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SME alert!
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An enabling environment for private sector growth

Lessons from international experience

Sound and stable macro-economic policies are an essential basis for development, but they have not been sufficient to encourage business growth in South Africa. In addition, the rate at which jobs have been created lags well behind the growth in the number of job seekers. Employment would have needed to expand more than 33 per cent since 1995 to have provided jobs for all new entrants in the job market[1].

A reappraisal of the enabling environment for private sector growth is crucial.

An enabling environment is good for all business, irrespective of size. Macro-economic stability is a critical element in such an environment. So too are legislative and institutional factors, together with an appropriate regulatory regime. The total package is important. But this is not always clear when seen through the eyes of the dominant private sector institutions – the corporates. While regulations affect the private sector as a whole, they weigh most heavily on smaller firms, which often do not have dedicated human resources staff, for example, or in-house tax specialists; more broadly, they do not have an official 'voice' in policy debates in South Africa since the unhappy demise of the National Small Business Council.

In setting out some key lessons from the international experience, this SME Alert establishes a framework within which South African policy-makers might usefully start to reassess their approach to private sector growth[2]. What emerges is that regulation and institutions matter.

International experience shows that an appropriate regulatory and institutional environment is the single most important element in an economic growth strategy. Only one other factor – a country's level of available skills, especially technical skills – is anywhere near as strongly correlated with per capita economic growth. However, interventions to improve the national regulatory and institutional environment within which business operates offer prospects for far more rapid impacts than inherently longer-term education and skills strategies.

The private sector and job creation

It is typically the private business sector that creates jobs and adds value by combining capital and labour to produce goods and service output. Development in market economies is driven by the efforts of large numbers of small firms complementing larger firms and co-ordinated by the market.

Government's role must be to create and implement an enabling environment. This is essentially about making markets work. Government must ensure that inappropriate legislation, regulations and administrative requirements do not prevent markets from operating effectively.

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In the early stages of development, small firms help to develop markets through trading activities, accumulating capital in the process. They help to develop a widespread commercial culture with the necessary skills, disciplines and organisation upon which further progress can be built. In later stages these functions continue, but as larger organisations emerge, SMEs increasingly carry out specialised activities which cannot be carried out optimally on a large scale, or can be sub-contracted to them, and therefore complement large firms[3].

Ratio of private to public sector job creation 1994-1998

Mexico	87:1
Costa Rica	20:1
Turkey	16:1
Kenya	13:1
Guatemala	12:1
Bolivia	10:1
Uruguay	5:1
Gabon	4:1

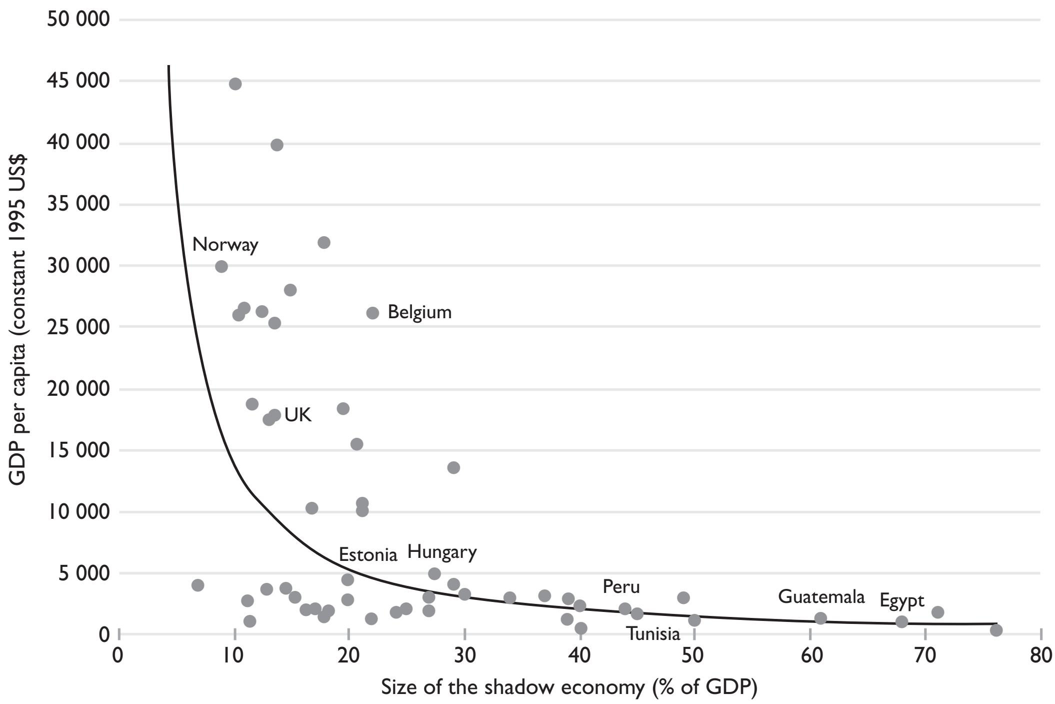
Source: Bannock, G *et al*, August 2002[4]

