

Examining the challenges facing small businesses in South Africa

The National Development Plan (NDP) sets out several ambitious goals for the small to medium enterprise (SME) sector - including a target for 90% of employment opportunities to be created by this sector by 2030. The NDP envisions the South African economy growing by at least 5.4% growth per year over the next 15 years, to treble in size – and identifies the SME sector as a pivotal player in driving this growth. Yet despite government’s commitment to growing and supporting the country’s SMEs, these firms continue to face an extremely hostile business environment, including lack of skilled staff, burdensome regulations, tough local economic conditions, lack of finance and the high costs associated with employing staff.

The NDP’s targets for job creation in the SME sector depend on the creation of a business environment that supports the growth and sustainability of existing SMEs, a culture of entrepreneurship, and enables new SMEs to prosper.

The new Small Business Development Ministry, under the leadership of Lindiwe Zulu, has an important role to play in achieving this. The Ministry has been established to deliver dedicated and focused support for small businesses and to ensure that the common challenges that confront the sector are addressed in a co-ordinated way. Priorities for the Ministry will include addressing the legal and regulatory environment; improving access to markets, and availability of finance; addressing the skills deficit; enabling better access to information; and improving the effectiveness and reach of support institutions.

If the Ministry is to address these challenges effectively, it will need to begin with a clear understanding of the diversity and complexity of the sector. Policies, incentives and support structures need to be designed on the understanding that the businesses that fall within the broad ‘SME’ category differ vastly from one another in their ambitions, their potential for growth, and their stage of development.

The SME landscape

One of the critical challenges facing policy makers is the dearth of information about the growth cycle and the dynamics that affect SMEs at each stage of firm development, from survivalist businesses to potential high growth entrepreneurial firms. This lack of empirical information has led to policy decisions that rely on anecdote, theory or ideology - shaky foundations at best. Assessing the potential impact of policies and regulations on small businesses requires a clear understanding of short and long term effects at sector level, and at the level of individual firms at different stages of development. A richer and more detailed analysis of the SME lifecycle therefore would enable policies to be targeted more effectively.

The potential of the small firms as an engine for growth in developing countries has been widely acknowledged by global institutions such as the World Bank. In South Africa, SMEs are responsible for a significant level of product

Examining the challenges facing small businesses in South Africa

innovation and have a geographically broad spread, providing a mechanism for wealth creation in both urban and rural areas. Yet the growth of the sector has been stagnant in recent years, and government's efforts to boost the sector over the past two decades have yielded limited results.

South Africa's SMEs are estimated to account for over 60% of employment, according to a 2010 Abor and Quartey report, compared to a global average of 77%. What's more, they have an exceptionally high failure rate - in May 2014, Minister of Trade and Industry Rob Davies noted that as many as 70% of the country's SMEs fail in their first year - giving us one of the highest failure rates in the world. According to the 2013 GEM report only 10.6% of South Africa's adult population is involved in early stage entrepreneurship and another 2.9% have been operating for more than three and a half years. The latter figure puts South Africa in fourth last place across the entire GEM study. In contrast, around 17% of Brazilians are active in early-stage entrepreneurship and 15% operate established firms.

The World Bank reports that the viability of micro-enterprises is closely linked to the motivation for starting the business – successful businesses with potential for growth tend to be started by choice, as entrepreneurial ventures. Survivalist micro-enterprises, motivated by a lack of other employment options, seldom turn into successful, larger firms. For the most part, these business owners would prefer to give up their businesses and become an employee, if the opportunity arose. They are not hiring, or growing their businesses. Most of South Africa's SMEs fall into the latter category.

The youth unemployment bulge is now in a critical condition with around 36% of South Africa's youth unable to attain employment. This presents a serious challenge to the country and could be a permanently destabilising factor if not resolved rapidly and effectively. The NDP places SMEs at the head of the employment charge, and with good reason. SBP studies show that small firms are more likely to employ young and older work seekers which make up a large percentage of the unemployed population.

