

# OBSTACLES TO FORMAL EMPLOYMENT CREATION IN SOUTH AFRICA: EVIDENCE FROM RECENT FIRM SURVEYS<sup>1</sup>

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South Africa has a formal employment problem which can be characterized as follows. Since the mid-1990s, while the rate of economic growth in the South African economy remained sluggish at 2-3 percent per annum, the rate of formal employment creation in large manufacturing firms declined consistently. In fact, between 1994-99, employment in the manufacturing sectors declined by 9.85 percent. Typically, if firms are competitive, they turn to global export markets as a vent for surplus when they face low domestic demand. This substitution helps to arrest large scale employment losses in manufacturing. However, since this does not appear to be happening on a visible scale, it is fair to conclude that the current trends are more likely to stay in the medium term. Considering that manufacturing absorbs a large proportion of the relatively less-skilled labor force, the poverty implications of persistent job losses are non-trivial. They have continued in an environment constrained by limited job opportunities in the traditional sectors - mines, agriculture or government. The exception is the rapidly growing service sectors which are intrinsically skilled-labor intensive and thus unsuitable for newly laid-off manufacturing workers. With pools of the latter joining the ranks of the openly unemployed, South Africa's unemployment is profiled by race, history, longer term, structurally unemployed individuals who have either never held a first job or have been laid off from a mine or a factory and are unemployable given the peculiarities of the present day labor market.<sup>4</sup>

If the formal employment problem were confined to job losses in manufacturing and mining, it would be one thing. But the fact that the formal employment problem also extends to the service sectors which have enjoyed phenomenal growth in recent years adds another wrinkle. Of course, the problem in the service sectors is a totally different matter. There the problem is not so much of weak labor demand as of the weak supply of labor skills. This trend is hardly new -- it has

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<sup>1</sup> *The findings, interpretations and conclusions expressed in this report are entirely those of the authors. They do not necessarily represent the views of the World Bank Group, its Executive Directors, or the countries that they represent and should not be attributed to them.*

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<sup>4</sup> For a comprehensive discussion, see "Look after low end jobs," in H. Bhorat, *Essays on the South African Labor Market*, Chapter 6, DPRU, Cape Town, 2001.

been in place since the 1980s. They why is it that in a setting with huge job losses among the less-skilled in manufacturing and abundant job opportunities for the skilled in the service sectors, the skills-divide persists stubbornly without a massive market-driven transformation of less skilled into more skilled labor?

A third aspect of the formal employment problem has to do with SMME development. With open unemployment rates edging over 35 percent, the formal employment problem is confounded by the fact that the much awaited blossoming of the new SMME entrepreneurs also did not happen. In the mid-1990s, policy makers in the new South African economy launched a series of programs and pinned their hopes of large scale employment creation on a targeted rapid expansion and growth in the SMME sectors (as well as the export-oriented large scale manufacturing sector). Almost 6-7 years into these initiatives, South Africa's formal employment problem remains largely unchanged. By default, as elsewhere in the world, the informal sector is serving as the employer of the last resort. But the level of earnings and quality of work offered by it are hardly what the people and policy makers of South Africa would deem an acceptable substitution for formal employment.

The remainder of this paper focuses on two aspects of the formal employment problem:

1. Why have growth and job creation stalled in the large manufacturing firm sector? In the medium term, why are the prospects for growth and job creation in the service sectors likely to be constrained?
2. Why has job creation stalled in the SMME sector?

This paper draws on findings from five 1999 GJMC-World Bank firm surveys<sup>5, 6</sup> conducted in the Greater Johannesburg Metropolitan Area (GJMA). In all cases except tourism, the sample from this area is strongly representative of most of South Africa's firms across production and services, and so, has implications for the larger national economy.<sup>7</sup>

- 1) The large manufacturing firm survey covered every 7<sup>th</sup> firm (and a total of 325 firms) across 8 manufacturing sectors in GJMA. In 1999, GJMA accounted for about 40 percent of South Africa's large manufacturing firms with over 50 employees and over 42 percent of national formal manufacturing employment.
- 2) The large IT firm survey of 73 firms represented every 2<sup>nd</sup> or 3<sup>d</sup> firm in GJMA.
- 3) In 1999, GJMA accounted for 23 percent of South Africa's large tourism firms and our sample of 37 firms represents every 2<sup>nd</sup> firm in the GJMA<sup>8</sup>.
- 4) While we cannot determine the share of GJMA in South Africa's SMME sector, our survey of 800 SMMEs across 8 manufacturing and service sectors is very representative of regional if not national SMME sector.
- 5) Where relevant, reference will be made to insights from the informal firm survey that covered 500 firms across 11 sectors in Johannesburg's predominantly Black neighborhoods and markets including the CBD.

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<sup>5</sup> Data sets and reports from the survey analysis are posted on <http://www.tips.org.za/lfs99/index.asp>.

