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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

**The Investment Climate in South Africa – Regulatory Issues:  
Some insights from the high-growth, export-oriented SME sector**

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**Key Messages**

1. SMEs in South Africa consider the local investment climate overregulated. While there may be good reasons for new regulations to address the distortions of apartheid, this has been done with little reference to principles of regulatory best practice.
2. The principal problems identified by SA SMEs are complicated labour regulations, skills development issues, difficulties accessing domestic capital and pressures, including regulations, to pursue an empowerment agenda.
3. Labour regulation burdens affect the investment decisions made by SMEs and contribute to capital intensive “jobless” growth.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

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## Introduction

1. This study links a focused “better regulation” agenda to the wider “better investment climate” agenda in South Africa (SA), with a specific focus on indigenous small and medium enterprises (SMEs). This case study presents the results of research conducted in SA between 2001 and 2003<sup>1</sup>. Interviewees were all participants in the UK government’s British Investment in SA (BIS) grant scheme. In practice almost all were potential high growth firms, mostly with export potential. It provides some key qualitative insights into the way in which regulation shapes investment and growth in SA’s SME sector.

2. To anticipate the conclusion, the key policy messages are:

### **(i). Investment Climate in SA**

3. A study for the State President’s Office in 2000 observed: “low business confidence is not caused primarily by dissatisfaction with macro-economic(s)”.<sup>2</sup> SA has achieved macro-stability since 1997 through the Growth Employment and Redistribution (GEAR) strategy. Expenditure has been reined-in and the deficit before borrowing reduced from 5% to under 1% in 6 years. Tax collection is up and the South African Revenue Service (SARS) claims to have doubled the number of taxpayers in this period. Main macro-economic concerns of investors are high interest rates and exchange rate instability.

4. The political system is widely and correctly perceived as stable despite concerns on the part of business about a “spill-over” of Zimbabwe’s lack of respect for the rule of law and property rights. SA political leaders repeatedly stress the differences between the two countries, emphasizing SA’s coherent legal framework for land restitution and constitutional protection of property. However there are a number of problems that are not immediately political, including high levels of crime, HIV-AIDS<sup>3</sup>, a shortage of technical skills and rising unemployment. The last was 31.2% on a

narrow definition<sup>4</sup> at September 2003<sup>5</sup>, an approximate doubling in the democratic era, despite consistently positive – albeit low (average 2%) – growth. These factors all have implications for the way the investment climate is perceived. The primary author of the study for the State President’s Office suggests: “decision-makers inside firms don’t feel secure enough to make further long term investments”.<sup>6</sup>

5. This paper singles out regulatory issues which, we suggest, provide key insights into a range of investment climate issues including especially both jobless growth and complications around dealing with SA’s skills shortage. Commentators suggest SA has not extended the logic of macro-reform to the regulatory environment. Over 1,000 pieces of new legislation were enacted between 1994 and 2003.<sup>7</sup> Much new legislation was necessary, given the distortions of apartheid. But regulatory best practice has mostly not been followed. This is recognized even in government circles. The head of SA’s commission on corporate governance has said: “it’s not the answer to pass more rules ... with all these bloody rules we’ve gone overboard in my opinion”.<sup>8</sup> The minister of finance has said: “Government ... is so enamoured with its self-importance ... it has construct(ed) new channels of bureaucracy” which are “obstacles to people trying to do business”.<sup>9</sup>

## **(ii). SMEs and Regulation**

6. SMEs are a key indicator of the impact of regulation as smaller companies have less ability to absorb compliance costs than bigger firms. SMEs are usually more labour intensive than large firms and thus have a key role in job creation. SMEs also help markets work. A vibrant, competitive SME sector provides large investors with the most efficient and cost effective inputs. The absence of such a sector is almost invariably indicative of an environment in which it is costly to do business, sometimes prohibitively so.

7. The 87 interviewed companies are a good sample of the more sophisticated end of the SME range in SA. The majority had either produced goods for the UK and EU markets (27 cases), or acted as partners in penetrating the SA/Africa market, 49 interviewees (56%) were manufacturers. Only 23 interviewees had differentiated management structures; so in 64 cases (74%), the administrative burden was carried by the owner-manager, a typical characteristic among SMEs.

