

# Are SMEs the answer for job creators? Towards the operationalization of a SME Observatory

Johannes Wessels<sup>1</sup> & Willem Ellis<sup>2</sup>

The Centre for Development Support, UFS, is in the process of establishing a SME Observatory with the Flemish International Co-operation Agency and the ILO as partners. The overall objective is to learn how various policies and strategies impact on Small and Medium Enterprise and their capacities to create job opportunities.

## 1. SMEs as the real job creators

In Vision 2030, the National Development Plan released by the National Planning Commission in November 2011 it is envisaged that "90% of the required jobs will be created in small and expanding firms"<sup>3</sup>. In this assumption the NPC aligns itself with what since the work of Birch<sup>4</sup> and others parades as common wisdom.

In South Africa there are widely divergent opinions about the role of formal enterprise, and therefore also SMEs, in society. There is, on the side of the Department of Trade & Industry (DTI) as well as other developments agencies, e.g. the Free State Development Corporation, a range of initiatives to facilitate the creation of new enterprises. This takes place in the framework of black economic empowerment. Numerous LED initiatives by local authorities also focus on a range of local initiatives, and in many cases focus rather on the creation of new community based enterprises rather than determining how existing local enterprises could be strengthened and enhanced.

These endeavours are driven by the belief that new small enterprises will create jobs, and also the perception that formal enterprise and organised business chambers are (in the main) beneficiaries of the apartheid era and that new entities should be created and encouraged. This is a parallel to the long saga of the SACOB, Nafcoc, Fabcos, AHI deliberations on business unity and BUSA. The comment by President Zuma at the 2012 ANC Policy Conference that the SA economy is controlled by white males reinforces this operating paradigm.

A key theme for a country struggling with high unemployment and income inequality is whether SMEs are the solution for job creation, regardless of whether it is a new enterprise or existing enterprises that are expanding. Since the research by *inter alia* Birch it has become common wisdom that SMEs are the main creators of job opportunities. This is a theme also harped upon by politicians everywhere:

- in France it is a rallying cry to protect local culture against the behemoths of globalization;
- in South Africa it forms part of the framework of affirmative action and support for emerging entrepreneurs;
- in the US it is about keeping jobs local rather than exporting jobs to China, Vietnam and Indonesia.

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<sup>1</sup> CEO of Rural Urban Integration Consultants CC and Research Associate of the Centre for Development Support, UFS, tasked with launching of the SME Observatory

<sup>2</sup> Director: Centre for Development Support, UFS

<sup>3</sup> National Planning Commission, 2011: *Vision 2030 - National Development Plan*. P 93

<sup>4</sup> Birch, D L (1987): *Job Creation in America: How Our Smallest Companies Put Most People to Work*. NY Free Press

## **2. But is that really the case?**

There is, however, a growing body of literature that questions the validity of SMEs as the main creator of jobs. John Haltiwanger<sup>5</sup> concludes that due to a range of factors it is more complicated than to simply arrive at this conclusion. Factors to be considered are that new firms (including employment) begin small, but that the attrition rate is also the largest in small firms. In addition, new franchising stores are counted as jobs in a SME environment, but can the creation of such jobs within a multi-national brand such as McDonalds be ascribed to the small franchise operator or to the large brand? He concludes that firm age is crucial to understand job growth: "*once we add controls for firm age, we find no systematic relationship between net growth rates and firm size*".