<sup>6</sup> The detailed findings of each survey are contained in individual reports published in 2001 as World Bank Discussion Papers numbers 14, 15, 17-19 (forthcoming, 2001).

<sup>7</sup> The sampling methodology of each survey report is contained in the reports themselves and is available either on the TIPS website or upon request from the authors (email: [vchandra@worldbank.org](mailto:vchandra@worldbank.org)).

<sup>8</sup> Note, the large tourism survey story is very representative of tourism in GJMA or (Gauteng) rather than the nation.

The main finding of this paper indicate that South Africa has a formal employment problem.

- I. Since the demand for labor is a derived demand, the crux behind slow job creation lies in unraveling the *structural constraints* to investment and growth. This is because in spite of a market-approved macroeconomic policy stance since the mid-1990s, growth in domestic or foreign private investment has been weak. It seems that the obstacles to growth lie elsewhere. Moreover, in the 1990s, South Africa experienced several structural changes that created complex structural constraints. In a globally integrated economy like South Africa's, there are no easy substitutes for grappling with these structural constraints.
- II. The CEOs of large firms in manufacturing, IT and Tourism identified the leading constraint to growth as crime and theft, followed by exchange rate depreciation, corruption in government, high interest rates and shortage of labor skills. In manufacturing, recent labor market regulations are identified as the number two constraint, ranked jointly with exchange rate depreciation and interest rates, but in IT and Tourism, they rank lower. In IT, the skills shortage is most severe.
- III. The two fundamental structural constraints in the South Africa labor market are recent labor regulations and scarcity of skills. An analysis of recent labor regulations indicates that by raising the implicit price of labor for employers, over and above the wage and non-wage costs, they dampen labor demand and lead to job losses as well as the replacement of permanent jobs with non-permanent ones. This constraint is most applicable in large manufacturing firms that employ a substantial proportion of semi- and unskilled labor; it also worsens with firm size. In the high skills-intensive IT sector, tourism, and SMME sector, the recent labor regulations' constraint is non-binding.
- IV. The most acute labor market constraint hampering formal employment in all large firms (manufacturing included), but especially those in IT is a shortage of skilled labor, especially professionals. The skills constraint is potentially the most crippling constraint for South African industrial employment and growth.
- V. The SMME employment problem implies the slow emergence of Black SMMEs, especially in post-apartheid South Africa. Survey evidence shows that the pool of unemployed Blacks who were envisioned as potential SMME owners do not, for historical reasons, have the initial stock of entrepreneurial capital or work experience that appears to be the pre-requisite for SMME development and growth. They also lack basic business skills to survive and grow. Existing SMME policies seem to inadvertently focus more on promoting the emergence of new SMMEs rather than providing continued business support to existing ones who can only create growth and jobs when they can graduate beyond the one-two person business they initially set up.

## 2. KEY CONSTRAINTS TO INVESTMENT AND JOB -CREATION IN SOUTH AFRICA

### *The economic environment*

The formal employment problem arises from a persistent and low demand for formal labor. Generally a country's economic environment defined by its prevailing macroeconomic policy stance and investor expectations affects investment decisions which, in turn, affect the demand for labor and job creation. The demand for labor is thus a derived demand. In the decade of the 1990s, South Africa's economic performance was driven by a strong and credible commitment to

a macroeconomic policy stance based on tight monetary and fiscal policies approved by global markets. The 1990s witnessed declining inflation that dropped to less than 5 percent by 2000 and low fiscal deficits (see Box 1 for details). Yet in spite of the frequent applause from global markets for maintaining fiscal and financial stability, a significant and sustained surge in private investment did not occur. GDP growth rates peaked only once at 4 percent and averaged less than 2 percent for the decade. The weak performance of the real sectors surfaced in high unemployment rates reaching 37 percent<sup>9</sup> in the 1990s and persistent job losses in non-agricultural employment measuring 14 percent between 1990- 98.

The reasons for formal sector job losses since the mid-1990s in the face of a fairly stable macroeconomic policy stance appear fuzzy. Even though the economy appears to be clambering out of the current business cycle trough, it is not expected inevitably to shift to a path of high and sustained investment growth. Today, in the South African economic context, while minor gains can be garnered from additional fine tuning of the existing macroeconomic stance, it has become increasingly obvious that such efforts need to be complemented with an analysis of the structural constraints<sup>10</sup> to investment and employment creation.

Two types of structural factors appear to dominate investment and employment decisions in the South African economy today. First, the external and internal trading and production environment in the economy changed fundamentally in the 1990s and affected its comparative edge, especially in its export markets. This contributed to low domestic demand as well as low foreign demand for non-mining South African exports. Second, investors' expectations and even more importantly, perceptions seem to be even more important than the traditional determinants of investment. Each of these is discussed next.

