

**What role can small and micro businesses
play in achieving inclusive growth?**

Questions requiring answers



GROWTH AGENDA
Priorities for mass employment and inclusion



About CDE

The Centre for Development and Enterprise (CDE), an independent policy research and advocacy organisation, is South Africa's leading development think tank. Since its establishment in 1995, CDE has been consulting widely, gathering evidence and generating innovative policy recommendations on issues critical to economic growth and democratic consolidation. By examining South African and international experience, CDE formulates practical policy proposals outlining ways in which South Africa can tackle major social and economic challenges. CDE has a special focus on the role of business and markets in development.

CDE disseminates its research and proposals to a national audience of policy-makers, opinion formers and the wider public through printed and digital publications, which receive wide media coverage. Our track record of successful engagement enables CDE to bring together experts and stakeholders to debate the policy implications of research findings.

Series Editor: Ann Bernstein

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Introduction

South Africa needs a more inclusive economic system, one where millions of excluded people can find jobs or space to start new firms.

There is an important idea on the table that small and micro businesses could somehow be strengthened and linked more directly to the mainstream institutions of our economy, and then form the basis of a more inclusive system.¹ However, before we can consider what an inclusive growth strategy would look like that harnesses the potential of smaller businesses – formal, informal, and those in-between – we need to establish what the state of knowledge in South Africa is, how experts define and think about the parts of the economy where these businesses are located, how much potential there is in this segment of the economy, and how connected or disconnected it is from the economic 'mainstream'.

To find answers to these questions, CDE convened a series of conversations with global and local experts in late 2020. Our series of webinars brought to light the unsatisfactory state of our knowledge on this topic, the difficulties and limits of distinguishing between formal and informal firms, the overlapping challenges that the majority of these firms confront, and the complexities of identifying priorities and the right policy mix if the goal is to find sustainable ways to strengthen these firms and the contribution they make to the economy.

“The shocking truth about small, medium and micro enterprises is that we know very little about them.”

Although different challenges face a sole trader selling magwinya (fat cakes) in Thohoyandou and an aspiring digital solutions entrepreneur in the Cape Town CBD, CDE believes that there are also overarching challenges confronting them in the South African business environment. Whether differentiated policy responses are required for such varying firms, or whether wholesale policy and regulatory reform could better spur business growth across sectors of the economy, is an open question that merits further investigation.

This report is not intended to provide comprehensive, conclusive answers to the questions posed. Instead, it is meant to serve as a guidepost to future conversations and explorations that are urgently needed if we are to grow the economy faster and more inclusively.

There is a lot we do not know about firms on the periphery of the South African economy. Before we can move to an effective policy framework, then, we need much clearer thinking around crucial issues, better data, and a serious debate about what is possible. As the Small Business Institute's (SBI) John Dlodlu put it, “The shocking truth about small, medium and micro enterprises (SMMEs) is that we know very little about them.”²

1. How many formal and informal SMMEs are there in South Africa?

There is little clarity about the size and growth of the SMME sector, although more so for informal firms than formal ones. As Dlodlu put it when speaking to CDE, “South Africa lacks a baseline study of SMMEs, which is why estimates over the past decade range from 670 000 to an impossible six million. Not only do we lack a common set of facts, but we also don't know what makes them succeed or fail, in which sectors they flourish, and where opportunities lie. Thus, all the tweaks and piecemeal changes in policy have been based on little

empirical evidence and so may well have missed the mark. But regardless of which statistics we use, South Africa is far from reaching the NDP's goal of SMMEs creating 90 percent of jobs by 2030."

There are mixed signals about the size of the sector. Some statistics provide signs that the SMME sector was starting to expand before the Covid-19 pandemic created unprecedented challenges. The positive signs can mostly be found in government-generated statistics, especially those in the SMME Quarterly report, put together by the Small Enterprise Development Agency (SEDA). This report includes data on both formal and informal SMMEs to develop a holistic picture of the entire sector. By combining the number of employers and own-account workers from Statistics South Africa's Quarterly Labour Force Survey, SEDA estimates that, of the more than 2.6 million SMMEs that SEDA counted during the first quarter of 2020:

- 66.9 percent (1,748,031) were classified as informal;
- 28.9 percent (755,265) were classified as formal;³ and
- 74.8 percent (approximately 565,000) of formal SMMEs were black owned.

Other important statistics from the report include the following:

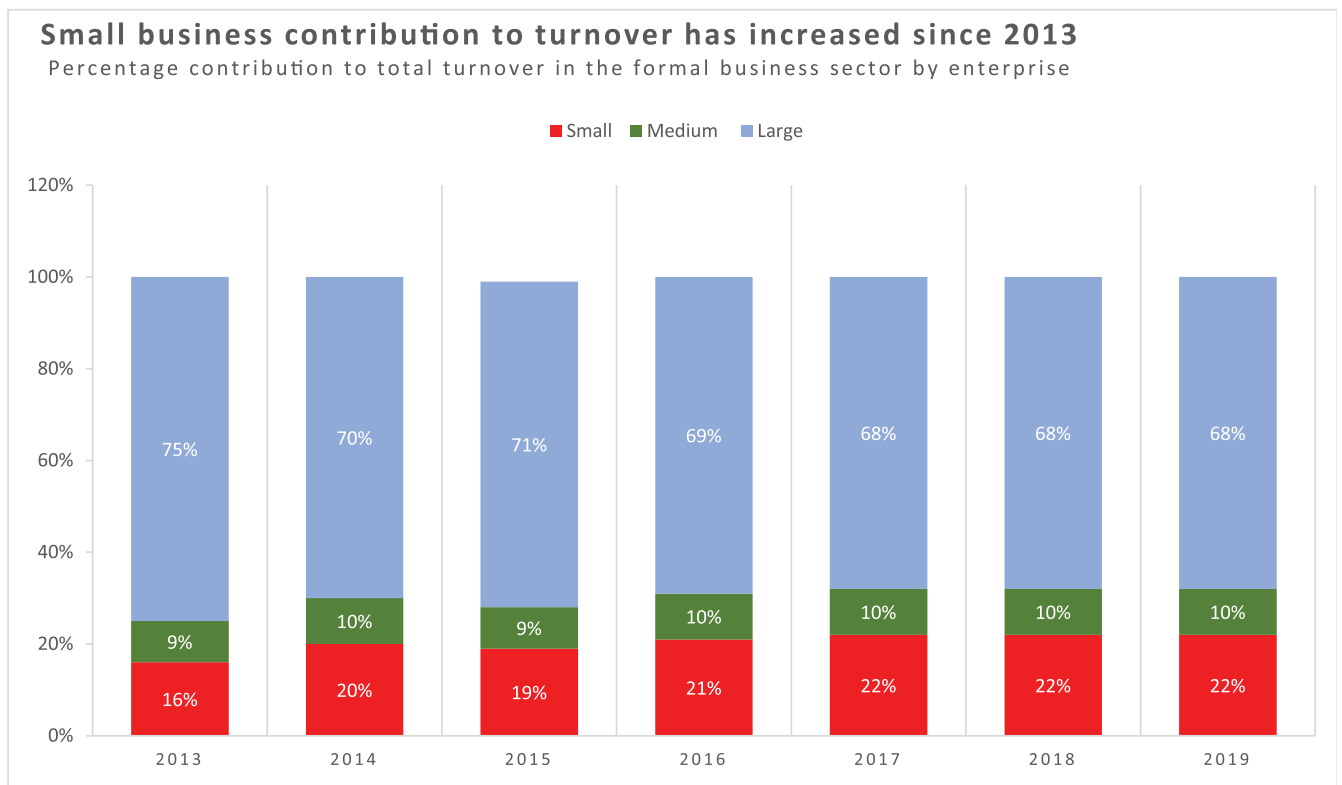
- The number of SMMEs increased from 2,343,058 in the third quarter of 2016 to 2,614,063 in the first quarter of 2020, a growth of 11.6 percent over a period of three and a half years.
- The formal SMME sector grew faster than the informal SMME sector, at a rate of 14.8 percent versus 9.7 percent.
- Employment in all SMMEs expanded from 9,683,639 jobs in 2016 Q3 to 11,830,042 jobs in 2019 Q4 (just prior to the impact of the Covid-19 pandemic), an increase of 22.2 percent in just over three years, or more than 1,800 jobs in SMMEs per day.⁴

In the context of rising unemployment during the past three years, the increase in employment in SMMEs estimated by SEDA seems highly implausible, especially if, as we show below, one considers that the respective contributions to annual turnover by formal and informal firms across the economy hardly changed between 2016 and 2019. It is likely, therefore, that SEDA's statistics give a misleading representation of the small enterprise landscape.

In its 2018 analysis of formal SMMEs, the Small Business Institute (SBI) set out to apply a "coherent definition of SMMEs", given that "SMMEs are defined differently across different sets of legislation, statistical studies and policy documents" in South Africa. The SBI analysis used size definitions that were determined by the number of 'person year jobs' associated with a firm: 0-10 for micro enterprises, 11-50 for small businesses, 51-200 for medium-sized firms, and more than 200 for large, established concerns.⁵ Analysing IRP5 forms from the South African Revenue Services and National Treasury, SBI found that, in 2016, formal SMMEs made up 98.5 percent of all formal firms. But their estimates for the size of the formal SMME sector were far lower than SEDA's: they found 176,333 micro enterprises, 68,494 small businesses, and 17,397 medium-sized firms in the formal sector – a total of 262,224 formal SMMEs. This is around a third of the number of formal SMMEs estimated by SEDA.

"The relative size of the formal small business sector has stayed broadly consistent during the past five or six years."

Another way to view the situation is to look at the relative contribution that formal SMMEs have made towards total revenue generated in the formal sector. The graph below reveals that out of R10.5 trillion annual turnover generated by the formal sector in 2019, 22 percent (R2.3 trillion) came from formal small businesses (32 percent if you include medium-sized enterprises). This is more than double the R1.12 trillion turnover they generated in 2013 (16 percent of R7 trillion), albeit that these are nominal figures.⁶ However, the relative size of the formal SMME sector has stayed broadly consistent during the past five or six years, hovering either just below or just above 20 percent. This raises questions about statistics that show dramatic growth in this sector.



Source: Annual Financial Statistics (AFS), 2019



2. What has government's impact on the SMME sector been?

As a sign of its commitment to this sector, government set up a Department of Small Business Development (DSBD) in 2014. Under its auspices are numerous entrepreneurship support programmes, as well as various forms of targeted support, including legislated requirements. It would be good to have a clear picture of the resources that have been sunk into these initiatives and what kinds of returns they have produced. Indications are that government spends R15 billion on small business intervention, but the DSBD only gets around R1 billion of this allocation.⁷ Research on the impact of government's interventions and spending is sorely missing.⁸ At CDE's webinars we heard from many advocates and representatives of small business who are growing increasingly frustrated with what they see as government's inability to provide sufficient assistance in the development of the sector. Oupa Pilane of the Kruger Lowveld Chamber of Business is a business representative extremely frustrated about the current state of affairs. He told CDE that "A large chunk of government procurement has not created business; in fact, over the past 25 years, the state has not created enterprises."

One possible explanation for this rising frustration is that while the government has focussed a lot on providing special assistance to selected firms (and there could be numerous problems with the way this assistance is doled out), it has not devoted nearly enough attention to creating a more conducive environment in which businesses of all sizes could thrive.⁹ While more knowledge about how the regulatory environment inhibits the establishment and growth of businesses would be deeply valuable, there is widespread agreement that SMMEs, both formal and informal, find it particularly difficult to get ahead in the current context.¹⁰ Two ways in which the state is seen to hinder business growth were highlighted strongly at our webinars: the labour regime, especially as it concerns wages, and the behaviour of local government.

"There is widespread agreement that formal and informal small businesses find it difficult to get ahead in the current context."

