

**RIAS and private sector development:
Some thoughts from the South African context'**

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'Too much red tape' is a common complaint from many South African businesses. Since 1994 government has passed more than 1 000 pieces of legislation which have spawned a myriad regulations.¹ The cumulative impact of this legislation – not just the individual pieces - adds complexity to doing business in SA.

Business associations have the impression not only of over-regulation, but of poorly drafted regulation and/or of good law being poorly implemented, all of which act to constrain business growth and investment, hobble enterprise and can cost jobs. Finance Minister Trevor Manuel was recently quoted as saying that the government has constructed 'new channels of bureaucracy' which are 'obstacles to people trying to do business'.²

Is the level and cost of regulation in SA appropriate, particularly for SMEs? Is over-regulation clogging up the statute books? Is there room to 'lighten up' on the regulatory load while not undermining health and safety standards and workers' rights? Can business burdens be measured in a meaningful sense?

The honest answer is that we don't know. South Africa does not have strong research-based evidence with which to advocate for a better environment conducive to business growth, investment and job creation. Evidence is often patchy, contradictory, over-reliant on anecdote and reported 'perceptions'. For this reason comments and complaints about the extent of 'over-regulation' of South African business must necessarily be somewhat speculative. They do however, paint a picture of South African business in a tight spot.

This paper captures current gripes relating to the regulatory environment in SA, within the confines of a desktop survey. It does so within the context of regulatory best practice and from a small business perspective, often ignored in public debates.

Not all businesses are affected by regulation in the same way – sectoral considerations, the size of the firm, how long it has been in operation, whether the firm is in the formal or informal sector - all play a role. And, while the focus of this paper is on the regulatory environment and its impact on business, SBP is well aware of other factors that play a role in boosting or hampering entrepreneurship – including crime, poor infrastructure, low savings rates, quality and availability of staff, the role of attitude in entrepreneurial orientation. However, there is enough evidence to suggest that a shift to a regulatory environment that reduces the administrative burden for SMEs would be a positive investment in SA's future. Remove unnecessary regulatory barriers and the private sector may well bloom.

SBP is not arguing that business interests should be the sole determinant of public policy. Nor are we saying that regulation is necessarily a bad thing. What is important is that the cost of regulation be assessed against the benefits. Our message is a modest one: policy should take full account the practical realities for businesses, particularly SMEs. Why? It is trite but true to say that a flourishing small business sector is important to the success of black economic empowerment, that it holds the potential not only to dent unemployment, but also to drive growth and create jobs.

And now for something completely different

The SBP's research agenda over the next 24 months will explore these issues in greater detail, adding depth and texture to the picture presented here and the issues raised as we attempt to measure the costs of doing business. Specifically we will

undertake a national survey to identify those regulations that impose disproportionate costs on business, particularly small and medium enterprises (SMEs). The overall objective is threefold:

- to measure the costs of doing business, to the extent that this is possible, to provide much-needed research-based evidence. More needs to be known about the real burdens faced by business, in particular small business; burdens which must be weighed against the benefits deriving from the regulation. The exploratory nature of this work must be stressed;
- to further increase the profile of regulatory best practice (RBP), and specifically the use of regulatory impact assessments (RIAs) – a key element in improving regulation. SBP has argued that South Africa needs better regulation or in some cases re-regulation, not simply deregulation. Government must set its sights on making SA a good place to do business, where investment is protected, where laws and regulations are sensible, enforceable and can be easily complied with, by large and small businesses alike;
- to inject more of a small business perspective into policy debates and thus give greater weight to the interests of this sector – which has been without an official voice since the demise of the National Small Business Council in 1997³.

In the bustle of national legislation, small business often risks being lost. Injecting a small business perspective into policy debates will always be difficult. Few entrepreneurs have the time and/or inclination to participate in representation as they are too busy running their businesses. The claim that business associations tend to neglect issues which impact most on small business has a ring of truth to it, given the predominance of corporate power in many associations. One way of giving voice to small entrepreneurs is for government to introduce RIAs into the process of governing.