In 2011 Carolyn Freund, Chief Economist for the World Bank (Middle East and North Africa), concluded that SME development is no silver bullet for growth and job creation. SMEs are, according to World Bank research, not the main net job creators given that they are less productive than large enterprises: "*A sizeable share of the productivity gap between developed and developing countries can thus be explained by the estimated 30 percent share of SMEs in economic activity in developed countries as compared with a 60 percent share for developing countries. Of special concern is that SMEs in developing countries tend to be exceptionally stagnant as compared with their developed country peers*".<sup>6</sup>

The economic melt-down and the financial crisis of 2008 also brought key issues to the fore:

- Forsman & Temel<sup>7</sup> based their research on empirical evidence emanating from 2 data sets describing innovation and business performance in 145 small enterprises (in this case with 50 employees or less) in the period 2005 – 2009. The results suggest that during the period of five years, non-innovators have been the best performing enterprises in terms of operating earnings and return on investments and during the recession the less vulnerable enterprises were non-innovators and those innovators characterised by the high diversity of developed innovations.
- Are linkages with successful large corporates and multi-nationals a key indicator between successful and failing SMEs? Chinomona & Pretorius<sup>8</sup> found that manufacturing SMEs benefit from the expertise of large corporations. This is also supported by the Mthente-study for BEDCO where Lesotho SMEs were linked into the supply chains of large textile manufacturers<sup>9</sup>.

The evidence is mixed and underlines the need for an Observatory that can provide evidence-based policy advice regarding SME development.

## **3. Defining SMEs**

A key aspect that requires clarity is the definition of small (and medium) enterprise in different contexts. The definitions even change within countries over time. To deduce therefore from, say, Southeast-Asian studies or North American research that small enterprises form the womb for innovation or job creation, would not imply that these findings would be valid in Sub Saharan context or in a Southern African context *per se*.

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<sup>5</sup> Haltiwanger, J C (2010): *Who Creates Jobs? Small vs Large vs Young?* National Bureau of Economic Research, Working Paper 16300

<sup>6</sup> <http://menablog.worldbank.org/small-medium-sized-enterprises-not-silver-bullet-growth-and-job-creation>

<sup>7</sup> <http://ideas.repec.org/a/wsi/ijimxx/v15y2011i03p641-665.html>

<sup>8</sup> [www.scielo.org.za/scielo.php?pid=S2222-34362011000200004](http://www.scielo.org.za/scielo.php?pid=S2222-34362011000200004)

<sup>9</sup> [www.bedco.org.ls](http://www.bedco.org.ls)

Also in South Africa different institutional definitions of small enterprise exist. SARS has for income tax purposes defined a small business corporation as an entity with a turnover below R14 million and for capital gains tax a small business is an entity whose net assets would not exceed R5 million. In some of the amnesty approaches, SARS operated with a turnover of below R10 million. The DTI also has a set of definitions for small and medium enterprise. Some international examples are:

- The UK's Companies Act of 2006 (sections 382 and 465) defines a SME for the purpose of accounting requirements. A small company is one that has a turnover of not more than £5.6 million, a balance sheet total of not more than £2.8 million and not more than 50 employees. A medium-sized company has a turnover of not more than £22.8 million, a balance sheet total of not more than £11.4 million and not more than 250 employees<sup>10</sup>
- The British Bankers Association (BBA) defines small business customers as sole traders, partnerships, limited liability partnerships and limited companies with an annual turnover of under £1 million.
- The European Union defines a micro enterprise as one with an employee headcount of less than 10 and a turnover or balance sheet total of not more than €2 million. A small enterprise has a headcount of less than 50, and a turnover or balance sheet total of not more than €10 million. A medium-sized enterprise has a headcount of less than 250 and a turnover of not more than €50 million or a balance sheet total of not more than €43 million.
- The US has different size standards for enterprises in the different NAICS coded industry sectors in an attempt to acknowledge industry differences<sup>11</sup>, e.g.:
  - 500 employees for most manufacturing and mining industries
  - 100 employees for wholesale trade industries
  - \$7 million of annual receipts for most retail and service industries
  - \$33.5 million of annual receipts for most general & heavy construction industries
  - \$14 million of receipts for all special trade contractors
  - \$0.75 million of receipts for most agricultural industries

This doesn't imply that international research findings on SMEs are not relevant for South African policies. There are key elements emerging especially regarding the architecture of enterprises.

