

## **Why regulations matter: A small business perspective**

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It is trite but true to say that a vibrant enterprise sector holds the potential to mop up unemployment, drive growth and make a substantial contribution to black economic empowerment. The importance of this role is difficult to overstate in the South African context.

It is also true to say that ten years into South Africa's democracy, the growth of the small business sector has been modest. Previous minister of trade and industry, Mr Alec Erwin, has said that the small and medium enterprise (SME) contribution to GDP at 35% 'should' be between 60 and 80% - something which would be achievable in the next ten to fifteen years.<sup>1</sup> According to the most recent Global Entrepreneurship Monitor, South Africa has slipped from its 2002 ranking of 19<sup>th</sup> out of 37 countries to 22<sup>nd</sup> out of 31 countries in 2003. SA is now in a group of countries with below average rates of entrepreneurship. SA is the only developing country in the GEM survey that is not performing on key measures of entrepreneurial activity, we are also the only one whose scores are getting worse. We lag behind Chile, Thailand, Mexico in terms of entrepreneurship.

This sounds like bad news. But perhaps the real question is not so much how we compare internationally, but rather how we compare with our own past.<sup>2</sup> While our entrepreneurial rate is lower than many of the small business driven economies of the world, there can be little doubt that it is already higher than it was 20 years ago. At that time, South Africa's small business economy was either neglected during the apartheid era, or in the case of black-owned enterprises, actively discouraged. That is no longer the case: SMMEs have increased their role as suppliers of the public sector and of corporates, their share in national exports and in overall employment, and their relative significance in many other dimensions of the economy has been noted. In addition, South Africa might be in bad shape in comparison to many developing countries, but we're in good company holding our own against some developed countries (Slovenia, Sweden, the Netherlands).

Nevertheless, the challenges are considerable. South Africa has the double whammy of integrating itself into the global markets as a competitive economy while simultaneously overcoming internal problems created and continuously reinforced by apartheid. The point that is taken from the above is that there is room for improvement. This talk is about why regulations matter, particularly for small business. It is in the form of a preliminary working draft, open to comment and critique.

## **The legacy of apartheid**

This topic has a specific resonance in South Africa where entrepreneurship was certainly blunted by apartheid policies. This factor has contributed to a highly dualistic economy characterised by a high productivity (modern) and a low productivity (informal) sector with scant interaction between them, and a division along racial lines. Our specific history meant the exclusion of the majority of potential entrepreneurs from proper education and access to property and/or financial resources.

One commentator has suggested that we need to go even further back than apartheid days. According to Mhone, the constrained role of SMEs is the consequence of at least three historical legacies:

- the nature of colonial development based on a model that simultaneously exploited and marginalised the majority of the labour force without absorbing them into sustainable economic activities;
- the biased nature in which an import substitution strategy was implemented to the benefit of particular groups and large scale economic activities, and
- the legacy of apartheid which resulted in unequal access to various forms of capital and opportunity in the labour market based on race, gender and age. Policies imparted a bias in favour of large-scale and capital intensive enterprises through a wide and complex array of regulatory and supportive measures.<sup>3</sup>

The apartheid legacy is linked to the structural role and status of the SMME sector and partly explains the participation of various groups on the basis of race and gender. For example, in 1999, StatsSA estimated the number of entrepreneurs (self-employed persons) to be about 1 630 000 or 3,7% of the population. About 70% of these 1,6 million entrepreneurs operate in the informal sector, 41% are women – this illustrates two of the main challenges of any SMME support strategy. The 1999 October Household Survey data showed that non-survivalist enterprises were still dominated by whites and Asians, accounting for 6,4% and 3,8% respectively. Black non-survivalist entrepreneurs accounted for only 0,54% of all economically active people.<sup>4</sup> African females have the highest incidence of informality while those of white males have the highest incidence of formality.