The way that the labour regime drives formal small employers out of business was stressed by Gerhard Papenfus, CEO of the National Employers' Association, who said, "I can't see a person in a start-up or in a small informal business paying the national minimum wage right from the start. These business owners are the ones who feel the devastating impact of the minimum wage in South Africa."

Papenfus also argued against the practice of extending wage agreements – often well above the minimum wage and made in bargaining councils where small businesses have no real representation – to small employers who cannot afford the

wages that larger, more capital-intensive firms are ready to pay. This is a longstanding issue, which was recognised as an impediment on small business growth by, amongst others, the 2017 Report on the High Level Panel on the Assessment of Key Legislation and the Acceleration of Fundamental Change, chaired by former President Kgalema Motlanthe. As that report articulated the problem: "In practice, the Labour Relations Act unintentionally forces the terms of an agreement reached by large employers and large unions onto SMEs. The result is higher than manageable wages for SMEs, arising out of agreements reached by larger firms and employers – with negative consequences for the growth of, and employment generation among SMEs in the relevant sectors."¹¹

The second factor raised at our webinars was the way local government, especially metro governments, impose and enforce bylaws, making it very difficult for various kinds of small firms, often defined as informal, to operate. This was a point made strongly by Charles Parkerson, SALGA Economic Development Director, who said, "In our country, we've given municipalities the powers to curb people from conducting business activity. Curtailing people's right to participate in the economy, whether it is running an informal or semi-formal business, or by selling their labour, is not a power that should be given to municipalities. And unfortunately, we've seen this overreach, which prevents people from participating in the economy and directly affects their well-being."

A particular issue in this respect is the way the police interpret and enforce regulations regarding trading in city centres and elsewhere, which leads to high levels of harassment and unfair restrictions on traders, even when they have licences. These broadly informal activities are not likely to be the most productive with the highest growth potential, but the harassment they face imposes unnecessary costs on activities in well located areas.

Informal street trading also provides employment and valuable services and can sometimes serve as a steppingstone into higher level business activities, whether through formalisation or simply firm growth. Professor Margot Rubin from the University of the Witwatersrand argued strongly against the de facto criminalisation of informal business activity, as seen in the way the police confiscate traders' goods in an arbitrary way and forbid them from operating in well located parts of the city. "We need to start recognising the contribution informal trading makes to a city's economic base. The fact that these activities ensure some kind of income for people, and more than that, some kind of livelihood, means that it ensures a better quality of life for them and their children, which in turn reduces dependency rates on the state," said Rubin.

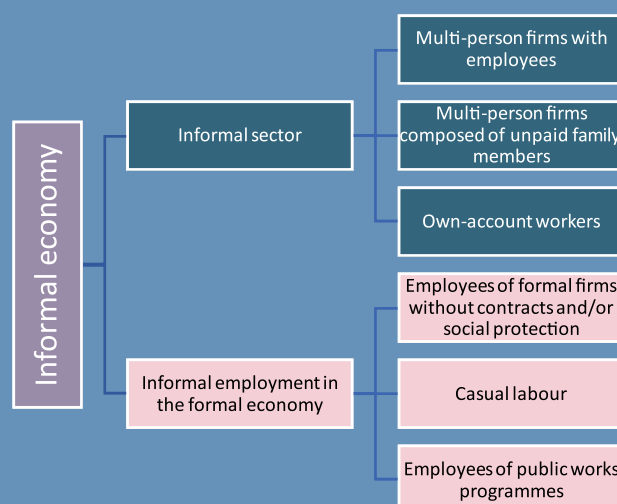
Rubin went further by opposing the very notion of informality. In her opinion, "The formal/informal distinction is arbitrary and does not make a whole lot of sense. Rather than attacking informal businesses, we should offer greater support to the organisations that can be found in the so-called informal sector."

3. What is informality, exactly?

The concept 'informality' can denote different things, which are utilised in different ways in service of different concerns, such as taxation or the nature of employment. The box below sets out some of the complexities contained in the way Statistics South Africa defines informality for the purposes of different surveys. A useful rule of thumb is that all informal firms are 'small' (or rather, no informal firms are 'big', since some may be 'medium-sized'), but not all small firms are informal. However, sometimes informal enterprises are defined as "unregistered enterprises that have fewer than five employees".¹²

Statistics South Africa on informality

In line with internationally accepted standards, Statistics South Africa splits up the term 'informal economy' into the 'informal sector' and 'informal employment in the formal sector' (see diagram). Informal sector enterprises are defined as "firms, own-account workers and persons working unpaid in their household businesses whose businesses are not registered for VAT or income tax". These firms consist of multi-person firms with employees, multi-person firms composed of unpaid family members, and own-account workers. All workers working in the informal sector are considered informally employed, but many working in the formal sector (for businesses registered for tax purposes) are also informally employed. These include employees of formal firms who do not have contracts and/or any form of social protection (e.g., medical aid), workers in public works or other government employment programmes, and casual labourers.¹³



University of the Free State Professor Frederick Fourie, editor of South Africa's most exhaustive book on informality, *The South African Informal Sector: Creating Jobs, Reducing Poverty*, is an expert on this topic. In a presentation at CDE's webinar series, Fourie said "What is key to recognise is that there is a spectrum of informal enterprises, at various stages of development, ranging from embryonic to mature. Firms can be formalised to different degrees."

An example that exhibits this spectrum in South Africa is the minibus taxi industry, which incorporates some elements of formality but lacks many others. Formally, taxi operators require operating licenses from the state, though simultaneously the operators are also beholden to associations that control taxi routes and thus provide access to route permits, even though these practices have no official, legal standing. This reduces competition and market access within the sector. It has also meant the collection of little, if any, tax from the sector, and little regulation of the quality and safety of vehicles. Thus, taxi associations are recognised by the state and to some extent formal, but they continue to operate as a law unto themselves and help to ensure that the taxis themselves are largely unregulated.¹⁴

Other sectors face different kinds of challenges, but this complex mix of features makes it difficult to choose the right policy response. Is it more or less regulation? In this case, is it a good or a bad idea to work with the taxi associations? What should be done about operators who fall outside the control of these associations? Such operators often provide a valuable service, especially in facilitating short trips inside townships, but are as deep in the informal sector as it is possible to get as they have to avoid detection by both the associations and the authorities.