In the 1990s, the South African economy was subject to a variety of external and internal structural shocks that transformed its basic structure relative to the 1980s and earlier. First, compared to their relative isolation during apartheid, in the 1990s, the economy integrated with global markets. The liberalization of the exchange rate and capital account ushered risky portfolio capital movements, leaving the exchange and interest rate regimes more susceptible to macroeconomic shocks such as the rand crises of 1996 and the Asian contagion of 1998. Trade liberalization exposed long protected South African firms to fierce foreign competition on the one hand, but also significantly larger global export markets and opportunities on the other. However, in retrospect, it appears that while domestic firms have been trying to adapt to competition from foreign firms, they have not yet, at least not on a discernible scale, begun to exploit global export opportunities. In sum, as elsewhere in the world, global integration has pointed to new opportunities but in exchange for a more vulnerable economy dominated by global competitive pressures and high volatility in its fundamentals (exchange and interest rates). All this has a singular implication for domestic employers: if they wish to remain in business either for the domestic or foreign market, they must continually adapt their technology and workforce to meet global changes in demand patterns and survive the global market place. For countries where firms can maneuver this easily, the flow of direct foreign investment follows naturally.

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<sup>9</sup> According to the extended unemployment definition and 25 percent by the narrow definition.

<sup>10</sup> See Box 1.1 for a detailed discussion of macroeconomic performance in South Africa.

On the domestic front, the structural reforms have been many. For one, following the integration of the large Black<sup>11</sup> labor force with the White workforce, the mechanisms that can transform the unskilled into skilled labor failed to keep pace with demand. Over the 1990s, this surfaced in a massive skills-divide that introduced a mis-match between the demand for and supply of labor skills in the industrial sectors. With the secular decline of mining since the mid-1980s, large-scale job opportunities for the relatively unskilled have vanished. At the same time, employers, especially in manufacturing, have had to adjust to trade liberalization by rationalizing – a process that has led to substituting old, relatively labor-intensive production technology with new relatively capital-intensive processes that have propelled large scale job losses.

Contemporaneously, a variety of labor market reforms, undertaken to rectify discriminatory practices of the apartheid era, introduced new and fairer rules in the workplace. In doing so, they appear to have implicitly raised direct and indirect labor costs and have had many unintended consequences. In the 1990s, each new business cycle reinforced the persistence of a low growth-negligible job creation status quo. Needless to say, these tumultuous changes levied non-trivial adjustment costs on South Africa's large firms as they sought to adjust to this spate of structural changes all at once. The findings of the firm surveys must be recognized against this turbulent backdrop. In interpreting the role of any particular structural constraint to investment or job creation, it would be erroneous to ignore the *cumulative* effect of all the changes and attribute firm responses to a singular factor.

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<sup>11</sup> Black here is used symbolically and refers to all Blacks, Coloreds and Asians who were previously disadvantaged.

### Box 1.1 Macroeconomic background

South Africa's post-apartheid government faced the challenge of promoting growth and employment while ensuring the country's transition in an environment of macroeconomic stability. Seven years later, the government's economic policies have achieved mixed results. Table 1.1 summarizes key economic trends. Declining fiscal deficits, low and falling external deficits, and the lowest inflation in decades are among the macroeconomic success stories. In the last several years, the government has taken steps to address other macroeconomic concerns. In particular, bank-lending rates have been brought down to a current level of 14.5 percent (they averaged 20 percent from 1996-98).

