SMEs and Employment in South Africa (2012)

SME Growth Index Thematic Paper

Prepared for the Employment Promotion Programme

By

Professor Neil Rankin	Chris Darroll	Terence Corrigan
Stellenbosch University	Chief Executive, SBP	Research Director, SBP

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1. Introduction

Little excites passions in South Africa like the issue of unemployment. This is for good reason: unemployment is not just a driver of poverty, but undermines social and political stability. Sufficiently widespread, it can undermine whole societies. It has been a feature lurking behind turmoil throughout the world, from the uprisings in North Africa, to rioting and the virtual collapse of governments in Europe. All of this is deeply alarming for South Africa, since it faces an unemployment malaise of quite possibly greater proportions.

Officially, South Africa's unemployment rate hovers around 25.5%. This is a serious problem in itself, around double the rate in Egypt, and about a third higher than that of Tunisia. But, as is often noted, it is a major undercount of the actual shortage of jobs; once provision is made for those who are out of work, but whose circumstances do not match the criteria of "unemployment", the unemployment rate escalates to well above 30%.

South Africa's National Development Plan envisions that the majority of the jobs South Africa will create in the future will be in small and medium enterprises (SMEs). This is not a novel idea, reflecting international experience. A vast body of research agrees that in today's economy, SMEs are the primary producers of jobs, often jobs that provide a crucial entry into the formal market for job seekers. In Brazil, for example, whose economy in many respects resembles South Africa's, it is estimated that around 96% of jobs are produced by SMEs – and Brazil's nurturing of its entrepreneurs has been widely noted.

For South Africa, SME development to absorb the unemployed has been a repeated expectation in every domestic economic plan – and a great many economic documents besides – for at least two decades. The outcome of this putative commitment has been questionable. But the impact of the global economic crisis, the growing strain on the fiscus, and the visible desperation of a large part of the population, are underlining the urgency of invigorating the SME economy. Failure to do so could well have tragic consequences.

If the importance of SMEs to alleviating unemployment, and to economic development in general, are widely recognised, the question arises as to whether they are performing this function.

The SME Growth Index, the second iteration of which was published in February 2013, attempts to fill some of the numerous information gaps that dog discussion around SMEs and the policy options that might contribute to their growth. The research was undertaken with the explicit intention of making a contribution to the policy debate and enabling prudent, evidence-based courses of action.

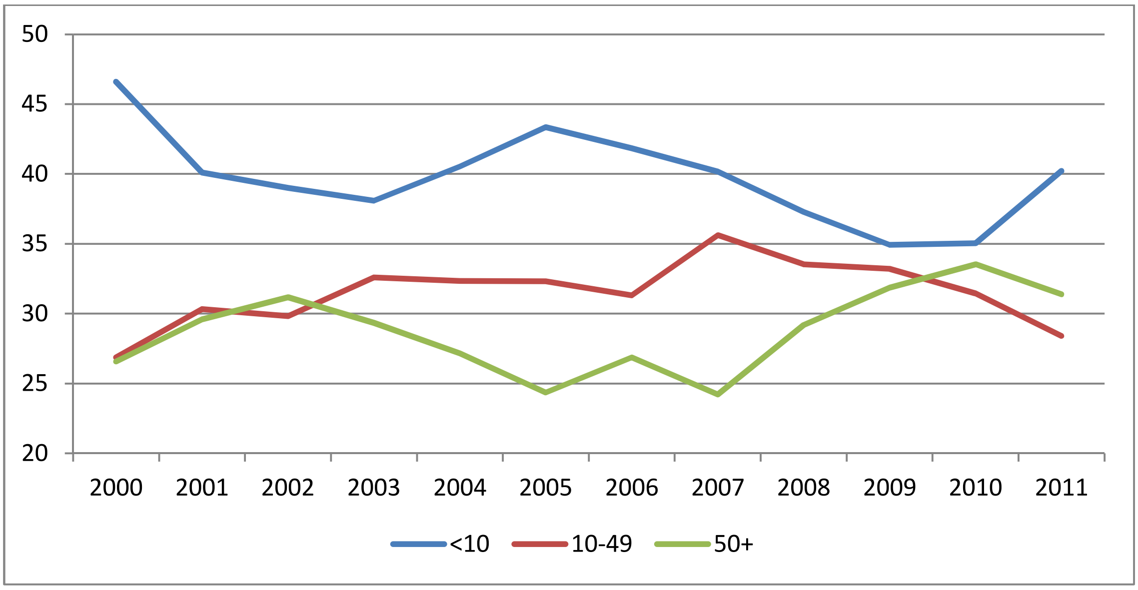
This paper applies the insights garnered from the Index to a broader assessment of the role that SMEs are playing in respect of employment, attempting to identify the trajectory of small firm employment and its implications for policy.

2. Broad trends in firm employment

Broader trends in the South African economy indicate that SMEs are becoming less important as job creators, not more. Data from the Labour Force Surveys suggest that the proportion of people working in firms employing fewer than 50 people has been declining since 2000. Since 2008, it seems that the share of employment among firms employing fewer than 10 employees, and those employing between 10-49 employees has been shrinking. The lack of small firm job creation is confirmed by research which has looked at job creation using official Statistics South Africa data on businesses. One study shows that between 2005 and 2011, there was net job destruction in all size categories of firms with less than 500 employees. Official data from both surveys and firms suggest that large firms are becoming a more important source of job creation and the role of small firms as job creators in the South African economy is being reduced. This is in contrast to much of the international experience, where SMEs account for growing proportions of the employment created.