**(iii). Labour Burdens**

8. The ANC government has legislated to “transform” SA’s labour market, making it highly protective of worker rights.<sup>10</sup> This may be a consequence of the role of organized labour in the struggle for democracy. But BIS interviewees tend to argue that the outcomes are inappropriate for SMEs: “Labour law in SA is designed for big companies”, “labour laws are against small business” or “it is wrong to have a first world labour regime for a third world workplace” are all actual quotations.

9. Did labour regulation affect investment? Only 8 companies interviewed were labour intensive. Significantly 5 of the 8 intended moving in a more capital-intensive direction; the other three are labour intensive by nature. The trend toward capital-intensive growth was general among interviewed companies. Not a single interviewee believed it was possible to “take advantage” of SA’s plentiful labour supply. Of the 20 cases asked about expansion plans, 14 said expansion would be capital intensive to avoid “problems with labour”.

10. Where there was no trade union presence, interviewees tended to boast about its absence. Some admitted to strategies to avoid unionization. Many stressed paternalistic relationships, in at least two instances based on family networks, itself a problem for expansion. In 3 cases production was spread across several sites although there appeared to be no good technical reasons. One interviewee admitted this was a ruse to avoid the attention of trades union organisers. A number of interviewees use

labour brokers as a way of contracting out compliance irritations. Two flagship BIS projects (FDI of R24m/26 employees; and 60 employees<sup>11</sup>) admitted that their sole motive for employing labour brokers was to avoid “labour hassles”.

11. The impact of the hassle factor relates to the profile of the workforce. In a high-tech industry, rigidities were expected and accommodated. But there is probably limited scope for high-tech investment in SA. One interviewee said: “You set up in SA, in the first place, because it is a semi-skilled environment”. Almost the only exceptions to this rule among interviewees were the 5 software and consulting firms.

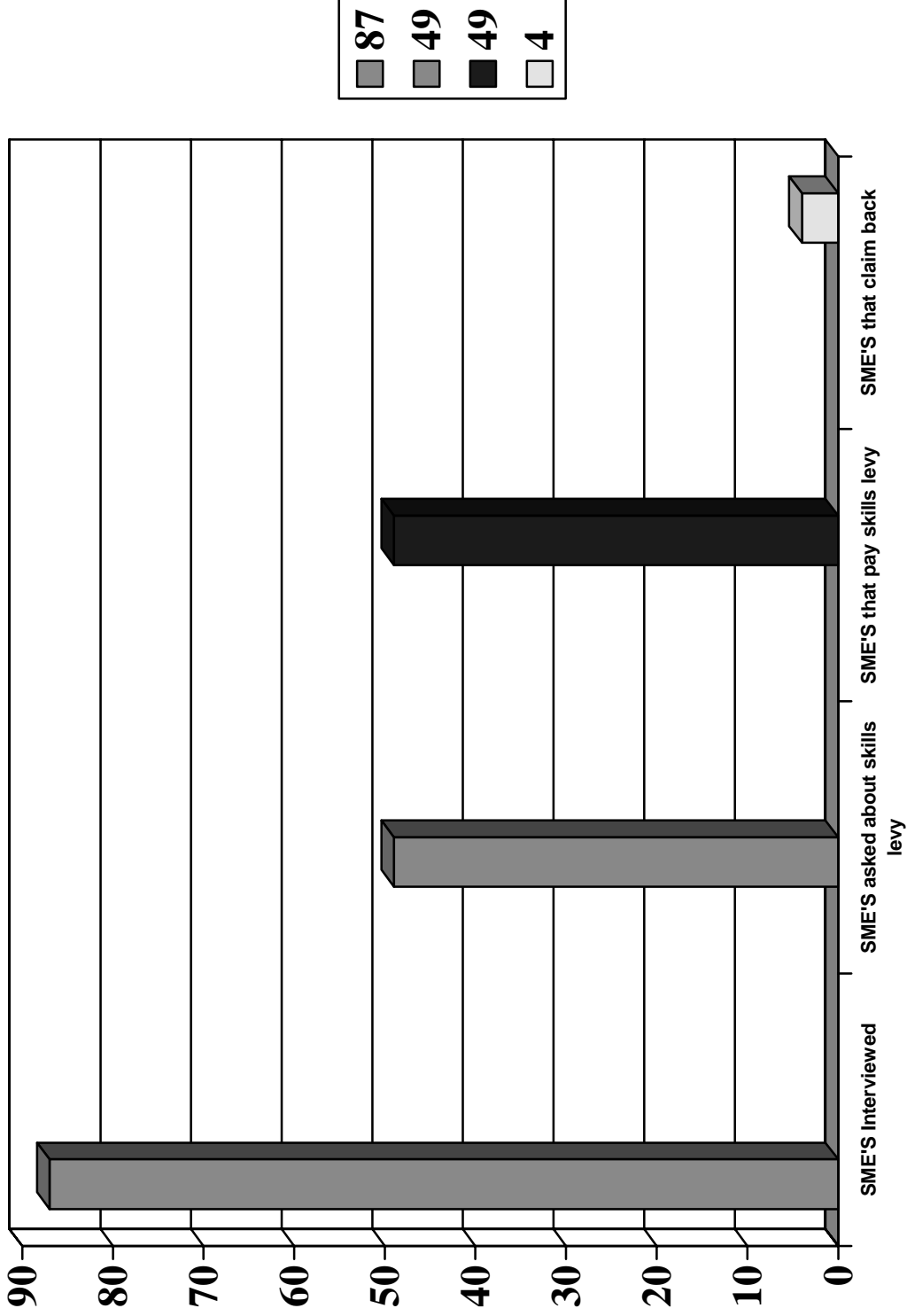
#### **(iv). Skills Development Burdens**