The big task of thinking 'small', fast

Those still labouring under the impression that the small business sector is mainly comprised of mom-and-pop stores, sidewalk hawkers and baking housewives need a wake-up call. According to Jo Schwenke of Business Partners, 'In South Africa about 95% of the 600 000-odd formal businesses are SMEs. They account for an estimated 35% of the nation's gross domestic product of about R1 000 billion. This means that the SME sector makes a contribution to our GDP estimated at R350 billion.'⁴ In addition, he noted that for every investment in an entrepreneurial business, an average of 15 jobs were created.

However, minister of trade and industry, Alec Erwin, has said that the 35% contribution to GDP should be ranging between 60% and 80% - something which would be achievable only in the next ten to 15 years.⁵ Smart thinking is needed, fast, if we are to improve on this.

Compliance costs vary with firm size; small business suffers most. Regulations impose disproportionate costs on SMEs because of their limited administrative resources and uncertain cash flows. To quote a disgruntled small retailer, large corporates have 'a department full of lawyers to deal with this junk. I have me.'⁶ An OECD report, *Businesses' view on red tape*, estimates that compliance costs burdens on business average around 4% of the Business Sector GDP across the eleven countries studied. Examining the costs of administrative compliance in almost 8 000 SMEs, the report found that compliance costs per employee were over five times higher for the smallest SMEs than for the largest. An American study concluded that firms employing fewer than 20 employees face an annual regulatory bill of \$USD 6

975 per employee. This burden is 60% higher than that faced by firms with more than 500 employees.

Noting the importance of SMEs to economic growth as well as the disproportionate impact of regulations on them, how can government programmes boost SME development most helpfully?

The OECD's report *From red tape to smart tape* distinguishes three approaches:

- active assistance to small businesses, in particular to meet the administrative compliance requirements of regulations;
- exemption or modification of the requirements themselves to make them less onerous for SMEs; and
- establishment of specific mechanisms to ensure that regulatory design takes better account of small businesses needs and concerns in establishing new compliance burdens.

In South Africa, government's approach to SMEs through its support services and assistance has met with little success. (see box *From support services to removing barriers: Can government change direction?*) The OECD argues that, "positive" discrimination of SMEs may have dynamic drawbacks by providing SMEs with incentives not to grow beyond thresholds qualifying for special support or to break up strategically as soon as the threshold is passed.⁷ In the UK, for example, a study of VAT collection costs showed that 18% of non-registered businesses stated that they intentionally forego growth so that their turnover remains below the VAT-registration limit. In addition to possibly creating a barrier to company growth, exemptions should not be used as a 'get out' option for poorly designed regulations.⁸

These factors attach problems and unintended consequences to both the first and second approaches suggested above.

The latter approach – namely, the establishment of specific mechanisms to ensure that regulatory design takes better account of small businesses needs and concerns in establishing new compliance burdens - is the most promising. This can be done through the mechanism of RIAs to assess the likely impact of regulations – as has been done in the US, the UK, New Zealand, Australia and Uganda. While RIAs are no panacea, they can be an instrument to decrease the barriers to SME development as a key part of the assessment revolves around small business compliance issues.⁹ In the UK, for example, regulators are reminded to 'think small first' in assessing the cost of proposed new regulations.

If we want to get entrepreneurs into the formal sector, it is difficult to overstate the importance of cutting red tape and in so doing curb the tendency to non-compliance.

The complications of simplification

RIAs offer the most promising solution, but simplifying regulations and the administration is an enormously complex process. It must be integrated into government's broader efforts to improve regulatory quality and regulatory 'best practice'. It 'may be considered "intrusive" to the integrity of individual departments.'¹⁰ But this sensitivity needs to be balanced against the need to boost private sector growth and job creation. Getting RIAs embedded into the process of governing would serve other purposes too. For example, it would act as a strong corrective to bureaucratic conservatism, to vested interests eager to preserve the status quo and their privileged position within it, as well as send a powerful message to investors that South Africa is a 'good place to do business'.

