

**Policy Brief – January 2012**

## **A supply side intervention in support of local economic development (LED)**

The role of local economic development (LED) represents policies to redress the economic marginalisation and dualism in the South African economy as a result of the legacy of apartheid in which economic activity was concentrated in certain areas at the expense of rural development, in particular in the former homelands. LED further aims to address various market failures which have contributed to high unemployment rates, low levels of income and wide spread poverty, including the often cited lack of entrepreneurial activity in South Africa, weak support mechanisms for small firms, lack of access to financial and business development services, as well as spatial marginalisation. The lack of economic development in many areas where marginalised individuals live means that large financial resources are spent on transport costs to not only buy goods but also to search for employment.

LED is often faced with the tension between addressing poverty in poor communities and increasing the competitiveness of the local economy in an environment of skills deficiencies, lack of infrastructure development and limited investment.

In terms of the governance and lines of responsibility, the mandate for LED falls

within the ambit of local government, a sphere of government which is plagued with inefficiency, corruption and lack of skills resulting in poor service delivery.

Local economic development is a process in which partnerships between the local government, community and the private sector are established to use local resources to create jobs and stimulate the local economy (Helmsing, 2001).<sup>1</sup> Three types of local economic development initiatives can be identified, namely: community based economic development, business or enterprise development and the development of the local area which relates to the planning and management of the economic and physical environment of an area. Complementary interventions by local government which support LED policies and focus on the spill over effects of these interventions, is also required.

*Why support small, micro and survivalist enterprises in the pursuit of local economic development?*

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<sup>1</sup> Helmsing, A.H.J. "Local economic development, new generations of actors, policies and instruments", A summary report prepared for the UNCDF symposium on decentralisation local governance in Africa held in Cape Town in 2001, Author from the Institute of Social Studies, the Hague.



Small business is an important driver of job creation by providing the opportunity to earn a livelihood, assist in developing entrepreneurial activity while also serving as a hub of innovation. Small businesses support economic growth especially in terms of their job creation potential. Chairman of the US Federal Reserve, Ben Bernanke has highlighted the importance of small business, which account for around 70% of all employment in the US economic recovery. He suggested that they assist the global competitiveness of the country as “they often offer a level of agility in bringing innovative products to the global marketplace that larger firms cannot match”<sup>2</sup>. This highlights the importance for all economies in providing support to these enterprises to expand and flourish.

In South Africa, small business is equally important; 68% of all private employment occurs in enterprises with less than 50 employees, and these enterprises account for 77% of all hiring.<sup>3</sup> Around 45% of workers are employed in firms with less than 10 employees. Large firms in South Africa accounted for very little job creation between 1985 and 2005; less than 10% of

all new employment was created in large firms.<sup>4</sup>

However it is also important to recognise which entrepreneurs to support; The Global Entrepreneurship Monitor (GEM) finds that support for South African opportunity driven entrepreneurs<sup>5</sup>, who generate new business ideas, as opposed to necessity driven entrepreneurs, would triple the employment creation potential of these firms; opportunity driven firms have an average of 4.4 employees per firm vs. 1.6 employees per necessity firms (GEM, 2008).<sup>6</sup> By creating economic opportunities through jobs and income in the areas where people live, these small businesses are able to support local economic development. While there are opportunities there are also many constraints faced by local enterprises and producers which may exist in the industry or economy as a whole; these include insufficient market access and the lack of infrastructure development in the area. In order to identify the types of enterprises which this research on local economic development could focus on, it is useful to

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<sup>2</sup> <http://blogs.wsj.com/in-charge/2011/11/10/bernanke-small-businesses-important-to-economic-recovery/>

<sup>3</sup> National Treasury, Budget Review 2011, Chapter 3, Employment.

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<sup>4</sup> Small Business Project (SBP), “Small business development in South Africa, time to re-assess”, SBP occasional paper, August 2009.

<sup>5</sup> An opportunity driven entrepreneur is solely driven by opportunity recognition and exploitation.

<sup>6</sup> Global Entrepreneurship Monitor South Africa, 2008, pp 17  
[http://www.gemconsortium.org/download/1325671952819/GEM2008SouthAfricanReport\\_1.pdf](http://www.gemconsortium.org/download/1325671952819/GEM2008SouthAfricanReport_1.pdf)

look at a definition of business while also identifying certain characteristics of what we may term survivalists, micro, very small, small and medium enterprises. The National Small Business Act of 1996 defines SMMEs according to industry and by total full time equivalent paid employees, total turnover and total gross asset value (fixed property is excluded).