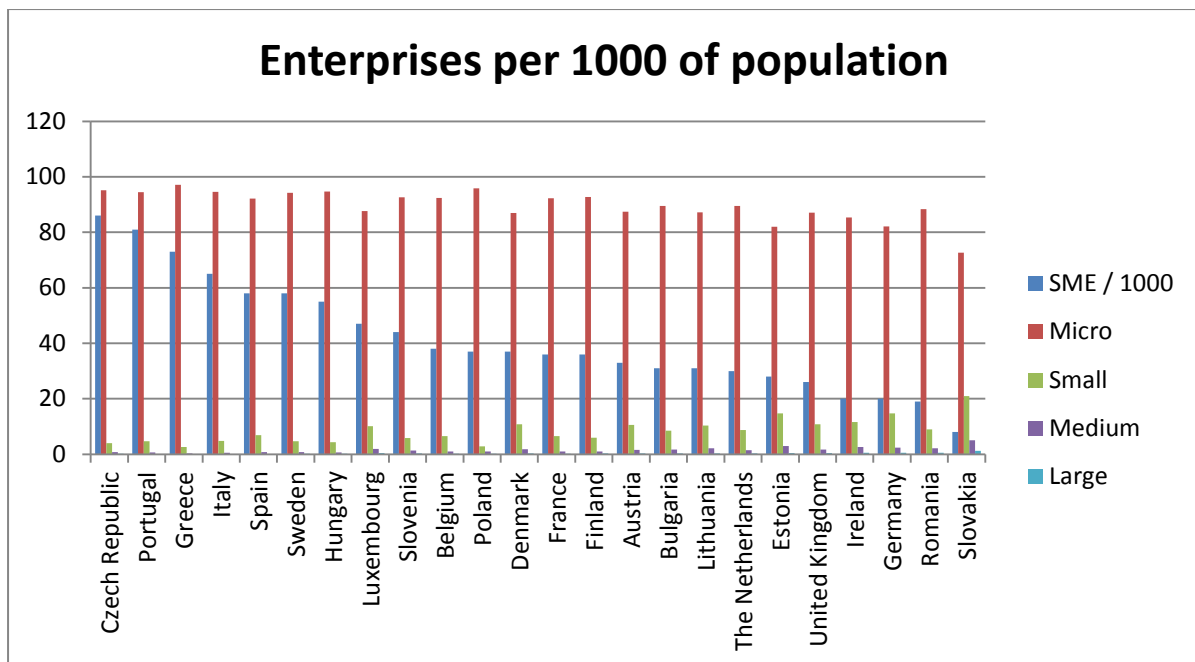
#### **4. What one can deduce from the Enterprise Landscape**

The European Union has been operating an Observatory to analyse the conditions and performance of SMEs in the member states. Based on time line data, they can already produce substantial trend analyses. What is interesting from the most recent data is how there are on the one hand differences, but simultaneously also divergence, in the statistics. The graph based on the most recent statistics compiled by the European SME Observatory is indicative:

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<sup>10</sup> Even in the UK context, one cannot compare findings on Small Enterprise before 2004 with those after 2004, since before 2004 the turnover caps were approximately 50% of those defined in 2004.

<sup>11</sup> <http://www.lib.strath.ac.uk/busweb/guides/smedefine.htm>



Some observations and questions are relevant:

- Countries with the highest incidence of SMEs per 1000 of the population, are in those positions mainly because of the predominance of micro enterprises (less than 10 employees)
- Countries where Small Enterprise exceeds the EU average of 6.9 small enterprises / 1000 of the population are in the main grouped to the right (with a slightly lower occurrence of micro enterprise).
- The higher incidence of Small Enterprise / 1000 occurs also in the main in countries with the highest occurrence of large enterprises/1000 of the population.
- The countries that a mere 25 years ago were still in the grip of centrally planned autocratic regimes appear spread from the left (Czech Republic has the highest occurrence of SME/1000) to the right (Slovakia has the lowest SME/1000). The question that could be raised in this context was what was the structural and policy frameworks when privatisation kicked in?
- Is it coincidence that Portugal, Greece, Italy and Spain (all struggling with crippling national debt) are filling four of the five positions with the highest occurrence of SMEs per 1000 of the population, whilst Germany, the bulwark of economic strength in Europe, lies on the other end of the scale?