**Table 1.1 Key economic indicators**

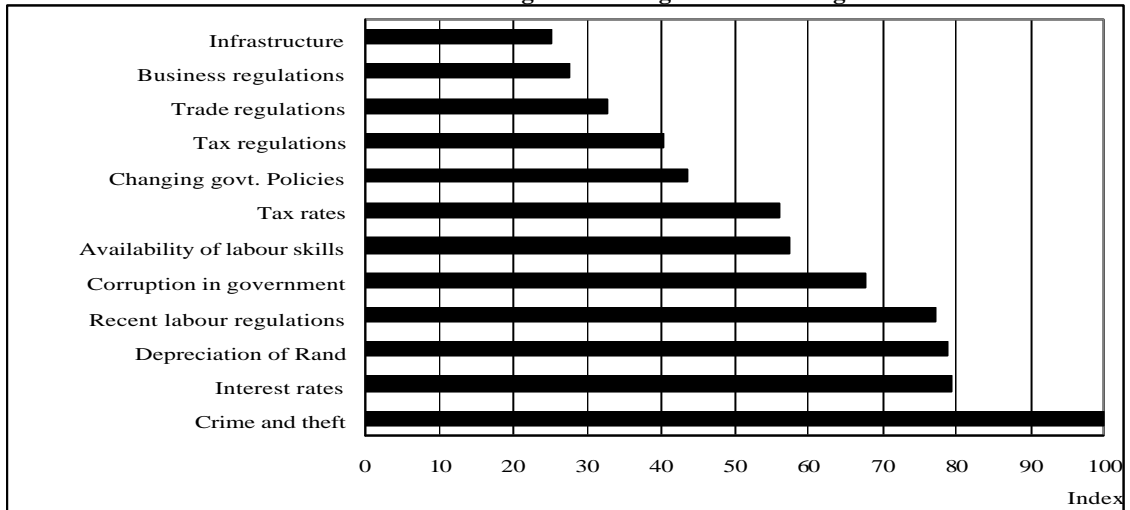
	1994	1995	1996	1997	1998	1999	2000
GDP [growth, percent]	3.2	3.1	4.2	2.5	0.7	1.9	3.1
Non-agricultural private sector employment [growth, percent]	-0.9	0.5	-2.6	-2.5	-4.8	-1.2	-2.7*
Exports, GNFS [percent of GDP]	22.2	23.0	24.5	24.6	25.9	25.9	29.1
Merchandise exports [net of gold, percent of GDP]	14.5	15.8	16.8	17.3	18.4	18.9	21.9
Merchandise exports [net of gold, growth in current Rand mls.]	19.6	23	20.0	13.6	14.6	11.4	27.1
Gross fixed capital formation by private business enterprises [percent of GDP]	11.1	11.6	11.7	11.8	11.3	10.5	10.7
CPI [growth, percent]	9.0	8.6	7.4	8.6	6.9	5.2	5.3
Interest rate [lending rate]	15.6	17.9	19.5	20.0	21.8	18.0	14.5
Exchange rate [R/\$, end-of-period]	3.5	3.6	4.7	4.9	5.9	6.2	7.6
Current account balance [percent of GDP]	0.1	-1.5	-1.3	-1.5	-1.8	-0.4	-0.3

Source: South African Reserve Bank

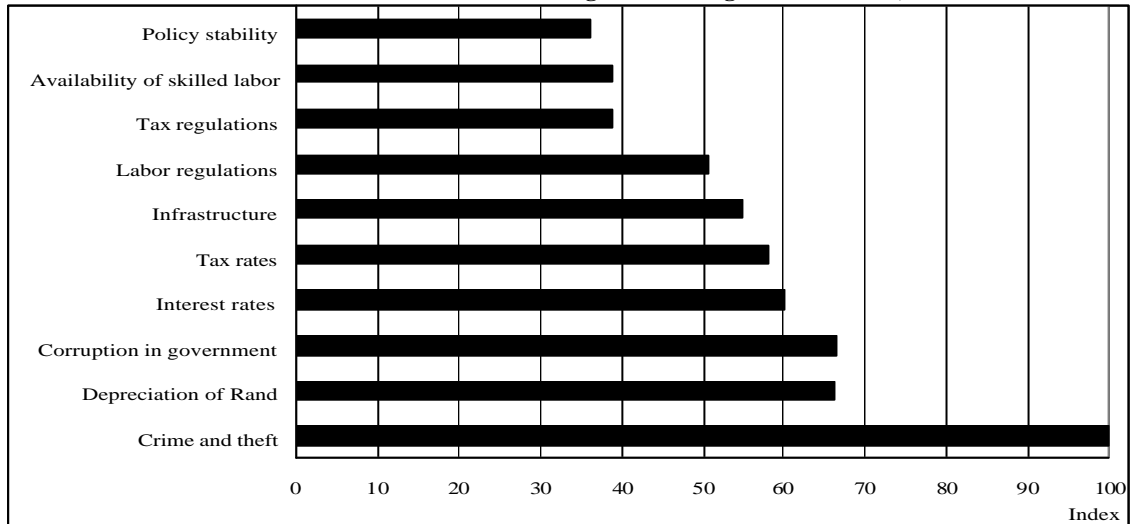
\*First three quarters

Despite various Government initiatives, sustained economic growth has not ensued. Of concern is the lackluster growth (averaging 2.7 percent during 1994-00) which, combined with tight fiscal and monetary policies, has resulted in job losses. While overall employment in the non-agricultural sectors declined by 6 percent, the private sector witnessed a 15 percent reduction in jobs during 1994-00. Gross fixed capital formation by private business enterprises fell by 3.6 percent in 1999. The sharp Rand depreciation in 1996 and again in 1998 did not result in sustained export growth. Formal sector jobs continue to be shed, especially in manufacturing and mining.