Table 1: The characteristics of survivalists, micro, small and medium enterprises.

Category of enterprise	Description
<b>Survivalist</b>	<ul style="list-style-type: none"> <li>Operates in the informal sector of the economy</li> <li>Mainly undertaken by unemployed persons</li> <li>Income generated is below the poverty line</li> <li>Little capital invested with little or no assets</li> <li>Limited or no training</li> <li>Limited opportunity to grow the business</li> <li>Hawkers, vendors and subsistence farmers</li> </ul>
<b>Micro</b>	<ul style="list-style-type: none"> <li>1-5 employees, owner and family run</li> <li>Informal with no licence, formal business premise or adhering to legislation.</li> <li>Turnover below the VAT registration level</li> <li>May have some basic business skills and training</li> <li>Could potentially make transition to a viable formal small enterprise</li> <li>Spaza shops, cafes, home based businesses, small scale construction and textile manufacturing</li> </ul>
<b>Very small</b>	<ul style="list-style-type: none"> <li>Part of formal economy</li> <li>Less than 10 employees</li> <li>Could include self employed artisans (electricians and plumbers) &amp; professionals</li> </ul>
<b>Small</b>	<ul style="list-style-type: none"> <li>Between 50 and 100 employees</li> <li>More established, formalised, fixed business premise and registered</li> <li>Owner managed but with a more complex management structure</li> </ul>
<b>Medium</b>	<ul style="list-style-type: none"> <li>Less than a 100 employees (200 employees in mining, electricity, manufacturing and construction)</li> <li>Mainly owner managed but with a decentralised management structure and division of labour</li> <li>Operates from a fixed premise having met all formal requirements</li> </ul>

Source: National Small Business Act, <http://www.etu.org.za/toolbox/docs/government/sbd.html>

*The role of the informal sector to absorb the unemployed.*

In South Africa, it has been argued, that the lack of an entrepreneurial spirit prevents the creation of small enterprises. The small informal sector is also perplexing given South Africa's high unemployment rate. Davies and Thurlow (2009)<sup>7</sup> highlight certain barriers to entry which exist within the informal sector including the lack of access to credit, high levels of crime as well as high reservation wages which may also account for a relatively small informal sector in comparison to peer countries. The legacy of the apartheid regime also had an impact on the informal sector by restricting activities in many areas

Table 2: Employment in the informal sector

Country	Year	Employment in the informal sector as percentage of total employment (%)	Female share in total employment in the informal sector (%)
Brazil	2001	46.6	47.7
Chile	2000	33.1	32.0
India	2000	55.7	20.2
Kenya	1999	36.4	42.0
Mexico	2005	28.0	36.1
Pakistan	2004	39.8	9.1
Philippines	1995	17.3	47.6
Tanzania, United Republic of	1991	22.0	35.4
Thailand	2002	72.1	
Tunisia	1997	21.6	14.6
Turkey	2000	11.2	16.0
South Africa	2009	15.8	44.4

Source: ILO, KILM, 8th edition

<sup>7</sup> Davies, R., Thurlow, J. "Formal-Informal Economy Linkages and Unemployment in South Africa", FPRI Discussion Paper 00943, December 2009.

Given the nature of the informal sector and the corresponding difficulties in quantifying the contribution of the sector in national statistics, coupled with differences in national definition, as well as the incomplete capturing of the size of the sector, identification of the contribution of the sector to the Gross Domestic Product (GDP) of the country is often difficult.

A number of studies have attempted to estimate the contribution of the informal sector to SA's GDP.

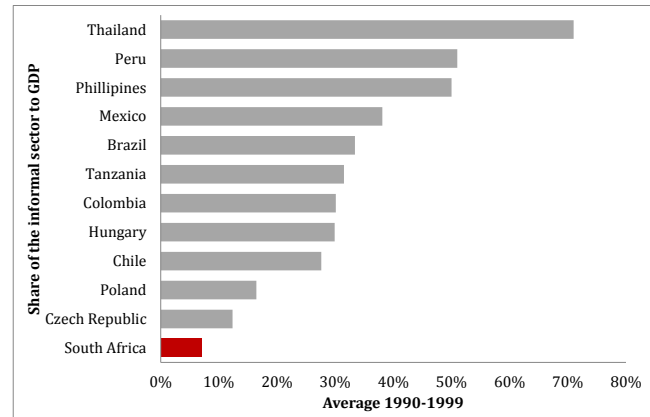
Table 3: Contribution of informal economy to GDP