Worryingly, however, Stats SA's Labour Force Survey shows that smaller firms that employ less than 50 people are becoming less important as job creators. The number of people working in this business demographic has been declining since 2000. These figures are in direct contrast to the international trend, which has seen SMEs accounting for a rising percentage of employment.

Red tape and burdensome regulations

Designed to respond to the dearth of empirical analysis of the SME sector, SBP's SME Growth Index is a multi-year research project geared towards establishing a solid, evidence-based understanding of South Africa's SMEs. The largest, most comprehensive study of the SME community ever undertaken in South Africa, and one of a few of its kind worldwide, the study tracks the experiences of a panel of 500 established small firms in the manufacturing, business services and tourism sectors. The data that has been assembled over the course of the study provides an unparalleled resource for understanding the lived dynamics of South Africa's SMEs.

Since its inception in 2011, SBP's SME Growth Index has repeatedly identified the regulatory burden as a critical challenge facing small businesses. Frequent changes in the regulatory environment, the need to keep track of overlapping and sometimes conflicting regulatory requirements across multiple departments and levels of government, poor communication and access to information, and administrative inefficiencies in government departments and municipalities, mean that the SME owner spends a disproportionate amount of time dealing with regulatory compliance. In fact, our SME Growth Index has established that small firms spend an average of eight working days a month dealing with red tape. Every one of those days represents management time spent away from core business functions, and thus loss of income. The Davis Tax Committee Interim Report on Small Business indicates a median cost of R20 500 to comply with all tax requirements. Using the same hourly rate used in the Davis report we can estimate that the cost of regulatory compliance (75 hours a month) to SMEs equates to roughly R18 000 a month, or R216 000 a year. If a company has a turnover of

Examining the challenges facing small businesses in South Africa

R5 million, these costs represent 4% of turnover. This is a staggering cost on the owner's time and clearly highlights the disincentive, and opportunity cost, for any aspiring entrepreneur endeavouring to comply with business legislation.

Firms identified their top red tape headaches as: dealing with SARS, labour issues, dealing with their municipality, and compliance with BEE. Responses differed somewhat across industries – tourism firms were more concerned about municipal issues, while manufacturers were more likely to struggle with labour issues.

SMEs may have the potential to be the biggest creators of jobs in the country but procedural challenges inherent in our labour system hamper their willingness to hire. Indeed, red tape is further highlighted where small firms can spend up to eleven days per case at the CCMA to resolve a dispute. Furthermore, studies indicate that the average SME is taken to the CCMA twice a year. This represents a huge cost in terms of lost work days – creating direct and opportunity costs for SME owners.

The decline in the workforce employed by the SME sector is indicative of a corresponding decline in the total number of SMEs in the country. Indeed, the latest GEM statistics show that South Africa currently has more established small businesses closing down than new SMEs being founded. Moreover, the Davis Tax Committee Interim Report indicates the declining share of SME investment in the economy - from 12.9% in 2010 to 8.5% in 2012. This shows a backward trend to SME activity, a trend that South Africa can ill afford.

While South African economic policy places a high value on entrepreneurship, and recognises the need for more entrepreneurs to start businesses with the potential for growth – the regulatory environment offers a great deal of risk, administrative burden and opportunity cost. Small firms are expected to find time, money and expertise to manage copious quantities of bureaucracy – with very little support.

The Small Business Development Ministry

South Africa's first Small Business Ministry has a variety of international counterparts from which it can potentially draw learning.

The United Kingdom's Department for Business, Innovation & Skills was designed by entrepreneurs, rather than civil servants. Its impressive resource portal provides SMEs with skill investment, education and support in growing a business, and assistance in navigating red tape.

Brazil created a small business secretary in 2013. The office reports directly to the Presidency, and exercises ministerial powers. It recognises that SMEs' interactions with government are spread across a range of ministries. The role of the secretary is to coordinate and to prevent unnecessary regulation.

In Malaysia, responsibility for the running of the SME programmes and policies lies with the National SME Development Council, headed by the Prime Minister and the small business agency, SME Corporation. This solution pulls in the expertise of representatives from a variety of institutions and departments that actively engage with the SME, toward ensuring a broader understanding of the issues facing the sector. The approach has been praised for cutting back on unnecessary bureaucracy and cost.

