Word Count: 4487

Policy for the effective development of the Small business sector in South Africa

Abstract

The small business sector is comprised of an array of differing economic and even cultural units, all with their own strengths and weaknesses. This variety is what makes an effective policy for the development of the small business community so complex and ultimately so difficult to achieve. However, with the use of correct mechanisms and careful decisions focussing on the broader long-run picture, effective solutions can be created to spur on this sector.

Introduction

Small firms cannot be fitted into one broad category. The very nature of the small firm varies widely between different sectors and regions and is dependant on a host of local factors such as market size, institutional relations and supply sector linkages. Global factors such as technology and sectoral differences are playing a more vital role in today's ever globalising economy (Goebel and Tewari, 2002). Therefore, policy aimed at addressing the problems associated with small businesses will have to be sector specific, as the requirements for change in different sectors will be distinct and unique in their applicability to the South African situation.

Recent debate as to the applicability of policies has shown that small firms have a unique roll to fill as a source of dynamic growth and creating demand and supply linkages. Through this development, the creation of external economies will allow for spillovers to other sectors through solid supply linkages, as institutions help build capital and labour knowledge into efficient enterprises moving forward through dynamism and flexibility (Goebel and Tewari, 2002).

In designing effective policy that will uplift the small business sector, current constraints to the sector will have to be identified. Therefore, this essay will firstly delve into some characteristics of small businesses. Section two will give a brief overview of the pros and cons of subsidies to small firms, with section three demonstrating examples of successful

methodologies of aiding firms. Section four gives actual policy recommendations which are based on ideas developed in sections one to three, with the conclusion following.

Features of the small firm

Firstly, is the small business sector really an engine of job creation? "In most developing countries the vast majority of industrial and service sector firms are small in scale. Collectively these firms account for the bulk of formal and informal industrial employment in most countries" (Goebel and Tewari 2002, pg. 5).

To documents whether these small firms produce sustainable employment, Biggs noted that one must look at net job creation and not gross job creation. The failure rate amongst small firms is relatively high and therefore destroys a proportionately large number of jobs, particularly in developing economies. Small firms thus do create a large number of jobs, but many of these are lost due to the high failure rate in this sector. Goedhuys (2002) typically notes that smaller firms tend to grow faster then their larger counterparts, but the growth is also more volatile. In addition, Tybout (2000) notes that there is a high entry rate of small firms into the market in South America, and an even higher job turnover rate, which is partly due to dramatic business cycles. This increased volatility in growth and firm turnover induces much lower job security in small firms.

Goedhuys (2002) relates the higher growth rates to the possibility of diminishing returns to scale. Firms will rapidly increase in size until the maximum efficient production point, as determined by the bottom of the average cost curve, upon reaching this equilibrium point, there is little incentive to grow. In addition, small firms grow faster due to their ability to dynamically alter production techniques to suit the current demand environment. In the case of large firms, obstacles such as institutional bureaucracy and already developed systems that have allowed for an efficient size to be reached cause a much slower growth rate to occur.

More comprehensive research on net employment growth is needed to discover trends in job creation rates, taking out outliers and aggregating out shocks. This will allow policy decisions to be focused on the development of long term sustainable growth. In this situation Goedhuys (2002) makes an important point that the focus should then be on the reasons behind the growth of the successful companies and industries, and establish these which mechanisms which could be used for further development.

There is also a negative relationship between firm age and the rate and variability of firm growth. Lucas (1978), and many others explained this phenomenon via learning by doing. This is based on the development of managerial efficiency and the understanding of an individual firm's efficiency curve over time. Learning by doing can decrease the volatility of a sector in allowing firms to grow through a nurturing environment.

Job quality is another issue that is an important issue. Do large firms or their smaller counterparts offer better jobs, measured in terms of income, stability of employment, and benefits? Larger firms tend to offer better jobs; in fact the wage differential can be as high as 50 percent between comparable large and small firms in developing nations (Biggs, undated). This evidence is robust even when factors such as age, education, experience, the nature of the industry have been taken into consideration. Also, large firms more frequently offer benefits such as pension plans, life insurance, medical aid, etc. Smaller firms find it more difficult to extend these extra fringe benefits to their staff. Therefore, from these findings, small firms are not generating the share of sustainable employment and wealth that was first noted (Biggs)

Who really benefits from employment gains in small businesses? Small and medium sized firms tend to provide employment disproportionately to the poorer deciles of society (Goedhuys, 2002). Considering the issues of income distribution in the South African economy, this is a vital point.