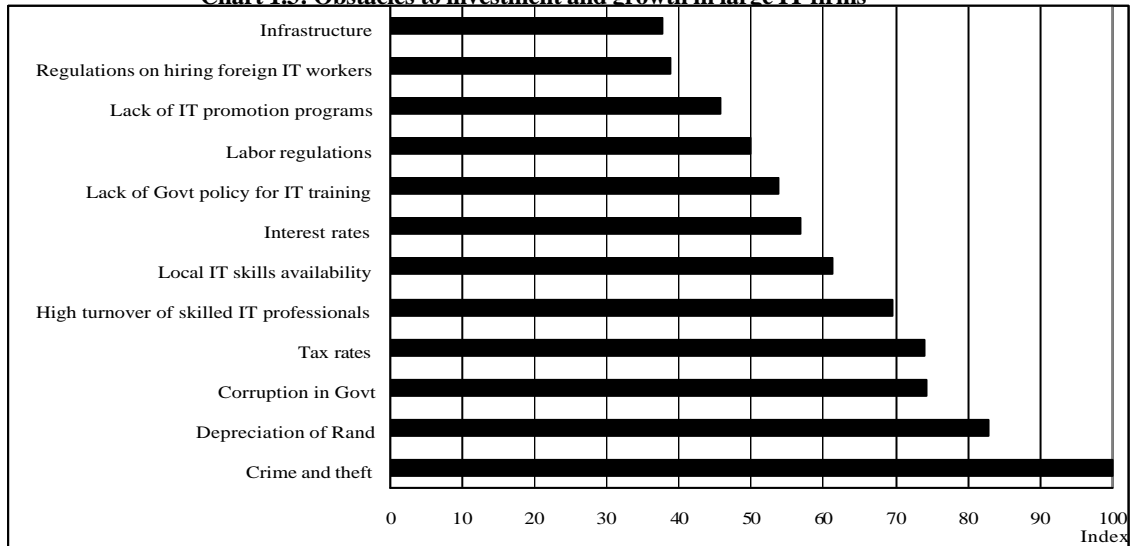
**Chart 1.1: Obstacles to investment and growth in large manufacturing firms**



**Chart 1.2: Obstacles to investment and growth in large tourism firms,**



**Chart 1.3: Obstacles to investment and growth in large IT firms**



### *Overall Constraints to investment and employment – evidence from 1999 firm surveys*

Since at the level of a firm, the demand for labor is a derived demand, it is useful to examine the overall obstacles to firm investment and growth because these drive job creation. In recent years, in addition to the traditional determinants of investment, investors perceptions and expectations regarding the prevailing economic environment have gained primacy as an important determinant of investment decisions.<sup>12</sup> The 1999 GJMC-World Bank firm surveys provide a critical insight into the perceptions of existing investors in South Africa's industrial sectors. A weighted index<sup>13</sup> of these perceptions indicates that CEOs of large firms (defined as firms with over 50 employees) do not consider the main obstacles to growth to be limited to a few factors that can be rectified readily by government alone (Charts 1.1 – 1.3). Clearly, the challenges for policy makers are enormous and daunting. Several key issues are raised by this index.

- 1) The ranking of the key obstacles displayed by the index in Charts 1.1 – 1.3 points to a complex and diverse array of constraints that vary from crime and theft ranked unanimously as the leading obstacle to growth, to standard macroeconomic problems such as a frequently depreciating exchange rate and high interest rates, to a shortage of skills and tax regulations and tax rates in the manufacturing and service sectors. Across the board, firm CEOs noted corruption in government as a deterrent. Since factual evidence from firm managers failed to validate this perception in the case of corruption associated with licenses and permits, the high rank assigned to it suggests that other forms of corruption may be prevalent.
- 2) Across manufacturing and services, there seems to be near unanimity about the top three or four constraints – in descending order they are: crime and theft, exchange rate depreciation, corruption in government and high interest rates (ranked somewhat lower in IT). However, intrinsically, these constraints are un-related with respect to the policy instruments as well as the time horizons and resource costs required to redress them. For example, exchange rate and interest rate comprise straightforward macroeconomic price-related obstacles that government has addressed aptly since 1999. But crime and government corruption are multifaceted and cannot be shot easily or with similar types of magic bullets.
- 3) Relative to the service sectors (IT and tourism), recent labor market regulations seem to constrain growth far more in manufacturing and emerge as the second most important obstacle.
- 4) Firm CEOs flagged an across-the-board scarcity of skilled labor. Surfacing in the face of low growth and persistent job losses, the skills shortage appears to bite more in manufacturing and the skills-intensive IT sector than in tourism, and portends that growth in the traditional (manufacturing) and frontier sectors (IT) alike will be stymied by the low availability of labor skills. In particular, IT CEOs noted several skills-related obstacles to growth: high turnover of IT professionals, immigration restrictions on importing foreign IT workers to ease the skills shortage, lack of government training programs to create IT -specific skills etc. (Chart 1.3).

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<sup>12</sup> For a good discussion of the role of expectations/perceptions, see the literature on hysteresis, Dixit and Pindyck, 1990.