Author	Year	Total GDP	Notes	Definition
Charmes (2000)	1995	6.9%	National accounts	Enterprise based
Budlender et al (2001)	1999	8-12%	National accounts WB data and calculated as % of GNP	Enterprise based
Schneider (2002)	1999	28.4%		Includes shadow economy Expenditure
Devey et al (2006)		7.0%	Reservebank calcs	surveys
Davies & Thurlow (2009)	2002	7.1%	SAM	Enterprise based

Source: Wills, G. "South Africa's informal economy: A statistical profile", WIEGO, Urban Policies Research Report, Number 7, April 2007.

While estimates differ, the average estimated contribution of the informal sector of around 7% of GDP is significantly lower than in many other developing nations.

Figure 1: Contribution of the informal sector to GDP



Source: Ayyagari, M., Beck, T., Demirguc, A. "Small and Medium Enterprises across the Globe", the World Bank, March 2005.

### The "second economy"

The South African economy is characterised by high and rising levels of inequality. The concept of a "first" and "second" economy gained prominence under President Mbeki's administration when the Trade and Industrial Policy Strategies (TIPS)<sup>8</sup> undertook search into the sector under the Second Economy Strategy Project. The analysis describes the differences between these two parts of the economy; the one a mainstream economy identified with wealth and security and the other characterised by marginalisation and poverty.

This distinction in the economy and the corresponding inequality between the two

<sup>8</sup> <http://www.tips.org.za/programme/2nd-economy-strategy-project>

segments is enforced by the centralised monopolistic structure of the economy which negatively impacts on competition and creates barriers to entry for especially new entrants and small enterprises, creating a bias in the distribution of assets and capital amongst a small elite group of the population.

However there are certain linkages and interdependencies between the first and second economy. Phillip and Hassen (2008)<sup>9</sup> highlight some of the linkages including:

- a) Street traders and local spaza shops buy branded goods from formal chain retail stores.
- b) Informal producers and subsistence agriculture rely on inputs bought from the formal sector and some may have supply chains to the formal sector, although these are often limited.
- c) Remittances from individuals working in the core economy are often important sources of income for households in rural areas. These remittances have however declined since 1993 and poor households are now primarily dependent on income from social grants.
- d) Seasonal workers in the agricultural sector have linkages to the formal

sector through their labour input to this large export sector.

- e) Contract workers, employed in the formal sector through labour brokers or temporary employment services may live in urban informal sectors.

However, by its characteristics the second economy is disconnected to important drivers of growth which include government and other services, limited access to financial service and markets, lack of access to information and even basic services.

There are two views regarding the link between the first and second economy; the one sees the second economy as a survivalist, stop-gap measure which entrench the poor in marginalisation, the other sees the sector as a stepping stone to the first economy, indeed work by Banerjee *et al* (2006)<sup>10</sup> finds that 12% of workers who were initially employed in the informal sector will transition to the formal sector within a 6 month period, suggesting that the informal or second economy to some extent serves as an entry path into the first or formal economy.

The structure of the core South African economy places restrictions on the effective and efficient operation of the

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<sup>9</sup> K. Phillip, E.K. Hassen, "The review of second economy programmes: An overview for the Presidency's fifteen year review" Second Economy Strategy Project, TIPS, 2008.

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<sup>10</sup> A. Banerjee, S. Galaini, J. Levinsohn, I. Woolard, "Why has unemployment risen in the new South Africa", *CID Working Paper No 134*, Harvard University, October 2006.



second economy. Phillip and Hassen (2008) suggest that policies which focus on local markets, the promotion of local production and consumption may have limited impact due to the monopolistic structure of the economy, which have resulted in the following:

- a) Individuals who partake in the second economy mainly live in marginalised areas and are poor, meaning that they are only able to buy a limited number of products which in the majority of the case are mass-produced in the formal economy, eg maize meal, bread, sugar, flour, tea, soap, tinned goods etc.
- b) Durable goods such as furniture and clothing are available through mass retailers which are normally located across rural areas. While store cards and hire purchasing makes it easier for poor communities to purchase these goods.
- c) Poor consumers often preferred branded goods due to price and quality certainty and the impact of marketing on influencing buyer perceptions. Locals small scale producers find it difficult to compete with these branded products.