12. Apartheid created a dual market with black workers having lesser skills. The skills levy system introduced in 1998 is intended to address this imbalance as well as resolving SA’s more general skills bottleneck. But the policy ignores the compliance costs for SMEs.

13. The skills levy is 1% on payrolls over R250 000, paid directly to SARS from where 80% is disbursed to 25 sector education training authorities (Setas). Firms can claim back up to 65% after conducting training and skills planning. The system is market-driven as firms are supposedly incentivised by the prospects of “claiming back”. But commentators warned that SMEs would experience the levy as an outright tax with no direct benefit.

14. Out of 49 BIS companies to whom the question was posed only 4 had claimed back a portion of their levy. A few medium enterprises interviewed expected to conduct training and claim back some of the levy in future. For companies that employ 10-30 workers, costs may exceed benefits. According to the Department of Labour the average 20-employee enterprise pays a levy of R8, 516 but can claim a maximum of R5, 961.<sup>12</sup>

# THE SA SKILLS LEVY



Source: SBP

15. One interviewee said: “I tried to get my secretary to do the paperwork. It was far too complicated. She was totally lost”. He estimated claiming would cost “one-third of the time of a full-time administrator”. Another interviewee complained that the levy added to his overall “hassle factor”. “It’s not that the levy is a big hassle on its own, but when you add it to all the other paperwork, I don’t have enough time to focus on the rest of the business”.

16. Some officials in the Department of Labour were aware of the cost-benefit issue from the outset. But a move within the department to subsidise up to 80% of SME training costs has lapsed. Officials argue that the new system has to “bed down”. It may be significant that 3 of the 4 BIS firms that did claim back were among the 9 most recent interviewees. But of those 9 companies, 5 would probably never claim back. “We train all the time – but it’s not the sort of training recognized by the authorities”, said one. One firm that did claim back had the necessary systems in place only through ISO certification. “If we had to do all of this just to claim, we would never have bothered”, she said.

17. Given underspending by the Setas (R3bn of R6bn collected remained unspent at July 2003<sup>13</sup>), the system is probably not generating anticipated skills. But it has marginalised SMEs. Several interviewees claimed they did not even know what Seta they belonged to. There has been no study to quantify the impact on SME-generated job creation. But it would be surprising if it was neutral or better.<sup>14</sup>

#### **(v). Empowerment Burdens**

18. Black Economic Empowerment (BEE) is a salient issue in SA, given past exclusion and inequity. A range of policies have been implemented by both State and private (mostly corporate) sectors. The signs are that the process imposes additional hassles on SMEs.