Don't forget, government can save too

Often forgotten, but very important is that there are benefits and savings to government itself of a lighter regulatory touch. Enforcement can be expensive. Government has to pay people to do it, train them and provide equipment they may need.¹¹ An international small business expert has said that the compliance burden is mainly carried by business at 80% but government has the rest of the burden. Many governments are rarely aware of the extent of the total administrative burdens imposed not only on businesses – particularly SMEs - but on government itself, nor of the cost-efficiency of many of the regulatory simplification mechanisms. In the Netherlands work done by ACTAL (Advisory Committee on the Testing of Administrative Burdens) has prompted simplification of administrative procedures in the areas of corporate taxation, social security, environmental regulation, and statistical requirements. The estimated savings are US \$600 million from streamlining the tax requirements alone.¹²

The savings are not just measured in monetary terms. Ill-informed regulation not only creates 'red tape' for business but more bureaucracy for the public sector. Using RIAs offers an early opportunity to see potential problems and unintended consequences. Ill-informed regulation, by contrast opens up opportunities for criticism. Thus, government can save face too.

While some regulation is desirable and necessary – to generate tax revenue and maintain reasonable safety and environmental standards, consideration might usefully be given to non-regulatory alternatives. Equally important is the option to 'do nothing' and not resort to the blunt regulatory fix. Alternatives to 'rules and regulations' that do not make citizens and businesses feel hemmed in might be considered and weighed up against the need for businesses to have certainty regarding the 'rules of the game'.

The World Bank, doing business, and some confusion...

Covering 133 countries, the recently released World Bank's *Doing Business in 2004* shows that higher regulatory costs are associated with more poverty, larger informal sectors, higher unemployment, lower productivity, longer delays more corruption and so on. The report focuses on five aspects of business activity: starting a business, hiring and firing, contract enforcement, getting credit and closing a business in different countries. Rigid employment regulation is associated with more poverty in developing countries. The regulatory framework is closely correlated with prosperity or lack thereof. Rich countries – Australia, Canada, the UK - regulate less. Poorer countries – Mozambique, Burkina Faso - regulate business the most, with regulation in these countries more cumbersome.

Is South Africa a good place to do business? According to the report, while not in the top 10 in terms of favourable regulatory environments, doing business in SA is not that different from doing business in prosperous countries elsewhere. Surprisingly, the report found that we place fewer regulatory burdens on employers than do many other countries. SA is the eighth least regulated country on labour laws – only marginally more regulated than the UK or the US.

However, some caution is needed before the minister of labour, Shepherd Mdlalana, pops the champagne corks. What was reported less is that *Doing Business* covered just one aspect of labour law, employment regulation – analysis of social security laws, industrial relations and workplace safety were not covered.

While not wishing to downplay SA's fairly positive rating, it must be mentioned that the survey does not cover the entire regulatory framework of doing

business firstly - business licences, property registers, corporate governance, trade infrastructure, law enforcement and tax policy, for example have not been included this year. They are however, important features of the regulatory environment within which business operates, as *Doing Business* itself recognises.

But perhaps most importantly, the findings for South Africa need to be set against examples of regulatory hassles that have been reported - some of them emerging curiously from within the World Bank itself.