As an additional example of how complex and uncertain these issues are for policymakers, consider that the failure of many SMMEs to pay direct tax could be a concern in a country like ours with a widening gap between tax intake and government expenditure. Informal enterprises do pay VAT on purchased inputs, but being unregistered, they cannot claim it back. Yet bringing these SMMEs into the tax net is unlikely to have a significant impact on South Africa's fiscal deficit, while some could be put out of business if we were to push tax compliance on them, which could potentially make the economy less inclusive. At the same time, allowing them to slip through the tax net means that everyone who does pay tax has to pay more, which could negatively impact on employment and growth.¹⁵ What to do about this is difficult to determine conclusively. Given that any policy approach will have winners and losers, costs and benefits, we need to be clear about what the purpose of our policy interventions are.

"Twenty percent of informal enterprises are multi-person, but they employ approximately 50 percent of the people."

4. How much potential is there in informal firms?

Naivety about the potential of activities on the margins of our economy is not the right place to start. Eighty percent of the informal sector, as defined above, consists of single-person firms. While we know too little about these firms to make a definitive statement about their potential, we cannot discount the possibility that many proprietors would prefer formal employment, and that they are active in the informal sector only as a way of dealing with not having a formal job. This may be especially true in the face of economic crises such as Covid-19 or the global banking crisis of the late 2000s. At the same time, it would be wrong to assume that there is absolutely no potential in this particular sub-sector. After all, Richard Maponya, who at his recent

passing had a net worth of R400 million, started out with his wife as a family-based enterprise, selling milk in the townships. It will, one suspects, never be simple for policymakers, or indeed investors, to distinguish between those micro-firms with potential and those without.

Fourie, who has analysed the data on informal firms more carefully than most, believes that larger informal firms have more potential than smaller, one-person firms. As he explains: "Firms that employ people are a small percentage of the enterprises in the informal sector, but they provide a large proportion of employment. Twenty percent of informal enterprises are multi-person, but they employ approximately 50 percent of the people employed in this sector. This is the category of firms we should be focusing on if the goal is to promote economic growth and expand employment."

Nevertheless, it remains unclear how much capacity for growth any of these firms actually have, and whether it would be worthwhile to target specific firms in a way that would unleash said capacity. More research and experimentation will be required to discover where the firms with potential are, how much potential they have, and what it would take to unlock that potential.

5. Why is the South African informal sector so small in relation to those in other African countries?

One reality that tends to suggest that the potential for growth in the informal sector is relatively limited is the very small size of the sector in South Africa, especially in comparison to other African countries. In our discussions with experts from Ghana and Kenya, the extent of informality in these countries was striking. According to Ed Brown from ACET in Ghana, the informal economy in his country employs between 80 and 90 percent of all workers. It is worth noting that, because Ghana employs the term 'informal economy', which includes the informal sector and informal employment in the formal sector, these figures are more encompassing than those in South Africa. But the general comparative point remains; levels of informality are far higher in Ghana than in South Africa.

The data are similarly high for Kenya. Dr Moses Njenga of KIPPRA told us that 75 percent of 7.4 million Kenyan firms had no business registration and 80 percent operated without a licence. According to Professor Rosemary Atieno of the University of Nairobi, 90 percent of the jobs created in Kenya in 2019 were created in the informal sector. In contrast, South Africa's informal sector, as of 2020, employs only a sixth of the country's workers, and contributes around six percent to GDP.

Even taking into account other differences in definitions – in most African countries people in the agricultural sector are mostly defined as informal whereas in South Africa the agricultural sector is excluded – there is clearly a big difference between the way businesses operate here versus the rest of Africa.

"Levels of informality are far higher in Ghana than in South Africa. Almost 90% of Ghanaian workers are employed in the informal economy."

An influential 2009 study by the Centre for Global Development's Alan Gelb and others, confirms a view put forward at CDE's webinar that the relative weakness of the state in many African countries undermines the

performance of formal firms, reducing their productivity, output, and growth.¹⁶ The result is that almost all activity is informal, as the benefits of becoming formal are just not worth the trouble. The key point about the rest of Africa is not the large size of the informal sector, but the small size of the formal sector.

In South Africa, the productivity differences between the formal and the informal sector are known to be much larger than in other parts of Africa.¹⁷ This suggests that we have a much better regulated environment that permits the expansion of formal businesses into most niches in the economy and which creates challenges for informal firms trying to compete with formal ones. At the same time, the situation also suggests that big productivity gains could be achieved if informal firms were able to shift over into the formal sector. Whatever we think about the potential within the informal sector, the formal sector is clearly much more important for growth and development.

"The entrepreneurial orientation of South Africans is not as feeble as numerous commentators have suggested."

6. Can 'formalisation' make a serious contribution to inclusive growth?

Professor Colin Williams of Sheffield University is a global expert on the informal economy. He stressed the important role the informal sector provides both as a safety net and as a place where, globally, innovative firms often get their start. Governments have to be careful, he argued, not to stamp out "the enterprise culture that can be found in the informal parts of many economies".

He nevertheless argued that policies to shift firms into the formal sector can be highly beneficial, if government approaches informal business owners with carrots rather than sticks. "The aim should be to reward good behaviour and make it easier and beneficial for businesses and workers to participate in the formal economy," he said. Carrots should mainly come in the form of making it easier to operate formally and providing the services and rule of law that would raise the benefits of operating formally.

In line with this, Fourie has suggested that a 'menu' of elements of formality be provided for SMMEs at various stages of development: "If enterprises can access these bit by bit, then those that are needed at a particular point will be used. In this way, firms can become more mature and gradually more formalised over time in an evolutionary process, without forcing them to formalise."

Williams pointed to some specific interventions that would increase the visibility of benefits that comes with operating formally. These include amnesties for unregistered firms; access to free marketing for registered firms; and using receipts as lottery numbers, which would give customers an incentive to ask for a receipt.