The functioning of the economy as described above means that money does not stay within local circulation and leaks back to the formal economy and thus the

only opportunities which does exist for local enterprises is in micro or at the household level, with virtually no scope for small scale local production. For an intervention aimed at stimulating local economic activity through support to local enterprises, it implies that market failures will need to be overcome and alternatives to formal value chains be obtained.

*Constraints faced by small and medium sized enterprises:*

Small and medium sized enterprises face a number of constraints. Latin America serves as a useful comparator for South Africa. In Latin America these enterprises serve as an important engine of productivity and value add labour absorption. The sector accounts for more than 70% of all private sector employment in Latin America and the Caribbean.<sup>11</sup>

The Inter-American Development Bank<sup>12</sup> identifies the following constraints which small businesses face in Latin America:

- Input constraints including the lack of access to capital, low supply of skilled labour which limits

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<sup>11</sup> Angelleli, P. Moudry R. Llistarry, JJ. "Institutional capacities for small business policy development in Latin America and the Caribbean", IADB, Sustainable Development Department, Technical Papers Series, December 2006.

<sup>12</sup> <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=1481577>

specialisation and raises costs, lack of access to appropriate technologies and information which limits competitiveness and ability to innovate and finally the constraints faced in terms of the access to production inputs.

- Output constraints in terms of the access to both domestic and international markets. Domestic market access can be limited through the lack of access to public contracts due to red tape as well as the control of distribution channels by larger firms. International markets which have increased international competitiveness have resulted in the need for expansion however this is impeded by small scale production, lack of standardisation and little quality control over product.
- Regulatory constraints relating to taxation and tariffs legal costs including licensing and registration requirements and inflexible labour regulations and other labour costs, raise the cost of doing business for small firms.
- Management constraints including skills and training and the lack of support service.
- Institutional constraints exacerbated by the wide range of interventions which claim to support SMEs, but with little policy

co-ordination in the area of SMME development.

While small businesses in South Africa face a number of similar constraints, it is clear that South Africa faces many unique problems, such as the limited ability of the informal sector to serve as potential absorber of large number of unemployed, the fact that markets in country's such as Brazil are significantly larger due to the sheer scale of the population and the starting point for interventions; countries such as Brazil have managed to halve poverty rates, while South Africa is still attempting to address the dual problems of high unemployment rates and poverty, combined with high levels of inequality. Suggesting that interventions required to support small businesses will differ.

*How do small businesses perform in South Africa compared to some of our peers?*

The small business sector in South Africa is significantly smaller than those in Brazil and India. A research report entitled "How South Africa can boost support to small businesses: Lessons from Brazil and India" (Timm, TIPS 2011)<sup>13</sup> finds that the 16 million small and micro enterprises in Brazil contribute around 20% to the

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<sup>13</sup> <http://www.tips.org.za/paper/how-south-africa-can-boost-support-small-businesses-lessons-brazil-india>

country's GDP, and employ 60 million people (56% of the urban workforce in the formal sector, data for 2008). In India, the 26 million small, micro and medium enterprises contribute 8% to the country's GDP, employing nearly 60 million people.

In comparison The FinScope South Africa Small Business Survey 2010<sup>14</sup> finds that there are 6 million small businesses and 5.6 million small business owners. 67% of these are run by the owner themselves with no employees; while 6% of the owners employ 5 or more people, 27% employ 1 to 4 people. In terms of registration of the business, only 17% of the small business owners run a registered business. The low levels of registration may point to difficulties encountered by these businesses when attempting to formalise. The low levels of registration may have a negative impact on tax revenue collection for the state while for the firms their access to services offered may be limited. The Department of Trade and Industry's Annual Review of Small Businesses 2006-2008 founds that in 2007 there were 2.43 million small enterprises of which 1.39 million were in the informal sector. The

estimate is that SMMEs contribute between 27% - 34% to the country's GDP.

#### *Measures to support small enterprises.*

In order to identify the support mechanisms needed by small and medium businesses it is important to identify the life cycle of these businesses. It starts with an idea, then the start-up of the business, often the most difficult phase and the time when many new businesses fail. If an enterprise weathers this storm, it would enter the expansion phase followed ultimately by maturity. The birth, death, growth and decline of small businesses is a natural occurrence in any dynamic economy.

Figure 2: Life cycle of a firm



This cycle described above also corresponds with a need for pre-incubation, incubation and post-incubation support.

