they are weak, entrepreneurs do not want to invest their retained earnings. In other words, effective institutions matter and weak framework conditions in one area (i.e. property rights) can spill over, and undermine, other areas.

Entrepreneurs can sometimes bypass or find substitutes for complex and badly functioning institutions and regulations. However, less opaque and more effective formal institutions are needed for these firms to scale up. High growth firms are therefore unlikely to emerge unless the business environment is reasonably stable and predictable. Any government that wants to create an environment in which firms with high-growth potential are more likely to emerge needs to simplify its legislative frameworks towards new firm formation and small businesses.

If these general framework conditions are wrong it is likely to be meaningless and a waste of time and resources developing sophisticated policies to promote specific types of small businesses.

Level 2: Targeting existing firms with potential

Providing help to existing small businesses to overcome some of their growth constraints is almost always a more successful approach to promoting small business expansion than distributing small amounts of money to startups, and both are better than untargeted awareness-raising programmes. The fact that existing businesses have survived and grown at least a little gives them greater credibility.

Do startups really create lots of good jobs?

Daniel Isenberg, Professor of Entrepreneurship at Babson College, US

Since President Obama exhorted Americans to create startups, and the US. government, the Kauffman Foundation, and other partners launched the Startup America Partnership, startups have been identified as drivers of economic growth and it's become accepted as fact that startups create jobs. But do they?

Different people mean radically different things when they use the term "startup". Some use it to refer to any new company, while others mean something more specific, usually linking the term to high levels of innovation. This inconsistency is a problem for anyone using the term in an economic policy context. A related challenge stems from what is called "survivor bias": since so many new companies fail in the first years, the few outliers who succeed are by definition more robust as businesses. This distorts our view. Hence, you could say "startups create jobs" – as long as you ignore the large majority that don't.

Consider the 2015 World Economic Forum (WEF) report specifying which countries have the most startup entrepreneurs. Uganda is number one, in which a remarkable 28.1 per cent of the population are entrepreneurs; Thailand is two, Brazil three, and Cameroon number four. Startup activity is strongly negatively correlated with the presence of mid-market firms ($10 million to $1 billion), which, according to a recent Dun and Bradstreet study, have created over 90 per cent of jobs since 2008. In the WEF report, the amount of entrepreneurship in a country is negatively correlated with its national competitiveness. A Stanford study reports that startups are also the biggest job shedders. Further confusing the picture, research by the Danish Business Authority shows that among beneficiaries of its programmes, 72 per cent of jobs are created by existing firms, 10 per cent by startups. It also found that public investment per job created in the form of business support programmes costs three times more for startups than for existing firms.

All successful startup-rich regions had quite large corporations in their pasts, infusing the ecosystem with talent, connections and knowledge: Boulder had IBM and nearby NORAD; Helsinki had Nokia; Israel had Tadiran and the Lavi project; Silicon Valley had Fairchild; Waterloo had Research in Motion; Bangalore had IBM; and Boston had Raytheon and MITRE. Later, each of these regions evolved a strong startup scene. But those few startups that grew arguably were results before they were causes.

There is no doubt that some – a very small percentage – of startups, do indeed create good jobs. But public and business leaders as well as policy-makers in the U.S. and elsewhere must see startups accurately and in perspective in order to foster growth and long-term economic prosperity.

Targeted interventions, especially those seeking to stimulate high growth firms (HGFs), are therefore preferable and most developed countries have now shifted their policy frameworks towards promoting HGFs. Closely targeting support allows governments to focus it appropriately and stimulates the expansion of the firms with the greatest economic impact.

There are nevertheless numerous challenges associated with targeted interventions. The most important is that it is almost impossible to decide by what criteria HGFs should be defined. There is no such thing as a 'typical' HGF: they are of varying ages and sizes, operate across a range of sectors, exhibit a variety of business models, management styles, and ownership structures. They also achieve growth through a number of mechanisms and channels. This means that targeting based on firm age or at firms in specific sectors, or on the basis of how much firms spend on R&D has generally been ineffective. HGFs are not necessarily new and can quite often be 'low-tech'. Studies have shown that HGFs are frequently not disruptive innovators, but rather modifiers of existing technologies. The management strategies of these firms tends to be customer-focused rather than R&D-focused.

A solution to this dilemma is to focus only on the firms that have already achieved relatively high rates of growth, but there is no guarantee that any firm's high growth performance is set to continue. Some HGFs experience one very brief period of growth, and are sometimes referred to as "Icarus firms" because of their failure following a period of rapid growth.