19. Most interviewees had comments to make on developments shaped by the Preferential Procurement Policy Framework Act<sup>15</sup>, intended to enhance black access to public sector contracts<sup>16</sup>. The Act is generally applied throughout the public sector, including local government, and while not binding on the private sector, is also widely utilized in corporate outsourcing.

20. Only 11 (7.3%) of the companies contacted<sup>17</sup> were black-owned and/or managed (i.e. conformed to the official definition of a “black enterprise”). But categorization wasn’t simple. In several cases an alliance existed between the original (white-owned) company and a subsidiary with a BEE component. Subsidiaries were mostly involved in sales and/or installation. Many black owners were former employees of the white-owned company.

21. It was impossible to work out what is really going on in these alliances. In one instance the black subsidiary appeared to be part-owned by the government officials who provide orders. In another instance, a white entrepreneur was trying to sell equity to his most reliable black suppliers. In another case – one of the IT companies – the black junior partner was a genuine entrepreneur with a substantial track record in the sector.

22. All interviewees, without exception, had either acted or claimed to be planning actions to address BEE. Of 16 public sector suppliers interviewed only one had actually been sold to a black owner.<sup>18</sup> Far more common were relationships with black-owned firms that acted as brokers for supplier contracts. Most interviewees said they were determined to avoid “fronting”. In practice commitments were more rhetorical than real. One interviewee admitted: “If government wants to spend 20% more, that doesn’t worry me so long as I can keep doing the same level of turnover”. Another interviewee admitted that his main problem with “fronting” was the difficulty of recourse “should things go wrong”.

23. Only one company, a consultancy, had closed down as a result of BEE.<sup>19</sup> However many companies contacted BIS in an effort to find export business as an alternative to dealing with BEE issues. Where companies failed to re-orient themselves towards international markets, all, with the exception of the consultancy referred to previously, simply accepted the need to manage BEE despite the added hassle.

**(vi). Difficulties Accessing Domestic Capital**

24. Access to capital is shaped by the regulatory environment. The suggestion that South Africa's financial markets are over-regulated was at the time of writing being investigated by a number of researchers, including the National Treasury. BIS interviews suggest that there may be a case for suggesting that the system errs on the side of prudence.

25. Across 41 cases, there was not a single instance where investment was known to have been financed primarily by a South African bank. Sources of capital, in order of significance, included the UK partner(s), local funders like the Industrial Development Corporation (IDC) and Business Partners, venture capitalists, own sources (like retained earnings), other local partners and grants.

26. Capital is costly in SA. But questions were not about the cost of money but about the hassle of accessing it. It may have been assumed in public debate that the (predominantly white-owned) high-growth export-oriented SME sector has easy access to capital, at least by comparison with emerging black-owned business. But BIS suggests little room for complacency.

27. At one point 30 consecutive interviewees were asked to identify their biggest hurdle to doing business and provided with a list including (in order) "labour relations, availability of skills, access to capital, BEE, relations with your bank, regulations

generally, taxation". In 27 of the 30 cases the first issue raised was "relations with the bank".

28. At mid-2003, the 4 major SA banks had all closed down their small business units, citing transactions costs. But this is in an environment that, one analyst said, is "extremely stable but also complacent and uncompetitive"<sup>20</sup>. BIS interviewees agreed: "SA banks don't have a clue when it comes to SMEs – the problem wasn't the business plan because the IDC used those figures to give us a loan", said one. "Why would you want to know your bank manager?" said another. "He has no discretion. He just implements a formula sent down from head office". The most common complaints were that collateral requirements were "unreasonable" and short-term finance unavailable even against secure instruments like guarantees from other financial institutions. In 8 cases firms had never used overdraft facilities that banks had granted – in 5 cases without being asked to do so. Two interviewees complained that they couldn't get loans even though they had (unasked for and unutilized) overdraft facilities of R100,000.

29. However at least 2 interviewees had recent bad debt judgments against them – similar problems (from a banker's perspective) may apply in other cases. Nevertheless given that 22 SA firms were able to attract investment from abroad while none succeeded in approaches made to indigenous banks suggests, at the very least, a case for asking further questions.