It must be remembered that even in the apartheid days – where regulations discriminated specifically against the development of black businesses – there were many examples to support the view that ‘you can’t put a good entrepreneur down’. Entrepreneurship will out, as it were. As Kane-Berman notes, ‘Richard and Marina Maponya ... made their fortunes more than 25 years ago. Not only was this before the term “empowerment” was coined, but they made it when the National Party government lumbered black entrepreneurs with dozens of handicaps designed to nip success in the bud. Herman Mashaba, boss of the haircare company Black Like Me, started out in a homeland nearly 17 years ago and last year opened up in London.’<sup>5</sup> The growth of the taxi industry and spaza shops show how the efforts of ordinary people ‘voting with their feet’ created new rights in the business field despite a hostile official and legal environment. The Group

Areas Act could not prevent many Indian businesses prospering, using white nominees and front companies, and attracting white customers to areas where Indians could legally operate.<sup>6</sup>

In addition, as the Trade and Industrial Policy Strategies warns us, ‘There is a danger in ascribing all the responsibility for the underdevelopment of SMMEs to political disenfranchisement, since the corollary to this argument is that the new economic order provides a sufficient condition for the revitalization of the SMME economy. The removal of apartheid, although necessary, has been insufficient in unraveling the full potential of the SMME economy.’<sup>7</sup>

### **Getting the macro-economy sorted – necessary but not sufficient**

Similarly, stable macro-economic policies (GEAR) - while an essential basis for development - have not been sufficient to encourage business growth. The rate at which jobs have been created lags well behind the number of job-seekers. Research by Haroon Borat shows that employment would have needed to expand more than 33% since 1995 to have provided jobs for all new entrants in the job market.<sup>8</sup>

Also important are the legislative and institutional factors, together with an appropriate regulatory regime. Entrepreneurship can be hampered through deliberate policy – such as apartheid – or inadvertently through a maze of inappropriate regulations.<sup>9</sup> A key research finding – and here I draw on the work of Bannock Consulting in the UK, specifically their ten country study 7 in Africa, 3 in Central Europe - is that an appropriate regulatory and institutional environment is the single most important element in an economic growth strategy. Only one other factor – a country’s level of available skills, especially technical skills – is anywhere near as strongly correlated with per capita economic growth.<sup>10</sup>

Education and skills strategies are inherently long-term – akin to ‘turning a supertanker’. Most usefully, they must be complemented with interventions to improve the regulatory and institutional environment within which business operates in the short term. While I do not wish to downplay the importance of education, it must be remembered that entrepreneurial success is possible even on the back of limited formal educational qualifications. In some cases, no education might be better as it is not so much education per se but the orientation and quality of education that matters. An entrepreneurial culture is not boosted in schools that churn out would-be bureaucrats rather than calculated risk-takers. Focus on formal education obscures the important and often hidden curriculum of family experience, exposure to entrepreneurial role models and learning by doing/from experience.<sup>11</sup>

Despite the strong mandate given by the White Paper on the national strategy for the development and promotion of small business (1995) and National Small Business Act which paved the way for public sector institution building, it is clear that much work remains. Government’s track records in supporting South Africa’s entrepreneurs is not well-regarded. TIPS quotes a survey in 2000 showing that 57% of emerging SMMEs interviewed in Gauteng and 70% in the Western Cape, for example, had never had contact with or even heard of any small business support institution.<sup>12</sup> A World Bank survey indicated that ‘no more than 20% of SMMEs were aware of Khula and Ntsika

programmes.<sup>13</sup> There may well be exceptions to this picture, but it would be fair to say that government's 'reach' into this sector is seen to be low. There is an uneven spread in where, how and in which field services are offered. Poor co-ordination results in a replication of services and clustering of institutions in urban areas.<sup>14</sup> It must be noted that South Africa is not unique, supporting small business is difficult all over the world. Nevertheless, it does suggest a need for rejigging. In policy terms what the above shakes down to is rather than promote support services, government's explicit focus might usefully shift to removing the barriers that might make the support less necessary.<sup>15</sup>

### **A better environment for business, particularly small business**

Enterprise start ups and operation are influenced not only by markets but also by the regulatory and institutional environment established by governments. The cumulative impact of numerous regulations and formalities originating in many areas and layers of government is to slow down business responsiveness and to discourage entrepreneurship. Covering 133 countries the 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 regulatory framework is closely associated with prosperity or lack thereof. Rich countries – Australia, Canada, the UK – regulate less. Poorer countries regulate business the most, with regulation in these countries more cumbersome.