In the Southern African context, Lesotho is an interesting study field due to the industrialisation thrust. Based on the Lesotho Bureau of Statistics Business Surveys of 1996 and 2003<sup>12</sup> micro enterprises in this period increased by 227% to a total of 2 177 firms whilst large enterprises increased in this period by 402% to 206 enterprises. Job creation was in these two categories of the same percentage order: 140% in the case of micro enterprises and 146% in the case of large enterprises. The net gain in jobs in the micro enterprise category was 2 361 compared to the 25 514 additional job opportunities created by large enterprise.

<sup>12</sup>

Subsequent survey findings not published as yet.

An analysis of the enterprise constellation of a society indicating the forces of economic gravity and the relationship and behaviour between entities (some small enterprises are like moons kept in motion by their own kinetic value and the pull of a large enterprise/planet that they are circling) will yield an understanding of the forces that impact on their behaviour. Formal SME development initiatives that do not take account of the broader economic context of trade regimes and the role and linkages with national and international large and multi-national enterprises, will not be able to maximise the returns on small and medium enterprise development.

To conduct an analysis of the enterprise architecture in South and Southern Africa, the CDS is establishing the SME Observatory to conduct an analysis of the SA situation.

### **5. The functions of the SME Observatory**

The Observatory will in the first instance develop a data base of SMEs to study and analyse the enterprise landscape and the relationship between small, medium, large and even multinational enterprises. The objective is to monitor changes in the occurrence of SMEs and their employment and to determine which factors impact positively or negatively on the livelihood of SMEs as well as on their employment creation potential.

The following functions and products of the Observatory are envisaged:

#### ***SME monitoring and assessment***

An integrated monitoring system to develop a data base is required. Whilst the ideal is an *SME Census approach* every 3<sup>rd</sup> year (to capture SME trends in geographic pockets or in sub-sector categories), the need to develop early products as well as initial resource constraints, argue towards a *SME survey approach*. Initially the SME Monitor will identify a number of SMEs in 6 to 8 enterprise sub-sectors. The differences between the Census and Monitor approach is summarised below.

The data would further be evaluated in the context of demographic and economic trends, specifically for the national, regional and locally relevant economic sectors and the description of value chains could be enhanced through such a data base.

As resources can be mobilised, it is envisaged to enhance the sector analysis of SMEs also with geographic intelligence to analyse inter alia:

- Whether small town SMEs in a specific industrial classification are more vulnerable to certain risks than SMEs in larger settlements or cities.
- How differences in regulatory approaches in different provinces / metro councils / district municipalities impact on SMEs and job creation.
- What constitutes – apart from population size which is directly related to the number of trading enterprises in a locality<sup>13</sup> - the conditions for the establishment and growth of enterprises in specific sub-sectors.

The data derived from the SME Monitor base will also be utilised to inform the data sets developed by Toerien and Seaman.

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<sup>13</sup> Toerien D: 1. South African Journal of Science 106: 24-33 2. Water SA 37: 47-56 3. South African Journal of Science 108: 1-10 4. Chapter in book: *Visions for Global Tourism Industry: Creating and Sustaining Competitive Strategies* pp. 113-138. 5. Chapter in book: *The Functioning of Ecosystems* pp. 229-248.