Inappropriate regulation: a barrier to development

Inappropriate regulation creates obstacles to the process outlined above by raising the costs of business entry and growth. In particular, inappropriate regulation and inadequate institutions for property rights and the rule of law create barriers to the transition from the subsistence and very small-scale economy to the modern more productive sector. Surveys conducted across Southern Africa indicate that less than one per cent of firms 'graduate' from the microenterprise seedbed and become established enterprises employing more than 10 workers[5].

A large informal sector can be a significant indication that the regulatory costs imposed on business are too high and the regulations themselves inappropriate. The size of the informal sector (shadow economy) is inversely related to economic devel-

GDP per capita and the size of the shadow economy



Source: Erneste & Schneider, 1998[6]

opment, as illustrated in the chart: *GDP per capita and the size of the shadow economy*.

The large number of small firms in developing countries is not in itself a sign of their underdevelopment; rather it is the fact that these firms are confined to subsistence and insufficiently productive activities. In the advanced countries the vast majority of business enterprises are also very small but they participate in the modern, formal economy and account for a disproportionate share of employment creation. Even in Africa (despite the regulatory barriers that are the subject of this study) surveys show that micro and small enterprises employ more than 40 per cent of all new entrants to the labour force. Under optimal circumstances perhaps five per cent of these enterprises grow to employ ten or more people. These figures suggest the potential to be realised if barriers to their growth were removed.

Even though regulations may not be enforced in the informal sector, inappropriate regulations act as a barrier to development by keeping a large proportion of the population out of the formal economy.

A single lead ministry focussed on supporting the indigenous private sector is crucial. In bringing about a more favorable enabling environment, political will, leadership and policy coherence are essential

