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SME alert

an SBP publication promoting regulatory best practice

Is South Africa a good place to do business?

'Too much red tape' is the common complaint of many South African businesses. Business associations have the impression not only of over-regulation, but of poorly drafted regulation or of good law being poorly implemented; all of which act to constrain business growth and investment, hobble enterprise and can cost jobs. Since 1994 government has passed more than 1 000 pieces of legislation which have spawned a myriad regulations.[1] The cumulative impact of this legislation – not just the individual pieces – adds to the complexity of doing business.

Finance minister Trevor Manuel was recently quoted as saying that the government has constructed 'new channels of bureaucracy' which are 'obstacles to people trying to do business'.[2]

Is the level and cost of regulation in South Africa inappropriate, particularly for small and medium enterprises (SMEs)? Is over-regulation clogging up the statute books? Is there room to 'lighten up' on the regulatory load while not undermining health and safety standards and workers' rights? Can business burdens be measured in a meaningful sense?

The right answer is that we don't know. South Africa does not have strong research-based evidence from which to draw conclusions and advocate for a better environment conducive to business growth, investment and job creation.

Evidence is often patchy, contradictory, over-reliant on anecdote and reported 'perceptions'. For this reason comments and complaints about the extent of 'over-regulation' must necessarily be somewhat speculative. They do however, paint a picture of South African business in a tight spot.

This *SME Alert* captures some current concerns relating to the regulatory environment. It does so in the context of regulatory best practice (RBP) and from a small business perspective, often overlooked in public debates.

Not all businesses are affected by regulation in the same way. Sectoral considerations, the size of the firm, how long it has been in operation, whether the firm is in the formal or informal sector all play a role. And, while the focus of this *SME Alert* is on the regulatory environment and its impact on business, SBP is well aware of other factors that play a role in boosting or hampering entrepreneurship – including crime, poor infrastructure, low savings rates, quality and availability of staff, and the role of attitude in entrepreneurial orientation. However, there is enough evidence to suggest that a shift to a regulatory environment that reduces the administrative burden for SMEs would be a positive investment in South Africa's future.

SBP is not arguing that business interests should be the sole determinant of public policy. Nor are we saying that regulation is necessarily a bad thing. What is important is that the cost of regulation be assessed against the benefits. Our message is a modest one: policy should take full account of the practical realities for businesses, particularly SMEs. Why? It is trite but true to say that a flourishing small business sector holds the potential to dent unemployment, drive growth, create jobs, and make a major contribution to successful black economic empowerment.

small business project

South Africa needs better regulation or in some cases re-regulation, not simply deregulation

And now for something slightly different

The SBP's research agenda over the next 24 months will explore these issues in greater detail, adding depth and texture to the picture presented here and the issues raised as we attempt to measure the costs of doing business. Specifically we are undertaking a national survey to identify those regulations that impose disproportionate costs on business, particularly SMEs. The overall objective is threefold:

- To measure the regulatory compliance costs (RCCs) of doing business, to the extent that this is possible. RCCs are the cost of staff time, bought-in services such as accountants and lawyers and incidentals such as books and postage, incurred in meeting regulatory requirements. Capital costs (such as smokestack equipment) are also included in RCC calculations but for simplicity are normally left out of survey work. RCCs consume real resources which could have alternative uses. More needs to be known about the real burdens faced by business, in particular small business; burdens which must be weighed against the benefits deriving from the regulation. The exploratory nature of this work must be stressed.
- To further increase the profile of RBP, and specifically the use of regulatory impact assessments (RIAs) – a key element in improving regulation. SBP has argued that South Africa needs better regulation or in some cases re-regulation, not simply deregulation.
- To inject more of a small business perspective into policy debates and thus give greater weight to the interests of this sector – which has been without an official voice since the demise of the National Small Business Council in 1997.[3]

In the bustle of national legislation, the interests of small business are often at risk of being lost. Injecting a small business perspective into policy debates will always be difficult. Few entrepreneurs have the time and/or inclination to participate in representative bodies as they are too busy running their businesses. The claim that business associations tend to neglect issues which impact most on small business has a ring of truth to it, given the predominance of corporate power in many associations. One way of giving voice to small entrepreneurs is for government to introduce RIAs into the process of governing.

What is regulatory best practice?

Governments create the environment within which business operates. This comprises policies, legislation, regulation and administration. RBP is the idea that this environment should be as favourable to trade and investment as possible – which in practice means both minimising compliance costs (red tape) for firms as well as ensuring the administrative burden facing government agencies is within their capacities. RBP is intended to facilitate investment, the growth and development of established firms, the establishment of new enterprises and the formalisation of previously informal business.