In Williams's view, raising awareness about the benefits of formalising and strengthening the trust that people have in government are undervalued ways to tackle the challenges of informality. "Arguably, citizens will not change their behaviour until government changes its ways. In many countries people regard the government as rapacious and hostile and prefer to avoid all contact with officialdom," he said. Little can therefore be achieved until there are improvements in the levels of trust.

Williams's presentation was received positively by local experts on SMMEs, independent consultant Septi Bukula and project manager at the Small Business Project, Brendon Darroll. They felt strongly that many SMME owners do not trust government officials and that this situation needs to be urgently addressed. In Darroll's words, "If we as citizens do not trust the individual who is administering small business policies and programmes, then we are probably going to avoid getting involved. I think a shift in culture within government is required, which should then lead to a change in how regulations and policies are administered."

Darroll went on to emphasise that South Africa is very far from the kind of ideal that Williams outlined, as there are currently few incentives for informal SMMEs to formalise. He concluded that we need to think much harder about how we could nurture nascent businesses into becoming employment-generating enterprises that are able to operate formally. "Very few small firms can make that transition in our current circumstances," he argued.

"The private sector lets you know in less than 48 hours about your loan. The best you can hope for from the public sector is a reply in 3 or 4 years, if they reply at all."

7. Are South Africa's entrepreneurial levels particularly low?

It might be suggested that entrepreneurship levels in South Africa are low and that we would benefit from a greater readiness amongst South Africans to take risks and start up innovative firms, even if that is in the informal sector. Any improvement in this area would, furthermore, have a positive impact on our extremely high unemployment rates.

However, if we look at the Global Entrepreneurship Monitor (GEM) survey for 2020, which allows us to draw comparisons with 49 other countries,¹⁸ it emerges that amongst middle-income countries, South Africa ranks sixth out of 12 in terms of total early-stage entrepreneurial activity as a percentage of the adult population.¹⁹ Our overall rank is also right in the middle, 25th out of 50 countries. By contrast, the percentage of the population owning an established business is very low, at 3.5 percent, which puts us near the bottom: 44th out of 50 countries.²⁰

The entrepreneurial orientation of South Africans, at least in terms of their readiness to start up new firms, is not therefore as feeble as numerous commentators have suggested.²¹ Some of those who spoke at our webinars who have studied the situation and/or work with small enterprises gave further support for the view that entrepreneurship is alive and well in South Africa. For example, Fourie argued that the number of new informal enterprises that emerge every year is in fact quite significant. In his opinion, "There is no lack of entrepreneurship or ambition in South Africa. The challenge is that the majority of informal firms are highly vulnerable, especially in the early stages. About 40 percent of start-ups close down within six months. The total number of new jobs involved are, however, significantly in excess of the jobs that government seeks to create through various initiatives."

Mark Barnes, CEO of the Kisby SME Fund, which seeks to provide formal small and medium enterprises with access to capital, argued that South Africans are too fixated on high-end, formal business zones like Sandton City and the V&A Waterfront. In his opinion, the 'real economy' is located in less formalised areas, where there

are plenty of small-scale entrepreneurs. The challenge that these SMME owners face, he went on, "is not entrepreneurial zeal or ignorance of market conditions, but rather the difficulties relating to expanding their businesses and becoming more competitive. They cannot obtain economies of scale, and they pay very high costs per unit of output, because they do not have access to capital and they cannot trade wholesale. With better support, the best of these firms could overcome these challenges and start competing with more established, larger firms."

8. Is a lack of finance holding back the growth of small firms?

Numerous contributors at our discussions mentioned the difficulties of accessing finance as a key constraint on both formal and informal SMMEs. Unregistered firms face an insurmountable challenge in accessing formal loans as they cannot supply the necessary paperwork. However, there is a strong view amongst experts that even registered small businesses cannot access the kind of financing that they need to grow. For example, GG Alcock, a leading advocate of informal township entrepreneurs, believes that the small loans, rotating credit, and finance for short-term stock purchases that small businesses need are just not available. He claims that "there is a massive opportunity to explore how we supply formal loans at a reasonable rate into the informal sector".

Pilane broadly echoed this view. "It is easier for me to obtain a credit card or finance my car than to finance my business," he explained. Pilane thought that government efforts were even worse than private sector ones: "At least the private sector will let you know in fewer than 48 hours whether or not you got the loan you applied for. The best you can hope for from the public sector is that they reply in three or four years, if they reply at all."

"The credit available to small, emerging businesses is destructive rather than enabling."

Bukula, who has decades of experience in entrepreneurship and SMME policy, felt that access to more credit will not necessarily advance the cause of SMMEs in a significant way. He explained that entrepreneurs in Soweto can usually find ways to raise additional money when necessary, but more credit is not always desirable and does very little to help small businesses break through the harder constraints standing in the way of their success. Bukula identified these as an inability to access markets, the unfair business practices of larger corporations, and the lack of legal recourse for SMMEs.

Barnes cautioned that the lack of access to affordable credit was probably not the most important issue holding SMMEs back. However, he stressed that "The credit that is available to small, emerging businesses is destructive rather than enabling. It allows entrepreneurs to eke out a living, at best, but it doesn't allow them to grow very easily." There are informal credit providers for unregistered businesses, but they tend to demand much higher interest rates than formal lenders operating in a competitive market. For Barnes, improving access to affordable finance for small-scale entrepreneurs in an incremental and experimental way could lead to significant growth of new firms currently stuck on the margins of the economy. As he put it, "When you are borrowing money at 40 to 50 percent, can you imagine what you could do with an appropriate mix of capital that is properly priced?"

9. Do big businesses block the development of small businesses?

There was a lot of discussion at CDE's webinars about market dominance by large corporations holding back

small business development and entrepreneurial growth. For example, Fourie speculated that entrepreneurship in South Africa would be higher if our history had not been dominated by large mining companies, which led to a highly concentrated economy.