With regards to labour intensity and firm size, the claim is that due to the cost of capitalisation, smaller businesses would be more labour intensive. Indeed the evidence does not point in this direction. There is no discernable pattern of labour intensity that is related to firm size (Biggs). The largest variation in labour intensities occurs across industries rather then within differing firm sizes in a particular industry. This is a significant finding in terms of policy aimed at job creation. Therefore, if South Africa focuses on policies to increase employment, research would be required at a sectoral level to determine those industries that have the potential to increase employment significantly through growth. Sectoral specific policy is required to provide favourable conditions for growth to take place.

In addition, there are only a small number of firms that maintain high growth rates and it is these firms that account for the main share of employment growth. Indeed this fraction of firms is even smaller in developing nations. There are very few firms that actually grow into medium size enterprises. The firm distribution often lends itself to a large number of small and micro firms supporting or competing with large firms, with few intermediate firms and is known as the missing middle (Tybout, 2000). This distribution is puzzling because of the fact that small firms as a whole tend to grow faster. There are obviously external factors at play that inadvertently limit the growth potential of these firms past a certain size limit.

The growth of small firms into the intermediate size bracket is an important element in the successful development of a strong industry supply sector, and it is the aim of this paper to provide a policy solution to achieve this. Further research into why South African firms do not graduate into medium sized firms is important in taking the nation forward.

Large firms in developing nations usually have the upper hand in terms of technology and productivity, as research and development tends to be focussed on mimicking processes developed from other nations and applying them locally. These companies have the capabilities to source international technologies and the resources to adapt the technology and apply it locally. This interaction with international markets is sited as one of the key mechanisms driving technological development (Biggs).

There are also comparatively higher costs for small firms to undertake research and development. Therefore, the expected return must be more significant then that for larger companies. This is seen in reality, where small firms are more efficient in research and development (one possibility could also be diminishing returns to scale). The larger companies are more closely associated in funding university based research, but the small firms are more flexible in being able to alter their production techniques and are thus better equipped to use the new innovations (Biggs). Small firms have an advantage in technology and innovation in skill intensive industries that make use of technology. However, in the capital intensive industries, larger firms have the edge. Larger firms may have expanded using older, low technology solutions and inherently know the production processes, and their maximum efficiency production combinations to produce far more efficiently.

Small businesses have a particularly low export propensity, especially in developing nations. The proportionately high transaction costs, uncertainty, and sunk costs of entry into the export market are inhibiting for small businesses (Tybout 2001). The increased capacity for larger firms to export allows for an increase in efficiency through either scale economies in production, access to foreign technologies, or increased supply chain linkages. Thus, the efficient firms in the domestic market are able to expand, increasing industry production levels and enabling an increase in the benefits for local suppliers (Tybout 2001).

Small firms can provide a vital role in indirect exporting by supplying local firms. They can add flexibility to the supply chain by being able to alter inputs and shift production, allowing them to react to shocks, aiding the competitiveness of the cluster (Biggs). This dynamism is an integral part of the efficient development of any sector.

Lessons learned from other nations

There have been a variety of failed attempts at stimulating the small business sector in different nations, with a number of parallels evident in each case. This section gives a critical view on traditional reasons for the protection of small business, which is a policy background to the author's suggestions on developing the South African small business sector.

The common rationales for subsidising the small business sector include (Based on Biggs review of the business sector):

1. The contribution to development and alleviation of poverty
2. Market failure
3. Institutional failure
4. To improve the learning capability of small businesses

However, are all these subsidies warranted? Special focus on the development of small firms in a country could have undesired effects such as an inefficient use of resources allowing for an inefficient industry to develop supported by subsidies. The goal of an effective development policy should be a good private sector development policy (Biggs). The returns inherent from this small sector development strategy should match or exceed those of other development policies such as infrastructure development.

One important area is looking into any past and present policies that stem the growth of the small business sector and seek to eradicate distortions that prohibitively increase business costs. Analysis of these distortions will result in policies focussed on broader problems such as lack of appropriate development, unnecessarily high bureaucratic costs and access to credit. A clearer idea of the natural size distribution of firms in the economy is also required, given local attributes such as internal market characteristics (Biggs).