Data from Stats SA demonstrates clearly the overall trend in the distribution of employment over the past decade. Dividing employment into three broad categories (i.e., firms employing fewer than 10 people; firms employing between 10 and 49 people, or the group covered by the SME Growth index; and firms employing 50 and more people) highlights the increasingly role played by larger businesses.

Figure 1. Proportion of people employed by firm size category

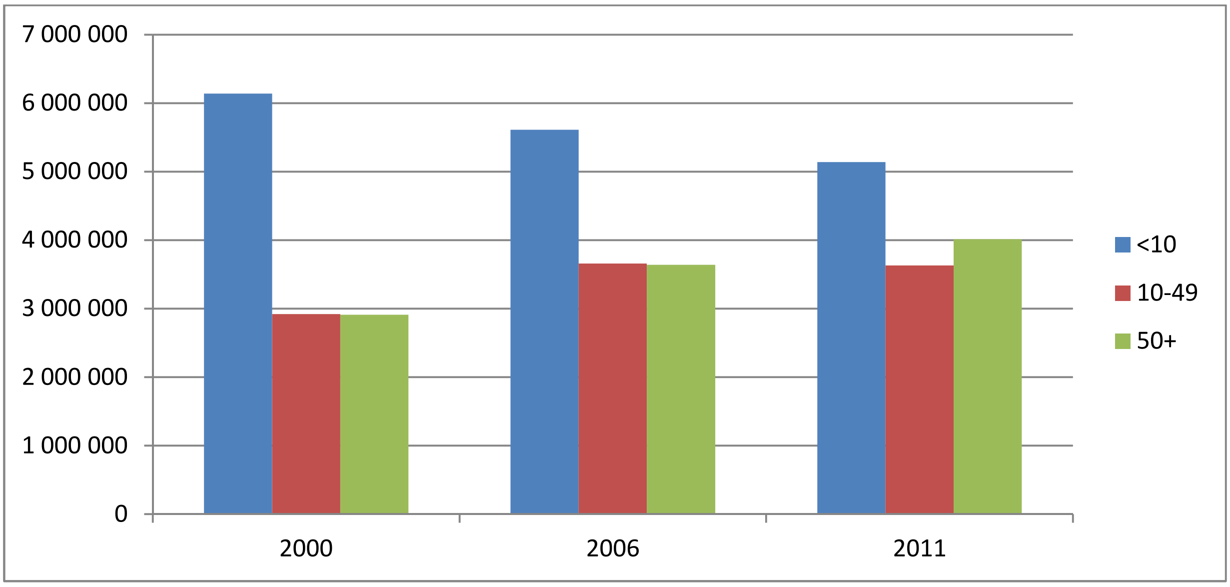


Notes: Calculated from Statistics South Africa's Labour Force Survey (prior to 2008) and Quarterly Labour Force Survey (post 2008). Those who did not report a firm size category, because they did not know it, are excluded.

The greatest change has been in the contribution made by the smallest firms, which saw an overall decline from 46.6% in 2000 to 40.2% in 2011. Firms with between 10 and 49 employees, and those with 50 and more began the decade contributing more or less the same proportion of employment (27% each). Subsequently, the smaller group outpaced the larger, and in 2007 firms in the 10-49 employee range employed over 10 percentage points more of the workforce than those employing 50 and more. From that point, there was a gradual change to this, with the contribution made by the 10-49 employee group falling sharply, and being overtaken in proportional terms by firms employing 50 or more people.

In actual numbers, there were a third more people working in firms with more than 50 employees in 2011 than in 2000. Employment in firms with less than 10 workers has dropped by 1 million over the period. Actual numbers of those employed in firms in the size group 10-19 increased initially between 2000 and 2006 but since then have fallen marginally to 3.6 million people.

Figure 2. Actual of people employed by firm size category



Notes: Calculated from Statistics South Africa's Labour Force Survey (prior to 2008) and Quarterly Labour Force Survey (post 2008). Those who did not report a firm size category, because they did not know it, are excluded.

Behind these numbers lies an important conceptual matter. Research in Europe has found that firm growth processes differ profoundly between small and large firms. Small firms grow organically, whereas larger ones tend to grow through mergers and acquisitions. In other words, it is among SMEs that growth is expressed in the creation of new jobs, while in their larger counterparts, it typically involves consolidation and the creation of economies of scale. Indeed, it is not unknown for firms that are “growing” in terms of market share or turnover to actually be scaling back on employment, as they harness efficiencies that allow them to dispense with labour.

The decline in the employment share of SMEs and to a limited degree in the overall numbers employed by SMEs employing between 10 and 49 people (certainly in relation to those employed by larger firms), evident in the graphs above, pose the subsidiary question as to the fate of small firms. At present, no mechanism of which SBP is aware tracks the growth or decline in the number of firms operating in the economy, and therefore any comment on this must at present necessarily be speculative. However, the decline in the workforce employed by SMEs suggests that there has been a corresponding decline, of some magnitude, in the number of firms. This in turn implies a smaller potential base on which employment can be expected to grow, and a declining entrepreneurial stock. Indeed, the first round report of the *SME Growth Index* noted the advancing age of both the firms and firm owners in the sample, and the relative trickle of new firms and younger entrepreneurs into the economy. The exact dynamics in respect of firm attrition over time need to be investigated.

SMEs report a variety of reasons why this may be the case. Particularly over recent years, firms of all sizes have faced an inhospitable economic environment. This has manifested in reduced demand, and a choke on profit margins. Although this is a general problem, SMEs – with smaller reserves, less access to credit and with fewer options in general available to deal with these conditions – have been vulnerable.

