



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

Questions requiring answers



Executive Summary

South Africa needs a more inclusive economic system, one where millions of excluded people can find jobs or space to start and grow firms. There is an important idea on the table that small and micro-businesses could somehow be strengthened and then form the basis of a more inclusive economy. 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'.

Whether differentiated policy responses are required for the variety of firms in this sector, 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.

What do we know

There is little clarity about the size and growth of the SMME sector, although more so for informal firms than formal ones. Before we can develop an effective policy framework, we need much better data and a serious debate about what is possible. We know too little about what makes some small firms succeed while others fail, which sectors have the strongest businesses, and where the best opportunities to establish and grow small firms are concentrated. Most policies in this field are based on very little empirical evidence.

Statistics relating to the size of the SMME sector vary widely because different institutions use different definitions and sources – and produce wildly varying results. Estimates over the past decade range from 670 000 to six million small enterprises. It is undoubtedly the case, though, that the

informal sector is relatively small, employing only a sixth of South Africa's workers and contributing a mere six percent to GDP. The formal sector is thus more important for growth and inclusion.

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. Around the world, the most common criteria for formal firms are registration with a government agency, keeping regular accounts, tax compliance, and the nature of employment contracts. Sometimes informal enterprises are defined as "unregistered enterprises that have fewer than five employees". A useful rule of thumb is that all informal firms are 'small', but not all small firms are informal. It may be useful to think of a spectrum from greater formality on one pole to greater informality on the other. This makes choosing the right policy approach for firms located along this spectrum a complex issue.

Data from global surveys indicate that South Africa's level of early-stage entrepreneurial activity ranks in the middle of international tables. The entrepreneurial orientation of South Africans, at least in terms of their readiness to start up new firms, is not therefore as limited as numerous commentators have suggested. It might therefore be sensible to be less concerned with initiatives to push more South Africans to take risks and start innovative firms, and to think much more about what could be done to enable existing firms to grow and create more employment.

What has government done to help SMMEs?

The government, through the Department of Small Business Development, is responsible for numerous entrepreneurship support programmes and various forms of support for small, mostly formal businesses, including through 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. Research on the impact of government's interventions is sorely missing. In the absence of reliable assessments of impact, it is instructive that many small business representatives express frustration at government's inability to provide sufficient assistance in the development of the sector.

Oupa Pilane, President of the Kruger Lowveld Chamber of Business, complained that it is difficult for small businesses to access finance from either the private or public sector, but "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."

President of the Wesvaal Chamber of Business, Kgotso Mmadi, opined that "Government's procurement strategy does not help us in any noticeable way. It works for a few connected individuals, but does nothing for most of us."

Two important ways in which the state is hindering business growth were highlighted at CDE webinars: the labour regime, especially in relation to wages, and the inhibitory behaviour of local government. We urgently need more knowledge about the precise ways in which various constraints, particularly regulations and how they are applied locally and nationally, prevent the establishment and expansion of small businesses.

What potential does the informal sector have?

Single person firms constitute 80 percent of the informal sector. Some experts believe that larger informal firms have more potential than one-person firms. The remaining 20 percent of informal firms that are multi-person employ approximately half the people in this sector. If we were to develop a targeted approach, we should be shining a spotlight on these firms, but it is not clear that targeting specific firms is the best way of unleashing growth.

South Africa's informal sector is small relative to other African countries such as Kenya and Ghana, where upwards of 80 percent of firms operate in an informal way. The key point about the rest of Africa, though, is not the large size of the informal sector; rather, it is the small size of the formal sector. The relative weakness of African states undermines the performance of formal firms, reducing their productivity, output, and growth. In South Africa, the productivity gap between formal and informal firms is much higher than in other parts of Africa, which means big productivity gains could potentially be achieved in this country if informal firms were able to move into the formal sector.

Government attempts to 'formalise' firms can have serious

pitfalls unless the approach is dominated by carrots rather than sticks. Some experts argue that carrots should mainly come in the form of reducing the cost of doing business across the economy and providing the services and rule of law that would raise the benefits of operating formally. Specific incentives that could increase the visible benefits of operating formally include amnesties for unregistered firms and access to free marketing for registered firms. However, many local entrepreneurs and SMME experts believe there is little trust between small business owners and the South African state, which may undermine processes to encourage informal firms to register and become tax compliant.

What are the barriers facing small firms in South Africa?

Numerous contributors at our discussions mentioned the difficulties of accessing finance as a key constraint on both small and informal firms. At present, small firms, especially those confined to the informal sector, face very high interest rates on loans. But not everyone agreed that more credit is always desirable or that it does very much to help small businesses break through the harder constraints standing in the way of their success. Mark Barnes, CEO of the Kisby SME Fund, cautioned that the lack of access to affordable credit was probably not the most important issue holding small and micro businesses back. Nevertheless, he pointed out that the credit that is available, "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. Improving access to affordable finance for small, marginal entrepreneurs in an incremental and experimental way could lead to significant growth of new firms currently stuck on the margins of the economy. 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?" There was a lot of discussion at CDE's webinars about market dominance by large corporations holding back small business development. Late payments were cited as a corporate practice that is hugely detrimental to small business growth. It is telling that as recently as November 2020, 50 large businesses needed to make a public commitment to pay SMEs within 30 days. However, there are many ways in which the expansion of big businesses is good for small business growth, and it is unlikely that breaking up big firms and replacing them with many small firms will necessarily lead to either inclusion or growth.

Women entrepreneurs face additional barriers. They are often the first to go out of business and are most likely to work in the least remunerative sections of the informal sector. Patriarchal societies place larger reproductive, care, and other domestic burdens on women than they do on men. Women are also often prevented from taking advantage of entrepreneurial opportunities because men stand in their

way. To help women overcome these disadvantages, experts believe that South Africa needs to develop higher levels of social compliance with the rule of law and equal access to courts.

Many entrepreneurs across South Africa struggle to run their businesses in parts of the country that are either a legacy of apartheid's unjust spatial policies or are in relative economic decline. One proposed solution to developing lagging economic areas within cities is Gauteng's Township Economic Development Bill, which aims to "enhance the potential and growth of township enterprises" by providing special, legislated opportunities for township-based businesses. This includes procurement set asides for township firms and, controversially, an apparently unconstitutional prohibition on foreign ownership of township enterprises. The problem with this approach is that, while it may give some firms a boost, it does nothing to change the prevailing circumstances, which make it extremely challenging for firms to survive, never mind grow.

One way to help people change the environment in which they run their businesses, is by making it easier for them to relocate to more dynamic urban areas. This is in many ways a daunting prospect for people located in declining or disconnected regions. However, one set of reforms that would help should be centred around strengthening the management of South Africa's major urban centres. Improving access to affordable accommodation, reducing crime, enhancing public transport networks and flows, and keeping neighbourhoods safe and clean would represent a huge boost for business activities in urban centres, where they have the best chance of succeeding.

Concluding remarks

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 inclusive growth strategy 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. The big issue when it comes to small and micro businesses is deciding to what extent these firms are being constrained by the institutional environment if they want to stay or become formal.

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 faster 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 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.

Read the full report available on CDE's website (www.cde.org.za)

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