Market failure does hold back small sector development. Developing economies are plagued with market failure such as access to finance, technology and skills development (Biggs). Sectoral and general policy programmes to eradicate market failure are needed not only for the development of small firms, but for the welfare of the economy.

Appropriate supply-chain linkages between firms are also necessary for the development of an effective small industry based on competitive advantage. This will require the aid of large companies, and incentives to larger companies may be needed to necessitate this link.

However, even the best policies aimed at reducing market and institutional failures will at best be marginally uplifting if small firms do not have the capacity to learn and develop. Many small firms don't know what they don't know, and may therefore not respond to the new policies. In this case, further interventions are required to aid small firms reach their potential through expanding the learning environment and giving firms access to business development services (Biggs).

Nurturing small businesses

Some important characteristics and problems about the small business sector have been highlighted above. These attributes are all vital in understanding the needs of the small business sector, with the attention now turning to different successful policies that have been implemented in other nations.

Government policy has an influence on the ability of small firms to grow. There is often a breakpoint in the firm size distribution among developing nations, which is usually related to increasing institutional and administrative costs with graduating to a medium sized business. This structural break in costs is a large disincentive for the growth of small firms. Medium sized firms can be treated like large corporations "commanding the same levels of profit and

capacity to spread the administrative costs of regulatory compliance between a greater resource base and also to offset the costs with certain benefits of legitimacy" (UNCTAD 2001, pg. 4), and are dropped from being protected to having the full administrative and tax costs thrown at them with a slight size increase. Regulatory costs, in addition to inefficient credit markets causing increased costs of borrowing and in most cases the complete lack of access to credit results in few informal firms graduating to formal status (Tybout, 2000).

The first point to be addressed is in the nature of the legal and regulatory environment. Costs that fall onto small businesses from legal and regulatory practices often form a disproportionately large percentage of income. When these become too high, the small firms have incentives to leave the formal sector. The challenge is to produce an environment where there is no structural break in the costs of compliance to incentivise small informal businesses to grow into larger organisations (UNCTAD 2001).

Tybout (2000) notes that excessive wage rigidities in the presence of an excess supply of labour and scarce capital will formalise the job market, resulting in a number of workers having to open their own microenterprises.

Business development services can perform a vital role in nurturing small firms that suffer from lack of access to markets. Many small firms could potentially grow if they had access to such markets, which include finance and skills. Support linkages to large firms and horizontal and vertical integration of the product chain is required to facilitate the increased development of the small business sector. A balance of support must stem from public-private sector partnerships and government support services. This will result in a demand-driven response based on the idea of fostering linkages within firms in the same or related sectors and developing Marshallian demand linkages and positive externalities of industrial clustering as a source of growth in employment and efficiency in a given sector (Goebel and Tewari, 2002).

There are a variety of areas that are typically targeted by business development services, such as training, marketing, product development, credit and technology. However, many of these programmes and institutions have been plagued by lack of governance, shortage of skilled and motivated staff, sufficient coverage and effective coordination and communication efforts

(UNCTAD 2001). Many programmes offered by government and NGOs may be competing in the same area for support, while leaving others untouched.

These services typically focus on aiding start-ups, and do not offer long-term support, services, training and access to finance. The long-term nature of support is vital for the continued growth of any small business sector, especially in terms of access to credit. While many firms have no problems in accessing credit to start their businesses, the real constraint is brought about with opportunities to expand. These firms often do not have effective access to credit for expansion due to risk from poor financial records, the high small firm turnover and insufficient assets due to a low level of capitalisation. The high cost of access to credit, especially in developing nations limits a small businesses option for expansion (UNCTAD 2001).

Many developing economies are not focussing on this, but rather on macroeconomic policies that aim for a stable environment, with a passive push to the development of small business. While macroeconomic and price stability is vital for the successful development of the economy, this must be complimented with grass roots initiatives to stimulate further linkages in the supply chain.

Lessons can be learnt from the East Asian experience in developing small business sectors. A pre-appraisal monitoring system was put into place, in which access to credit is based on performance and credit would be quickly withdrawn with lack of performance. Those firms with the best growth potential and those that were likely to create positive externalities were targeted (UNCTAD 2001).