In contrast, in India, a bloated cabinet has resulted in the small business ministry struggling to co-ordinate efforts with other ministries, and being regularly side-lined as a result.

Across the globe, experience has shown that small business ministries are more likely to succeed in supporting SME growth and sustainability when they are run by people with a deep understanding of the sector, and are built on robust partnerships with industry.

Conclusion

The creation of the Ministry of Small Business Development has the potential to dramatically improve the business environment for South Africa's SMEs –if the Ministry makes an effort to understand the complexity and diversity of the sector, and the need for carefully targeted policy responses. Different firms have different needs and will respond to different incentives. Policy and regulatory proposals need to recognise that SMEs are operating at very different stages of development and levels of sophistication. There can be no “one size fits all” approach to the small firm.

Regulatory reform should be an immediate priority. SBP's SME Growth Index demonstrates that small firms continue to suffer direct and opportunity costs as a result of unnecessary red tape and burdensome regulations.

Policy coherence and co-ordination is crucial. We would urge the Small Business Development Ministry to support more consistent and effective use of Regulatory Impact Assessments, as a mechanism to reduce the red tape burden for SMEs. Indeed, the National Small Business Act makes specific provisions for this.

Labour regulations are a key concern. Hiring and firing needs to be procedurally easier. And urgent interventions are needed to address skill shortages, and to support and incentivise SMEs in upskilling their employees, while ensuring that these programmes are easy to access with little bureaucracy.

We would urge the Minister to consider the recommendation of the Davis Report, that SARS and the National Treasury consider implementation of a separate tax incentive to encourage angel investors to support micro businesses that are too small to receive financial aid from government or commercial banks. Above all, we urge the new Ministry to recognise the diversity and heterogeneity of its sector, and to create targeted and specific support measures, that are sensitive to variations across industry, age and size of business, and ambitions for growth.

SOURCES:

1. SME Growth Index 2013
2. Global Entrepreneurship Monitor (GEM), 2012
3. Olawale, F. and Garwe, D., 2010. “Obstacles to the growth of new SMEs in South Africa: A principal component analysis approach” African Journal of Business Management, Vol. 4(5):729-738
4. SBP, 2004. “Counting the cost of Red Tape for Business in South Africa”, SBP Headline Report
5. Timm, S., 2012. “How the state and private sector can partner to boost support to SMEs: Lessons from Chile and Malaysia” A report for the Department of Trade and Industry and TIPS.
6. World Bank, 2011. “Improving the Business Environment for Growth and Job creation in South Africa: the second investment climate assessment”
7. World Economic Forum, 2013. “Global Competitiveness Report 2013-2014”
8. The Performance of the Department for Business, Innovation & Skills 2012-13. <http://www.nao.org.uk/wp-content/uploads/2015/01/Departmental-overview-the-performance-of-the-department-for-business-innovation-skills-2012-13.pdf>
9. <http://www.bdlive.co.za/business/2014/05/06/dragon-sees-benefits-of-small-business-ministry>
10. <http://www.treasury.gov.za/TaxReviewCommittee/DTC%20SME%20Report%20for%20Public%20Comment%2014%20July%202014.pdf>



SBP is a not for profit company specialising in improving the environment for doing business. We have worked in Africa and internationally since 1998 providing innovative solutions for policy formulation, better regulation and development in emerging markets. We have a special interest in small business as vehicles for growth and job creation.

79 Oxford Road, Saxonwold, Johannesburg, South Africa
PO Box 1051, Houghton 2041, Johannesburg, South Africa
T +27 11 486 0797, F +27 11 486 0798
www.sbp.org.za
info@sbp.org.za
www.smegrowthindex.co.za

SBP acknowledges the financial contribution of the Friedrich Naumann Foundation for Liberty.

Copyright SBP 2014. This work is copyrighted. It may only be reproduced or referenced either in whole or in part on the strict understanding that SBP is acknowledged in accordance with the provisions of the Copyright act, 1978.