<sup>13</sup> CEOs of large firms were asked to assign a rating to each constraint to firm growth. Their responses were weighted as follows: major problem = 1; moderate problem = 2; not a problem or not applicable = 0. The index of this ranking reflects both the proportion of firms that responded to this question as well as the severity of the responses and is robust across alternative sets of weights.

- 5) An interesting sectoral contrast is reflected in the rank assigned to infrastructure. Relatively fewer CEOs in Greater Johannesburg's traditional and prized manufacturing zones found infrastructure and service delivery problematic. However, in the newly expanding tourism and IT sectors that are dispersed across Greater Johannesburg, infrastructure problems surface with far greater severity.

Survey data could also not validate the significance attributed to tax rates and problems associated with tax and business regulations. It is reasonable to consider these as CEOs perceptions. All other obstacles are supported by factual evidence from firms and fall into the category of 'reality.' The set of 'real' obstacles is a mixed bag of fairly inseparable factors with short and longer term time horizons. For example, as the record shows, macroeconomic constraints such as high interest rates can be and were addressed fairly expediently by policy adjustments. Others such as crime<sup>14</sup> and the shortage of skills pose far more difficult policy challenges and require longer time horizons. Yet for existing and potential investors alike, *all* obstacles jointly constitute a constrained business environment --- the marginal gains from resolving *only* a few are unlikely to usher in significant investment and job creation.

### *Some International comparisons*

To put our findings into an international context, two sets of results are presented from firm surveys in other developed and middle income countries. The Asian Manufacturing Recovery Survey of 1998 was conducted to evaluate the investment climate of middle-income Asian economies after the Asian financial crisis in 1997. Because the list of constraints differed, the ratings presented in Table 1 are not directly comparable to those in Charts 1.1-1.3. Nevertheless, the table provides a useful point of reference.

Although crime and exchange rates are not options in Table 1, the CEOs in the 5 East Asian economies rated high interest rates as the number one problem. Like South African large firm CEOs, East Asian CEOs gave a high ranking to the shortage of skilled labor (Thailand and Malaysia), and corruption in government (Thailand and Philippines). In contrast to the South African economic environment, labor regulations are ranked relatively low in Table 1, but labor costs are ranked relatively high in East Asia.<sup>15</sup> Access to finance and red tape were identified as key constraints in East Asia. In our surveys, access to finance emerges as an issue in only the SMME sector – large firms in South Africa with over 50 employees have good access to financial markets. East Asian firms also enjoy relatively good infrastructure and a relatively hassle free business and trade regulatory environment.

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<sup>14</sup> Survey evidence shows that on a per employed basis, large firms spend a fair amount on crime prevention. For example, in 1998, large manufacturing firms spent R 700 (over US \$ 100) – R 2500 (US\$ 400) plus per employee per year on crime prevention.

<sup>15</sup> In our surveys, firms were not willing to comment on labor costs directly.

**Table 1 Rankings of constraints to business growth in 5 East Asian countries\***

	<b>Thailand</b>	<b>Philippines</b>	<b>Indonesia</b>	<b>Korea</b>	<b>Malaysia</b>
High interest rates		1	1	1	1
Labor costs	1	2	2	4	4
Red Tape	2	3	6	2	6
Access to finance	4	4	4	3	3
Supply of skilled workers	3	10	5	5	2
Quality of suppliers	6	6	3	8	5
Corruption	5	5	10	6	11
Customs administration	8	7	9	7	9
Duty exemptions/tariffs	7	8	11	9	7
Infrastructure	9	9	7	11	10
Labor regulations/unrest		11	8	10	8

\*Simplified from original report for comparability. Source: Asia Manufacturing Recovery: A firm level analysis, World Bank, 2000

Another set of comparisons, albeit not perfect, are provided by the World Business Environment Survey (WBES, 2000). We selected comparable countries Latin American and the OECD (Table 2) for comparison. The South Africa results in Table 2 are not from our surveys – rather they represent the results of the firm survey done in South Africa as part of the WBES 2000. Except for Mexico, Thailand (not shown here) and South Africa, crime is not a serious problem in the other countries shown in Table 2. In the case of exchange rates, South Africa does better than Mexico, falls short of European countries and the U.S., and can be bracketed with other Latin American countries and the U.K. In finance, South Africa is comparable to OECD and ranks well above Mexico. However, in labor regulations, South Africa falls short of OECD countries (except Italy), falls even below Mexico, and is comparable to Brazil and Argentina.