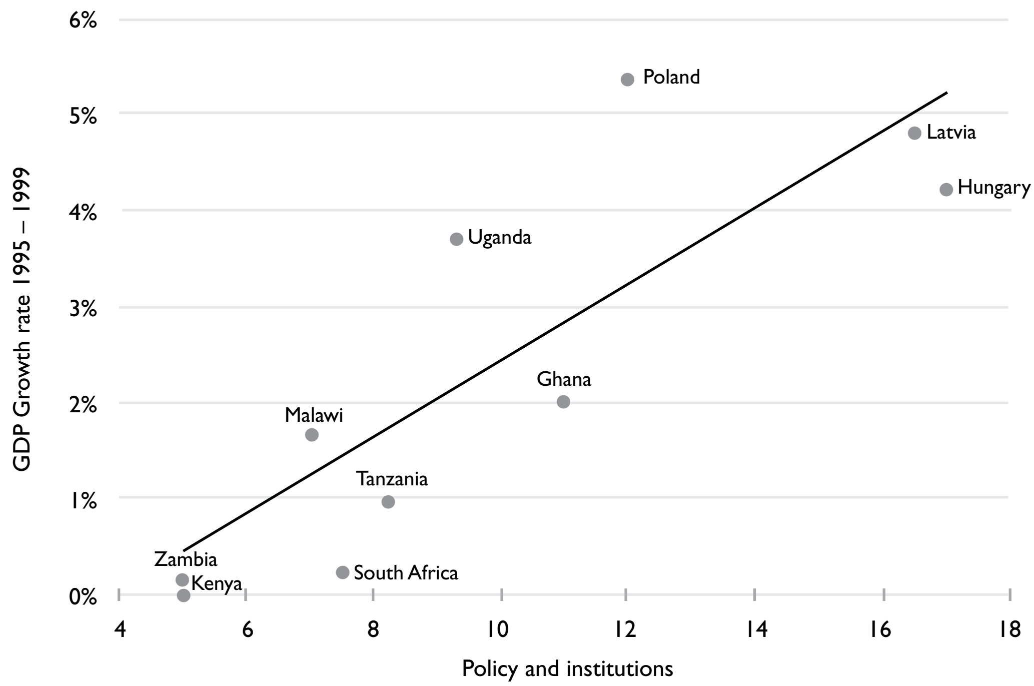
Counterproductively, inappropriate regulations offer incentives to remain small and informal. Regulatory regimes are in effect 'walls' that informal businesses have to scale in order to be formalised. Development requires formalisation because it is only when SMEs operate in the formal sector that they can access capital and utilise infrastructure in order to grow. The challenge is to turn the 'wall' into the most gentle slope possible.

It must also be noted that the more complex the regulatory apparatus, the more opportunities there are for corruption. This does not apply only to formal businesses. In many instances informal business owners have to pay bribes because they are not complying with regulations.

Regulatory costs

Regulatory problems affect rich, developed countries as well as lesser developed countries. The critical difference is that the costs of inappropriate

GDP per capita growth rate against sum of policy and institutions to improve the enabling environment: 1995-1999



Source: Bannock, G *et al*, August 2002[9]

Few countries in Africa have policy frameworks premised explicitly on the need to remove legislative obstacles to private sector development

regulation are proportionally greater for developing countries. Moreover, recent research shows that the regulatory costs in most respects (and in relation to incomes) now seem to be much higher in the developing world than in the advanced countries[7]. (See box: *The hassle factor of over-regulation*) Regulatory costs may or may not deter entrepreneurship, but they certainly make it more difficult to start and expand a business[8].

Few countries in Africa have policy frameworks premised explicitly on the need to remove legislative obstacles to private sector development. Most focus on promoting support services instead of removing barriers which could render support unnecessary. This relates to the mindset of policy-makers where transaction costs are all too often not adequately considered. It is also notable that, in Africa in general, the private sector is hardly consulted in the policy formulation process.

Although it cannot be guaranteed that the adoption of the favoured institutional and policy mix will bring higher GDP growth, a recent ten country study shows that differences in policy and policy implementation are reflected in dramatically different rates of growth of GDP per capita achieved. See the chart: *GDP per capita growth rate against sum of policy and institutions to improve the enabling environment: 1995-1999.*

Better regulation not simply deregulation

Questioning the regulatory environment may arouse concerns that standards will be undermined if regulations are relaxed.

Regulation inevitably raises the costs of business entry and operation, but some regulation is desirable and indeed necessary, for example to raise tax revenues and maintain reasonable environmental, health and safety standards. Certain minimum standards – environmental protection, health, prevention of child labour – are non-negotiable. But when imposed at unrealistic levels, regulation divides the economy into formal and informal sectors and erects barriers between the two which perpetuates the division. Where regulations are too complex they often compromise standards by inadvertently providing an incentive for entrepreneurs to evade official regulation. In over-regulated systems many regulations cannot be fully enforced, and this brings the law into disrepute and encourages corruption. It must also be said that under-regulation can be just as problematic. For example, it caused the near collapse of the banking system in Zambia.