The big task of thinking 'small', fast

Those still labouring under the impression that the small business sector is mainly comprised of mom-and-pop stores, sidewalk hawkers, Piet's boerewors rolls sold at the side of the road, and baking housewives need a wake-up call. According to Jo Schwenke of Business Partners, 'In South Africa about 95% of the 600 000-odd formal businesses are SMEs. They account for an estimated 35% of the nation's gross domestic product of about R1 000 billion. This means that the SME sector makes a contribution to our GDP estimated at R350 billion.'[4] In addition, Schwenke notes that for every investment in an entrepreneurial business, an average of 15 jobs are created.

Minister of trade and industry, Alec Erwin, has said that the 35% contribution to GDP should actually be ranging between 60% and 80% – something which would be achievable only in the next ten to 15 years.[5] Smart thinking is needed, fast, if we are to improve on this.

Compliance costs vary with firm size; small business suffers most. Regulations impose disproportionate costs on SMEs because of their limited administrative resources and uncertain cash flows. To quote a disgruntled small retailer, large corporates have 'a department full of lawyers to deal with this junk. I have me.'[6] An OECD report, *Businesses' view on red tape*, estimates that compliance costs burdens on business average around 4% of the Business Sector GDP across the eleven countries studied. Examining the costs of administrative compliance in almost 8 000 SMEs, the report found that compliance costs per employee were over five times higher for the smallest SMEs than for the largest. An American study concluded that firms employing fewer than 20 employees face an annual regulatory bill of US $6 975 per employee. This burden is 60% higher than that faced by firms with more than 500 employees.

Compliance costs vary with firm size; small business suffers most

Noting the importance of SMEs to economic growth as well as the disproportionate impact of regulations on them, how can government programmes boost SME development most helpfully?

The OECD's report *From red tape to smart tape* distinguishes three approaches:

- active assistance to small businesses, in particular to meet the administrative compliance requirements of regulations;
- exemption or modification of the requirements themselves to make them less onerous for SMEs; and
- establishment of specific mechanisms to ensure that regulatory design takes better account of small businesses' needs and concerns in establishing new compliance burdens.

Problems and unintended consequences can attach to both the first and second approaches suggested. In South Africa, government's approach to SMEs through its support services and assistance has met with little success (see box *From SME support to removing barriers: Can government change direction?*).

The OECD argues that discrimination in favour of SMEs may have dynamic drawbacks by providing SMEs with incentives not to grow beyond thresholds qualifying for special support, or to break up strategically as soon as the threshold is passed.[7] Illustratively, a study of VAT collection costs in the UK showed that 18% of non-registered businesses stated that they intentionally forego growth so that their turnover remains below the VAT-registration limit. In addition, exemptions should not be used as a 'get out' option for poorly designed regulations.[8]

The third approach – namely, the establishment of specific mechanisms to ensure that regulatory design takes better account of small businesses needs and concerns in establishing compliance burdens – is the most promising. This can be done through the mechanism of RIAs to assess the likely impact of regulations – as in the US, the UK, New Zealand, Australia and Uganda. While RIAs are no panacea, they can be an instrument to decrease the barriers to SME development, as a key part of the assessment revolves around small business compliance issues. In the UK, for example, regulators are reminded to 'think small first' in assessing the cost of proposed new regulations.

If we want to get entrepreneurs into the formal sector, it is difficult to overstate the importance of cutting red tape and in so doing curb the tendency to non-compliance.

The complications of simplification

RIAs offer the most promising solution. But simplifying regulations and their administration is an enormously complex process which must be integrated into government's broader efforts to improve regulatory quality and RBP. The process 'may be considered "intrusive" to the integrity of individual departments.'[9] But this sensitivity needs to be balanced against the need to boost private sector growth and job creation. Getting RIAs embedded into the process of governing would serve other purposes too. For example, it would act as a strong corrective to bureaucratic conservatism, to vested interests eager

From red tape to smart tape:
Trends in OECD regulation

- Focus is shifting from examining the cost of existing regulation to ensuring that unnecessary burdens are not imposed in the first place.
- Simplification initiatives are being integrated into broader government programmes.
- Simpler regulation is being driven by recognition that businesses should be free to conduct their affairs except where there is a compelling case to protect the public.
- Simplification is being driven by IT mechanisms.

