"Small business is praised for its potential to create jobs and grow the economy. Do you believe that overall policy in the form of the newly released New Growth Path and the Industrial Policy Action Plan together with the budget support the development of small business in South Africa? Substantiate your answer with references to the relevant documents."

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Word count: 2175*

* Not including title and references

Budget Speech Competition: Undergraduate Category

1. Introduction

The South African economic landscape has been subject to increasing scrutiny in the last decade. It is deemed Africa's innovation and economic hub, and a favourable environment to conduct business. Although South Africa presents lucrative commercial opportunity, it is also rife with persistent poverty, income inequality, and high unemployment (Edwards and Schoer, 2001).

The South African government has in a bid to reduce unemployment, alleviate poverty and reduce income inequality, undertaken initiatives to promote the development of small and medium enterprises (Edwards and Golub, 2003).

This report assesses the effectiveness of the New Growth Path, Industrial Policy Action Plan and the fiscal budget of 2012 in facilitating the development of small and medium enterprises. The report considers theoretical and empirical evidence, and international experience to evaluate the government's policy response to achieving the aforementioned objectives.

Section 2 and 3 provide a contextual description of South Africa, Section 4 considers the empirical evidence, with particular emphasis on the challenges faced by SME's. Section 5 critically assesses the policy responses to the aforementioned challenges. Section 6 provides a yardstick to South Africa's SME development by means of comparison with Kenya and Pakistan. The concluding remarks and policy recommendation are addressed in Section 7 of the report.

2. Background

The cornerstone to South Africa's democracy is the Freedom Charter of 1955. It explicitly states the right and duty to work of all citizens. Furthermore, it stipulates the benchmark of a national minimum wage and full employment benefits. These labour-related rights are cemented in Chapter 2 section 7 of the Constitution (Constitution, 1996). The declaration of these rights has unfortunately not materialized for many South Africans. Of the jobs that are created annually, 75% are attributed to small businesses (Kogolo, 2010). In total, small business accounts for 60% of the employed labour force (Kogolo, 2010). Of the unemployed in 2011, 2.8 million were not registered with an educational institution; thus significantly reducing their chances of future employment (Creamer, 2011).

It is within this context that South Africa has set an objective of creating 5 million jobs by 2020; a target many have criticised as unrealistic (Jones, 2011). This objective is intended to be attained through the development of Micro, Small and Medium enterprises (NGP, 2010).

3. Theoretical framework

3.1 Definitions

The definition of *small business* varies within literature. The commonly used description of an SME is ‘a separate and distinct business entity, including co-operative enterprises and non-governmental organizations, managed by one owner or more persons which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy’ (National Small Business Act, 1996).

It includes both the formal and informal sector; those businesses registered and otherwise for tax purposes and operating in urban and rural areas. It is worth noting that data relating to the latter sector is not widely available in comparison to the former, thus limiting the extent of comparison between sectors.

3.2 Policy considerations

Post1994 election, the newly elected ANC government set out to achieve the objective of creating “a better life for all”. During the period of 1994 to 2009, the government employed three economic programmes to achieve this objective; namely the Reconstruction and Development Programme (RDP), the Growth Employment and Redistribution Programme (GEAR) and the Accelerated and Shared Growth Initiative of South Africa (AsgiSA). As these programmes failed to achieve their objective, a fourth policy was introduced in 2010. The New Growth Path (NGP) aims to increase economic growth rates between 6% and 7% per year, creating 5 million jobs by 2020, thereby reducing the unemployment rate to 15% (NGP, 2010).

The NGP is intended to work in conjunction with the IPAP2 and the fiscal budget of 2012 to achieve these objectives. Both the NGP and IPAP2 place emphasis on small businesses to pioneer employment creation. The contentious question is whether the policies *facilitate* the creation and development of these small businesses.

4. Empirical evidence

The Bureau of Market Research estimated the failure rate of micro, small and medium enterprises in South Africa to be between 70% and 80% (Brink, Cant, and Ligthelm, 2003). According to the World Bank's Second Investment Climate Assessment of South Africa, obstacles facing SMEs can be categorized; based on their origin, into the internal and external environments (World Bank, 2010; Brink, Cant, and Ligthelm, 2003).

Internal factors

Internal factors pertain to inadequate managerial skills, poorly trained and low-skilled employees, lack of financial knowledge, and lack of expertise in functional areas including human resource management and marketing (World Bank, 2010).