The argument is for better regulation, and for better enforcement of a simplified regulatory structure.

The hassle factor of over-regulation

Policy-makers have choices when it comes to regulation. The following examples illustrate how they can sometimes make bad ones:

• In Tanzania, in 1996 a firm could expect to submit at least 89 separate filings per year compared to 21 in Ghana, 29 in Namibia and 48 in Uganda. In addition, a bank was expected to submit 285 returns through the course of a year while a hotel was required to submit more than 454 separate documents to various agencies within government. Since then, there have been significant improvements in Tanzania.[10] For example, delays on business registration have been reduced from 90 to as little as 3 days.

• In the UK, Australia and Japan, the paperwork involved in setting up a company takes about one week to complete. In Italy and Spain the process can take some months.[11] Hernando de Soto's Institute for Liberty and Democracy discovered that in Peru registering a business required 11 different procedures lasting a total of 289 days.[12]

• Business entry costs as a percentage of GDP per capita are less than 3% at best in the advanced countries, 67% in Central Europe and 94% in Africa.

There are also examples of what can be done to improve the enabling environment:

• In Kenya, reforms to the licensing system have been introduced which, when fully completed, will reduce compliance costs by 1% of GDP annually.

• In Uganda, a commitment is being given to customs goods clearance within 24 hours.

A large informal sector can be a significant indication that the regulatory costs imposed on business are too high and inappropriate

Regulatory impact assessments

A single lead ministry focussed on supporting the indigenous private sector is crucial, more important even than a small business act.

One of the reasons is that such a department can provide a home for a regulatory impact assessment unit.

Internationally, the use of regulatory impact assessments to predict the likely consequences of particular legislative changes has become more and more prevalent. Typically, they set out to identify the problem or issue that gives rise to the need for action, the desired objective and options available. This is followed by outlining the costs and benefits of each of the options, setting out a consultation process, and providing recommendations and a strategy for achieving the desired outcome.[13]

Regulatory impact assessments do not solve all the problems but experiences around the world show that they can make a big difference.

Fostering entrepreneurship: Broad principles[14]

In 1998, the OECD provided broad policy guidelines based on a five country study (Australia, the Netherlands, Spain, Sweden and the US) which yielded important indicators of policies that foster entrepreneurship.

- Examine the overall institutional framework within which economic activity takes place in order to establish whether it provides maximum scope for entrepreneurship to flourish.
- Ensure that specific programmes designed to foster entrepreneurship operate as part of an integrated and coherent strategy that complements the framework conditions.
- Improve the effectiveness of entrepreneurship programs by drawing on the knowledge of local levels of government.

A single lead ministry can also provide coherent leadership. Established interests often feel threatened by the move from over-regulation to more appropriate regulation. In bringing about a more favorable enabling environment, political will, leadership and policy coherence are essential.

Fostering entrepreneurship: Some specifics[15]

- Identify and dismantle barriers to competition which limit the incentives of enterprises to innovate and perform more dynamically.
- Examine whether current regulations governing financial institutions and/or financial markets inhibit or facilitate the availability and optimal allocation of finance for entrepreneurial activities.
- Allow scope for flexible employment contracts to be negotiated, with remuneration arrangements and working conditions that are well adapted to the needs of dynamic enterprises.
- Relax employment protection measures that inhibit restructuring or discourage firms from taking on new workers.
- Examine the cost of complying with government-imposed administrative or regulatory requirements and identify where reductions could be made.
- Examine the overall effects of the tax system on entrepreneurship, and identify features that discourage entrepreneurs or the financing of entrepreneurial activity; ensure that the tax system is transparent and that compliance is straightforward.
- Review and simplify the registration procedures required to create a business and ensure that firms are able to close quickly should they wish to.
- Ensure that personal bankruptcy legislation provides an appropriate balance between encouraging risk-taking and protecting creditors.
- Examine the effects that social insurance provisions may have on encouraging or discouraging would-be entrepreneurs.
- Avoid policies that stem from too narrow a definition of entrepreneurship (e.g. that entrepreneurship is only about startups or only about high technology) and which may divert attention from getting the broader economic policy settings right.
- Widen the target population for entrepreneurship programmes to attract the participation of women, the young and minorities.
- Undertake regular and comprehensive evaluation of programmess, and ensure that evaluation findings are acted on.