The regulatory and administrative aspects of the environment in which firms operate can have a substantial impact on a country's competitiveness and capacity to create jobs as well as on the health of the SME sector. Why? Compliance costs vary with firm size, small business suffers most. While regulations affect the private sector as a whole, they weigh most heavily on smaller firms because of their limited administrative resources, uncertain cash flows, limited understanding of their rights in relation to, for example, tax matters. Complying with regulations can be expensive and difficult, assuming a business can work out what constitutes compliance in the first place.<sup>16</sup> Many small firms do not have dedicated in-house tax specialists or human resources staff. In addition to costs of lawyers and consultants there is little doubt that navigating 'red tape' requires not just time but patience and results in a fair amount of stress. A large corporation may well be able to absorb these costs, the situation is different for a small enterprises. This is also the area where there is the greatest degree of non-compliance. Examining the costs of administrative compliance in almost 8 000 SMEs, an OECD report found that compliance costs per employee were over five times higher for the smallest SMEs than for the largest. An American study has concluded that firms employing fewer than 20 employees face an annual regulatory bill of US \$6 975 per employee. This burden is 60% higher than that faced by firms with more than 500 employees. It seems unlikely that South Africa would show significantly different trends. The disproportionate impact of regulations on small business has a sharp significance in the South African context where the weight of the smallest size category (micro) is overwhelming.

Of course, informal and formal entrepreneurs respond differently to the policy and regulatory environment as the former tend to ignore regulations, taxes, levies, health

standards and the like. A large informal sector can be an admission that the regulatory costs imposed on business are too high and inappropriate. Says de Soto, 'Massive extralegality is not a new phenomenon; it is what always happens when governments fail to make the law coincide with the way people live and work.'<sup>17</sup>

Even though regulations may not be enforced in the informal sector, inappropriate regulations act as a barrier to development by keeping a large proportion of the population out of the formal economy.<sup>18</sup> Somewhat unhelpfully, they offer incentives to remain small and informal. There is little job security in the informal sector, jobs tend to be low-paid. Entrepreneurial activity might be promoted here but at the price of non-compliance in respect of tax and other regulations. *Doing Business* adds that workers have no protection in the informal economy, enjoy no social benefits, cannot use pension plans and school funds for their children, they have no paid vacations or maternity leave. Importantly, firms do not grow to their efficient size, thus reducing the number of productive jobs and diminishing the opportunities for growing out of poverty. Businesses do not pay taxes, reducing the resources for the delivery of basic infrastructure.

Essentially, when imposed at unrealistic levels, inappropriate regulation divides the economy into formal and informal sectors and erects barriers between the two which perpetuates the division. Somewhat unhelpfully, inappropriate regulations offer incentives to remain small and informal. Small business consultants have suggested that rather than see the informal sector as 'unfair competition' to the formal sector, it is more useful to see it as an incubator to build skills and assets before an enterprise enters the formal sector. However, surveys conducted across Southern Africa indicate that less than one percent of firms 'graduate' from the micro-enterprise seedbed and become more established enterprises employing more than 10 people.<sup>19</sup>

It would be unwise to underrate the degree of economic activity and commercial spirit in the informal sector. Commenting on the implementation of reforms in Peru, economist, Hernando de Soto, notes 'Some 276 000...entrepreneurs recorded their businesses voluntarily in new registry offices we set up to accommodate them – with no promise of tax reductions. Their underground businesses had paid not taxes at all. Four years later, tax revenues from formerly extralegal businesses totaled US \$1.2 billion.... We...cut dramatically the costs of the red tape to enroll small businesses. By 1994 Peru had the world's highest growth rate of about 13% per annum. It was a huge shock. The fact is that people do come in. This is not to say that people do not care about their tax bill... All we had to do was make sure the costs of operating legally were below those of surviving in the extralegal sector, facilitate the paperwork for registration, make a strong effort to communicate the advantages of the programme, and then watch hundreds of thousands of entrepreneurs happily quit the underground... Extralegal manufacturers and shopkeepers know basic arithmetic.'<sup>20</sup>

While a degree of non-compliance is perhaps inevitable, widespread and enduring non-compliance can devalue regulatory instruments in general and diminish the credibility of the government.<sup>21</sup>

A better strategy is to promote compliance is perhaps to discard what is not useful (unnecessarily complex bureaucratic procedures) and enforceable and absorb what works.

### **Some examples of regulatory drag**

External forces tend to have more impact on small businesses than on large ones. Changes in government regulations, tax laws, labour and interest rates affect a greater percentage of expenses for small businesses than they do for large corporations. 'Such limitations mean that small businesses can seldom survive mistakes or misjudgements.'<sup>22</sup>

Some examples of areas for improvement that have been noted in the South African context include:

- the World Bank's *Doing Business in 2004* notes that it takes 38 days to register a new business in SA, there are 9 separate procedural requirements, costing 8,7% of income per capita. This is 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. Uganda fares very badly indeed on the costs of starting a business – 135.1% of per capita gross national income. 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.
- According to *Doing Business* a typical business bankruptcy might take six months in Ireland or Japan; in South Africa it takes two years - certainly snappier than the 10 years it takes in Brazil and India, but there is room for improvement.
- Many small enterprises see the Skills Development Levy as 'just another tax'. Being unable to claim the levy for financial or administrative reasons, many SMEs have not produced a training plan that can be recognised by their SETAs 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 benefits;
- Particularly awkward is the South African Revenue Services' decision that VAT should be paid on invoice rather than receipt of payment which has led to cash flow problems for small businesses sub-contracting to large entities – such as the government.