The goal of small business policies, especially in a country like South Africa, is to expand significantly the number of firms that are creating jobs. This requires that policy makers target firms with high growth potential, so called "latent gazelles". The task of identifying these firms has proven to be problematic for policy makers in rich countries, and is likely, at this stage, to be an insurmountable challenge in South Africa. One finding that may be helpful in identifying the firms with the most potential is that they are typically innovative and export-oriented. Firms could be asked if they have exported in the last two years or whether they have introduced a new product or service over the last three years. In South Africa, strict adherence to such an approach may, however, produce a very small number of businesses that qualify.

Another approach would be to provide support to entrepreneurs from other countries to start businesses in South Africa. Two global programmes that have adopted this approach are Start-up Chile and the Future Fifty programme in the UK. They have not yet been comprehensively evaluated, but their initial performance seems very promising. Within the Start-up Chile programme the levels of survivorship and job creation appear especially impressive. Given this, there may be some justification for economies with limited levels of growth-oriented entrepreneurs overcoming this entrepreneurial deficit by importing entrepreneurs from elsewhere, who then contribute to the country's growth and employment levels.

The importance of finance and how to solve it

Difficulties with accessing credit represents possibly the most severe impediment to the growth of small firms in the early years of activity. However, assessments of different policy approaches in this area, such as the New Zealand business support programme and Japan's Credit Supplementation Scheme, showed mixed results in terms of policy effectiveness. A clear cause of concern exists when entrepreneurship policy subsidises the credit made available to a broad swathe of firms, regardless of their potential. Providing targeted finance to established firms with growth potential is clearly preferable. In addition, rather than widely available loan subsidies, loan guarantee schemes (which are widely used across EU economies) can work more effectively as they lower risks but nevertheless bring private lenders into contact with small businesses. This can then lead to longer term relationships between banks and successful firms, stretching beyond the period of the government provided guarantee.

One source of the difficulties of accessing finance is a lack of knowledge amongst small business owners about who potential lenders are and how best to approach them. Studies show that small businesses with better knowledge of financial alternatives are generally better able to access finance. Another difficulty is that small firms often use non-standardised ways to record their finances, making it difficult for lenders to assess their credit-worthiness. One way of addressing the informational asymmetries that exist in credit markets is to standardise the financial information on small businesses. This could generate a standardised credit rating for small and medium enterprises which could be used by all lenders, similar in form to the way in which standardised credit ratings are attributed to various municipal authorities and governments by credit rating agencies. This approach has been used successfully in the European Union, and governments in emerging economies may wish to examine this innovative policy solution.

While low growth small businesses may have to rely on internally generated resources to fund expansion by making do with what they have, growth-oriented firms may resort to innovative forms of "bootstrapping" to overcome financing constraints. Bootstrapping refers to a variety of financing methods that minimise the need for debt and equity financing from lenders and investors such as using trade credit, forgoing managerial salaries, leasing rather than buying equipment, and using credit cards. The use of credit cards to finance business expansion has been noted in research on South Africa, especially amongst black entrepreneurs. Accessing new innovative forms of funding, such as crowdfunding, is another potential option found to be useful for risk-oriented small firms.

Training support

Recent evaluation evidence shows that the better targeted training support is at the specific needs of small businesses, the more cost-effective this form of support will be, and that generalised training is seldom very effective. Different types of small businesses will benefit from different types of training initiatives so care should be taken when designing the content of these interventions. Given these complexities it is difficult to envisage government agencies providing the right kind of training support at the right time to a variety of small businesses. It may be better to let the market and private training providers address these needs, and to provide under-resourced firms with training vouchers they could use to engage the private provider that best suits their needs.

Level 3: 'Economic gardening'

Entrepreneurship is deeply spatially and relationally embedded. Where a firm is established fundamentally shapes the nature of the business in terms of access to human and financial capital, access to markets, access to business networks and the nature of its customer interactions. Where firms are located is also crucial to shaping the barriers they will face when trying to grow.

An increasingly popular policy approach can be labelled 'economic gardening'. This is more bottom up, based on government agencies and other actors helping small businesses overcome the constraints on their growth, and relies on business owners themselves to identify these. This approach is somewhat easier to implement at the local level (in metros and some secondary cities for example) as it allows for one on one and context specific interactions between firms with growth potential and local officials who are directly responsible for promulgating or reformulating by-laws, registering businesses, local support initiatives, etc.

The limitation of this approach is that local government may not have jurisdiction over key regulatory features of the entrepreneurial ecosystem.