Source: OECD

to preserve the status quo and their privileged position within it, as well as sending a powerful message to investors that South Africa is a 'good place to do business'.

Don't forget, government can save too

Often forgotten, but very important is that a lighter regulatory touch has benefits and savings to government itself. Enforcement can be expensive. Government has to pay people to do it, train them and provide equipment they may need.[10] An international small business expert has pointed out that while the compliance burden is mainly carried by business at 80%, government has the rest of the burden. Governments are rarely aware of the extent of the total administrative burdens imposed not only on businesses – particularly SMEs – but on government itself, nor of the cost-efficiency of many of the regulatory simplification mechanisms. In the Netherlands work done by ACTAL (Advisory Committee on the Testing of Administrative Burdens) has prompted simplification of administrative procedures in the areas of corporate taxation, social security, environmental regulation, and statistical requirements. The estimated savings are US $600 million from streamlining the tax requirements alone.[11]

The savings are not just effected in monetary terms. Ill-informed regulation not only creates 'red tape' for business but more bureaucracy for the public sector. Using RIAs offers an early opportunity to see potential problems and unintended consequences that could be damaging or embarrassing to government.

While some regulation is desirable and necessary – for example, to generate tax revenue and maintain reasonable safety and environmental standards – consideration might usefully be given to non-regulatory alternatives where possible. Equally important is the option to 'do nothing' and not resort to the blunt regulatory fix. Alternatives to 'rules and regulations' should be considered and weighed up alongside the need for businesses to have certainty regarding the 'rules of the game'.

The World Bank, doing business, and some confusion…

Covering 133 countries, the recently released World Bank's *Doing Business in 2004* shows that higher regulatory costs are associated with more poverty, larger informal sectors, higher unemployment, lower productivity, longer delays, more corruption and so on. The report focuses on five aspects of business activity in different countries: starting a business, hiring and firing, contract enforcement, getting credit and closing a business. Rigid employment regulation is associated with more poverty in developing countries. The regulatory framework is closely correlated with prosperity or lack thereof. Rich countries – Australia, Canada, the UK – regulate less. Poorer countries – Mozambique, Burkina Faso – regulate business the most, and in more cumbersome ways.

Is South Africa a good place to do business? According to the World Bank report, while not in the top 10 in terms of favourable regulatory environments, doing business in South Africa is not that different from doing business in prosperous countries elsewhere. Surprising many, the report found that we place fewer regulatory burdens on employers than do many other countries.

South Africa is the ranked as the eighth least regulated country on labour laws – only marginally more regulated than the UK or the US. However, some caution is needed. *Doing Business* covered just one aspect of labour law, namely employment regulation. Social security laws, industrial relations and workplace safety aspects were not covered.

While not wishing to downplay South Africa's fairly positive rating, it must be noted that the survey does not cover the entire regulatory framework of doing business – business licences, property registers, corporate governance, trade infrastructure, law enforcement and tax policy, for example, were not

Good vibrations: Abalone fishing

At the end of August 2003, *Financial Mail* reported that the Department of Environmental Affairs and Tourism's proposed policy for abalone fishing came close to following the RIA model for developing policy. The department's draft policy document discusses the likely impact on the abalone fishing impact of each of three options: to maintain the status quo; to close commercial and recreational abalone fishing; or to co-manage the abalone resource together with fishing-rights holders and the coastal communities. The department explained why it chose co-management as the most viable option.[12] This approach to policy development is to be welcomed.

included. They are however, important features of the regulatory environment within which business operates, as *Doing Business* itself recognises.

But perhaps most importantly, the findings for South Africa need to be set against telling examples of regulatory hassles that have been reported - some of them emerging from within the World Bank itself.

