

SUMMARY

Small enterprises make a significant contribution towards employment, GDP and poverty reduction in South Africa. Yet, the growth of small enterprises is hampered by high levels of informality and numerous challenges. These include, among others, administrative red tape, burdensome registration and permit issuing procedures; complex hiring and employment practices; limited representation of business in policy and social dialogue; limited knowledge among entrepreneurs of available support programmes; limited access to finance and market opportunities; and a lack of proper and adequate skills.

In 2016, Business Unity South Africa (BUSA) and the International Labour Organisation (ILO) published a report titled “Enabling Environment for Sustainable Enterprises (EESE) in South Africa” (ILO, 2016), which provided an assessment of the current business environment in the country and identified areas for improvement. The study suggested numerous policy options to address the challenges experienced by small businesses and to facilitate transition of

informal businesses to formality. These included providing easy access to information for business start-up and support services; reducing and simplifying burdensome regulations; strengthening the voice of small business in policy and social dialogue; simplifying hiring and employment practices; developing new ways to increase access to finance and market opportunities; and mainstreaming entrepreneurial training and skills development.

In line with the ILO’s Recommendation 204 concerning the transition from the informal to the formal economy, it is suggested that the government and other responsible parties address among others, policy inconsistency, incoherence and lack of coordination at all three spheres of government as well as issues around administrative inefficiencies, the regulatory burden and corruption. Furthermore, support programmes should be differentiated and targeted to encourage transitions to formality, growth and competitiveness.

CONTEXT

DEFINITIONS

Small, Medium and Micro Enterprises (SMMEs) play a vital role in South Africa’s economy, especially with regard to their significant contribution towards the country’s employment and production (BER, 2016).

Box 1: What is SMME?

According to the National Small Business Amendment Act of 2004, small businesses in South Africa are:

- Defined as “a separate and distinct business entity, together with its branches or subsidiaries, if any, including cooperative enterprises, managed by one owner or more predominantly carried on in any sector or subsector of the economy”.
- Categorised into groups such as survivalist, micro, very small, small and medium. The categorisation differs for each economic sector depending on the number of employees, the annual turnover of a business, and its gross asset value.

However, the SMME sector in South Africa is hampered by high levels of informality, with recent data suggesting that two thirds of an estimated 2.25 million South African SMMEs were operating in the informal economy in 2015 (BER, 2016).

Box 2: What is informal economy?

The ILO defines informal economy as (Recommendation 204, 2015):

- Economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements; and
- Economy that does not cover illicit activities, in particular the provision of services or the production, sale, possession or use of goods forbidden by law, including the illicit production and trafficking of drugs, the illicit manufacturing of and trafficking in firearms, trafficking in persons, and money laundering, as defined in the relevant international treaties.

Being “informal” can be a result of intended or unintended decisions and circumstances. On one hand, it can be a conscientious decision for the purpose of avoiding business registration and saving on operational costs. On the other hand, it can be a result of necessity, due to the restraining nature of selected policies and regulations.

In South Africa, informality seems to be largely out of necessity, as unemployment was cited as the major reason for pushing many people into informal enterprises (Stats SA, 2012). Therefore, the majority of individuals engaging in the informal economy find themselves to be there not by choice

but simply to survive. This is due to the following unfavourable characteristics of the informal economy (ILO, 2007) (Stats SA, 2012):

- Low or irregular income streams for entrepreneurs;
- Low levels of productivity among enterprises;
- Small turnover levels and realised profits by enterprises;
- Small or undefined work places;
- Unsafe and unhealthy working conditions;
- Low coverage of social protection; and
- Lack of representation and voice.

From a government perspective, the informal economy distorts the statistics about employment and economic growth, which creates challenges for government in terms of planning and policy implementation. Most importantly though, the informal economy reduces the potential for government to earn revenue through taxes, rates, and social security allocations, which in turn negatively impacts on its ability to deliver quality services.