The types of services which can be provided to small businesses can be classified as follows (Howard, 2000)<sup>15</sup>:

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[http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfecc2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&IID=3\\_3](http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfecc2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&IID=3_3)  
[http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfecc2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&IID=3\\_3](http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfecc2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&IID=3_3)

<sup>15</sup> Howard, D, Hine, D. "The small enterprise environmental matrix; A tool for strategically positioning small business assistance programmes", Journal of Enterprising Culture (JEC), Volume 8(1), 2000.



- Consulting services: focusing on information dissemination and management support.
- Finance support in the form of loans provided through specialised banks and microcredit.
- Provision of training in areas such as costing, organisation, productivity.
- Marketing assistance.
- Provision of access to facilities such as technology and office space.

In terms of creating an environment in which the sector can function, it is important that the political and legislative framework be in place to allow the informal sector to function within the local market, as well as the support from policymakers for the role that the sector plays in employment creation and economic growth.

*International case studies on intervention to support the establishment and growth of small businesses.*

### **India**

Policy makers in India promoted small businesses development mainly through reservation policy in the manufacturing sector however this support scheme was removed in 1991, exposing small businesses to increased competition from abroad, resulted in the closure on a

number of these firms (Timm, 2011)<sup>16</sup>. In addition, institutional inefficiencies have meant that government support for the sector has had a limited impact. In 2000, the government introduced an integrated policy package which focused on improving the access to credit, providing collateral free loans up to a value of 2.5 million rupees and the implementation of a capital subsidy for the upgrading of technology and infrastructure. Responsibility for the development of small businesses lies in the hands of the state and union territories, but at the national level the Ministry of Micro, Small and Medium enterprises was established in order to co-ordinate all interventions and policies related to this sector.

The setting up of the Ministry was by decree of law which also addressed regulatory burdens faced by small enterprises, including simplifying procedures to register businesses, setting up of councils to deal with the late payments to small firms, as well as the development of preferential procurement policies by government in order to support market access. In general it appears that despite these interventions very few small businesses were aware of the programmes; only around 20 to 30% indicated that they had any knowledge of the programmes' existence. A number of support schemes focused on increasing the competitiveness of

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<sup>16</sup> TIPS, <http://www.tips.org.za/paper/how-south-africa-can-boost-support-small-businesses-lessons-brazil-india>



small firms including access to finance and support in acquiring new technology.

The introduction of facilitation councils allowed small firms to settle outstanding debt with public and private corporations. However the effectiveness of the councils were limited firstly, because not all councils were set up and, secondly many small businesses feared that future work would be limited if such a small business took the firm to the council for payment.

The Indian government also set up the National Small Industries Corporation, an entity under the Ministry of Micro, Small and Medium enterprises, in 1995. The corporation's mission is "promoting, aiding and fostering the growth of small industries and industry related micro, small and medium enterprises in the country". It operates through countrywide networks of offices and Technical Centres providing tailored schemes designed to put small businesses in a competitive and advantageous position. The schemes comprise of facilitating marketing support, including consortia marketing to facilitate the execution of large orders, single Point Registration Scheme for government tenders, credit support, entering into strategic partnerships with commercial banks to facilitate long term and working capital loans, provides performance and credit rating scheme for small industries and finally technology support.

### **Brazil**

Policies in Brazil have been relatively effective in supporting small businesses. In particular, the setting of measurable targets<sup>17</sup> as developed by the Planning Department and laws which simplified tax regimes, as well as supported government procurement from SMME, have been effective. The setting up of a Small Business Ministry may support the sector further by lending priority and focus to the development of policies to support this sector.

As in many countries these small business owners still struggle to gain access to finance and need to overcome red tape, but support to small and micro businesses across the spectrum from informal traders to established small traders has received priority. The goals as set out by the government for the period 2008 to 2011 regarding the development of small businesses focused on:

- Continue to simplify taxes and increase government procurement opportunities for small and micro businesses.
- Improve the participation of small and micro enterprises in the domestic and international market.
- Improve the management of enterprises.

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<sup>17</sup> Some of the measurable targets set include; by 2011 65.42% of all jobs in the formal sector be created by small, medium and micro enterprises; by 2011 8.58% of small and micro firms should be involved in exporting.



- Increase capacity and the use of innovation.
- Provide incentives for small firms to form or join associations and co-operatives.

In 2008 the Emprededor Individual (Individual Entrepreneur), a business support service, was introduced with the aim of assisting sole proprietor entrepreneurs, with no share in any other business and an annual income of less than R\$36 000 to formalise and thereby gain access to social security, such as pension and medical aid, as well as workman's compensation. The law also reduced the number of steps required for registration and lower taxation rates apply. An internet portal was established to allow entrepreneurs who wish to formalise to complete the process online.