### **Reasons to be cheerful**

In the 2004 Budget Speech the Minister of Finance, Mr. Trevor Manuel, said:

'Reducing the regulatory burden on [small] businesses is a key element of Government's strategy for encouraging employment creation. A working group will be established this year to review the compliance burden on small businesses.'

The SARS Commissioner, Mr Pravin Gordhan, has initiated a process to identify ways to ease the tax administration burden for small businesses. He said, 'We take SMMEs

seriously and want to assist them and at the same time want better compliance from them.’ This fits into government’s broader agenda of reducing compliance burdens and removing the regulatory barriers to the advancement of the SME sector given depth and weight by President Thabo Mbeki’s announcement in his State of the Nation speech.

The SARS initiative is likely to be significant. Studies have shown that tax compliance costs absorbs a large share of the total administrative costs of businesses. In the UK tax compliance costs – on the basis of studies available, appear to account for 40-50% of all regulatory costs. Respondents to survey conducted in New Zealand, claimed that approximately 30% of compliance costs are tax-related, 30% employment-related and 25% environment-related. The issue of reducing compliance burdens for SMEs – not just confined to tax but incorporating labour, health and safety and related business regulatory and compliance issues – is important if South Africa is to avoid getting the booby prize in the entrepreneurship stakes in future years.

A specific problem in the South African context is that there is little research-based evidence on constraints to doing business. Evidence is often patchy, over-reliant on anecdote, sometimes contradictory, sometimes politicized. The claim that business associations tend to neglect small business concerns has a ring of truth to it given the predominance of corporate power among most of them. For their part, few entrepreneurs have the time and/or inclination to participate in public policy debates as they are too busy running their businesses.

One study which I’ve found particularly interesting is that conducted by Upstart Business Strategies – using the Mistral approach pioneered in the Netherlands. UBS recently quantified VAT-induced administrative burdens for small businesses in a South African context – the costs of complying with the information obligations resulting from government-imposed legislation and regulation (costs of taxation, permits, licences, interest, fees and dues, penalties are not included in the definition of administrative burdens). The total administrative burden for an SME in terms of VAT amounted to R8 441 a year. According to Upstart’s report, ‘of the enterprises registered for VAT, approximately 498 500 are SMMEs. Upstart then notes that the total VAT induced administrative burden for the 498 500 SMMEs amounts to R4.37 billion. These administrative burdens originate mainly from the obligation to keep records (70% of the total administrative burdens) followed by the tax return (28%).

**Total and Average structured and once-off administrative burdens of VAT<sup>23</sup>**

Information obligations	VAT	
	Total Rb	Average per SME
<i>Once-off burdens</i>		
Registration	30	1, 063
Communication with SARS	12	97
Inspection by the commissioner	26	506
Notify changes	3	83
De-registration for VAT	1	664

<b>Total once-off burdens</b>	<b>72</b>	<b>2 414</b>
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<i>Structural burdens</i>		
Record-burdens	3 071	3 556
Tax return	1 227	2 471
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<b>Total structural burdens</b>	<b>R4 298b</b>	<b>R8 441</b>
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More broadly, while the concept of Regulatory Impact Assessments is relatively new to South Africa, it promises to play an increasingly significant role in the formulation of policy.

**To sum up:**

The overall aim of policy-makers interested in promoting small enterprises might be to reduce unnecessary bureaucracy by:

- regulating only when necessary, after considering non-regulatory alternatives;
- doing so with a light touch, proportionate to the risk;
- simplifying existing regulations, wherever possible. Inroads must often be made to tackle the stock of unnecessary bureaucracy that already exists – a tricky task as vested interests may protect their turf and resist the process.

It must be remembered that regulatory environment is just one facet of the overall environment in the overall business climate. Also important are: the quality and availability of staff, crime, infrastructure, the savings rate, the impact of Aids on a business as well as the role of attitude in entrepreneurial orientation, not to mention innovation.<sup>24</sup> In addition, it is easy to overlook the role of trust and personal networks in business, but social networks – who people know – have value. This is particularly the case for smaller enterprises. These factors all play a role, but the shift to better regulation – that reduces the administrative burden for SMEs – is a good, potentially great, investment South Africa can make in its future in the shorter term.