Beyond general economic conditions, SMEs in South Africa experience a number of obstructions to their profitability and competitiveness, and which have direct and indirect bearings on their demand for labour. A key issue is the administrative burden of bureaucracy – the so-called ‘red-tape’ cost. Dealing with red tape costs smaller firms a much higher proportion of their turnover than larger ones. In a 2004 study, SBP found that compliance costs represent 8.3% of turnover for enterprises with annual sales of less than R1 million, and 0.2% of turnover for corporations with sales of R1 billion or more. Bigger businesses can often afford to hire specific individuals whose sole job is to deal with the various bureaucratic issues, while in smaller firms it is often the owner or manager who has to do this. This takes time away from more productive tasks. It reduces profit margins and makes the firm less competitive. Despite talk of reform, and the central role that regulatory reform is given in the NDP, firms do not report that the regulatory burden is easing. Not one respondent in SBP’s *SME Growth Index* panel reported that red tape eased in 2012.

Regulation not only adds a compliance burden, but also provides perverse incentives to firms that have to engage with them. For example, labour market regulations are widely perceived by firms as biased against them, while institutional structures, such as the CCMA, frequently consume a large amount of senior management’s time; these all discourage firms from hiring, and encourage the substitution of workers by machines where this is possible.

Smaller firms are also unable to withstand the lost revenue which comes with strikes, which further disincentivises employment. In addition to this, labour market bargaining structures –such as bargaining councils, where wage agreements are generally negotiated between larger firms and their workers, and then extended to smaller firms that were not party to these agreements – have the effect of restricting labour-intensive production processes which smaller businesses would naturally use. Higher wage costs particularly affect smaller firms where labour costs are often a larger proportion of input costs than in larger firms. Increases in these costs can drive labour intensive, low-wage small firms out of business.

In this kind of environment, shortages of skills have also become a binding constraint. It is near universally acknowledged that South Africa faces a severe shortage of skills, with a special stress on the "hard" artisanal skills and high-end professional skills. As a simple function of supply and demand, these skills can command considerable pay packets. Small firms generally cannot afford to pay the wages which larger firms pay and thus struggle to recruit skilled people. Even training their own staff might be a fleeting investment, since they may find it difficult to retain them as the upskilling opens up better paid options elsewhere. In the 2012 SME Growth index, this factor came out very strongly. Inadequate skills were raised in many different contexts across the survey. And when queried about the most important "shocks" internal to the firm that those surveyed may have experienced, the loss of key staff emerged as the single most common. Some 15% indicated having experienced it, with a few indicating that their staff had been "poached" by government or other businesses.

Employment in SMEs is thus squeezed on two sides. There is an incentive to substitute away from low-skilled employees given the structure of the labour market, but it is difficult to recruit and retain more highly skilled employees due to an inability to compete on wage rates.

A further factor which may be associated with the declining share of employment in smaller businesses is competition, or more accurately the lack of competition. The World Bank argues that market share and firm-level efficiency are not well correlated in South Africa – less efficient firms often have a larger market share than they should have. Small businesses struggle to increase market share, because many industries are dominated by a small number of large incumbents that can adopt predatory pricing or other uncompetitive behaviour if they feel challenged. This sclerotic environment does not reward innovation or encourage smaller firms to expand.

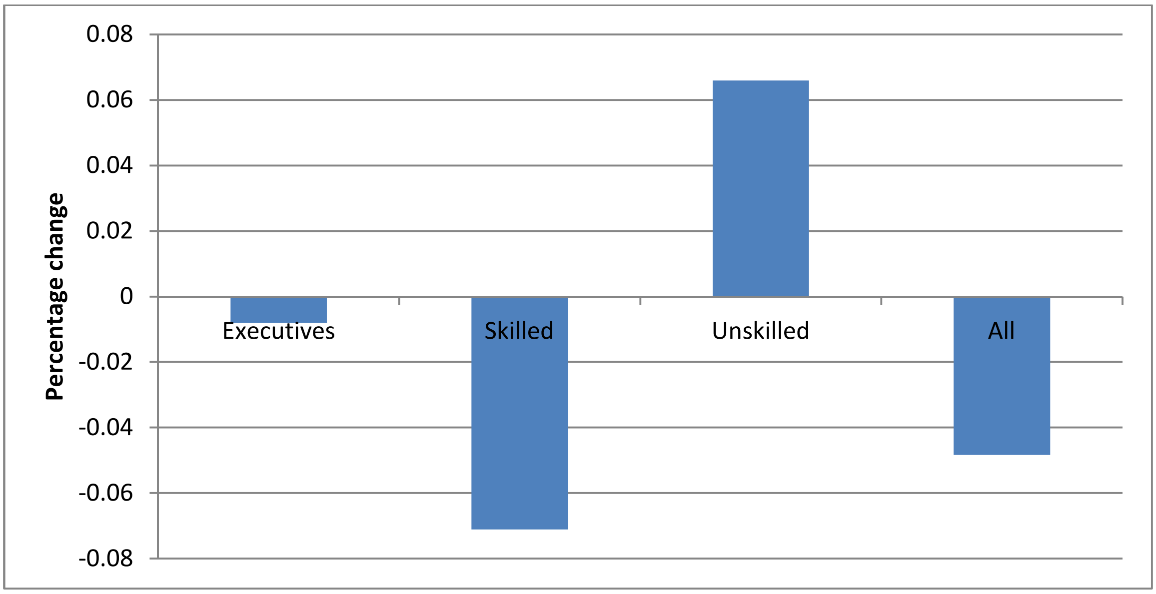
Governance and service delivery issues also disproportionally affect smaller firms when compared to larger ones. Smaller businesses are less likely to own things like back-up generators for when power fails or have their own drivers to deliver packages which could ordinarily be sent through the postal system. Other costs for providing services privately, such as security, which the state is supposed to provide, also often constitute a higher proportion of turnover for smaller firms than for larger ones. When input prices increase steeply, they are unlikely to be able to pass on the full cost to the consumer without a real risk of losing scarce business. These costs place smaller operators in an unfavourable position relative to their larger competitors that are more likely to have advantages of scale to begin with.

