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**STREAM 3, POLICY BRIEF 2**

# SMALL AND MEDIUM BUSINESS DEVELOPMENT

Policy brief prepared for the Labour Caucus in the Jobs Summit Small and Micro-Enterprise Support working group by the Institute for Economic Justice (IEJ).

Stream: Small and Micro-Enterprise Support Stream, brief 2

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Note: This briefing paper is focussed on small and medium businesses and has a specific focus on opportunity-based businesses.

## 1. NATURE OF THE PROBLEM

The National Development Plan (NDP) (2011) argues that small and medium businesses will create 90% of new jobs by 2030. This amounts to around 9.9 million jobs of the target of 11 million jobs by 2030. The NDP economic scenarios do not provide a breakdown by sector of the contribution of small, medium and micro-enterprises (SMMEs). This enthusiasm for the SMME sector to create employment has gained ground in South Africa, and in some respects the SMME sector has become something of a panacea to the employment challenge in South Africa. Whether or not this vision is realistic it is clear that SMMEs have an important role to play in job creation.

**Five sets of data on small business creating the number of jobs envisaged in the NDP are of significance:**

1. **Unrealistic growth expectations:** The arithmetic to reach the NDP calculations assumes a rapid increase in the number of small businesses that are unlikely to emerge. Based on an arithmetic modelling undertaken, the prospects for reaching this goal are highly optimistic, and even unrealistic. The data shows that somewhere between 1.9 million and 9.9 million new small businesses are needed between 2012 and 2030 to reach the target assuming no failure rates.

However, as shown below, assuming even a 10% failure rate requires more than 190 000 jobs. As one moves down the table and assumes higher failure rates, anywhere between 1.3 million and 7.9 million new enterprises are needed.

2. **Stagnant growth:** Research by Trade and Industrial Policy Strategies (TIPS) (2017) and Development Policy Research Unit (DPRU) (Bhorat, Asmal, Lilenstein, & van der Zee, 2018) indicates that the number of small businesses has remained stagnant or in fact decreased over the last decade.
3. **Net job creation:** Traditionally, small business is viewed as the central source of job creation. Data shows that small businesses account for the largest number of formally employed. Based on the Labour Dynamics Survey data, TIPS shows that that small formal businesses employ 4.3 million people, as opposed to 3.6 million employees in about 30 000 large formal businesses. This is an important finding for it shows that small formal businesses contribute to employment. A different study argues that big business however is a better net job creator than small business (Kerr, Wittenberg, & Arrow, 2014). This finding is important as it raises the importance of small businesses surviving.

- Low established businesses:** The finding that small businesses contribute significantly to formal employment, however, sits cheek-by-jowl with low levels of established businesses. The Global Entrepreneurship Monitor (GEMS) (2016), which provides internationally comparable data, describes established businesses as those being in businesses for 42 months or more<sup>2</sup>. South Africa has one of the lowest established businesses ownership in the world, and in addition low entrepreneurial intent. Data is presented in Appendix to this report. Data from TIPS and the DPRU further corroborates these findings, by indicating the absence of significant growth in the sector.
- Government support is too heavily focussed on big business.** According to the Annual Financial Statements prepared by StatsSA big business still received the biggest share by far of government support. The data shows that small business receives only 9.9% of government subsidies and incentives, and only 1.39% of capital transfers, while medium sized businesses receive 10.6% and 0.41% respectively. Large business receives the largest share of government subsidies and incentives (79.5%) and for capital transfers (98.2%) (Statistics South Africa, 2016).

**The overarching problem can be described as follows:**

- Current small businesses contribute significantly to current formal employment;
- The small business sector has however not grown significantly in the last 10 years and may in fact have experienced a decline; and
- Consequently, without interventions to grow the sector, employment gains from small businesses are unlikely to emerge.

An additional area, prescient to this brief, is the relationship between supporting small business on the one hand, and labour rights for decent work, on the other hand. The debate in this regard is overtly politicised, with labour regulations being deemed as a reason for low small business growth. This brief argues that a deeper challenge and a more accurate reason to explain slow growth of the sector relates to highly concentrated economic ownership. In addition, the development path in South Africa may present opportunities to ensuring both growth of small business sector and ensuring fair labour practices, and more boldly decent work.

## 2. CONCEPTIONAL OPTIONS AVAILABLE TO GOVERNMENT

## AND SOCIAL PARTNERS

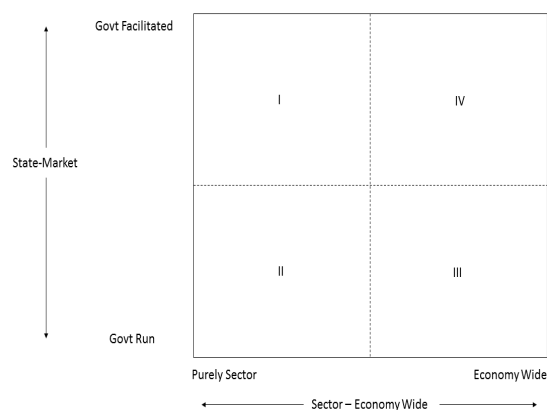
This section starts with conceptual options available to government and social partners in South Africa.