External factors

External factors are macroeconomic exogenous variables, beyond the control of the enterprise. These include resource scarcity, rapidly changing technology, and economic instability (Brink, Cant, and Ligthelm, 2003).

From the numerous surveys on SMEs conducted between 2003 and 2010, there are three core recurring challenges in the internal and external environments. These are namely; inadequate access to finance, lack of managerial and labour skills training, and lastly, restricted access to international markets.

Inadequate access to finance

The World Bank surveyed 213 SME owners in South Africa in 2008. The survey reported that bank financing covered only 7% of the firm's working capital needs and 26% of investment needs (World Bank, 2010). The surveyed enterprises rated a lack of access to funding as the greatest impediment to growth. The survey found that enterprises were less likely to apply for banks loans, citing discouragement from previous attempts as the primary reason. Microenterprises recorded rejection rates of 89%, 32% for small enterprises, and 13% for medium-sized enterprises, compared to 8% for large firms in 2009 (World Bank, 2010).

The second issue relating to finance is the relatively high cost of capital (nominal interest rates). Prime bank overdraft rates averaged 9% compounded monthly in 2011. Furthermore, SMEs in the formal sector are subject to paying taxes. The ratio of total tax to GDP in the last quarter of 2011 was recorded at 27.3%, a 0.8% increase from the fourth quarter of the previous year (Budget Review, 2012).

Lack of managerial and labour skills training

The competence of management in SMEs is determined by the availability of management and financial information (Brink, Cant, and Ligthelm, 2003). The lack of clear financial direction and management hinders SME growth (World Bank, 2010).

The increasingly competitive nature of international trade has resulted in a shift in the composition of labour; moving away from labour-intensive industries to more capital and skills-intensive sectors (Nattrass, 1998:18). As a result, SMEs are not sufficiently large enough or labour-absorptive as the South African government has eluded (World Bank, 2010:6). Nattrass reports that middle-income countries are experiencing “import penetration” from low-wage countries, thus causing a decline in the demand for unskilled labour (1998:19).

This restructuring of labour by firms demands that the government actively pursue skills development as an urgent mandate, if it hopes to gain competitive advantage in international markets.

Access to international markets

The economic growth gap relative to the level of employment in South Africa reflects the need for increased domestic saving. Gouw suggests a three-tiered approach to achieving the necessary level of savings (2011). The first tier is opening up the South African market through increased international trade. Secondly; promoting the export of South Africa goods and lastly, attracting more Foreign Direct Investments (FDI) (Gouw, 2011).

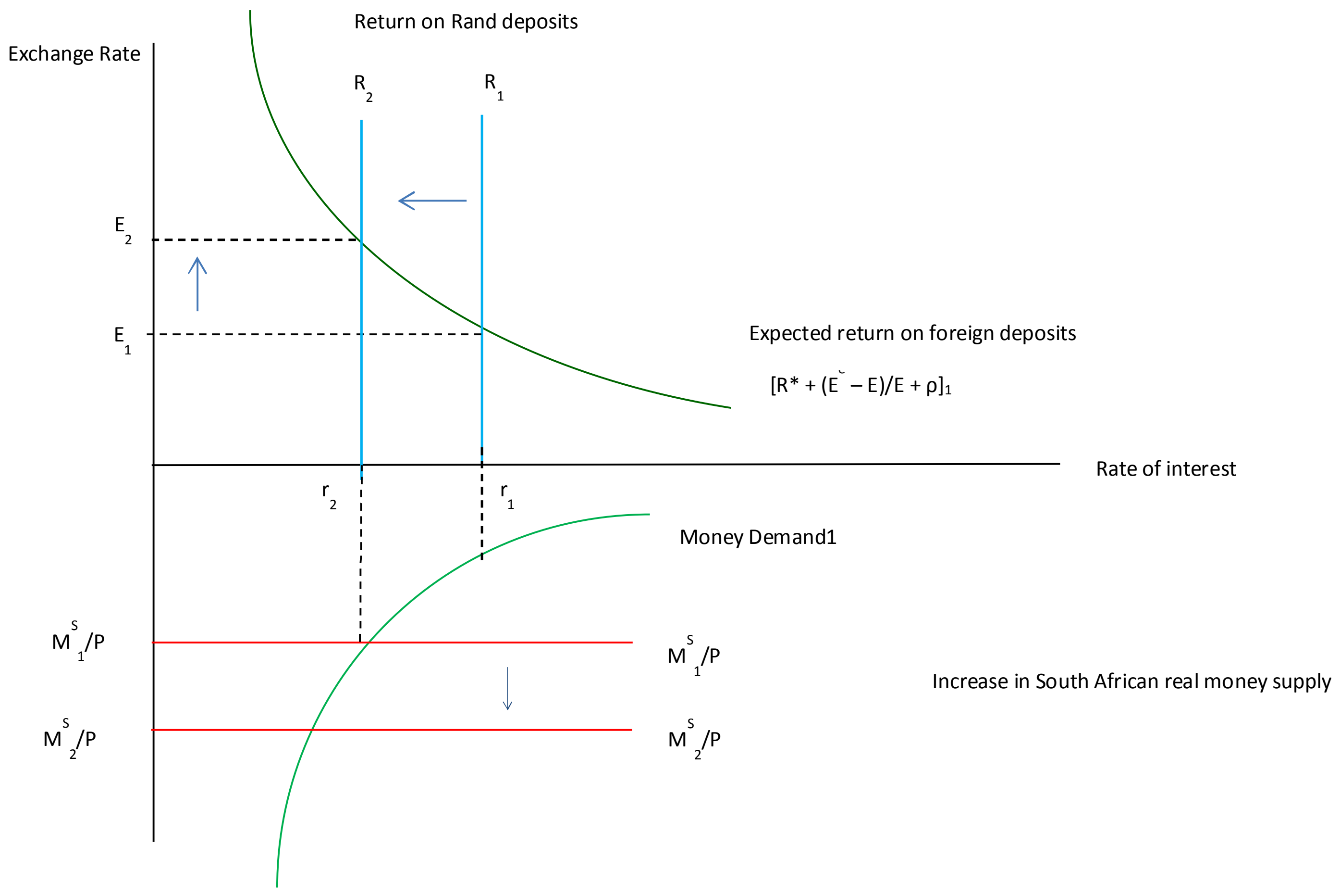
5. Policy responses to growth impediments