**Table 2: Constraints to business growth in Latin America, OECD, and South Africa\***

	<b>South Africa</b>	<b>Argentina</b>	<b>Brazil</b>	<b>Chile</b>	<b>Mexico</b>	<b>UK</b>	<b>Germany</b>	<b>Spain</b>	<b>Italy</b>	<b>United States</b>
Crime	3.6	2.5	2.7	2.5	3.4	2.0	1.7	1.9	2.1	2.2
Finance	2.4	2.9	2.7	2.4	3.2	2.3	2.5	2.2	2.1	2.3
Exchange Rate	2.4	1.8	2.9	2.5	3.2	2.3	1.7	1.9	1.9	1.6
Policy Instability	2.0	3.1	3.5	2.6	3.3	2.2	1.6	2.4	2.9	2.0
Inflation	2.5	2.0	2.7	2.2	3.4	2.2	1.9	2.3	2.2	2.2
Corruption	2.6	2.6	2.5	1.9	3.3	1.3	1.8	2.1	1.8	1.8
Labor Regulations	3.2	3.0	3.5	2.5	2.8	2.6	2.8	2.4	3.0	2.3
Taxes	2.8	3.3	3.6	2.2	3.2	2.8	3.1	2.6	3.3	2.4
Business Regulations	2.0	2.4	2.7	2.3	3.2	1.9	2.2	2.2	2.6	2.1
Infra-structure	1.8	1.9	2.2	1.9	2.3	1.6	1.8	1.9	2.3	1.8
AntiCompetitive	na	2.4	2.4	1.9	2.8	1.7	2.2	2.3	2.2	1.7

\*A score of 1 means no obstacle and a score of 4 means major obstacle.

Source: WBES, 2000.

For most macroeconomic variables, including infrastructure and financial services, South Africa enjoys a rating closer to OECD than Latin America or East Asia – this suggests that in terms of

these key determinants of investment, there are many opportunities for South Africa to attract investors. In many of the East Asian countries, firms are relatively more constrained by red tape and business regulations, access to financing and labor costs. In addition to these constraints, firms in Latin America face corruption and policy instability. For South African firms, the business environment is relatively free of these constraints. However, in the case of crime, labor regulations and most importantly labor skills, South Africa's rating falls below OECD and comparable countries in Tables 1 and 2 – reflecting the challenges it faces.

### 3. LABOR MARKET ISSUES AND JOB CREATION IN LARGE FIRMS

According to existing investors, even though labor market issues are *not the only* constraint, they are a critical constraint to growth and employment in South Africa's large firms. Some examples of these structural factors identified by firm CEOs include constraints associated with "labor regulations," shortage of skilled labor and under-training of workers in South Africa. Since the mid-1990s, four key pieces of labor legislation – the Labor Relations Act (LRA 1995), the Basic Conditions of Employment Act (BCEA 1997), Employment Equity Act (EEA, 1998) and the Skills Development Act (SDA, 1999) - were enacted to establish a fair and productive work place for all. Each of these regulations raises the implicit price of labor *over and above* the direct wage and non-wage benefit costs, and encourages potential labor-shedding -- an unintended consequence. In this paper, we specifically focus on those aspects of labor market regulations that deter investors. It is not any *one* legislation or any *particular* clause of a legislation *per se*, but the *collective* effect of all pieces of labor legislation that raises the transactions costs for firms to adjust their workforce in response to rapidly changing global demand patterns.

The new labor regulations have affected two types of labor costs that firm CEOs consider problematic. The first relates to the *direct* wage and non-wage benefits that firms and workers negotiate each year. Since most of the sectors are "covered" by collective bargaining agreements and the levels at which remunerations are set is well known, we do not address direct wage cost issues here. The second relates to the indirect costs that are as critical but more difficult to quantify because of intricate regulations and waivers in place. Nevertheless, they involve transactions costs for employers and cost real resources. Examples include the time and resource costs of doing business with a large number of unions, the time taken to hire and fire entry-level workers, the level at which collective agreements are struck, the number of disciplinary inquiries per firm etc.. Similarly, the prevailing mis-match in the skills supply also inflicts a real albeit different cost on employers. The type of skills available and those required by large firms for expansion, especially to remain competitive globally, do not match. In this paper, we try to unravel some of these costs.

Labor market constraints relate to (1) the *demand for labor*, which is affected by recent labor regulations that can *directly* dampen labor demand and a variety of other factors that *indirectly* affect labor demand, such as low aggregate demand, interest rates and exchange rates, crime and corruption; and (2) *labor skills issues which also affect labor demand*, i.e. the type of labor skills available and the type of labor skills and characteristics that firms prefer to hire. Of course, there are crucial sectoral differences. Nevertheless, for efficient job-creation, both aspects of the labor market are equally pertinent. They are intricately inter-related in that labor regulations seem to

be more problematic for employers in sectors that are relatively semi- and unskilled-labor intensive as opposed to high-skill intensive. Additionally, the time and resource costs of relaxing these constraints differ. While it is possible to moderate the implicit cost of labor regulations or even explicit labor costs through bargaining or fiat in the short term, skills accumulation requires a longer time horizon and different types of resources. In sum, in the exclusive context of the labor market, policies that rectify only labor demand or only labor skills in the medium to longer term, are unlikely to lead to job creation. An effective policy stance requires a comprehensive approach towards both aspects.