Endnotes

1 This figure is based on research by the Development Policy Research Unit quoted in 'Matric farewell' in *Business Day* 28 December 2001.

2 This edition of SME Alert incorporates the findings of a ten country study co-ordinated by Bannock Consulting. This study was undertaken for the Department of International Development. It reviewed the machinery and policies used in seven countries in sub-Saharan Africa (South Africa, Zambia, Tanzania, Kenya, Uganda, Ghana and Malawi) and three in Central Europe (Poland, Hungary and Latvia). The SBP undertook the study in South Africa. The results of the study were presented and discussed at six workshops co-ordinated by the SBP in Botswana, Lesotho, Namibia, Cape Town, East London and Pretoria.

3 Bannock, G *et al*, August 2002: *Indigenous private sector development and regulation in Africa and Central Europe: A 10 country study*, p.11.

4 Quoted in Bannock, G *et al*, August 2002: *Indigenous private sector development and regulation in Africa and Central Europe: A 10 country study*, p.13.

5 Mead, DC and Liedholm, C, 1998: 'The dynamics of micro and small enterprises in developing countries', *World Development*, 26, p.67.

6 Eneste & Schneider, 1998 and WDI, 2001. Including 53 developed and developing countries from all continents, except Australia. The OECD country data is based on the average WB-reported GDP per capita (constant 1995 US$) and the average informal sector share of GDP (as calculated through the physical input method by Eneste et al) 1990-93. The same methods apply for the rest of the countries for the period 1989-90.

7 Bannock, G *et al*, August 2002: *Indigenous private sector development and regulation in Africa and Central Europe: A 10 country study*.

8 Bannock, G, 2001: 'Controlling regulation' in *Regulation and the small firm* Journal of The Institute of Economic Affairs, Volume 21 No 2, June 2001, p.2.

9 Bannock, G *et al*, August 2002: *Indigenous private sector development and regulation in Africa and Central Europe: A 10 country study*, p.54. Rating of policy and institutions by Bannock Consulting, based on detailed case studies against 20 key indicators.

10 Macculloch, F, 2001: 'Government administrative burdens on SMEs in East Africa: Reviewing issues and actions' in *Regulation and the small firm*, Journal of The Institute of Economic Affairs, Volume 21 No 2, June 2001, p.10.

11 OECD, 1998: *Fostering entrepreneurship*, Policy brief Number 9, 1998; quoted in 'Policy options to promote entrepreneurship' in *Economic Reform Today*, Centre for International Private Enterprise Number 4, 1998.

12 CIPE, 1998: 'Growing an entrepreneurial economy' in *Economic Reform Today*, Centre for International Private Enterprise Number 4, 1998, p.4.

13 Evans, C, 2001: 'The operating costs of taxation: A review of the research' in *Regulation and the small firm*, Journal of The Institute of Economic Affairs, Volume 21 No 2, June 2001, p7.

14 OECD, 1998: pp.28-30.

15 OECD, 1998.

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SME Alert! is published by SBP - the Small Business Project. SBP is a specialist support and research unit engaged in small business development. It is an independent private sector section 21 company.

SBP has pioneered the Private sector initiative (Psi) as a vehicle for corporations to work in partnership with each other, donor agencies and governments in market-driven enterprise development. Unlike traditional linkage programmes, SBP projects are not primarily about helping new businesses to get started, but assist existing small firms to perform better, grow, employ more people and add value to the local supply chain, as a means to local economic development.

Based on its success in South Africa, SBP is now expanding its activities into a number of other African countries.

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