3. Who are employed by SMEs?

The shrinking role of small firms as job creators in South Africa has a further troubling dimension. Not only could they be sources of dynamism and growth in the South African economy under different conditions, but small firms employ the type of people whose labour market characteristics mirror those of the unemployed. As such small firms could provide an important source of employment for the most marginalised in the South African labour market.

In the first instance, the SME Growth Index found that employment created by the sample under review was heavily biased towards unskilled employees. There had been little change in executive positions, and a noticeable fall in skilled jobs (probably a combination of the skills shortage, retirement and insufficient demand). By contrast, those jobs that had been created were concentrated among the unskilled.

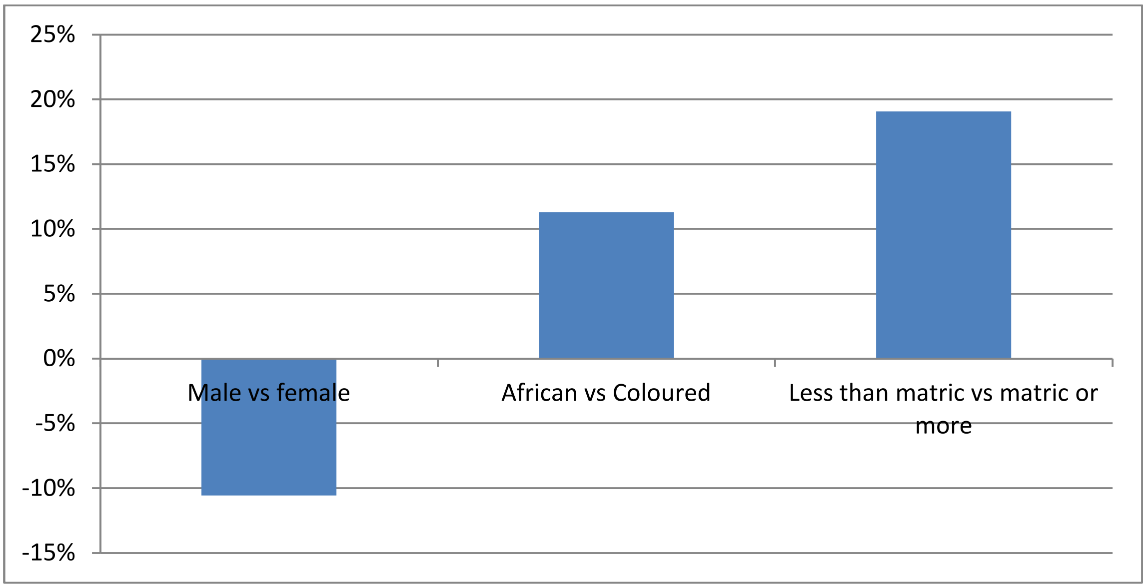
Figure 3. Jobs created by SMEs for each skilled category, 2012



Notes: Sourced from SBP's SME Growth Index survey.

Amongst the employed, females, Africans and those holding educational qualifications below a matric (in other words, the low-skilled) are all less likely to be employed at all than males, white, coloured and Indian people, and those holding a matric or tertiary qualification. If employed, however, people from these groups are the most likely to be employed in SMEs. The figure below shows the differences in probabilities of being employed in a firm with more than 50 employees, based on the Quarterly Labour Force Survey data from Stats SA, between those with certain characteristics. Males are 11 percentage points more likely to be employed in large firms (those with 50 or more employees), and conversely females are 11 percentage points more likely to be employed in firms with less than 50 employees. Africans are approximately 11 percentage points more likely to be employed in small firms compared to coloureds and those with less than a matric are 19 percentage points more likely to be in small firms compared to those with matric or higher.

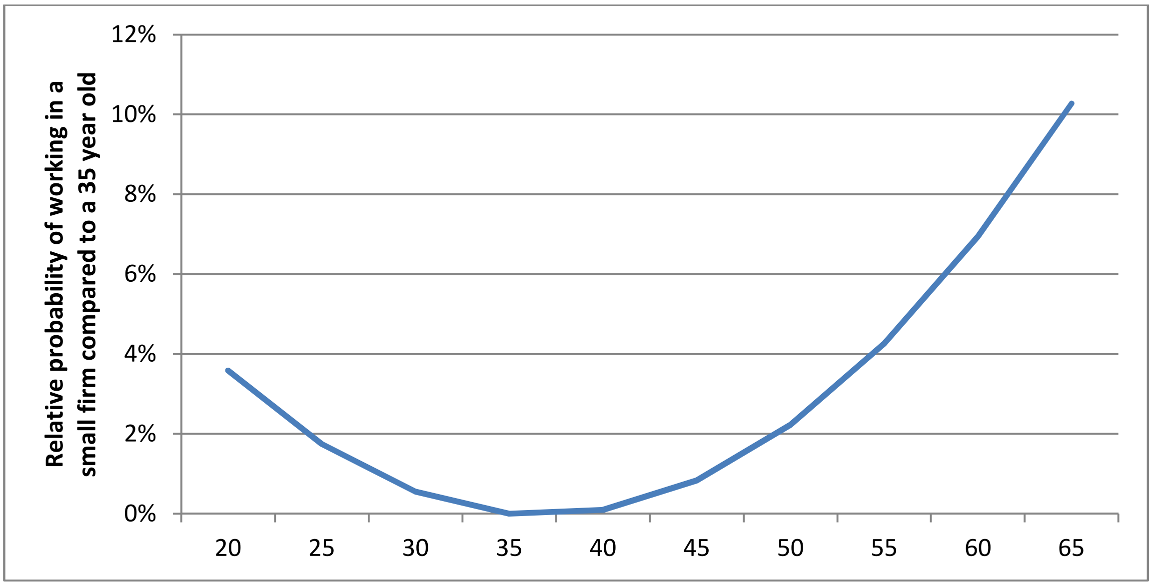
Figure 4. The relative probability of being employed in a small firm (with less than 50 employees)