Some examples of regulatory squeeze

- The 2003 International Business Owner's survey by Grant Thornton reports that a large section of South African business owners see regulation as the major constraint on business expansion: 46% versus the global average of 35%.
- A recent survey conducted on a small sample of SMEs in South Africa showed that, in general, businesses have to comply with over 140 pieces of regulation.
- No government anywhere lets entrepreneurs register a new business in a single procedure but *Doing Business* notes that some come closer than others. Reportedly, it takes 38 days to register a new business in South Africa – faster than Germany, the Netherlands and China and definitely faster than the 203 it takes in Haiti and the 215 in the Democratic Republic of Congo. However, for business entry only two procedures – registering for statistical purposes, and for tax and social security – are absolutely necessary to fulfill the social functions of the process. Australia limits entry procedures to these two. This may well be a case where less is more.
- *Doing Business* noted that South Africa was slower than Zimbabwe and Cote d'Ivoire in enforcing legal contracts, taking 207 days to go through the legal process. Granted South Africa does better than Guatemala where it apparently takes four years to enforce a contract.
- Taxation ranks high as a source of regulatory cost and difficulty for the private sector. The Katz Commission Report noted that the minimum number of returns to be submitted by any small enterprise totals 46 - 3 for income tax; 13 for PAYE; 6 for VAT; 12 for RSC levies; and 12 for UIF.[13] In addition, there are the skills development levies, provisional tax returns, company tax (shareowner's withholding taxes), property tax, sales tax, excise duties, customs tax, and so on. Each additional tax imposes administrative burdens on the taxpayer. Many of these returns are required to be submitted on a monthly basis which places an added burden on business to keep its records up to date.[19] For many small entrepreneurs their role as unpaid tax collection agents for government

A large section of South African business owners see regulation as the major constraint on business expansion

From SME support to removing barriers for entrepreneurs:
Can government change direction?

The SBP has previously argued that rather than promote support services for entrepreneurs, government's explicit focus should shift to removing barriers that could render the support less necessary.[14] This argument is persuasive for three main reasons:

- Government's track record in supporting South Africa's entrepreneurs is not spectacular. The Trade and Industry Policy Secretariat (TIPS) quotes a survey in 2000 showing that 57% of emerging SMMEs interviewed in Gauteng and 70% in the Western Cape, for example, had never had contact with or even heard of any small business support institution.[15] A World Bank survey indicated that 'no more than 20% of SMMEs were aware of Khula and Ntsika programmes.[17] There is an uneven spread of where, how and in which field services are offered. Poor co-ordination results in a replication of services, and clustering of institutions in urban areas.[16]
- An undesirable consequence of government involvement in this field is that private business service providers may find it difficult to compete, and are crowded out.
- International research shows that the single most important thing that government can do to stimulate the growth of small and medium business is to get rid of burdensome and inappropriate regulations.[18] Remove unnecessary regulatory barriers and the private sector may well bloom.

comes at a high price – high administrative costs, having to hire experts to manage the compliance burden, and the greater costs that result from tax-induced distortions in the pattern of savings, investment and production.[20] Particularly difficult is SARS' decision that VAT should be paid on invoice, not on receipt of payment. This has led to cash flow problems for small businesses sub-contracting to larger entities that are slow to pay.

- Many small businesses see the Skills Development programme – revolving around levies on the payrolls of businesses and learnerships – as 'just another tax'.[20] Being unable to reclaim their levy for financial or administrative reasons, many SMEs have not yet produced a training plan that can be recognised by their Sector Education Training Authority, and end up paying their levy without recovering it. Moreover, according to the Department of Labour the average 20-employee enterprise pays a levy of R8 516 but can only claim a maximum of R5 961, suggesting that costs may exceed benefits.[21]
- An inhospitable legal and regulatory framework has been criticised for blocking the availability of finance for SMEs. The key issue is how to direct capacity and resources towards small business lending and remove regulatory restrictions that hamper this, while at the same time ensuring consumer protection. A prominent banker argues that 'the absence of an appropriate and favourable legal framework is a major impediment to the availability of finance for SMEs.' The Usury Act and Credit Agreement Act which regulate the contractual aspects of credit granting, have been criticised in this context. An investment consultant contends that, the Usury Act 'needs to be redefined. People should be rewarded for risk.'[22]
- According to the *National Small Business Regulatory Review*, 'the rigidity of many land use and transport planning frameworks makes no provision for the objective of supporting small businesses. The rigidity inherent in land use plans often works against small businesses, which typically use land in a mixed way, not separating residential, light industrial and retail uses'.[23]

Present legislation on insolvency and bankruptcy ... contains a glut of obsolete provisions and is often obscure

