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South Africa: Reducing Financial Constraints To Emerging Enterprises

South Africa's black enterprise sector is a residual employer with an important role to play in improving welfare and alleviating poverty. It is also a source of dynamic and potentially dynamic firms that create wealth and generate employment. The challenge facing South Africa is to design an institutional framework that accords black enterprises much broader access to financial services, training, and technical assistance. That framework is contained in the government's policy paper, National Strategy for the Development and Promotion of Small Business in South Africa. Details of the institutional framework to increase access to financial services by emerging enterprises are discussed here. Like South Africa, many countries in Africa, Asia, and Latin America face severe unemployment, a stagnant formal economy and a burgeoning informal economy made up of small enterprises which constitute the only means of livelihood for a substantial share of the population. South Africa's efforts to develop its formal financial sector's capacity to serve the needs of small, new businesses offers potentially interesting lessons for other countries.

The Legacy of Apartheid

Despite the repeal of apartheid legislation in the late 1980s, the South African economy remains characterized by profound inequalities between the black majority and white minority. In the formal sector, unemployment among blacks is a staggering 50 percent, compared with 20 percent among whites, Asian, and coloreds. The South African economy is stagnant, and by 1992, the formal economy could absorb only 8 percent of new entrants to the labor market, plummeting
from 80 percent in 1960. In contrast, the informal sector is growing dramatically and represents perhaps 8 percent of Gross Domestic Product (GDP).

The new government is committed to ensuring that the fruits of economic growth are divided more evenly. As part of this goal, it seeks to assure that small businesses form an integral part of the nation's economy. Yet the major state institutions that develop enterprises have yet to restructure their operations in line with the new government's priorities. Building an institutional framework that supports the development of black business is therefore a matter of urgency for the new government.

**Characteristics of Black Emerging Enterprises**

Despite the severe constraints facing black entrepreneurs in South Africa, evidence of dynamic growth exists among black firms. About 20 percent of the more established black-owned firms are dynamic -- defined from the survey results in terms of observed levels and high growth of turnover, profitability, sustainability, employment and replacement value of capital invested in the business as assets -- and another 20 percent could grow if certain constraints were alleviated. Among microenterprises, light manufacturers, in particular, have above average incomes, employment, and growth. Specifically, their net monthly income is in excess of R2000 (US$550 equivalent) compared to the average for the sector which is below R650 (US$180 equivalent). Also, they employ on average 3-5 staff compared to the sector average of 2.

The policies of apartheid have left black-owned enterprises severely handicapped, especially relative to mainstream South African enterprises. This is confirmed by the results of two World Bank surveys carried out in 1992: a multisectoral survey of constraints facing black enterprises throughout the country and 4 subsector surveys of more established black enterprises, and a 1990 GEMINI (Growth and Equity through Microenterprise Investments and Institutions) survey of small enterprises with up to 50 employees in 2 black townships (Mamelodi and Kwazakhele). Black enterprises were found to be overwhelmingly microenterprises that employ fewer than 10 employees. They share the following characteristics:

- Half are less than 3 years old, and employment among surviving firms is growing at 25 percent a year; Employment growth is related to age of the firm. The average growth rate for those created in the past year is an average of 46 percent, and 25-29 percent for those in existence for 2-3 years.
- Most new firms were created as a survival strategy for coping with unemployment.
- Women operate 62 percent of all microenterprises, and their firms tend to be in sectors with the lowest levels of profitability and growth in employment
- Seventy percent of firms are in commerce and trade, while only 17 percent are in manufacturing, usually food and clothing production. Street vendors account for almost half of microenterprises. Only about 7 percent are in light manufacturing.
- Net monthly income is on average below the established subsistence level of R650 (US$180 equivalent).
- Owners tend to be young and to have only 6 years of formal schooling: 35 percent are less than 30 years old, and 30-40 percent lack basic literacy skills.
- Few owners have worked in the formal sector, and most are unskilled and lack supervisory or managerial experience.
Constraints Facing Black Emerging Enterprises

Emerging entrepreneurs consider the principal impediments to their business growth to be:

- **Financial constraints.** Under apartheid, blacks were prohibited from owning land and thus had no access to collateral for loans. Today, access to formal lenders is scarce until the firm exceeds 5 employees and has been in existence for 3-5 years. Only 20 percent have received credit, and the major sources of funding are rotating savings clubs as well as the savings of the owner and of friends and family. Lack of operating funds (working capital) is a problem among new firms, whereas lack of investment funds is a problem among older firms.
- **Market constraints, identified as tremendously competitive market conditions.** Under apartheid, blacks were restricted to operating a narrow range of businesses, mainly township based retail enterprises. They were prohibited from operating in the so-called white areas. Today, competition is intense and largely confined to the low-income black market; and supplies are expensive.
- **Inadequate business premises and tenure arrangements.** Under apartheid, whites controlled the allocation of all formal business sites. Today, most microenterprises (71 percent) are operated in the home, far from commercial traffic. Half of those operating outside the home do not have permission to occupy their site.

Proposed Mechanism

A centerpiece of the government's Reconstruction and Development Programme is recognition of the need to broaden access to financial services by emerging microenterprises that have historically been excluded from it. The proposed framework, which was created in close collaboration with the government and with practical input from South Africa’s principal financial institutions and nongovernmental organizations, takes a systems approach. This involves building up a range of institutions capable of providing sound, responsive, and sustainable financial services to emerging enterprises.