SIZE AND CHARACTERISTICS

The number of SMMEs in South Africa, excluding agriculture and private households, increased from 2.09 million in the first quarter of 2008, to 2.17 million in the second quarter of 2015 (BER, 2016). Out of these 2.17 million SMMEs, around 667,400 (30.8 per cent) SMMEs were formal enterprises, while slightly under 1.5 million (69.2 per cent) were informal enterprises (Figure 1). The increase in the number of enterprises between the 1Q of 2008 and the 2Q of 2015 was largely attributed to a striking growth of informal enterprises during this period, i.e. for every new formal SMME there were 83 informal SMMEs that were created (BER, 2016).

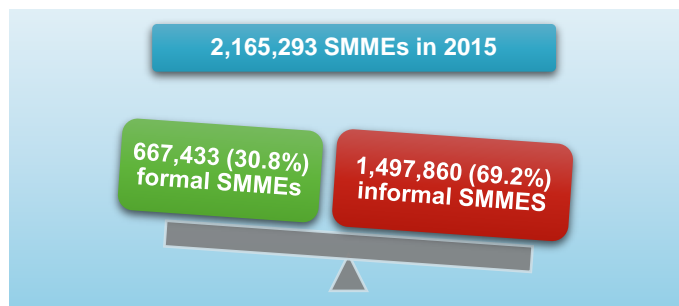


Figure 1: Distribution of formal and informal SMMEs in SA (BER, 2016)

Other characteristics of formal and informal enterprises in South Africa include:

- **In terms of ownership:** Informal SMMEs largely comprise of enterprises with 'own account workers', or individuals who employ only themselves (80 per cent of informal SMMEs); while formal SMMEs are dominated by enterprises that comprise of an owner and employees (about 70 per cent of formal SMMEs). Informal enterprises are predominantly run by black Africans, aged between 35 and 44 years, and those with the lowest levels of education (Stats SA, 2012).
- **In terms of provincial distribution:** The majority of formal SMMEs are concentrated in Gauteng and the Western Cape. Aside from Gauteng and KwaZulu-Natal,

informal enterprises are concentrated in rural provinces such as Limpopo, Mpumalanga and the Eastern Cape.

- **In terms of sectoral distribution:** Trade and accommodation, and community services are the top two sectors where both formal and informal SMMEs are concentrated. However, construction is the third most common industry among informal enterprises as opposed to financial and business services that is very common among formal SMMEs. Noticeably, there are more than two informal SMMEs for every one formal SMME in the manufacturing sector.
- **In terms of the value:** The turnover of the South African informal economy is estimated at around R160 billion (~USD16.6 billion), making its value 2.5 times larger than the GDP contribution of the entire agricultural sector (Institute for Economic Research on Innovation (IERI), 2013). However, considering that the turnover of formal SMMEs was estimated at R727 billion (BER, 2016), informal enterprises generate only a fifth of the value created by formal SMMEs in South Africa.

EMPLOYMENT

The majority of the employed people in South Africa fall within the non-agricultural formal sector, which absorbed over two thirds of 15.8 million employed in the first quarter of 2016 (Stats SA, 2016). At the same time, 16.5 per cent of all those employed in the country were working in the non-agricultural informal sector (Stats SA, 2016), illustrating a significant contribution that the informal sector makes towards employment in South Africa. Between 2008 and 2015, the number of people employed in the informal sector grew at the same rate as the number of informal enterprises in the country.

Community services, finance, trade, and manufacturing were the largest employers among formal non-agricultural sectors (Stats SA, 2016). The concentration of the non-agricultural informal sector employment in South Africa mirrors that of informal enterprises, with trade-related activities, community services, and construction being the largest employers (Figure 2).