The effectiveness of the policy is assessed according to the extent to which the challenges; impeding the growth of SMEs, are addressed.

Accessing finance

The NGP and IPAP2 address the issue of restrained access to finance in two ways. Firstly, it proposes a looser monetary policy and inflation targeting to lower the real interest rate (IPAP2, 2010:17, NGP, 2010:16). In addition, the Central Bank will purchase more foreign currency in order to keep the Rand at a "competitive" level (IPAP2, 2010:17). The effect of these propositions is three-fold.

<u>Equilibrium in the money and foreign exchange market</u>



A looser monetary policy and purchase of foreign currency causes an increase in the real money supply. The Money Supply curve shifts downwards from Ms_1/P to Ms/P_2. This change in the South African money market causes a decrease in the real rate of interest, resulting in a lower return yielded from government bonds. Moreover, the cost of borrowing and investing is lower for SMEs and foreign investors, inducing an increase in investment in South Africa. In turn, there is an increase in the direct exchange rate, representing a depreciation of the Rand.

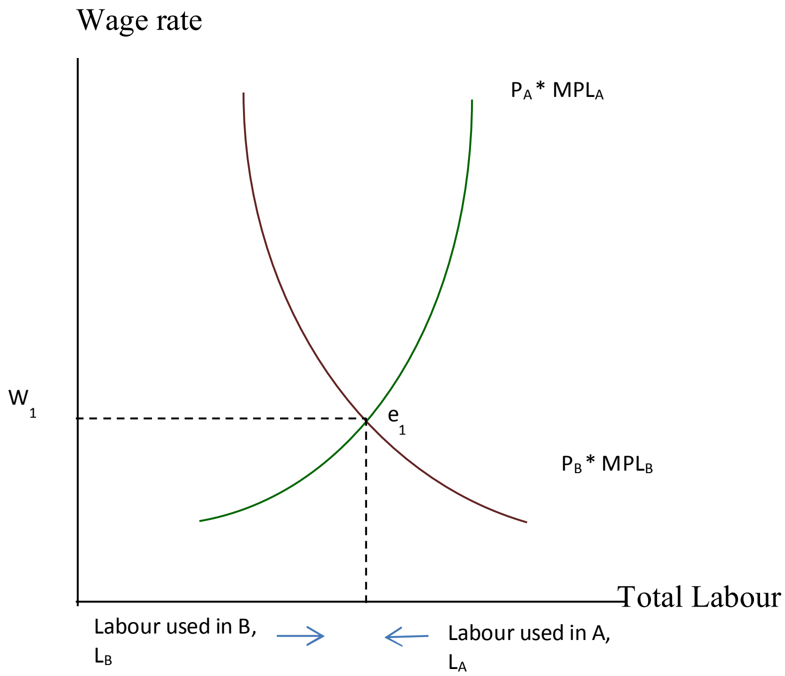
The NGP and IPAP2 note that to increase the effectiveness of development finance institutions; including Khula and the Industrial Development Council, in funding small and micro businesses, it is necessary to revamp institutional structures (NGP, 2010:18). The 2012 budget addresses the need for lower taxation rates for SME's by providing tax relief, decreasing bureaucracy expenses and improving cash flow for micro and small businesses (Budget Review, 2012).