Notes: These are based on the marginal effects estimated using a probit estimator of whether a person was employed in a firm with more than 50 employees compared to a firm with less. Males are compared to females, Africans to coloureds and those with less than a matric to those with more. The model controls for gender, race, age (and age squared), education level, province of residency and time period. It uses the first 14 rounds of the Quarterly Labour Force Survey collected by Statistics South Africa (2008Q1-2011Q2).303,783 individual observations are used to calculate these figures.

Age and small firm employment are also related. Those at the beginning and end of their working lives are much more likely to be working in smaller firms than those in middle age. Relative to a 35 year old, a 20 year old is almost 4 percentage points more likely to be in a small firm, and a 65 year old, more than 10 percentage points. This suggests that small firms provide an important entry point for young people into jobs and that smaller firms are also more likely to retain older people than bigger firms.

Figure 5. The relative probability of being employed in a large firm (with more than 50 employees) by age (relative to a 35 year old)



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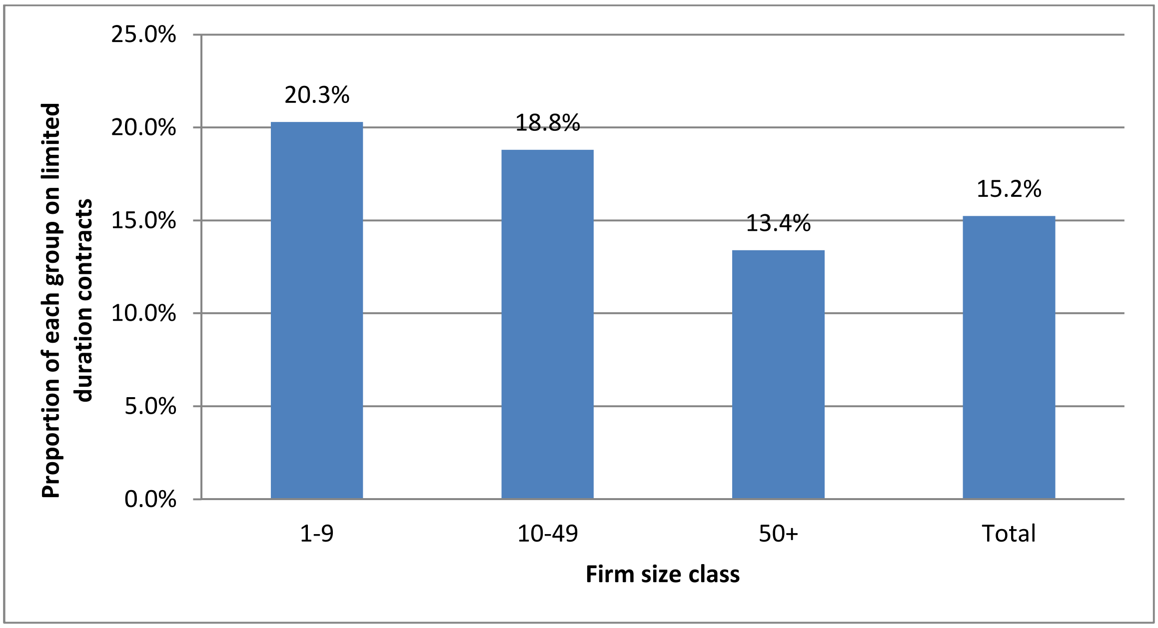
Africans, females, the low-skilled and those at the beginning or end of their working careers are the mostly likely to be employed in smaller firms since these types of firms are generally more labour-intensive than larger firms. This is the case because machines and other types of capital are generally 'lumpy' – a business cannot buy a proportion of a machine but must buy a full one, and it is only cost-effective to buy one if it can be used at close to capacity. Since smaller firms do not have the scale to justify using lots of capital and may not have the cash reserves or access to finance to be able to afford the large investment, they generally have to use a more labour intensive approach. This approach calls for less skilled, and lower paid, people which in the South African context are generally African, female, those with less than matric and at the beginning of their working life. Older people may be employed in smaller firms because they provide a more flexible working environment, may not have mandatory retirement ages, or because they have developed a particular relationship with the employee and wish to retain him or her for personal or professional reasons. From the perspective of the employee, there may be a need to work and smaller firms are the only ones willing to employ him or her.

An additional dynamic pertaining to SMEs is the use of fixed-term or temporary labour. Data from Stats SA shows a clear correlation between the use of such labour (as a proportion of the overall labour force) and the size of firms.

Figure 6. The proportion of fixed term contract employees as a proportion of the whole labour force working in firms of differing size classes



Notes: This table has been compiled on the basis of employees with a written contract, and excludes from the calculations those whose terms were "unspecified".

Clearly, SMEs are far more likely to make use of fixed-term labour than the average across the economy, and firms employing 50 or more people. The SME Growth Index suggests that there is an ongoing shift on the part of firms from permanent to temporary employment.