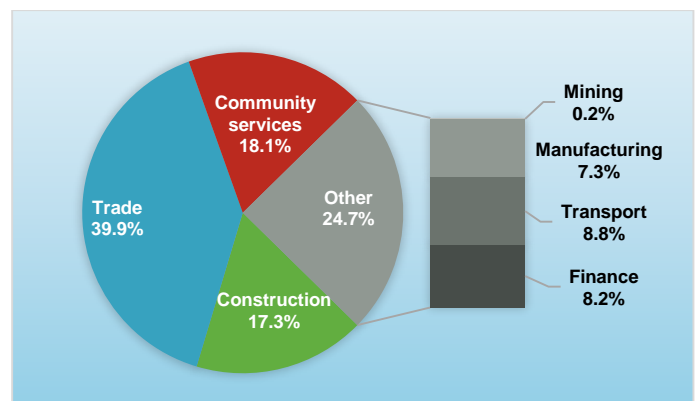


Figure 2: Sectoral contribution to informal non-agricultural sector employment (Stats SA, 2016)

Informal employment by community services and construction has been increasing between 2008 and 2016; while the non-agricultural informal sector employment weakened during the same period. For that reason, it is imperative to take note of

the importance of informal enterprises in providing employment in other industries but trade.

CHALLENGES FACED BY FORMAL AND INFORMAL SMMEs

There is a myriad of challenges facing both formal and informal SMMEs in South Africa. The next sections highlight the most prominent challenges, many of which apply to both formal and informal SMMEs. These are derived from the assessment of the Enabling Environment for Sustainable Enterprises in South Africa (ILO, 2016).

CHALLENGE 1: LACK OF PROPER REPRESENTATION IN POLICY AND SOCIAL DIALOGUE PLATFORMS

Social dialogue is fundamental to having an enabling environment for sustainable enterprise development. Both formal and informal enterprises perceive that organised business does not provide an adequate representation of their concerns.

CHALLENGE 2: ADMINISTRATIVE RED TAPE AND BUREAUCRACY

Burdensome procedures and costs associated with registering a business and acquiring necessary permits have been identified by both formal and informal enterprises to be among the most prominent challenges faced by SMMEs, which cost them both time and money. They specifically refer to the need to comply with regulations that are perceived to:

- Include too many procedures;
- Change frequently; and
- Are highly time-consuming due to administrative inefficiencies relating to issuing of business licences, registrations, permits, etc.

The most time-consuming and troublesome categories of regulations in South Africa, as identified in the ILO's study of 2012 (ILO, 2012), included:

- Tax-related (i.e. VAT, tax administration, UIF, and PAYE);
- Labour related (i.e. the Commission for Conciliation, Mediation and Arbitration (CCMA) and bargaining councils);
- Sectoral Education Training Authority (SETA) related;
- Municipality related (i.e. regulations, charges and levies); and
- Health, safety and Black Economic Empowerment (BEE).

CHALLENGE 3: LACK OF KNOWLEDGE REGARDING SUPPORT PROGRAMMES

Both formal and informal enterprises face, in some instances, similar changes. Aspects related to labour law and hiring practices, red tape, and bureaucracy in obtaining required registration and permits are bottlenecks that are faced by formal SMMEs, and these are also some deterrents for informal enterprises to formalise. Therefore, it is important to first of all, acknowledge that the policy interventions implemented by government need to be designed and implemented bearing both formal and the informal enterprises in mind.

Both formal and informal enterprises perceive the SMME support services in South Africa to be significantly underdeveloped. Only a small percent of SMMEs receive support from the government; however, in many instances the problem lies not in the access to the support but the knowledge about its availability and processes involved in applying for it.

CHALLENGE 4: COMPLEX HIRING AND EMPLOYMENT PRACTICES

South Africa's labour regime is often criticised for its inflexibility and negative impact on employment. Formal enterprises see this as a big constraint to their growth and informal enterprises consider this as a deterrent to formalisation of their activities.