## **Conclusions**

30. Compliance costs associated with labour administration were consistently identified as a major problem. This appears to shape investment in a capital intensive direction. But skills shortages are also problematic and can be expected to restrict capital-intensive investment. The current mechanism for dealing with this (the skills levy system) places considerable burden on SMEs without, in most cases, delivering any benefit. BEE is widely accepted as one of the "rules of the game" although it

clearly complicates business. While everyone claims to reject “fronting” the reality is that something of the sort appears, on the evidence here, to be widespread. There are also problems accessing capital and at least some of these do appear to be related to an unresponsive (and possibly over-regulated) banking system which demands extreme compliance from potential borrowers.

31. More work is needed before the constraints on SMEs in SA can be adequately quantified.<sup>21</sup> But the BIS interviews suggest a less-than optimal regulatory environment for SMEs to do business. This implies less competition, innovation and job creation than could be achieved under more benign circumstances – in other words that the immediate problem is stagnation (and over-regulation) not political instability. But inappropriate regulation will hinder growth and job creation, which, in the longer term, contains the seeds of political instability.

## Notes

<sup>1</sup> Research into 150 SA SMEs involving 87 primary and 16 follow up interviews.

<sup>2</sup> Available as Gelb, S. (2001a) “Economic Development, Growth and Equity”, the Edge Institute, Johannesburg.

<sup>3</sup> Some of the companies interviewed here were asked about the impact of HIV-AIDS on their enterprises. Only in one instance was an actual negative experience recounted as opposed to opinions on the general issue. The tendency among interviewees was to express ignorance (of the status of their workforce or customers) as a result of which the question was dropped from the interview format.

<sup>4</sup> i.e. excluding so called discouraged job seekers.

<sup>5</sup> Seria, N. (2003) “Formal sector fails to create jobs in first quarter of the year”, Business Day, Johannesburg, 25 September.

<sup>6</sup> Gelb, S. in CDE (2001b) “Why is South Africa failing to get the growth and jobs that it needs?” *CDE Round Table*, November.

<sup>7</sup> McLaughlin, P. (2003a) “Is there too much law in South Africa?” *JCCI Parliamentary Monitor* and McLaughlin, P. (2003b) “Too much law. Can business cope?” *Parliamentary Monitor Review*, April.

<sup>8</sup> Mervyn King (2003) Address to Durban Chamber of Commerce and Industry (quotes in Ardé, G. “Honest companies lure labour”, *Natal Mercury*, 27 August 2003). See also G. Bannock et al (2003). The importance of the Enabling Environment for Business and Economic Growth.: A 10-Country study for DFID, mimeo.

<sup>9</sup> Trevor Manuel (2003) Speech at Gordon Institute of Business Studies (quoted in Wray, Q. “Manuel slams business ‘short-termism”, *Business Report*, 29 July 2003).

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<sup>10</sup> Legislation includes the Labour Relations Act (No 66 of 1995), the Basic Conditions of Employment Act (No 75 of 1997), the Employment Equity Act (No 55 of 1998), the Skills Development Act (No 97 of 1998).

<sup>11</sup> This interviewee refused to give investment figures.

<sup>12</sup> Department of Labour (1999) internal discussion document (1998 figures).

<sup>13</sup> Petro, N. (2003) "Training bodies fail to spend major portion of budgets", *Business Day*, July 11.

<sup>14</sup> Interviewers were sufficiently intrigued to interview consultants to the department of labour who confirmed that those who presented a small business viewpoint were marginalised during policy design. These interviewees requested confidentiality.

<sup>15</sup> *Preferential Procurement Policy Framework Act* (No. 5 of 2000).

<sup>16</sup> Additional points are allocated to bids from black-owned companies. An 80/20 points system applies to tenders up to R500 000 (80% = price; 20% = bonus for black ownership). Above R500 000, the weighting is 90/10.

<sup>17</sup> Not all of these BEE companies were interviewed Thus this figure is most appropriately read as 11 companies out of the full 150 cases.

<sup>18</sup> Toolquip and Allied, sold to Saccawu Investment Holdings, a trade union investment fund.

<sup>19</sup> Interview with former director, now returned to UK, conducted by e-mail.

<sup>20</sup> Interview with consultant to Finmark Trust (name withheld at interviewees request).

<sup>21</sup> SBP is undertaking a very large survey to understand, quantify and aggregate the compliance burden faced by small business in South Africa. The programme is to be funded by the Business Linkage Challenge Fund.