Nor are business interests the sole determinant of public policy choices. Regulations can be used to collect taxes, protect citizens and consumers from unsafe products, protect employers from unfair employment practices, as well as to protect the environment for current and future generations. A more modest message is being suggested: policy should take full account of the practical realities for business, particularly small business.

<sup>1</sup> *Business Day* 12 November 2002

<sup>2</sup> see Hudson, J *Debunking myths in the South African context* Paper presented at the 48<sup>th</sup> International Council for Small Business conference, Belfast, 18 June 2003

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- <sup>3</sup> Mhone, G *Entrepreneurship in small, medium and micro enterprises in South Africa: Findings based on the 1999 October Household Survey* Prepared for the Ntsika Enterprise Promotion Agency, January 2001, pp.28-29.
- <sup>4</sup> Berry and others, *The economics of small, medium and micro enterprises* Trade and Industrial Policy Strategies, 2003, p.14
- <sup>5</sup> Kane-Berman, J 'Empowerment versus entrepreneurship' in *Fast Facts* No.3, South African Institute of Race Relations, March 2003, p.1.
- <sup>6</sup> See Hudson, J *Debunking myths about entrepreneurship in the South African context* presented at the International Council for Small Business 48<sup>th</sup> conference, Belfast, June 2003.
- <sup>7</sup> Berry, A et al *The economics of small, medium and micro enterprises in South Africa* Trade and Industrial Policy Strategies, 2002, p. 9.
- <sup>8</sup> See Hudson, J 'An enabling environment for private sector growth: Lessons from international experience' *SME Alert* published by the SBP, November 2002
- <sup>9</sup> See Hudson, J *Debunking myths about entrepreneurship in the South African context* presented at the 48<sup>th</sup> International Council for Small Business Conference, 16 June 2003.
- <sup>10</sup> See Bannock, G *Indigenous private sector development and regulation in Africa and central Europe: A 10 country study* August 2002.
- <sup>11</sup> See Hudson, J *Debunking myths about entrepreneurship in the South African context* presented at the 48<sup>th</sup> International Council for Small Business Conference, 16 June 2003.
- <sup>12</sup> TIPS *The economics of SMMEs* December 2002, p.39
- <sup>13</sup> Chandra V et al *Constraints to growth and employment in South Africa: Evidence from small, medium and micro-enterprise firm surveys* World Bank 2000, p.v.
- <sup>14</sup> TIPS *The economics of SMMEs* December 2002, p.39
- <sup>15</sup> see Hudson, J *An enabling environment for private sector growth: Lessons from the international experience* published by the SBP, November 2002
- <sup>16</sup> see Hudson, J *An enabling environment for private sector growth: Lessons from the international experience* published by the SBP, November 2002; Hudson, J *Understanding regulatory impact assessments: Key issues from the international experience* published by the SBP, January 2003; Hudson, J *A small business perspective on tax compliance* published by the SBP, October 2003.
- <sup>17</sup> See Hudson, J (ed) *The mystery of capital: Why capitalism triumphs in the West and fails everywhere else – A South African conversation with Hernando de Soto* published by the Centre for Development and Enterprise, November 2001, p.2.
- <sup>18</sup> see Hudson, J *An enabling environment for private sector growth: Lessons from the international experience* published by the Small Business Project, November 2002.
- <sup>19</sup> Mead, DC and Liedhold, C 1998 'The dynamics of micro and small enterprises in developing countries' in *World Development* 26, p.67
- <sup>20</sup> Hudson, J (ed) 'The mystery of capital: Why capitalism triumphs in the west and fails everywhere else': A South African conversation with Hernando de Soto *CDE Focus* November 2001, p.2.
- <sup>21</sup> [www.cabinet-office.gov.uk/regulation](http://www.cabinet-office.gov.uk/regulation)
- <sup>22</sup> Welsh, J and White, J 'A small business is not a little big business' in *Harvard Business Review* July-August 1981
- <sup>23</sup> Upstart Business Strategies *Value-added tax act and regional services councils act-induced administrative burdens for small businesses* Draft final report, May 2004, p.93
- <sup>24</sup> see Hudson, J *Is South Africa a good place to do business?* published by the Small Business Project, November 2003, p.1