In the past, support to retail intermediaries for lending to microenterprises depended on access to donor funds and to government allocations. This did not necessarily reward efficiency. The proposed framework seeks to provide a level playing field in terms of access to resources for all financial intermediaries that finance microenterprises and that commit to the achievement of high standards of efficiency, sustainability and outreach. The intent is to develop the capability of the financial system as a whole to reach a much larger share of entrepreneurs from historically disadvantaged groups. It is recognized that different types of institutions will have different market niches. For example, commercial banks could develop the capability to lend profitably to small enterprises. However, true microenterprise lending (with loan sizes below R2000/US$550) would likely be the domain of NGOs and community-based organizations with lower cost structures and easier access to information based on community ties. The financial systems approach acknowledges that the financial needs of a range of borrower sizes and capabilities can be best met by a range of institutions with different approaches.

The Financial Services Apex Institution
The principal mechanism is the Financial Services Apex Institution (FPAI), which will:

- Support the development of self-sustaining retail intermediaries;
- Serve as a catalyst for the introduction of techniques and innovations based on international best practices in microenterprise finance; and
- Will intermediate resources (according to strict commercial principles) from organizations with funds to retail financial intermediaries that finance microenterprises.

Two means are proposed to induce banks and financial intermediaries to lend to black microenterprises:

- Incentives to serve that market; and
- An institutional development program to introduce best practices. Both are intended to reduce transactions costs.

Incentives include subsidies and a guarantee scheme. Subsidies available during a 5-year learning period will enable banks and retail intermediaries to cover the initially high transactions costs of lending to microenterprises. For example, the portfolio of loans to qualifying microenterprises, consisting of loans below a cut-off point, will be eligible for a subsidy that will, in effect, bring the cost of refinancing to around 3 percentage points below the average costs of funds to the commercial banking system. A tiered portfolio guarantee scheme will limit heavy losses if loss rates become unmanageable. This scheme will cover losses on a bank’s microenterprise portfolio at a low rate if losses are at a modest level, at an intermediate rate at the next level of losses, and so forth.

The institutional development program will include a diagnostic of the participating institution by the FSAI and development of a program to address constraints and weaknesses. Local training seminars and study tours will address key constraints and provide exposure to approaches that have been successful in other countries. Technical assistance will reinforce the use of best practices and support the development, installation, or adaptation of management information and accounting systems specially designed for microenterprise lending institutions. The institutional development component is intended to reduce transactions costs of microenterprise lending by making commercial banks and nongovernmental organizations operationally more efficient in serving this market.

The Apex will provide funds and assistance for refinancing, seed grants, capitalization, and institutional development to institutions that are committed to meeting stringent standards of performance. These standards are based on international best practice found in microenterprise finance institutions: that is, loan repayment rates (at least 90 percent on-time repayment of loans and annual portfolio losses no greater than 4 percent), and outreach (at least 1,000 active loans to microenterprises or 200 active loans to small and medium enterprises). In addition to commercial banks, three categories of nonbank intermediaries, including development corporations and NGOs will be eligible to participate:

- Those that have already achieved substantial efficiency and scale of operations and are approaching the minimal international standards of best practice. (Eligible for refinance,
institutional development support, and capitalization grants to significantly expand operations or to become a bank.)

- Those that have some track record in microenterprise finance, but whose portfolio is characterized by low volume or high arrears and whose operational efficiency is low. (Eligible for seed grants and institutional development funds.)
- New entrants with outstanding potential, perhaps based on the provision of nonfinancial services to microenterprises. (Eligible for seed grants and institutional development support.)

South Africa's Government of National Unity is in the process of finalizing implementation arrangements for the proposed Apex Institution, which is expected to be operational by November 1, 1995. Access to financial services will be complemented by the provision of technical support to small enterprises through a national network of Local Service Centers.

Over the next 5 years, it is expected that emerging enterprises enjoying access to support and finance will increase from 25,000 -- about 1 percent of the total emerging small business population of 2.5 million -- to at least 250,000, and that the percentage of commercial bank assets invested in emerging and small enterprises will at least double to 10 percent. This will help to dismantle the economic legacy of apartheid and free up the vast potential of the small business sector in South Africa.

This article was written by Thyra A. Riley of the Macro, Industry and Finance Division, Southern Africa Department, The World Bank. It summarizes the work of a team consisting of Nancy Barry, Ranjit Fernando, Elena Folkerts-Landau, Mohini Malhotra, Marcello Romero, and William Steel. It is based on surveys of black enterprises "Characteristics and Constraints Facing Black Businesses in South Africa: Survey Results", by Thyra A. Riley and on detailed papers "Framework for Providing Financial Services to Emerging Enterprises in South Africa" and "Establishing a Financial Apex for Emerging Enterprises", which were prepared in collaboration with a South African Reference Group consisting of representatives from commercial banks, nongovernmental organizations, contractual savings institutions, investment banks, development corporations, small enterprises, and government officials. The program is being implemented by the South African government with ongoing World Bank technical and supervisory support. For copies of the surveys and associated papers, please contact Ms. Riley, Rm. J 11-143, AF1MI, The World Bank, 1818 H Street NW, Washington D.C. 20433. Tel. no.: 202 - 47-34060.