### ***SME Action research***

A SME **action research agenda** that aims at the generation of new knowledge through systematic learning by teams of entrepreneurs, administrators and academics, will deal with topical issues. Investigative research will be used to harvest the knowledge and business experiences that merit dissemination or up-scaling. In the Observatory's focus are, inter alia, the following issues:

- What are the characteristics of SMEs in South Africa that are resilient and have grown (both turnover and employment wise) with an analyses of drivers (locality / linkages with corporates / specific economic subsectors / leadership / markets / years in business / etc.)
- In the case of SMEs that are job creators: in which sectors and localities do they operate and what are the conditions for that?
- What is the impact of municipal service delivery on SMEs?
- What is the impact of national and provincial policies / strategies and practices on SMEs?
- What is the impact of failing / performing schools in small and medium towns on enterprises in these localities?
- What is the impact of the informal sector on SMEs in the locality / value chain and what are the consequences of this for enterprise development?
- Are there linkages between social grants and SME development?
- Is there a sustained impact of LED initiatives on SME development?
- What distinguishes effective and efficient Business Development Services (BDS) from ineffective and inefficient BDS?
- Red tape and regulatory frameworks and SMEs

### ***SME Service Providers Monitor***

There is a wide range of service providers impacting on SMEs. In the public sector there is at national level the DTI and its SEDAs, the Dept. of Agriculture, at provincial level a range of departments, para-statal such as the IDC, the provincial development corporations and agencies, district and local municipal procurement incentives as well as activities in the field of LED and the IDP planning processes, banks, private service delivery agencies (e.g. Business Partners), franchise arrangements, as well as a range of academic organisations.

A monitor to assess the SME situation through the data and impressions from a range of SME service providers would provide an enriching insight that will supplement and shed from another angle light on the information obtained from the SME monitor as well as the topical Action Research.

### ***Knowledge exchange and learning***

The many stakeholders in the SME layer of the enterprise world can become better informed and the Observatory can facilitate more systematic learning on SMEs among entrepreneurs as well as other stakeholder groups. This kind of learning can take place in so-called **communities of practice**, temporary alliances that are forged around a common learning objective. If the community of practice consists of economic chain actors, the term "platform" is often used. Communities of practice and platforms can grow into partnerships or even ventures if, apart from knowledge, resources are shared.

In order to make the acquired knowledge and expertise accessible from a distance and in time, the Observatory will streamline and improve the **documentation and knowledge networking** of SME experiences. Linking existing databases and developing new ones is an essential element of the Observatory.

### ***Evidence-based advocacy***

An SME Observatory that wants to contribute to the public good has to provide evidence-based arguments to influence policies and practices that will enhance the well-being of enterprises. It must analyse policies and practices and their impact on SMEs and engage with public entities (national, provincial and local authorities) on issues where policies and practices harm growth and job creation.

Likewise it has to engage financial institutions if access to capital appears to be too problematic to enable SME development, as well as large corporations if a more SME beneficial supply and procurement approach would be beneficial to SME development.

### ***Products***

Products will be packaged for a range of purposes and could be any of the following:

- Public information pieces in the form of workshop presentations, newspaper articles, e-newsletters, web-based think pieces
- Policy influencing through targeted interaction with a range of authorities (national / provincial / local) in the form of more detailed policy briefs, quarterly workshops, etc.
- Mobilising alliances for policy influencing on specific issues (e.g. conferences, newspaper articles, road shows, etc.)
- Academic journal articles.

## ***6. The SME Observatory and Poverty***

The SME Observatory will through proper research hold up the mirror to reflect to the NPC and other entities whether the observations obtained from studying the enterprise constellation validate the assumption that the creation of 90% of new jobs will be in small enterprises.

It is through asking the right questions and pursuing candid answers in the field of enterprise development, that we will now how best enterprise development and the rolling back of poverty can be pursued. South Africa has a sad history of ideologically driven investment and enterprise development: think border industries, Botshabelo and job reservation. It would be inappropriate to tackle the existing poverty issues again with an ideologically blinkered approach. In the field of SME development, the Observatory will strive to delve up evidenced based findings and interpretations to enable better informed decisions about policies and strategies.