The establishment of the "Forum for Micro and Small Business" which allow government and the private sector to discuss issues related to the sector has been hailed as one of the successes.

While the country is doing well in terms of setting up of different funds to facilitate access to finance for small business, lack of data and statistics makes it difficult to determine the impact of many of the policies. In addition, lack of access to finance, high interest rates, red tape associated with opening and closing

businesses and the need for the state to create angel funding networks<sup>18</sup> still hampers the development of small enterprises.

*What is potentially required to support South African small businesses and entrepreneurs?*

The FinScope South African Small Business Survey (2010)<sup>19</sup> highlights that lack of space to operate, perpetuated by municipal bylaws, lack of access to finance, including the cost of finance and maintaining a healthy cash flow, and competition, in particular too many competitors and too few customers are the major barriers to growth. These constraints highlight both the internal and external challenges faced by small and micro businesses.

The Small Business Project (SBP)<sup>20</sup> suggests that because small businesses are varied, a differentiated approach in their development is required. Government policies and support should be integrated and comprise a mix of interventions including:

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<sup>18</sup> Comprise of affluent individuals who provide capital for business start-ups usually in exchange for convertible debt or ownership equity.

<sup>19</sup> [http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfec2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&lID=3\\_3](http://www.finscope.co.za/new/pages/Initiatives/Small-Business.aspx?randomID=bfec2e2-f62d-4a1b-846f-eff257aea785&linkPath=3&lID=3_3)

<sup>20</sup> <http://www.sbp.org.za/>

1. Promoting skills, social capital, mentorships and networks.
2. Support the growth potential of small firms through facilitating access to finance information, technology and infrastructure.
3. Provide incubator facilities which facilitate access to physical infrastructure and other business support services.
4. Improve the access to markets.
5. Establish the enabling environment in which red tape is reduced.
6. Improve the data collected on small business which is an essential element to identify and track the sector.
7. Focus on sector specific issues to tailor interventions and support to needs to the sector.

Timm (2011)<sup>21</sup> highlights areas of success regarding entrepreneurial support from Brazil and India which include:

- Develop a national entrepreneurial vision with measurable targets, with backing from the president.
- Build more forums based on partnerships between government and the private sector.
- Simplify government's support architecture.

- Put effective real-time monitoring mechanisms in place.
- Improve the capacitation of government agencies.

*Measures which have been undertaken in South Africa to support SMMEs.*

Within the context of South Africa, measures to support small and medium enterprises have centred on releasing regulatory burdens for this sector, support for business development and increasing access to finance.

Phillip and Hassen (2008)<sup>22</sup> highlight the specific interventions which have taken place in South Africa in support of SMMEs:

1. The reduction in the regulatory burden through tax concessions in – particular the scrapping of regional council levies, exemptions from Skills Development Levies for firms with a payroll of less than R500 000 per annum. In addition a manual has been developed for use by municipalities to reduce the red tape for these enterprises.
2. A standard definition for SMME has been developed.
3. The National Treasury introduced a tax incentive to individuals or companies at the time of the 2008

<sup>21</sup> <http://www.tips.org.za/paper/how-south-africa-can-boost-support-small-businesses-lessons-brazil-india>

<sup>22</sup> K. Phillip, Hassen, E.K. "The review of second economy programmes: An overview for the Presidency's fifteen year review" Second Economy Strategy Project, TIPS, 2008.

budget which promotes “Angel Finance”.

4. Amendments to the procurement system have resulted in a 30 day payment system for SMME as well as preferential procurement in support of SMME development.

Many of these interventions do not cater for very small and micro enterprises or the informal sector. For example municipal by-laws do not support especially the informal retail sector which constitutes the majority of the informal sector in South Africa creating barriers to these traders in selling their goods in urban areas.

The Small Enterprise Development Agency (SEDA) is an agency established in 2004. It is mandated to:

“Implement government’s small business strategy; design and implement a standard and common national delivery network for small enterprise development; and integrate government-funded small enterprise support agencies across all tiers of government.”<sup>23</sup> The agency provides support services to enterprises in different stages of development from the idea for a business, developing business plans, starting a business including establishing a new business, buying an existing business or entering into a franchise, to the building phase focusing on new opportunities such

as tenders, networking, and improving productivity to ultimately growing the business through technical support to understand the business needs for sustained growth, building management skills and growth opportunities in the form of exports.