Some examples of regulatory squeeze

- The 2003 International Business Owner's survey by Grant Thornton reports that South African business owners see regulation as the major constraint on business expansion: 46% versus the global average of 35%;
- A recent survey conducted on a small sample of SMEs in SA showed that, in general, businesses have to comply with over 140 pieces of regulation;
- No government lets an entrepreneurs register a new business in a single procedure but *Doing Business in 2004* notes that some come closer than others. It takes 38 days to register a new business in SA – faster than Germany, the Netherlands and China and definitely faster than the 203 it takes in Haiti and the 215 in the Democratic Republic of Congo. For business entry, only two procedures – registering for statistical purposes, and for tax and social security – are necessary to fulfill the social functions of the process. Australia limits entry procedures to these two. This may well be a case where less is more;
- *Doing Business* noted that SA was slower than Zimbabwe and Cote d'Ivoire in enforcing legal contracts, taking 207 days to go through the legal process, granted SA does better than Guatemala where it apparently takes four years to enforce a contract;
- Taxation ranks high as a source of regulatory cost and difficulty for the private sector. The Katz Commission Report noted that the minimum number of returns to be submitted by any small enterprise totals 46 - 3 for income tax; 13 for PAYE; 6 for VAT; 12 for RSC levies; and 12 for UIF.¹³ In addition, there are the skills development levies, provisional tax returns, company tax (ie shareowner's withholding taxes), property tax, sales tax, excise duties, customs tax, and so on. Each additional tax imposes administrative burdens on the taxpayer. Many of these returns are required to be submitted on a monthly basis which places the added burden on business to keep its records up to date.¹⁴ For many small entrepreneurs their role as unpaid tax collection agents for government comes at a high price - high administrative costs, the burden of having to hire experts to manage the compliance burden, cash flow problems, and the greater costs that result from tax-induced distortions in the pattern of savings, investment and production.¹⁵ Particularly difficult is SARS' decision that VAT should be paid on invoice, not on receipt of payment. This has led to cash flow problems for small businesses that sub-contract to larger entities that are slow to pay;
- Many small businesses see the Skills Development programme - revolving around levies on the payrolls of businesses and learnerships - as just another tax.¹⁶ Being unable to claim their levy back for financial or administrative reasons, many SMEs have not yet produced a training plan that could be recognised by their SETA, and end up paying their levy without claiming it back. 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 suggesting that costs may exceed benefits¹⁷;

- An inhospitable legal and regulatory framework in South Africa – specifically the Usury Act and Credit Agreement Act, which regulate the contractual aspects of credit granting - has been criticised for blocking the availability of finance for SMEs. The key issue is how to direct capacity and resources towards small business lending and remove regulatory restrictions that hamper lending. A prominent banker argues that ‘the absence of an appropriate and favourable legal framework is a major impediment to the availability of finance for SMEs.’ The Usury Act and Credit Agreement Act have been criticised in this context. Lamented one investment consultant, the Usury Act ‘needs to be redefined. People should be rewarded for risk’¹⁸;
- According to one report, ‘the rigidity of many land use and transport planning frameworks makes no provision for the objective of supporting small businesses. The rigidity inherent in land use plans often works against small businesses, which typically use land in a mixed way, not separating residential, light industrial and retail uses’¹⁹;
- The process of exiting a business in South Africa via liquidation is expensive for a small business. Present legislation on insolvency and bankruptcy – incorporated into the Insolvency Act No 24 of 1936, contains a glut of obsolete provisions and is often obscure. It is sometimes necessary to refer to the common law, the Insolvency Act, the Companies Act or the Close Corporations Act. While this situation is not helpful, the World Bank’s *Doing Business 2004* report notes that a typical business bankruptcy might take six months in Ireland or Japan, but more than 10 years in Brazil and India – so South Africa’s 2 years needs to be viewed in this context;
- Unemployment has doubled since 1996, at the same time South Africa’s labour market has become more regulated. Is there a connection? Some three years ago, the World Bank, in partnership with the then Greater Johannesburg Metropolitan Council, undertook a study of 325 manufacturing firms – each with more than 50 employees, in eight manufacturing areas - in the greater Johannesburg Metropolitan area. According to this report, labour laws had adversely affected employment and investment. In particular, interviewees commented on the ‘hassle factor’ caused by new labour regulation – the 1996 Labour Relations Act, the 1997 Basic Conditions of Employment Act, the 1998 Employment Equity Act, and the 1998 Skills Development Levy - including the time and resources consumed by union negotiations, hiring and firing, disciplinary enquiries, etc. While it was ‘not any one law or particular cause of legislation per se, but collective effect of all pieces of labor legislation that raise the transaction costs of firms to hire and fire workers in response to rapidly changing global demand patterns’.²⁰ The report noted *inter alia* that:
 - it took 2,7 months on average to retrench an entry-level worker;
 - it cost R9 000 to hire and R2 160 – R2 900 to fire a least skilled worker;
 - partly as a result, some 40% of firms hired fewer workers, used more machinery, hired temporary staff, and/or subcontracted.