The policies are criticized for the numerous inherent contradictions. One such contradiction is the looser monetary policy coupled with a tighter fiscal policy (NGP, 2012:12). The decrease in government spending implies reduced provision for skills and development training to improve worker skills-base and the welfare of society. This trade-off between depreciating the Rand to increase exports and improve the current account balance, and decreasing government spending on public infrastructure is widely criticized by public groups including COSATU (COSATU, 2011). Moreover, it is implied that the government is able to dictate monetary policy. This is in fact, not within the government's jurisdiction. Government controls fiscal expenditure and tax collection, whilst the South African Reserve Bank independently pursues inflation targeting by adjusting the interest rates (Krugman et al., 2011).

Skills training, productivity wages and comparative advantage

The IPAP2 stresses the development of large-scale employment sectors; especially in agriculture, light manufacturing and services (NGP, 2010:7; IPAP2, 2010:19). These sectors are becoming increasingly capital-intensive, which is consistent with literature reporting a decrease in the demand for low-skilled workers.

In opening up the economy to international trade as suggested in policy, the unit labour costs of competing countries become increasingly important to consider (Edwards and Golub, 2003:4). The wage rate is directly related to labour productivity; where low wages are likely to reflect low productivity (Golub, 1998). In turn, the level of productivity within a country determines its' comparative advantage against competing nations (Krugman et al., 2011). According to David Ricardo, comparative advantage depends on the ratio of productivity in the two industries within a country. Ideally, a country should then export goods in the industry in which it has comparative advantage (Hausmann and Klinger, 2006; Krugman et al., 2011).



The labour market is equilibrium at e_1, paying a wage rate of W_1. P is the price of the each good, and MPL is the marginal rate of productivity of labour required to produce the good. Therefore the wage rate is a factor of Price of the good and the labour required to produce the good. No external costs in perfectly competitive markets.

There are two concerns with policy regarding labour productivity and prevailing wages. Firstly, the South African government must acknowledge the change in production from labour-concentration to capital and skill-intensive practices (Nattrass, 1998).

Secondly, South Africa's rigid labour laws are unfavorable to international investors. The stronghold of the trade unions has resulted in the 'pegging' of the wage rate to inflation, resulting in 'sticky' wages. These set wages are above the marginal rate of productivity of labour (MPL). A downfall of the policy is its' indecisive stance on the determination of the wage rate (Jones, 2011). It is inconsistent to encourage international trade and competition yet not adopt the practices of allowing the market to determine the wage rate where wage = Price*MPL, resulting in inefficiency (Gouws, 2011).

6. Kenya and Pakistan: Embracing small business

Both Kenya and Pakistan have embraced potential of small survivalist business to create employment and alleviate poverty. In Kenya, small business accounts for 25% of non-agricultural gross domestic product (GDP), creating 81% of private sector employment (Lyons and Snoxell, 2005). Similarly, in Pakistan small business makes up 90% of private employment, 80% of which are in the non-agricultural sector, contributing 40% of national GDP (Lyons and Snoxell, 2005).

These countries are a mantel of the success of microenterprises, thriving in the informal sector. South Africa is yet to fully accept microenterprises as a viable means of sustainable employment (World Bank, 2010). The rate of success of small business is however, dependent upon the development stage of each country and the success achieved in Kenya and Pakistan's informal sector, may not apply to South Africa (Kogolo, 2010).

7. Policy recommendations

South Africa has recognized the potential of small business to create employment. Current policy is in favour of the development of small business; however numerous considerations must be made to ensure the success of small business. South Africa's policy supports liberalization of the market and increased competition. To compete internationally, there is a need for labour skills training and wage rates reflecting the productivity of factors of production. These considerations ought to be reflected in the fiscal budget to ensure that a tighter fiscal policy does not compromise government spending on skills training. Moreover, increased access to funding, tax incentives and a reduction of bureaucracy for small business should be reflected, in specific detail in policy, so as to avoid ambiguity of government's stance.

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