During the 2010/11 financial year 57%<sup>24</sup> of potential entrepreneurs who entered SEDA programmes progressed into trading businesses. 64 000 clients approached service delivery points with a conversion rate from enquiry to client at 42% which is inline according to SEDA with Brazilian and Indian conversion rates.

In the area of enterprise finance provision, Khula Enterprise Finance is responsible for “bridging the funding gap in the SME market not addressed by commercial financial institutions” focusing on loans, start-ups and early expansion capital to SMEs. Services offered by Khula include:

- Mentorship services provide pre and post loan mentorship to small and medium sized enterprises
- Khula Credit Indemnity Scheme was established to give access to finance to people who wish to start or expand small to medium sized businesses but do not have sufficient collateral / security to support facilities provided by

<sup>23</sup> <http://www.seda.org.za/Pages/Seda-Welcome.aspx>

<sup>24</sup> Since there is no set target or comparable measures to compare this progression figure too, so it is unclear whether 57% is an acceptable measure of success.





participating banks. The scheme covers facilities from R10 000 to R3 million.

- Khula Land Reform Empowerment Facility (LREF) is a Black Economic Empowerment Fund capitalised by the Department of Rural Development and Land Reform and supported by European Union. The fund is housed in and administered by Khula. LREF is a wholesale financing facility through which Khula lends money to commercial banks and other reputable agricultural lenders for on-lending to Land Reform beneficiaries
- Non-bank Retail Financial Intermediaries are independent organisations or companies, which are lent money by Khula on a wholesale basis to on-lend to SMEs. Since RFIs are obligated to repay Khula, they use their own lending criteria to on-lend Khula's funding. However, each RFI has to contribute towards the achievement of Khula's developmental impact objectives, such as providing funding to SMEs which are black owned, women owned and from rural areas. Khula restricts its RFIs to on-lending a minimum of R10 000 and a maximum of R3 million per SME.
- Khula Joint Venture Funding comprises of the following funds: the Izibulo SME Fund, Small Business Growth Trust Fund,

Identity Development Fund (IDF), Enablis Acceleration Fund and the Enablis Khula Loan Fund.

During the 2010/11 financial year R81.3 million of loan facilities were approved of which just over R70 million had been disbursed, a growth rate of 18% in the portfolio. During the financial year 2 500 jobs were created and 1 500 SME s funded. 70% of these loans were for amounts below R250 000 and for black owned businesses.

While a significant amount has been allocated through the various Khula Enterprise Finance schemes, the success of the projects is very difficult to gauge without clear indicators of success. Measurable indicators including sustainability of the firms post receiving loans, return on investment for the funds, the number of jobs created and the increase in the income generated for the small business owner, thus a measure of welfare creation. , should be tracked. Based on the data provided above, the R70 million allocated created jobs at a cost of nearly R47 000 per job. This compares relatively favourably to other government programmes in terms of the cost per gross job created, eg the EPWP at R123 000 per year per job and learnerships and apprenticeships at R92 000, but less favourably than the CWP which costs R18 108 per year per job created and the National Youth programme proposed by

the Department of Economic Development with an estimated cost of R31 000 per gross job created.

Access to capital and micro loans remains a major constraint for very small and micro enterprises as the formal financial system does not lend to this group due to high risk profiles, unsecured loans or loans secured by small amounts and the low value of capital required.

In recognition of this constraint the South African Micro Finance Apex Fund (SAMAF), a wholesale funding institution, was established with the aim of "...facilitating the provision of affordable access to finance by micro small and survivalist business for the purpose of growing their own income and asset base."<sup>25</sup>

The purpose of this fund is to reduce poverty and unemployment through the extension of financial services to rural and peri-urban areas while also building a network of self-sufficient and sustainable micro-finance institutions

Currently the products which are offered include:

1. Two types of loans to financial intermediaries, namely micro-enterprise loans where intermediaries loan to the poor to establish and grow survivalist and micro enterprises and development

loans which are aimed at Financial Services Cooperatives (FSC) and Microfinance Institutions (MFI) for on-lending to clients (household earning R1 500 and below per month). Clients can use development loan for paying school fees, medical fees and improvements to the household.

2. Capacity building incentives comprises of two elements - training funds and working capital to assist FSCs and MFIs to function effectively
3. Subsidising of operational costs of financial intermediaries to ensure their sustainability.
4. Management information services to assist in capturing reliable and accurate data which would serve as a monitoring tool of the loans issued.
5. Savings mobilisation is a product aimed at growing financial intermediary savings in support of developing a culture of savings in South Africa.