There are many potential gains that could occur with effective dialogue between the public and private sectors. Cooperation between these two sectors is beneficial to both sides in many aspects such as skills, infrastructural development and the promotion of vertical and horizontal linkages is thus of vital importance. This has been a feature in the successful development of any economy. Despite the importance of this collaboration, it is often sorely lacking in developing economies, where the private sector is not reactive to government initiatives and set on lobbying for special interests. Large firms often drown out the voice of the small business sector and take preference due to their size and the fact that they are

competing directly against imports. Even when these small businesses can take part in the decision making process, the sector often is either not unified or too weak (UNCTAD 2001).

Non-financial business development services (BDS) have been used successfully to stimulate the small business sector through marketing and market linkage. Furthermore, these services are often sustainable on a long-term basis. Goebel and Tewari 2002 document three types of these services that have been used which are categorised as marketing institutions. The first is a non-profit marketing business, which would buy the output of a small business and look to other regions to sell the product and develop market linkages. These marketing businesses tend to be focussed and target only a few firms for market development. The next type of BDS provides a brokering service to the small business where it assists the small business to reach markets, but doesn't buy or sell the product. The third mechanism focuses on actually developing a regional marketing infrastructure which will have a long lasting impact by fostering demand linkages through access to trade fairs and provides information about external markets via a consulting service (Goebel and Tewari 2002).

Fostering business linkages through clusters and networks is an important tool. Four popular examples of this are subcontracting, franchising, brokerage and procurement (Goebel and Tewari 2002). The recent focus has been on developing linkages in attempting to understand the competitive dynamics of small businesses and inter-firm relations. Here, the nature of the network is important, and not just the competitiveness of the individual firm (Goebel and Tewari 2002). This is more of a holistic view on determinants of small sector development and attempts to take into account the role played by various actors such as workers, interactions with learning organisations, relations to other firms, and the vertical and horizontal linkages in developing the sector. The goal is to understand where the firm is in its supply chain and the role it plays in the market.

This demonstrates clearly the extent of institutional linkages facing the firm which gives policymakers a better understanding of the effects of changes in legislation and optimal solutions for fostering growth. Research has demonstrated that firms working together in industry groups in conjunction with programmes that target such action foster a more supportive and growth enhancing network for small firms. This encourages competitiveness and development through economies of agglomeration and reduces the problem of isolation facing. Policy is thus not just focussed on solutions for individuals, but on connections that

help in reducing risk, spreading costs and developing coping mechanisms for uncertainty from supply and demand (Goebel and Tewari 2002).

Policies aimed at developing the small sector generally tend to be broad and are characterised by aid through access to credit, relaxing of regulation and training. There are many good political arguments for this such as ease of implementation, universal access to aid so as not to exclude any firm that is need of assistance, and for help to be as broad as possible in its reach (Goebel and Tewari 2002). However, these supply driven policies tend to be ineffective and inefficient in their implementation and often do not solve the problems at hand.

Non-exclusionary policies that are sector specific can elicit more benefits through solving the inherent problems in the industry (correcting for market failure in a sense). These policies are aimed at sectors where potential spill-over effects such as lateral migration or stimulating demand in related industries can occur. Nevertheless, these polices are prone to corruption where a few of the elite obtain the majority of the benefits. The solution to this is greater transparency and accountability through open discussion and public scrutiny (Goebel and Tewari 2002). The focus should be on developing an environment where these small firms can be nurtured through access to inputs, finance, market oriented reforms and stimulating foreign direct investment (UNCTAD 2001).

Policy Recommendations

The above mentioned policies will be used as elements of a successful economic policy increasing the strength of the small business sector and encouraging small firms to grow to eradicate the problem of the missing medium sized firms in South Africa. Firstly, as the world has increased its openness to trade, there has been a significant growth in the share of world trade by developing economies, mostly as a result of the growth of many of Asian countries (Goebel and Tewari 2002). Lessons can be learned from these successful economies. In each country where rapid industrialisation occurred, there were four key policy settings that were universal, namely:

1. A solid macroeconomic framework with which to build upon
2. Outward orientation through the stimulation of exports by the state
3. Actively promoting foreign direct investment
4. Selective interventions that were effective in building supply capacity and comparative advantage (UNCTAD 2001)

These polices formed the core of the developmental framework. However, in any successful development strategy there is also a keen focus on infrastructural development and increasing human capital capacity, which is required to take advantage of foreign direct investment and to sustain development. These policies have indeed uncovered a structural weakness in South Africa via neglected skills development and training. This is becoming a key capacity constraint to the growth and to take advantage of foreign investment. The Asian economies focussed heavily on skills development and knowledge capacity, especially in the areas of science and engineering.