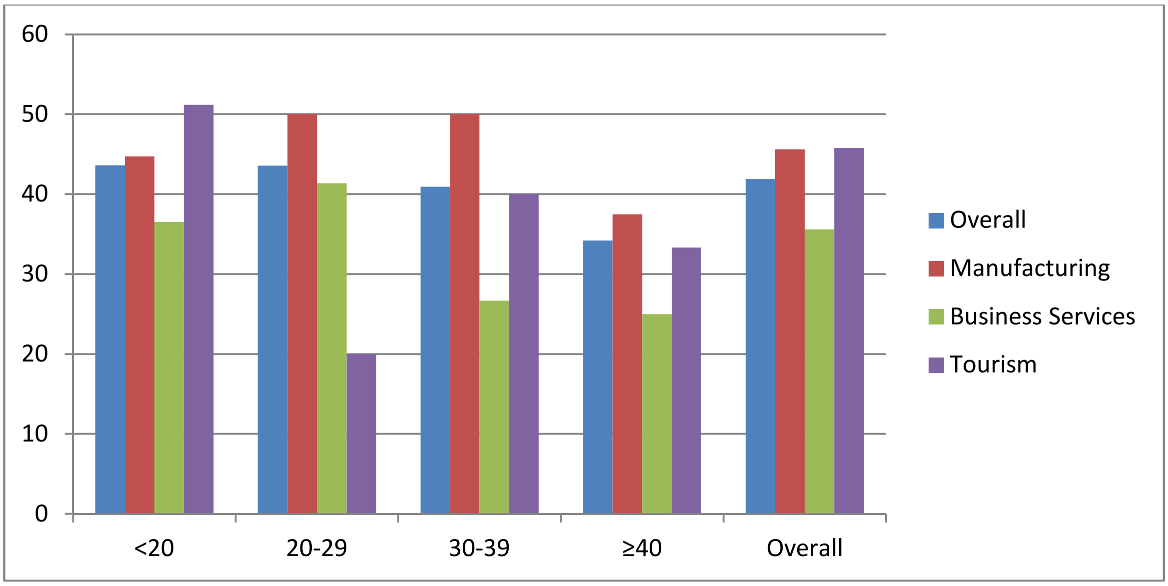
Such labour provides an important element of flexibility, allowing them to ramp up their activities when warranted, and dispense with labour costs at other times. It also clearly has the collateral benefit of allowing firms to skirt the labour regime: by taking only a time-bound responsibility for staff, employment can cease with the expiry of a contract, avoiding the potentially costly and time-consuming dismissal that might arise in relation to a permanent employee. Those engaged in this way arguably fulfil a wide range of functions, and are not necessarily poorly skilled. Expensive specialist skills may be required from time to time, but may not be needed permanently within a firm. However, temporary work does allow firms to engage untried, low-skilled people without the risk of being locked into indefinite obligations. As such they reduce the risk of hiring such applicants, and raise the incentives to do so.

4. What is associated with employment growth in smaller firms?

The preoccupation of policy makers and commentators with SMEs hinges largely on the understanding that these are the firms with the best prospects of creating desperately needed jobs. Government representatives have conceded that they have not had much success in encouraging the growth and employment uptake of SMEs; and if policy is to play a constructive role in this respect, it is imperative that an in-depth understanding of the dynamics behind SME employment creation be developed.

Approximately half of the firms in the sample polled for the SME Growth Index grew in terms of the number of permanent employees between 2011 and 2012. The figure below indicates that there is a negative relationship between the original size of the firm and whether it grew over the period. In the smallest size category, firms with less than 20 employees, slightly more than 40% of firms grew. This proportion falls with the increase in size category and in the largest size category, those firms which started out with 40 or more employees, only one-third of firms experienced an increase in employment. This suggests that smaller firms may be more likely to grow, if they survive. This 'up-or-out' pattern is found in other countries such as the United States.

Figure 7. Proportion of firms growing in terms of permanent employment between 2011 and 2012, by original size category in 2011



Notes: Sourced from SBP's SME Growth Index survey.

Both the business services and tourism sectors seem to follow a similar pattern with smaller firms more likely to be growing. However, among manufacturing firms it is those in the 20-29 and 30-39 size categories, which are most likely to have increased employment. What is also apparent from the breakdown by sector is that in very few of the size categories are firms more likely to be growing than not. These are: tourism firms with fewer than 20 employees; and manufacturing firms in the 20-29 and 30-39 size groups.

When we compare firms with similar characteristics, business services are, on average, approximately 13 percentage points less likely to have experienced growth in employment than manufacturing firms which have approximately the same probability of growing over this time period when compared to tourism firms.[1]

These differences between sectors may be related to the scale at which businesses can operate effectively in each sector. Firms in tourism and business services are likely to be better able to operate, and thus grow, at smaller sizes compared to those in the manufacturing sector. Bed and breakfasts, tour guides, accountants and software firms are all able to function with relatively small numbers of employees when compared to manufacturing firms. The growth in employment in manufacturing firms in the middle size categories may reflect successful firms increasing as they scale-up.

However, the point should be made that it is troubling that there appears to be a visible decline in growth as firms operate in the top quintile of the sample. Intuitively, it appears that some factor or combination of factors come into play, which exert a constraining influence. One postulate is that there may be a conscious decision on the part of owners to cease growth at this point, as it is also among this group that concerns with red tape and compliance matters become most pronounced.

One of the strongest correlates on whether a firm grew employment between 2011 and 2012 was whether the firm had experienced a threat to its survival or not. On average those who had experienced such a threat were 15 percentage points less likely to have grown than those who had not. These differences are largest among manufacturing firms (21 percentage points) and those in the business services sector (15 percentage points).