Very little information is available regarding the success of this fund beyond a few case studies. However, there may be certain lessons to be learned from these case studies:

- There is a demand for the product as the product occupies a niche market.

<sup>25</sup> <http://www.samaf.org.za/SitePages/Index.aspx>

- Financial support was given to existing enterprise in most of the case studies.
- Many of the existing businesses had linkages with the formal sector including the government and private sector.
- Many of the loan applicants had previously borrowed from loan sharks.
- Activities are dominated by clothing and dressmaking, selling and buying of second hand clothes, as well as catering.
- Building up a credit history is important, having accessed one loan and successfully repaid that loan results in the increase in access to future loans which are used for expansion.
- Financial intermediaries are also used as savings vehicles and participants feel interest rates are affordable in contrast to those charged by loan sharks.

*Examples of interventions outside government which have proved successful*

Awethu Project:<sup>26</sup>

Is an initiative which aims to identify talent in poor communities in South Africa and assist young entrepreneurs to become successful through providing training and other resources. The programme does not have the normal criteria for small business

support models. Participants do not have to have started a business nor do they need a matric, but rather potential entrepreneurs must show potential. The initial screening of the talent identification process is undertaken through psychometric and numeracy tests. The next phase involves further tests for 25 candidates during an achievers weekend, after which 8 individuals are chosen to spend a month at the organisation's offices. It is during this time that cognitive processes and work ethic are observed. Two entrepreneurs were chosen in 2011, each provided with a R1.5 million investment fund combined with mentoring from top business schools or consulting firms. Over a three year period, the businesses will undergo an incubator phase during which the entrepreneur would earn equity of 50.1% and Awethu the remaining share of 49.9%.

Small Business Project (SBP): Business Bridge: A peer networking model:<sup>27</sup>

This model has been piloted in South Africa and Malawi and aims to build social capital and networks amongst small business owners. The model targets entrepreneurs who want to expand their business through broadening their client

<sup>27</sup> SBP Publications: "Networks achieving business growth, Psi Malawi", 2007 [http://www.sbp.org.za/uploads/media/PSI\\_Malawi\\_June\\_2007.pdf](http://www.sbp.org.za/uploads/media/PSI_Malawi_June_2007.pdf) &

"The next evolution of linkages: Pilot phase, final report to GTZ", 2007 <http://www.sbp.org.za/index.php?id=22>

<sup>26</sup> <http://www.awethuproject.co.za/>



base, acquiring more corporate clients and successfully tendering for government tenders.

It provides an informal forum accompanied by facilitators for owners to get together and discuss issues and share ideas. Procurement representatives from large companies and government also attend these forums to explain their procurement rules. The forum thus serves as a networking opportunity between SMMEs and potential buyers.

#### Corporate involvement in small business development.

Anglo American's development fund, the Anglo Zimele Empowerment Initiative Limited is one example of corporate involvement in supporting SMMEs. The aim of the initiative is the creation and transformation of SMMEs with a particular focus on rural areas. Zimele provides loan and equity finance to start-up or expanding enterprises and operates through three funds: the Supply Chain Fund, the Anglo Khula Mining Fund and the Small Business Start-Up Fund (SBSF) which was established in 2007 and focuses on businesses within a 50km radius of Anglo's operations. The SBSF provides seed and working capital at favourable interest rates. The fund's portfolio comprises of 40% woman owned enterprises and 34% youth owned enterprises. Small Business Hubs complements the work of the SBSF by providing support in the form of business

planning and advice, while at the same time providing access to business equipment, faxes, telephones, and internet, as well as infrastructure such as meeting rooms.

#### *Conclusion*

While small businesses in South Africa face a number of challenges, understanding the particular needs survivalists, micro and small enterprises in South Africa, requires more research. Policies currently have a limited focus.

Understanding the needs of these enterprises and the obstacles faced will go some way in reaping the benefits from enterprise development in terms of job creation and local economic development. The research undertaken by the Studies in Poverty and Inequality Institute, made possible by the financial assistance of the Ford Foundation, aims to follow mainly survivalist and micro enterprise owners to identify what they consider constraints to their operations. By addressing these constraints the programme aims to stimulate local economic development.

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## Policy Brief – January 2012

# Theory of change

## Supply side intervention to support LED