### 2.1 Conceptual Options

This section starts with a conceptual overview of what government and social partners could potentially be doing to support small business. A 2x2 box is used to outline possible strategic positions of social partners.

- Sector-economy wide continuum:** This axis distinguishes between sectoral based interventions with government providing targeted support to identified strategic sectors on the one hand, and economy-wide interventions that are not sector specific,
- Market-state relationship:** The market-state relationship is the other axis, which covers the continuum between government run and government facilitated approaches, to highlight questions of state capacity.

### Box 1: A quadrant of choices for small business reform in South Africa



Four broad policy options are observable, which are summarised below:

**Quadrant I. Sector Partnerships:** In this quadrant, government seeks to identify sectors that show strong prospects for meeting economic objectives, and works with the private sector to develop sector-specific mechanisms.

**Quadrant II. Choosing winners:** In this quadrant, government is accurately able to identify sectors and has the administrative capacity to undertake reforms.

**Quadrant III. Developmental state:** This quadrant sees government play an economy-wide role, seeking bigger

reforms that cut across sectors. Importantly, in this quadrant, government uses the instruments that it has at its disposal, and is not reliant on having wider economic partnerships.

**Quadrant IV. Economic deal:** In this quadrant, South Africa's economic stakeholders reach an economic deal, and construct a national social compact. The compact has clear responsibilities and a monitoring mechanism that enables society to reach higher levels of economic growth and employment.

The constructing of these four quadrants aims to provide a high-level conceptualisation of the options that are available to government to support small business. The quadrants are constructed not to suggest that one option is better than the other, but rather to indicate the wide range of government activities in each of these quadrants. Box 2 below summarises the options, and undertakes an assessment of prospects for success.

**Box 2: Option Analysis for Small Business Interventions**

	Scale	Admin– istrative Capacity	Catalytic (Support– ing programmes at all levels)
<b>Quadrant I: Sector Partnerships</b>	If specific sectors are identified, the potential impacts could be big	Capacity to undertake programmes limited.	Restricted to sectors. Programmes may fail due to lack of enabling environment.
<b>Quadrant II: Choosing winners</b>	Unlikely to be large	Limited administrative capacity at sector level.	Unlikely to support a wider range of programmes, but excellent learning opportunity
<b>Quadrant III: Developmental State</b>	Potentially large impacts on startups and supporting established businesses.	Designed to require less ongoing capacity	Provide a basis for sector interventions to succeed.
<b>Quadrant IV: Economic Deal</b>	If a meaningful social compact is struck, this could have large impacts	With partnership, state capacity constraints could be overcome.	Support a wider economic strategy, may translate to strong support for small business.

This brief focuses on the potential for rapid improvements in the environment for small business possible in Quadrant IV.

**The following agreements were assessed:**

- 1999 Presidential Jobs Summit

- 2003 Growth and Development Summit
- 2004 Financial Sector Charter

Each of the previous Jobs Summits have had agreements to support small business. **The agreements broadly cover five areas:**

1. Support for local procurement
2. Government procurement reform
3. Commitments to support extension of credit
4. Linkages between small business and large business
5. Specific sector-based interventions

**3. APPROACH**

The approach in previous agreements by government has unfortunately not yielded the results required to rapidly grow employment through small business and entrepreneurship development. The approach advocated here is one that prioritises government facilitated and economy wide agreement. Quadrant IV in the 2x2 box above. This is an approach focussed on economy wide reforms that improve the context for startups and for established small businesses to succeed. This includes a range of changes that unlock opportunities and growth for small business.

**4. PROPOSALS**

Eight specific proposals are used to illustrate the potential of economic-wide interventions. **These are:**

1. **Zero or lower taxes for startups:** One of the proposals floated for public debate has been to provide new companies with zero tax rate for three reasons, with the requirement that companies be formal, and register with the South African Revenue Service (SARS). The proposal is motivated as a signaling mechanism of government's seriousness to support small business, and potentially grabs headlines and creates an incentive for businesses to become formalised. Furthermore, reduction of the taxes should be linked to compliance with labour regulations and support decent work.
2. **Tenure reform in Traditional Authority Areas (TAA):** The debate on tenure security for individuals or households in Traditional Authority Areas is complex, with various proposals being advanced. The common thread in the alternatives is that providing individuals or households with tenure security will have positive development outcomes. Developing legislation in this regard is administratively complex and politically challenging, but has the potential to have large

impacts in rural economies, and potentially catalyse small holder businesses.