A recent *Economist Intelligence Unit* report described the labour market as a major deterrent to foreign direct investment and a handicap to the country in competing with other emerging markets. The practice of setting minimum wages sector by sector would continue to add to the burden of employers.²¹ SBP interviews for the UK-funded public grant scheme ‘British Investment in SA (BIS)’ consistently identified the hassle factor associated with labour

administration as a major problem, shaping investment in a capital intensive direction.

Agreements reached in bargaining councils can be made binding on unions, workers and employers who have not signed them - 'non-parties' in the official terminology. One interviewee noted, 'Bargaining council agreements between big business and unions grind little people and are bad for SMEs. If SMEs choose not to join the union or industrial council, why should they be bound by it?'²² Recently, small manufacturers complained that their survival in the face of cheap imports was at risk unless they could pay more production-related rates than that decreed by the council. While small business can apply for an exemption, the companies with the resources to do this are the big ones, not the small ones.²³

Doing Business suggests South Africa is not doing badly by international standards which is good for our confidence levels. But the need to boost investment and job creation suggests continued pressure for streamlining the regulatory environment still further. There is enough evidence to suggest, at the very least, a case for asking further questions. The importance of a comprehensive regulatory impact study that details the costs to business of all the legislation that governs it cannot be overstated.

¹ 'Lift the burden on business' in *Financial Mail* 23 May 2003, p.18.

² Quoted in Wray, Q 'Manuel slams business "short-termism"' in *Business Report* 29 July 2003

³ Some six years later a bill to amend the National Small Business Act (of 1996) was introduced in the National Assembly. The Bill sets out to *inter alia* formalise the demise of the NSBC and create an advocacy body for small business.

⁴ Quoted in 'Small business is big business' in *This Day* 27 October 2003

⁵ *Business Day* 12 November 2002

⁶ 'Behind America's small business success story' in *The Economist* 11 December 1997

⁷ OECD *From red tape to smart tape: Administrative simplification in OECD countries* 2003, p.11.

⁸ Better Regulation Task Force *Imaginative thinking for better regulation* published by the Better Regulation Task Force, UK, 2003, p.17.

⁹ see 'Understanding regulatory impact assessments: Key issues from the international experience' *SME Alert*, published by the Small Business Project, January 2003

¹⁰ OECD *From red tape to smart tape: Administrative simplification in OECD countries* 2003, p.60.

¹¹ Better Regulation Task Force *Imaginative thinking for better regulation* published by the Better Regulation Task Force, UK, 2003, p.15

¹² World Bank *Doing Business in 2004* p.xviii

¹³ quoted in SBP 'Relieving the tax burden for SMEs' *SME Alert* Vol 2 No 3, August 1997, p.2.

¹⁴ 'Tax barriers for small firms likely to go' in *Business Day* 26 February 2003

¹⁵ SBP 'Relieving the tax burden for SMEs' *SME Alert* Vol 2 No 3, August 1997, p.2.

¹⁶ *Big news for small business* "It's a tax, Mr Minister". - No 65, June 2002

¹⁷ Department of Labour (1999) Internal discussion document, 1998 figures

¹⁸ Interview with Jo Schwenke, Business Partners, 11 July 2002

¹⁹ Solomon, D 'By-laws and regulations' in *The National Small Business Regulatory Review: Final report* p113-115

²⁰ GJMC-World Bank partnership *Constraints to growth and employment in South Africa: Evidence from the large manufacturing survey* August 2000, p.v

²¹ quoted in 'Labour market crucial to investment' in *Business Day* 25 June 2003

²² Interview with Jo Schwenke, Business Partners, 11 July 2002

²³ Kane-Berman, J 'Perverse outcome of job protection' in *Business Day* 29 July 2003