South Africa also requires the development and the availability of good data at the firm level. A clearer picture is needed about geographic locations of clusters, and a more accurate picture of the number of firms in the economy. This is also pertaining to the depth of the informal sector. South Africa needs a firmer grasp on the role that informal firms play in fostering linkages and the creation of wealth. The further understanding of the dynamics of this sector is of vital importance. Interventions based on the ideas above must be developed to harness the potential of the informal sector, and where possible induce these companies to register in the formal economy.

In terms of selective interventions, the focus should be around four main sectors of the South African economy. Each of these sectors will be analysed in depth and on-going research of the problems inherent in each is required for the successful implementation of policy in developing linkages and growing each of these niche areas (Goebel and Tewari 2002).

Research must be done by a core of locally based specialists so that each sector will have its own ‘task force’ in pointing out key problems and challenges. This task force will continue to monitor the success of its sector bring solutions to any problems identified. Detailed studies of each sector are required to obtain information about demand/supply and vertical/horizontal linkages, historical reactions to policy, production centres and performances. Key inputs by major players such as producers associations, banks, public and private sector development agencies and training institutions should also be given incentives to get involved in development programmes. The help of these agencies is vital for the successful characterisation of problems and implementation of policy (Goebel and Tewari 2002).

Further trade liberalisation in the South African context should be focussed on the needs of the development of the four key sectors that are identified for growth. A correctly managed trade regime will stimulate these four sectors via fostering supply linkages though increased access to imports of materials, processes, technology and knowledge. Growth in these sectors should be export oriented to fully take advantage of scale economies and develop linkages with international competitors and suppliers for further technical and research and development benefits.

A clear and concise policy with unambiguous goals is required and must be developed in accordance with the major players listed above. This policy will incorporate the knowledge from sections one and two above, and the ideas developed in section three in achieving specific goals and targets for the promotion of growth. This is necessary for the maximum positive impact of policy that must, above all be transparent.

Conclusions

One cannot ask specifically what economic policies alone are needed to support the small business sector. The important issue here is to take a holistic view of the development of the economy and what role the small business sector has in this development.

Once a clear role has been defined, the nation must ask itself what are the constraints to achieving this, and what can be done to aid the process? The answers to these questions are definitely not clear, not simple and will take time to implement. It will take a variety of actors to find innovative solutions to the problems at hand and then carry them out effectively and transparently.

This essay has given some insight into the strengths and weaknesses of the small business sector as a whole, with some reference to economic policies that have not solved these problems. A solution is given on specific market actors, and now the important linkage to solving the inherent issues plaguing South Africa is research. Research that is targeted at key sectors for development and that will remain dynamic in its applicability and continue to look for sustainable growth solutions into the future.

References:

Biggs, T. undated, “Is small beautiful and worth a subsidy? Literature review”
Website: http://rru.worldbank.org/Documents/PapersLinks/TylersPaperonSMEs.pdf

CDE 2004. Key to growth: Supporting South Africa’s emerging entrepreneurs. Research report number 12

Goebel, J. and Tewari, M. 2002, “Small firm competitiveness in a trade liberalised world: Lessons from Tamil Nadu

Goedhuys, M. 2002, “Employment Creation and Employment Quality in African Manufacturing Firms,” International Labour Organisation, Seed Working Paper N. 26
Website: http://www.ilo.org/dyn/empent/docs/F1270684327/WP26-2002.pdf

Lucas, R. E. 1978, “On the Size Distribution of Business Firms,” *Bell J. Econ.*, 9, pg. 508–23.

Tybout, J. 2000, “Manufacturing Firms in Developing Countries: How Well Do They Do, and Why?,” *Journal of Economic Literature*, Vol. XXXVIII (March 2000) pg. 11-44.

Tybout, J. 2001, “Plant- and Firm-Level Evidence on “New” Trade Theories”, *Handbook of International Economics*

UNCTAD (2001). Growing micro and small enterprises in LDCs: The “missing middle” in LDCs: Why micro and small enterprises are not growing? Enterprise Development Series UNCTAD/ITE/TEB/5/, Geneva.
Website: http://unctad.org/en/docs/poitetebd5.en.pdf

UNCTAD (2006). The Least developed countries report. Part 2, Chapter 6.
UNCTAD/LDC/2006, Geneva
Website: http://www.unctad.org/en/docs/ldc2006p2ch6_en.pdf