This perspective was reinforced by Professor Ed Glaeser of Harvard University, one of the world's leading urban economists. In his contribution to CDE's webinar he drew on contrasting city-level experiences in the United States of America. Glaeser pointed out that New York has long exhibited higher levels of entrepreneurship than Pittsburgh, and that Pittsburgh's entrepreneurial disadvantage stems from the city being historically dominated by the big steel industry, "which then creates a certain type of child – a middle manager's child – which in turn creates big firms. By comparison, New York, with few natural resources, generated a vibrant and competitive garment and textile industry, which led to greater entrepreneurship and thus in the long run to greater growth." Bukula argued that in South Africa big business holds back smaller entrepreneurs in a more direct fashion. "There are corporate practices that are downright detrimental to small business growth," he said, citing late payments as one such factor. In this vein, it is telling that as recently as November 2020, 50 large businesses needed to make a public commitment to pay SMEs within 30 days, and that, apart from Massmart, none of the big retailers was part of this initiative. Nonetheless, Bukula warned that it is dangerous to generalise about big business. He argued that in the past there were several proactive corporations that came together and focused on small business development, citing Anglo American as one of the leaders in this respect.

It is unlikely that breaking up big firms and replacing them with as many small firms as possible will always be good for either inclusion or growth. In many poor parts of the globe, which includes most African countries, poverty is associated with a high proportion of small and recently established firms. Large firms have the advantage of reaping economies of scale, while also developing the capability and strength to undertake investments with long-term horizons. This is something that small firms, focussed as they are primarily on survival in highly competitive markets, are unable to achieve. Further, while large companies may, through their success, cut off small firms from certain market opportunities, they are just as likely to create new opportunities for smaller firms by virtue of generating new growth and demand for new inputs or distributing new products.

"An ideal economic system has a balance of firm sizes, ranging across small, medium, and large firms."

An ideal economic system, one that generates the most growth and the most inclusion, is usually one with a balance of firm sizes, ranging across small, medium, and large firms, as well as good numbers of both dynamic, new firms and more established, but still innovative, older ones.²² It is this balance that South Africa's economy has struggled to strike.

10. Are women entrepreneurs disadvantaged?

An important feature of small business entrepreneurship in South Africa is the large role played by women. The latest pre-Covid-19 statistics show that 1.13 million women were employed in the (non-agricultural) informal sector, against 1.79 million men. Sadly, women in this space have been particularly hard hit by the pandemic and the associated government lockdown. In the third quarter of 2020, only 860,000 women remained active in the informal sector, which is just more than half of the 1.6 million men who currently work there.²³ Unfortunately, women are often the first to go out of business while at the same time being most likely to work in the least

remunerative sections of the informal sector, not because of a lack of entrepreneurialism, but rather because of serious obstacles that stand in their way.²⁴ As Glaeser noted, "Globally, when women do become entrepreneurs, they tend to join a small number of industries, where they often talk about the advantage of being able to work with other women. The primary industries are either food or apparel manufacturing. This cuts many women off from learning skills from male entrepreneurs and being part of sectors with more growth potential."

A key reason for this pattern, as Rubin explained, is that "the reproductive role of women is holding them back". The other problem, detailed by Glaeser, lies in the nature of patriarchal societies: "Women are prevented from taking advantage of entrepreneurial opportunities both because they are expropriated by men and because they have to bargain with them." To help women get around these obstacles, Glaeser called for high levels of social compliance with the rule of law and equal access to the courts.

11. How should we think about firms disadvantaged by apartheid spatial legacies?

Entrepreneurs all over South Africa have, for nearly a decade now, confronted the major challenge of running their businesses in a low-growth environment. This challenge is hugely exacerbated for firms that operate in parts of the country that are either a legacy of apartheid's unjust spatial policies or are in relative economic decline.

Bulelani Balabala, founder of the national Township Entrepreneurs Alliance, pointed to the struggles he had in attracting capital for his township internet café venture, which he attributed to "a mentality that investors had about townships and their potential for growth, or lack thereof". He felt strongly that it was government's responsibility to correct this situation by setting preferential targets for small, black-owned, township-based enterprises in government procurement policies.

"The challenge in South Africa is less about turning around lagging regions and more about strengthening the management of urban centres."

The challenges confronted by township enterprises are even more severe in remote areas far from economic centres and surrounded by declining primary sectors such as mining. This is a situation all too apparent in a small town like Potchefstroom and surrounding areas. As President of the Wesvaal Chamber of Business, Kgotsi Mmadi, made clear, his members are confronted with very limited business opportunities: "We don't have the luxury of saying to our entrepreneurs that there are accessible markets for your products or services, because we operate outside of the economic mainstream and find it extremely challenging to access any significant market. At the same time, we cannot say that government's procurement strategy helps us in any noticeable way. It works for a few connected individuals but does nothing for most of us."

Glaeser pointed out that the challenge in South Africa may not be as much about finding workable ways to turn around the economic fortunes of lagging regions as it is about strengthening the management of South Africa's major urban centres. He felt that metro municipalities, supported by national and provincial government, should be doing much, much more to create well located and affordable accommodation, reduce crime, improve public transport networks and flows, and keep neighbourhoods safe and clean. Getting better at that would represent a massive boost for business activities in urban centres, which is where entrepreneurs have the best chance of succeeding.

12. What is the Township Economic Development Bill, and will it be a game changer?

Nomfundo Dlamini from the South African Cities Network is an advocate for the cause of small, black-owned businesses. Dlamini believes there is a new approach on the horizon that will change the prospects of black entrepreneurs, especially the business owners and entrepreneurs located in Gauteng's townships. This new approach, she argued, is encapsulated in the Gauteng provincial legislature's draft Township Economic Development Bill. "The Bill sets out the regulatory and policy interventions to change how commercial activity is governed and supported in townships, with the explicit goal of expanding existing businesses in township areas and enabling the creation of new businesses, in the hopes of driving mass employment for our deprived communities," she said.