CHALLENGE 5: LIMITED ACCESS TO FINANCE AND MARKET OPPORTUNITIES

The requirements for accessing finance from formal banking institutions are generally exclusionary and insensitive to economic and cultural conditions of informal enterprises. Furthermore, the micro-enterprise lending sector in South Africa is under-developed, compared to neighbouring countries. Access to finance is not only a challenge for informal enterprises in South Africa, but also for formal businesses. This is also partly due to the underdeveloped venture capital industry in the country.

CHALLENGE 6: LACK OF PROPER AND ADEQUATE SKILLS

Skills shortages in the workforce are consistently ranked as one of the main impediments impacting on growth of businesses. There is a perception that the current South African education system does not promote an entrepreneurial culture or equip learners with vital entrepreneurial skills.

CHALLENGE 7: SECURITY AND SOCIAL PROTECTION

Informal enterprises, more so than formal ones, are exposed to criminal activity, which increase their risks in doing business mainly due to lack of appropriate insurance. Furthermore, due to the informal nature of these enterprises, employees as well as owners of informal SMMEs often face unhealthy and unsafe working conditions and do not have access to social security, which increases their inequality and in some instances further aggravates their poverty status.

PRIORITY AREAS FOR POLICY ATTENTION

Countries such as Mongolia and Brazil have already successfully utilised policies to address issues around informality, which in turn, assisted in growing formal businesses too (ILO, 2014; p36).

Both pull and push factors should be utilised in order to assist formal SMMEs to sustain, strengthen and expand their businesses, and to facilitate informal enterprises to transition to formality. Such development could result in the expansion of the government tax revenues and the extension of social

protection and rights to people engaging in the informal economy.

Box 3: Brazil's success in addressing informality

Brazil adopted a national integrated policy framework to combat poverty, which assisted in achieving a rapid formalisation of its economy (i.e., job creation in the formal economy rose three times faster compared to that in the informal economy) (ILO, 2014; pp36). The key interventions that contributed to the success included:

- Non-contributory social protection programmes;
- Simplification of tax rules for small businesses;
- Increased incentives for firms to formalise their workers; and
- Increased enforcement of tax and labour regulations.

Considering the key challenges faced by both formal and informal enterprises, the following policy aspects are recommended for consideration in South Africa (ILO, 2016) (DCED, 2011) (the dti, 2012) (Nicolaidis, 2011) :

RECOMMENDATION 1: REDUCE AND SIMPLIFY BURDENSOME REGULATIONS FOR SMALL BUSINESSES

- Devise well-designed, transparent, and well-communicated regulations to facilitate formalisation and fair competition.
- Lower the costs of establishing and operating businesses, as well as simplifying business registration, licensing and operating procedures.
- Rationalise and streamline business registration and licensing regimes in order to make registration a simple administrative process that is separate from sector licensing.
- Adapt taxation, financing, and social security systems to address specific challenges faced by small businesses in line with their needs.

RECOMMENDATION 2: STRENGTHEN THE REPRESENTATION OF SMALL BUSINESSES IN POLICY AND SOCIAL DIALOGUE PLATFORMS

- The voices and concerns of small businesses should be communicated at the national level in authoritative institutes where policies are deliberated, for example at the National Economic Development and Labour Council (NEDLAC).
- Explore options to form a new social pact, which is constituted by, and representative of all key stakeholders.
- Include small businesses in local and national level policy formulation platforms through direct consultation with all stakeholders.
- Consider involving a wide range of representative bodies when organising and building a voice for small businesses, especially those in the informal economy.
- Organised business associations should find new ways to include the voice of small businesses and informal

enterprises in their dealings with the government and in labour on economic and social policy dialogues.

RECOMMENDATION 3: REVISE LABOUR LAWS TO SIMPLIFY HIRING AND EMPLOYMENT PRACTICES

- Revise complex hiring and employment practices, in support of small business development and the transition of informal enterprises to formality.
- Ensure access to relevant, accessible and up-to-date labour market information systems.