Rather than offering traditional "transactional" forms of assistance, there is now much greater emphasis on providing "relational" support in the form of network building and fostering peer-based interactions. This re-orientation within entrepreneurship policy is also resulting in changes to the thematic nature of support and the manner in which it is delivered, with fewer top-down national initiatives and more localised and multi-partnered initiatives. Positive spill-overs have also emerged when interventions have succeeded in linking small businesses with local or national companies and their supply chains.

Local municipalities and city metropolitan areas may therefore be the most appropriate vehicles for implementing these kinds of bottom-up, relational types of interventions. Local policy makers could be well placed to build strong connections to local entrepreneurs, universities, and local business organisations, but only if they have an appetite for, and an understanding of, this kind of facilitating function. Undertaking such initiatives will be easier in locations with reasonably high levels of growth-oriented entrepreneurial activity and high levels of entrepreneurial support.

Concluding thoughts: Small business policy dos and don'ts

The promotion of small business development and entrepreneurship is frequently regarded as an unambiguously 'good thing' without sufficient consideration being devoted towards the actual outcomes and the opportunity costs that different kinds of interventions produce. South Africa needs many more thriving, job-creating companies and much higher levels of entrepreneurship. However, careful consideration should be given to how this outcome can best be achieved, as well as realism about what is possible within the current context.

Dr Brown's review of the global initiatives that have been undertaken to promote small business across the developed and developing world contains a number of important ideas and principles that should guide South African initiatives to achieve the goal of making our economy more inclusive, more diverse, and, crucially, more dynamic.

What we should avoid doing in terms of small business policies is:

Promoting startups in general or dispensing generalised small business support: Generalised, indiscriminate support tends to be inefficient and is beset by deadweight costs.

Providing government designed training programmes: While the most common form of assistance to small business is training, rather than generalised, one size fits all forms of training, this needs to be targeted towards the needs of the recipient firms if it is to have any chance of being effective. Private training providers are more likely to provide such closely-tailored and effective forms of training.

Instead, we should consider undertaking the following interventions in a thoughtful and carefully designed manner:

Make every effort to improve the institutional environment: Research confirms that weak institutions, corruption, excessive business regulations, weak property rights, and weakly developed market-supporting institutions will all impact negatively on the emergence of small business growth.

Consider some support for firms with high growth potential: Some firms are much more likely to grow than others, and support targeted at them will generate more jobs. it is difficult to select these firms, and any intervention in this regard should start small with modest targets and select firms on the basis of carefully considered, transparent criteria.

Help small firms with potential to access finance: Broad based subsidies on small business loans are often inefficient. More effective interventions help small business owners connect more effectively with existing credit providers, and reduce information asymmetries in credit markets.

Attract and support foreign entrepreneurs: Recent evidence shows there are strong signs that growth-oriented entrepreneurs are highly mobile and inclined to move to different locations to improve their prospects. South Africa should attract ambitious entrepreneurs from other parts of the world, including the African continent.

Undertake locally driven, bottom-up, 'economic gardening' interventions: Although they may initially have a fairly modest impact, interventions that improve communications between local entrepreneurs and local governments, facilitate networking and information sharing, and create a more conducive environment for facilitating business growth are key to improving small businesses' prospects.

CDE Publications on Small Business

Opportunities First: A New Lens to Shape Priorities for Action in Middle-Income Countries, August 2017, **see here**

Youth Unemployment: An Agenda for Action. Business Growth and Inclusion: Tackling youth unemployment in cities, towns and townships, August 2017, **see here**

Cities - Pathways to Prosperity: A Presentation by Edward Glaeser, September 2015, **see here**

Young Soweto Entrepreneurs, June 2007, **see here**

Key to Growth: Supporting South Africa's Emerging Entrepreneurs, June 2004, **see here**

CDE Op-eds on Small Business

Smart Growth and Jobs for the Army of Unemployed Youth must be 2019 Priorities, The Sunday Times, 17 October 2017

CDE's Opportunities First: Create an Enabling Environment for all Entrepreneurs, Daily Maverick, 19 September 2017

How to Fix Crisis of Youth Unemployment in the Country, The Sowetan, 12 September 2017

A Perspective on Youth Unemployment, City Press, 21 August 2017,

The Future is Urban, We Should Take Advantage of it, Business Day, 8 May 2014

Transformation: Racial Myths Stand in the Way of Entrepreneurship, Business Day, 6 April 2011

State Fails Enterprise Challenge, Business Day, 12 July 2004

Five Vital Steps in Entrepreneurship, (Publication unspecified), 12 July 2004

Published in May 2020 by The Centre for Development and Enterprise

5 Eton Road, Parktown, Johannesburg 2193, South Africa | PO Box 72445, Parkview, 2122

Tel +27 11 482 5140 | info@cde.org.za | www.cde.org.za