3. **3. Completing telecommunications reforms:** Data shows that small businesses with internet connectivity are more likely to survive than those without access to internet (SME Survey, 2014). Furthermore, completing reforms in the sector will create an environment supportive of software and business processing startups. Reforms in the sector are however likely to be contested due to the completion of the liberalisation programme. However, a clearer sequencing of steps aimed to extend access and reduce prices, would provide certainty. Most importantly, such reforms that lower the costs of data, open up industrial and services processes linked to the so-called “fourth industrial revolution”.
4. **Procurement:** Government has placed a strong emphasis on reforming procurement, with the introduction of set-asides for small business. The potential for this reform is significant in supporting small and expanding firms to get a foothold in larger contracts, and to generate cash flow. The reform initiative in this regard potentially uses the large government budget to support small business growth.
5. **Expand access to development finance:** As argued in the brief regarding development finance institutions there is a need to improve access, including through development finance institutions such as the IDC. The IDC would do well to offer a large scale roll out of fairly small start up grants to SMMEs, even if a high number fail absorbing the loss would be worth it.
6. **Shift to venture capital:** The current model of financial support is focused on providing credit to small businesses. The development of a stronger venture capital sector in the private sector, and provision of government supported venture capital instruments would remove financial obstacles to setting up businesses and supporting the running of businesses. The current tax system provides for 12J venture capital companies, that has potential for greater scale. The intent is to provide venture capital instruments into opportunities that are smaller than those provided by Development Financial Institutes (DFIs).
7. **Improved coordination of existing government support for small business and entrepreneurship:** Research on government spending on small business and entrepreneurship indicates (a) lack of coordination and (b) project-based approach to supporting small business. A process of both improving coordination of government spending and focusing on policy reform

(including scaling existing successful projects) needs to be undertaken.

8. **Linking Competition Policies and Industrial Policy:** The usage of competition policy and instruments can be enhanced through several means. The Centre for Competition, Regulation and Economic Development (CCRED) has provided input that includes

**a. Opening routes to markets:**

- i. Mandate access for black businesses and SMMEs to shelf space in the main supermarket stores.
- ii. Introduce guidelines to limit the scope and duration of exclusive leases that supermarket groups enjoy over key retail spaces in malls in order to open up for small businesses and part-line stores to access consumers in the main retail spaces.
- iii. Implement supplier development programmes particularly in the agro-processing industry (replicating those under various competition law case settlements and remedies) that provide SMMEs and black-owned businesses with support at multiple levels of entry in the value chain.
- iv. Replicate recommendations in various competition law case remedies to open up fridge space in retail outlets to new suppliers.
- v. Code of conduct for retail chains in incorporating black-owned businesses and SMMEs into their supply chains.

**b. Building a development fund for small business through penalties for competition penalties.**

**c. Regulating for rivalry, through making changes in policies. CCRED illustrates the following examples:**

- i. In telecommunications, mobile operators can make the process of switching cumbersome or difficult for consumers, even though number portability has been implemented. This denies challenger firms access to consumers and customers the benefit of greater choice, price competition and convenience. Address various challenges of switching costs for consumers, including regulations which protect insiders.
- ii. Also relevant to telecommunications, is the need to open up spectrum allocation to new participants and wholesale access providers.
- iii. In banking, as in telecommunications, several countries are currently exploring the feasibility of open banking. Various practices such as opaque banking charges and credit scoring create lock-in effects for consumers, preventing switching between providers.

## 5. POLICY CHANGES

The proposals noted above indicate a wider range of changes to support small business. A deliberate and coordinated strategy for small business and entrepreneurship is thus required. To action, this intervention requires a process towards updating and revising the Integrated Strategy on the Promotion of Entrepreneurship and Small Enterprises (Department of Trade and Industry, 2005), developed in 2005, needs to be urgently undertaken by social partners, as a core work area arising from the Jobs Summit.

## 6. FINANCIAL IMPLICATIONS

The majority of proposals do not require additional funding, but require a reprioritisation of funding. **In terms of proposals for reduced taxes, a modelling exercise would need to be undertaken to test the logic that:**

1. Encouraging registration through providing tax incentives;
2. Support growth of the sector and supports businesses to find profitable markets;
3. Expand access to development financing;
4. In the long run the tax base for small business would increase, ultimately growing the amount of taxes collected; and
5. 5. Even if tax will not increase, the potential for creating employment that is formal would be enhanced.

## 7. ROLE OF STATE INSTITUTIONS AND SOCIAL PARTNERS

The key role is for a review of policy and rapidly putting in place a process for a new overarching policy on small business.

## 8. SEQUENCING AND TIMEFRAMES

It is envisaged that a new white paper process could be completed in six months, given the large convergence between social partners on majority of issues facing small business.

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1. This brief draws on work the author has conducted for the Programme for Programme to Support Pro-Poor Policy Development (PSPPD) and for the Ministerial Task Team on Small Business Finance. In addition, aspects are drawn from the authors MA thesis, on the 'Political economy of government spending on small business and entrepreneurship' which is currently being examined. The Centre for Competition, Regulation and Economic Development – CCRED contributed a note on competition policy and small business that is incorporated in this brief.

2. According to GEMS - Established Business Ownership Rate: Percentage of 18-64 population who are currently owner-manager of an established business, i.e. owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than 42 months.