The Bill states, correctly, that the "township economy remains in the margins of the mainstream economy with high levels of poverty, unemployment and inequality". One of the major causes of this marginalisation, according to the Bill, is "the regulatory failure or lack of enabling legislation to enhance the potential and growth of township enterprises". The Bill seeks to address this perceived shortcoming by providing special, legislated opportunities for township-based businesses, by means of a broad approach that largely mimics the way national government has sought to promote small business.

Among the objectives of the Bill are:

- The introduction of specific procurement rules which will allow government and its main contractors to buy from a large group or groups of township-based enterprises; and
- Compelling enterprises that get government contracts to ensure a certain percentage of their procurement spend is on township-based enterprises and cooperatives.

The most controversial part of the Bill is the provision that excludes foreigners from owning businesses in certain (as yet unnamed) sectors in (yet to be designated) townships. This, as many commentators have pointed out, is likely unconstitutional. It also has the potential to incite xenophobic violence and it is something that even some of its ardent supporters are uncomfortable about.

In the discussions CDE held with South Africans active in this space, there were some who supported at least the broad thrust of this policy and wanted to restrict competition and reserve certain activities for designated groups. A slightly modified perspective was voiced by Pilane, who felt that, "It all depends on whether foreigners are here legally or not. We do not want to exclude foreigners totally. If a refugee is here legally and has their papers in order and they have skills in entrepreneurial development, we would want to incorporate them into the system so that they can help others."

"There is an understandable desire to support and encourage black-owned businesses, especially in disadvantaged areas like townships."

Zakhele Mazibuko, from Tshwane-based NPO Participate Empower Navigate, was opposed to the idea that foreigners were an obstacle in the way of promoting local entrepreneurship. As he put it: "Being born and raised in the townships of South Africa, I have seen all spaza shops move into the hands of foreign nationals, who are

amazingly entrepreneurial and financially literate. How do we groom a spirit of entrepreneurship among South Africans, and how do we secure their involvement? I believe solving this can help end xenophobia, and this will also ensure township economic growth where poor South Africans can be uplifted and empowered. We need to do this without neglecting foreign nationals as I believe they bring powerful skills and experience that can complement the economic growth of South Africa."

It is not clear that this Bill has adequately negotiated the tension, which we already identified at the national level, between a focus on direct support to specific businesses versus creating a broad environment in which it becomes cheaper and more feasible to start and run all businesses. There is an understandable desire to support and encourage black-owned businesses, especially in disadvantaged areas like townships, but any attempt to do that must, in CDE's view, think harder and differently with respect to the following issues:

- the unjust and unconstitutional restrictions on foreign people's right to earn a living;
- the costs of directing resources (in this case government spending) towards businesses with undefined potential;
- the regulations that seek to compel established companies to choose certain suppliers, which will almost certainly raise the costs of doing business for those companies; and
- the viability of doing all that in a context where even established businesses are struggling.

CDE believes that this Bill put forward by the Gauteng government in 2020 needs to be debated and significantly modified before it could be considered a positive contribution towards building a more inclusive economy in the province.

Implications for an inclusive growth strategy

On the whole, small and micro businesses, especially those that can broadly be said to be part of the informal sector, probably have only a limited potential to become engines of a new, more inclusive economy.

Nevertheless, the core aim of any strategy hoping to make the economy more inclusive must be to make it easier for firms of all sizes to eventually establish themselves in the formal economy, where, most importantly, they should have as many opportunities as possible to grow and to create new jobs. Thinking about the contents of such a strategy highlights some important policy considerations.

"It must become easier for firms of all sizes to establish themselves in the formal economy, where they should have as many opportunities as possible to grow and create new jobs."

The big issue when it comes to SMMEs is deciding to what extent these firms are being constrained by the institutional environment if they want to stay or become formal. There is, as mentioned above, a sense amongst experts that this is the case, but it is not clear exactly how constraining the environment is, which regulations impose the largest costs, and how different kinds of small firms are affected. It is unlikely that all firms will benefit to the same degree from various forms of deregulation, and there are many other factors at play in determining how and in which sector a firm operates. Many firms will undoubtedly remain informal even if large legislative changes are enacted.

When thinking about the right kind of regulatory mix for businesses in general, it is vital to recognise the central importance of economic growth. In a low-growth environment, the opportunities for establishing and growing a firm will always be much more restricted than they will be in a high-growth environment. Tweaking regulatory restrictions or providing various forms of direct support may therefore make little difference if the whole economy does not move onto a higher growth trajectory. It follows that we should avoid thinking about policies for small firms, or informal firms, or township firms, in isolation from the broader economy. The priority has to be to raise the rate at which the South African economy has grown ever since the financial crisis of 2008. That can only be done if investment increases; hence, all policy proposals and reforms should be evaluated in terms of the effect they have on the general willingness to invest in our economy.

Another large and important issue when thinking about how to strengthen the role of small and micro businesses is what to do about those located in far-away, disconnected, or declining parts of the country. The best way to counter the long-term effects of spatial disadvantage – some of which is a legacy of apartheid policies that restricted people's choices about where they could live – is to facilitate as much mobility as possible. One way to achieve that is to introduce some fundamental changes in how our cities accommodate urbanising people, including those hoping to set up their own businesses. The aim should be to make it easier for them to locate in the denser, more economically vibrant parts of the city, rather than pushing them onto the remote outskirts of our sprawling urban areas. Cities must be places where economic activity can cluster, because that is an important driver of greater efficiency and higher productivity. That requires better management of affordable construction in city centres and surrounding suburbs, where densification is already taking place, mainly through small black entrepreneurs. Building regulations, for example, must keep building costs down, failing which informality will increase. Land markets and building costs must make affordable the construction of medium- and high-rise buildings. Densification must be supported by maintaining and upgrading infrastructure, as well as designing sensible public transport systems that encourage developers to locate new structures along their routes.

“A strong, dynamic small business sector should form an important part of a healthy, inclusive economy.”