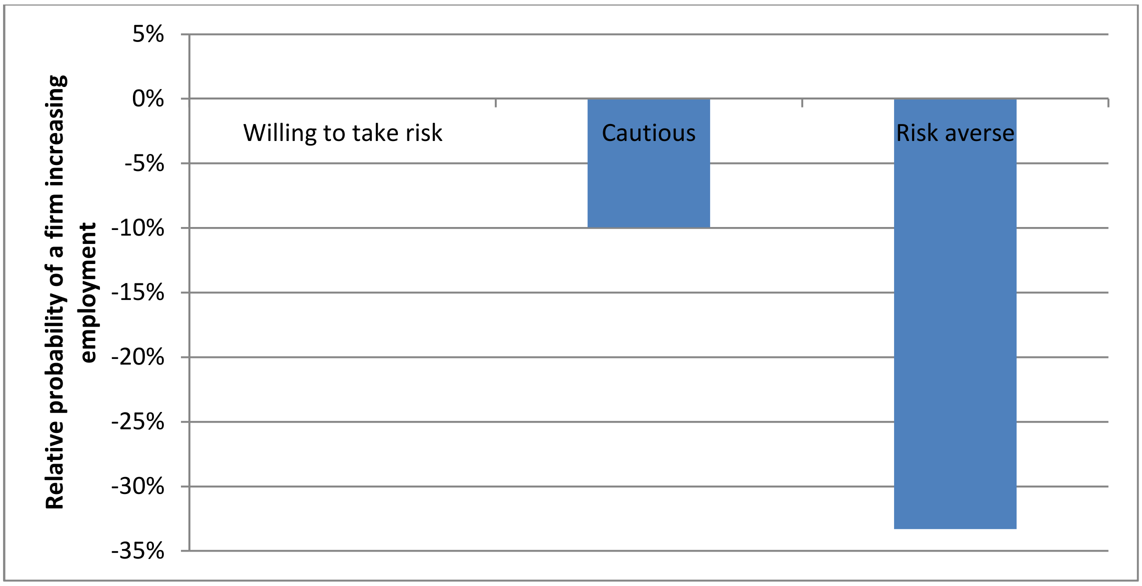
The employment composition of the various firms also seems to be related to whether they grew or not. The proportion of unskilled staff is negatively related to employment growth. This fits with two of the trends identified from the aggregate data: the share of employment in smaller firms is dropping; and low-skilled individuals are more likely to be employed in these types of firms. Taken together this suggests that smaller firms with large shares of unskilled employees are not growing,

[1] In order to investigate how certain characteristics of firms differ whilst holding other characteristics constant we run a probit estimator to determine which factors are correlated with employment growth. These estimation results are reported in the appendix. We discuss the marginal effect of a characteristic on the probability of a firm increasing in size which are derived from the coefficient estimates in these regressions.

and may actually be contracting. This is directly opposite to the trends which need to be occurring if smaller firms are creating jobs for the unemployed.

The business owner's risk appetite and firm growth are also related – firms with progressively more risk averse owners or managers are progressively less likely to have increased employment. The magnitudes of these effects are large. A firm whose owner is 'willing to gamble for a big win' is 33 percentage points more likely to have grown than a firm whose owner classifies him- or herself as risk averse. With the current dataset it is difficult to say whether this increase in employment is a reckless response to current market conditions or whether it will pay off over the longer term.

Figure 8. The relative probability of a firm growing based on the manager's attitude to risk (relative to a manger who is 'willing to gamble for a big win')



Notes: Sourced from SBP's SME Growth Index survey.

The results from the SME Growth Index also suggest that there are a number of factors that are uncorrelated with whether a firm grew or not. There is no indication that those affected by crime and those with BEE accreditation were more (or less) likely to grow than those without. There is also no correlation between firm growth and firm age and little correlation between the location of the firm and whether it increased employment.