- The process of exiting a business in South Africa via liquidation is protracted and expensive for a SMEs. Present legislation on insolvency and bankruptcy – incorporated into the Insolvency Act No 24 of 1936 – contains a glut of obsolete provisions and is often obscure. It is sometimes necessary to refer to the common law, the Insolvency Act, the Companies Act or the Close Corporations Act. While this situation is not helpful, *Doing Business* notes that a typical business bankruptcy, which might take six months in Ireland or Japan, can take more than 10 years in Brazil and India – so South Africa's 2 years needs to be viewed in this context.
- Unemployment has doubled since 1996. At the same time South Africa's labour market has become more regulated. Is there a connection? Some three years ago, the World Bank, in partnership with the then Greater Johannesburg Metropolitan Council, undertook a study of 325 manufacturing firms – each with more than 50 employees, in eight manufacturing areas – in the greater Johannesburg Metropolitan area. According to this report, labour laws had adversely affected employment and investment. In particular, interviewees commented on the 'hassle factor' caused by new labour regulation – the 1996 Labour Relations Act, the 1997 Basic Conditions of Employment Act, the 1998 Employment Equity Act, and the 1998 Skills Development Levy – including the time and resources consumed by union negotiations, hiring and firing, disciplinary enquiries, etc. While it was 'not any one law or particular piece of legislation per se, [the] collective effect of all pieces of labour legislation ... raise the transaction costs of firms to hire and fire workers in response to rapidly changing global demand patterns'.[24] The report noted *inter alia* that:
  - it took 2,7 months on average to retrench an entry-level worker;
  - it cost R9 000 to hire and R2 160 – R2 900 to fire a least skilled worker;
  - partly as a result, some 40% of firms hired fewer workers, used more machinery, hired temporary staff, and/or subcontracted.

A recent *Economist Intelligence Unit* report described the labour market as a major deterrent to foreign direct investment and a handicap to the country in competing with other emerging markets. The practice of setting minimum wages sector by sector would continue to add to the burden of employers.

SBP interviews for the UK-funded public grant scheme British Investment in South Africa (BIS) have consistently identified the hassle factor associated with labour administration as a major problem, shaping investment in a capital intensive direction.

Agreements reached in bargaining councils can be made binding on unions, workers and employers who have not signed them – 'non-parties' in the official terminology. One interviewee no ted, 'Bargaining council agreements between big business and unions grind little people and are bad for SMEs. If SMEs choose not to join the union or industrial council, why should they be bound by it?'[25]

Recently, small manufacturers complained that their survival in the face of cheap imports was at risk unless they could pay more production-related rates than those decreed by the council. While small businesses can apply for an exemption, the companies with the resources to do this are the big ones, not the small ones.[25]

Conclusion

Doing Business in 2004 suggests South Africa is not doing badly by international standards. This is good for our confidence levels. But the need to boost investment and job creation suggests continued pressure for streamlining the regulatory environment further. There is enough evidence to suggest a strong case for asking further questions.

In this context, the importance of a comprehensive regulatory impact study that details the costs to business of the legislation and regulations that govern it cannot be overstated.

SMEs speak

'Government has enacted labour legislation, including the Unemployment Insurance Fund, which creates an administrative nightmare. Instead of focusing on helping small business, government keeps us busy with admin. Labour legislation was not created by businesspeople. It was created by politicians, who have not been in business. That is the problem. They look at it from a socialist perspective, not a realistic one reflecting the situation on the ground.'

Entrepreneur at SBP focus group

'Instead of a gradual transition from an informal undertaking to a formal one, the entrepreneur who starts a formal business hits a wall of unsympathetic officialdom, inspectors, rules, regulations, laws and, worst of all, levies and taxes. This environment encourages many small businessmen to remain small or stick to informal micro businesses with the minimum number of employees. It also leads to tax evasion and tremendous problems for government. The business environment should be made so simple that compliance with the law and regulations is easy, automatic and logical.'

Letter to the *Financial Mail* [26]

'VAT calculations are not easy. The real question for the SME is "do you have the time to fill out the VAT application form?" You are forced to employ an accountant to do your taxes. This is unavoidable. I need a tax certificate to tender for government contracts.'

Entrepreneur at SBP focus group

'SARS is the biggest block in the wall – documents are lost, payments mislaid, fax machines do not work, appointments are ignored ... I have to date spent R10 000 of my chargeable time trying to sort out SARS problems this year alone. How do we encourage SMEs? By making life easier for us, not expecting us to be fountains of money for government use…and not assuming that we are hiding wealth and accusing us of deceiving the Receiver.'

Entrepreneur in software industry[27]

'It's not that the skills levy is a big hassle on its own, but when you add it to all the other paperwork, I don't have enough time to focus on the rest of the business'.

Entrepreneur interviewed as part of the BIS scheme

'South Africa banks don't have a clue when it comes to SMEs – the problem wasn't the business plan because the IDC used those figures to give us a loan. Why would you want to know your bank manager? He has no discretion. He just implements a formula sent down from head office.'

Entrepreneur interviewed as part of the BIS scheme

SME alert

Endnotes

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