RECOMMENDATION 4: DEVELOP AND ADOPT COMPREHENSIVE FINANCIAL INCLUSION STRATEGIES AND MEASURES IN ORDER TO IMPROVE ACCESS FOR SMALL BUSINESSES TO FINANCE AND MARKET OPPORTUNITIES

- Create an incentive-based policy environment and support system that make it possible for microfinance institutions to emerge, grow, and reach out to the financially excluded in greater numbers, providing diverse demand-driven and affordable financial services.
- Attract and develop private sector funding to augment the financial resources available from public and private institutions, specifically focusing on growing the venture capital and angel investors' activities in South Africa.
- Provide "wholesale finance" or guarantee schemes to retail financial intermediaries to be offered to eligible SMMEs.
- Establish an effective data collection framework to build reliable data sources for SMME finance, such as computerised business registries that would facilitate data gathering, as well as identification and quantification of underserved business segments.
- Introduce a match-making service to facilitate the development of supply chain linkages between small enterprises and larger enterprises.

RECOMMENDATION 5: MAINSTREAM ENTREPRENEURIAL TRAINING AND SKILLS DEVELOPMENT IN ORDER TO PROMOTE AN ENTREPRENEURIAL CULTURE AND EQUIP LEARNERS WITH KEY ENTREPRENEURIAL SKILLS

- Instil entrepreneurship education at the primary school level to foster a more entrepreneurial culture in the country.
- Encourage universities and other tertiary education institutions to develop rich entrepreneurial capital by adopting an entrepreneurial attitude and orientation in their programmes and by establishing internal support structures comprising of dedicated start-up support services such as consultations, access to networks, and premises.
- Promote and encourage employers to offer quality apprenticeships and quality internships to develop the skills base required by enterprises and facilitate the transition from unemployment/inactivity to work (for example, by offering financial incentives).
- Provide platforms and services to upgrade the skills of small enterprises and those in the informal economy.

- Promote business mentorship programmes for small businesses.
- Ensure recognition of prior learning such as through informal apprenticeship systems, thereby broadening options for formal employment.

RECOMMENDATION 6: IMPROVE ACCESS TO INFORMATION FOR BUSINESS START-UPS AND BUSINESS SUPPORT SERVICES

- Address geographical constraints to the provision of support to SMMEs by introducing more satellite offices to improve the reach of programmes, products and services.
- Develop an information portal with relevant government- and market-related information that business start-ups and other small businesses can easily access.
- Disseminate the information collated in the portal through awareness campaigns targeted at small and informal enterprises. Such campaigns should also include

outreaches to remote locations to help secluded small enterprises understand and comply with their obligations as well as access the available market opportunities.

- Establish specialised facilities, such as one-stop-shops and help centres, which would guide and advise small businesses on compliance processes and market opportunities could also play a pivotal role in supporting small businesses and transforming informal ones.

RECOMMENDATION 7: IMPROVE THE RIGHTS AND SOCIAL PROTECTION OF INFORMAL SMMEs AND THEIR EMPLOYEES

- Sensitise, empower, and support enterprises to address unsafe and unhealthy working conditions.
- Promote and extend occupational safety and health measures and social protection services to business owners and employees.

WHAT IS THE WAY FORWARD?

Considering the above, it is imperative for South Africa to address the various challenges faced by formal and informal SMMEs in the country. This will require a reform of the South African business environment to better support sustainable enterprise development and facilitate their transition to formality. This can only be achieved through a joint effort by government, organised business, and organised labour. It is recommended that these work together on the following:

1. Improving policy coordination, coherence, and policy certainty across all spheres of government.
2. Creating targeted support measures to encourage transitions to formality, growth, and competitiveness.

3. Simplifying the definition for small, medium and micro enterprises, and ensuring alignment across all government and public and private institutions.
4. Reducing the regulatory burden and administrative inefficiencies, and introducing the “think small first” principle in policy development and regulatory reform.
5. Reducing corruption.
6. Implementing a robust, consultative and transparent impact assessment system in order to reduce the effects of policies and laws that negatively impact on small businesses and the transitions to formality.

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