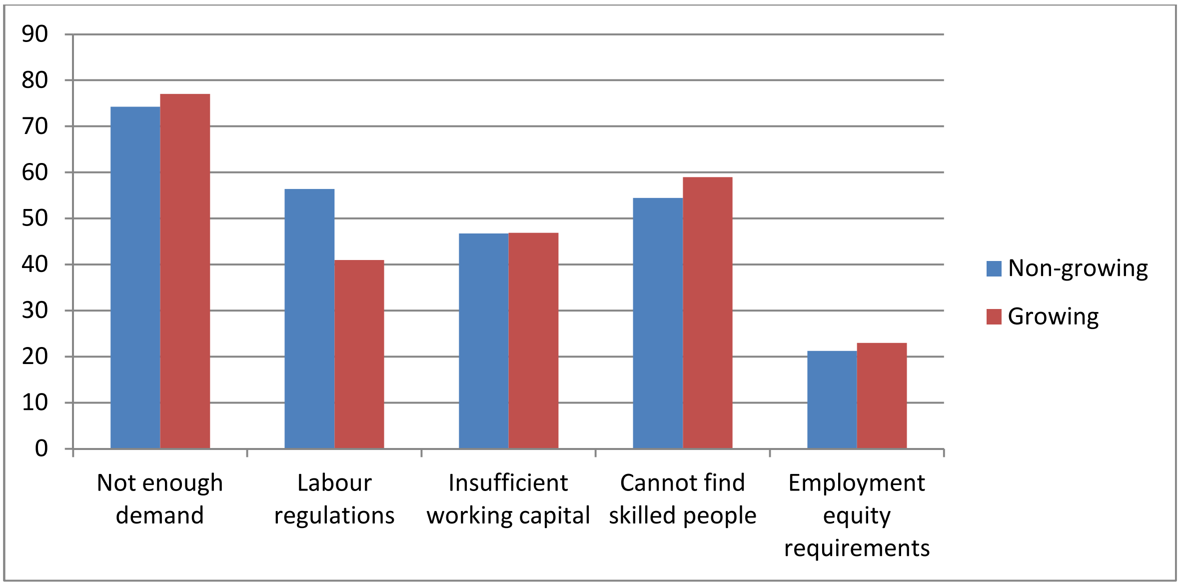
5. Constraints to hiring

The SME Growth Index report in 2012 interrogated the factors that hindered hiring additional staff. The single most common response given by the Panel, whether they are growing or not, was that a lack of demand is a constraint to hiring. This is followed by a lack of skills. For all constraints except labour regulations, the difference between the proportion of growing firms and non-growing firms reporting these as constraints is small.

In respect of labour regulations, non-growing firms are much more likely to report these as a constraint than growing firms. This may be because growing firms have found ways to cope with these labour regulations so that they are no longer onerous. If this is the case then information provided to firms on how to operate within the labour regulations may encourage growth. However, the difference may also be that these growing firms are the type that are less affected by labour regulations and labour regulations do act as a binding constraint. Certainly, this seems the most plausible explanation given that firms have been routinely complaining about labour regulations for at least the past ten years. If it was merely a question of information we would anticipate that perceptions of regulation would fall as firms learn how to operate in the current regulatory environment. Moreover, the fact that this is the only area where the responses of non-growing firms exceed those of growing firms, and the large magnitude of the difference between their responses (15 percentage points) strongly suggests that labour laws are objectively a significant barrier to SME employment growth.

Regulations are also a structural feature of the labour market; they are intrinsic to the very decision to hire staff or not. Where labour legislation imposes direct or opportunity costs, or prescribes the management of staff, the result is likely to be a reluctance to employ. As a matter of contrast, there is a small (although noticeable, at 4.5 percentage points) difference between the responses of growing and non-growing firms on the constraints imposed by skills shortages. Here, growing firms find this more of a constraint – but to view skills constraints as an issue would presuppose that the conditions for employing such staff within the existing economic and regulatory frameworks exist, but supply side issues hindered it.

Figure 9. Proportion of firms reporting the constraint as the first or second most binding constraint to hiring



Notes: Sourced from SBP's SME Growth Index survey.

Not surprisingly, the types of firms which find labour regulations the most constraining are those with higher proportions of unskilled labour. Only 42% of those firms with a workforce with 10% unskilled workers are likely to mention labour regulations as a constraint compared to 57% where half the workforce is unskilled and 73% where 90% of the workforce is unskilled.

Again the picture emerges that the circumstances in which smaller firms operate discourage them from hiring unskilled labour.

6. Concluding observations

A remarkable degree of consensus exists in South Africa on the desirability of SMEs to the country's employment prospects. The actual trajectory is, however, distinctly discouraging.

The evidence points to an SME community – the envisaged driver of employment – that is struggling with the prevailing conditions. A major casualty of this has been its collective capacity for labour absorption. Smaller firms in South Africa are in fact contributing a decreasing proportion of employment in the economy, quite in contrast to intention and expectations. This is most pronounced among the smallest group (those employing ten and fewer people), but a concerning trend is evident among the 10-49 group, the main concern here. At its most optimistic, its numerical employment trend can be viewed as stagnant, and in proportional terms in decline.

A related question – beyond the scope of the data canvassed here – is whether in addition to a failure to create jobs, the economy is actually shedding its SMEs. There are certainly strong circumstantial reasons to suspect this.

The failure of SMEs to take on staff is a serious problem given the magnitude of the country's unemployment malaise. It is doubly serious in view of the specific lost opportunities that this represents, since the employment profile of SMEs tend to mirror those least likely to find work in larger firms. In other words, a job creating SME community would probably create opportunities for the less skilled, and for those otherwise most likely to be excluded for the big business economy.

This state of affairs is explained by a number of factors, not least the overall difficulties in the global economy, and their domestic knock-on effects. However, there is ample evidence that this is by no means the only explanation. The business environment, in particular, the state of the labour market, the shortage of human capital and the unaccommodating regulatory framework are powerful disincentives to employment.

The latter point is an ideologically fraught one. Based on the data assembled here, it seems clear that the regulatory regime, particularly the labour regulatory regime, is a major barrier to SME employment creation.

Another disturbing finding is that the disincentivising impact of the labour regime is felt most acutely by firms most likely to employ unskilled staff. Thus, there is perfect storm of sorts for the most economically excluded in the country. The SME sector is under pressure, and is not taking on staff in large numbers – depriving those least competitive in the job market of the opportunities that it it might offer – while within the SME community, it is especially those firms relying on unskilled labour that are most dissuaded by the regulatory framework.

Equally, it should not be assumed that a focus on the regulatory environment would be a sufficient intervention to propel large-scale job creation. To do so is to simplify a complex of issues. The failure of South Africa's SMEs to drive job growth is an outgrowth of numerous factors that cumulatively express themselves in diminishing workforces – declining demand, restricted cashflow, waning sources of credit (official statistics indicate a major fall off in credit to SMEs over the past decade), dysfunctions in governance and society. However, as SBP has previously argued, the very fact of the global economic crisis and the stresses it has imposed on the South African economy as well as other factors not immediately amenable to resolution, makes action on those areas within the country's control all the more urgent. Failure to do so will perpetuate these problems in the future and pose a very real threat of collapsing the employment prospects of our SMEs irrevocably.