In general, developing an inclusive growth strategy that includes small and informal businesses requires an integrated approach. We need to consider the broader enterprise ecosystem and how we can realistically get to a point where we have a much better environment for business growth. How do you get the right policy mix and set of priorities between reforms that will make it easier/less costly for all entrepreneurs to start and grow their businesses, on the one hand, and, on the other, providing direct support to help new entrepreneurs set up successful and competitive enterprises? We need to factor in the limits of government capacity when choosing that policy mix. Are there ways to encourage more firms to move into the formal sector, or should we rely on a more organic process whereby, in a more conducive, high-growth environment, firms automatically find it easier to register and become tax compliant? Can we improve the financing opportunities for formal and informal small firms? Can we strengthen the position of women entrepreneurs, especially in the informal sector? Is there a way to create a better balance between the relative market power of large and small firms? To get there we need a lot more rigour in the discussion on small business promotion and the informal sector. The country needs more and better research, some well-designed experiments, clearer concepts, and more strategic thinking about how we can make change happen as quickly as possible.

All along we have to keep in mind that the only way forward is to expand inclusion and growth. Doing one without the other will not get us to where we want to be.

Concluding thoughts

A strong, dynamic small business sector should form an important part of a healthy, inclusive economy, and highly vulnerable firms and those stuck in the informal sector should have every opportunity to become part of the economic mainstream and fully realise whatever potential for growth they have.

South Africa's small and micro business sector faced many challenges before the pandemic and has been dealt a devastating blow by the Covid-19 outbreak and lockdown restrictions. South Africa's response to this requires a short, a medium and a long-term response:

- **In the short-term** government's effort to provide relief funds to small businesses and to informal traders has been largely inadequate. Any future relief efforts must improve the extent to which they reach the most vulnerable.
- **In the medium term** – and we should regard kicking this off as extremely urgent – the priority has to be to raise the investment rate, and to get South Africa onto a higher growth trajectory than we were on before the pandemic. This requires an approach to firm growth that is simple and clear. We cannot say we are easing the business environment, as the President did in the State of the Nation Address, and simultaneously introduce myriad requirements into every aspect of the economy for procurement requirements and localisation conditionalities.
- **In the long term** we need a carefully conceived and realistic inclusive growth strategy, which, as we have argued throughout, needs to harness the actual potential of small business, informal as well as formal, in ways that are implementable, affordable, and designed to maximise economic inclusion. This strategy must be based on an understanding of the realities confronting SMME business owners and, rather than merely regarding any promotion of small business development and entrepreneurship as an unambiguously 'good thing', it needs to carefully weigh up the actual outcomes and opportunity costs that different kinds of interventions produce.

CDE publications on small business and the informal sector:

- South Africa's informal sector in the time of Covid-19 (2020)
- Covid-19: Are we asking the right questions about... Small businesses and their struggle for survival? (2020)
- Global lessons for small business promotion (2020)
- Covid-19: The impact on small businesses and gaps in current solutions (2020)
- Young Soweto entrepreneurs: Organising for small business advocacy (2007)
- Key to growth: Supporting South Africa's emerging entrepreneurs (2004)
- Encouraging small business: Is government doing more harm than good? (1999)

Endnotes

1. President Ramaphosa is one who shares this vision. He recently stated that the Township and Rural Entrepreneurship Programme “will bring a lot more people into the mainstream of the economy.” He went on to say: “The era of big corporates creating thousands of jobs has passed. We have to recognise the need to open opportunities to entrepreneurs and we have to set procurement targets to empower this sector”. See Amanda Khoza, “Developing small business crucial for SA economy: Ramaphosa”, Times Live, 26 February 2021
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3. The difference between these two figures and the overall number comes from SMMEs in agriculture and private households, which totalled 85,889 and 24,877 in 2020 Q1, respectively. Small Enterprise Development Agency, SMME Quarterly Update 1st Quarter 2020 (2020), p. 2; 17.
4. Small Enterprise Development Agency, SMME Quarterly Update 1st Quarter 2020 (2020), p. 2; 17. Own calculations.
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11. Kgalema Motlanthe et al. Report on the High Level Panel on the Assessment of Key Legislation and the Acceleration of Fundamental Change (2017), p. 43-44.
12. Frederick Fourie, 2018. ‘Analysing the informal sector in South Africa: Knowledge and policy gaps, conceptual and data challenges’, in The South African Informal Sector: Creating Jobs, Reducing Poverty. Cape Town: HSRC Press, p. 11.
13. Statistics South Africa,
14. Andrew Charman, Leif Petersen, and Thiresen Govender, Township Economy: People, Spaces and Practices (2020), HSRC Press.
15. Firms are not liable to charge VAT unless they have incomes of R1m. They still pay VAT, though, on supplies. Experts think that by far the biggest gap in corporate tax collection is from otherwise formal small and medium-sized, family-owned/closely-held firms.
16. Alan Gelb et al., To Formalize or Not to Formalize? Comparisons of Microenterprise Data from Southern and East Africa, Center for Global Development Working Paper No. 175, July 2009.
17. Alan Gelb et al., To Formalize or Not to Formalize? Comparisons of Microenterprise Data from Southern and East Africa, Center for Global Development Working Paper No. 175, July 2009.
18. Niels Bosma et al., ‘Global Entrepreneurship Report’, GEM 2019/2020 Global Report, 2020.
19. Early-stage entrepreneurial activity, according to the GEM report (referenced above), can be defined as the percentage of the 18-64-year-old population who are currently owner-managers of a new business, i.e., who own and manage a running business that has paid salaries, wages, or any other payments to the owners for more than three months, but not more than 42 months.
20. According to the GEM report referenced above: Percentage of the 18-64 population who are currently owner/manager of an established business, i.e. who are owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than 42 months.
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22. This perspective is reinforced by the arguments of Baumol, William J. and Litan, Robert E. and Schramm, Carl J, Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity (2007). Available at SSRN: <https://ssrn.com/abstract=985843> or <http://dx.doi.org/10.2139/ssrn.985843>; In developing countries the balanced mix should also include informal enterprises in various stages of development. For more on this perspective see <http://www.econ3x3.org/article/creating-jobs-reducing-poverty-v-%E2%80%98formalising%E2%80%99-informal-sector-answer>
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