#### **4. ROLE OF RECENT LABOR MARKET REGULATIONS AND LEGISLATION IN CONSTRAINING LABOR DEMAND**

CEOs of large firms in South Africa point to recent labor regulations as a key constraint to growth and job creation. While sector-specificity introduces interesting wrinkles, evidence from the 1999 GJMC-World Bank firm surveys clearly indicates that firm CEOs deem these regulations to be far more problematic in large manufacturing firms than in the service sectors (tourism and IT, Chart 1.1 – 1.3). Because the manufacturing sectors account for a substantial share of overall formal employment and produce an equally significant proportion of South Africa's exports, it is crucial to understand how these regulations affect labor demand. Even though labor market regulations received lower scores from CEOs in the tourism and IT sectors, their emerging status as South Africa's new frontier sectors and their labor-intensive nature suggests that any factors enlisted in the top ten constraints to business growth should be examined.

In the remainder of this section, the magnitude of four recent regulations<sup>16</sup> legislated since 1996 is assessed from business's perspective in terms of how they raise the implicit cost of doing with labor. These are transactions costs that arise in the form of real time and resources (lawyers fees, managers time, court time, work stoppages etc.) that firms must devote to hire and fire their workers and keep their work force employed. It is important to recognize that these regulations in themselves were not designed to inflict additional costs on employers. On the contrary, they were essential and were intended to rectify racially motivated labor market inequalities instituted under apartheid, establish basic employment standards and worker rights and ensure a healthy work environment for all. In reality, occurring at a time when South Africa's long protected large firms were just beginning to learn how to cope with fierce competition from the global marketplace, they appear to have reduced the flexibility of firms to adjust to these competitive pressures by continually adjusting the size and composition of their workforce. This is why we refer to them as factors that raise the "implicit" cost of labor. CEO's also consider the explicit cost of South African labor, i.e. wage to be high. However, these costs<sup>17</sup> are not measured precisely for various skill categories by the 1999 surveys and so are not discussed in this paper.

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<sup>16</sup> These include the Labor Relations Act, LRA (1995), Basic Conditions of Employment Act, BCEA (1997), Employment Equity Act, EEA (1998) and Skills Development Act, SDA (1999).

<sup>17</sup> Many firm managers were unwilling to disclose the wage and non-wages benefits paid to different skill categories. Where available, the data is sparse and not representative.

***Firm responses to recent labor regulations – individually and collectively***

Since CEOs of firms singled our recent labor regulations as a constraint to growth, it makes sense to examine how each regulation affected their employment decisions. Survey evidence indicates that when HR managers were asked to indicate what effect each labor regulation had on employment numbers, the majority of their responses across sectors were similar: in 65-70 percent of the large manufacturing firms, the regulations had “no effect,” in 20 – 26 percent they “lowered employment,” and in 2 – 4 percent they had the intended impact, i.e., “raised employment.” The remaining firm managers were not aware of the regulations or they did not apply to the firm. The pattern of responses of Tourism and IT firm managers was similar but even stronger - almost 70- 80 percent of them said the regulations had “no effect,” between 2 – 7 percent in Tourism and 10 – 15 percent in IT noted a rise in employment; and 11- 17 percent in Tourism and 5 – 10 percent in IT noted that the regulations “lowered” employment. At the individual level, these responses fail to explain why firms assigned such a high ranking to labor regulations. Recall that in manufacturing, these regulations were rated as the number 2 constraint to growth.

**Table 4.1: Cumulative employment response of firms to recent labor regulations (percentage of firms )**

	Large manufacturing firms	Large Tourism firms	Large IT firms
Hire fewer workers	39.2	25.9	7.0
Substitute capital machinery for workers	38.9	7.3	14.0
Hire more temporary than permanent workers	41.6	27.9	14.0
Rely more on subcontracting	33.5	27.8	19.0
Improve labor relations	29.6	26.0	9.0
Increase labor productivity	11.9	18.7	n.a.

Firm responses to the cumulative effect of recent labor regulations shed a very different light on the role of these regulations in employment creation. The surveys show that four types of responses, namely a concerted decision to hire fewer workers, substitute capital or machinery for labor, replacement of permanent workers with temporary workers and greater reliance on subcontracting than in-house production occurred in 33 – 42 percent of the manufacturing firms but to a lesser extent in the service sectors (Table 4.1). Each of these responses had the same unintended effect on employment, led to a decrease in the demand for workers in the recent past. The sharp difference between the response of tourism and IT managers clearly indicates that in sectors such as IT that use relatively more skilled labor, the labor regulations lead to less of the unintended effects. Table 4.1 also indicates that some of the intended effects expected from these four regulations did materialize by way of improved labor relations in 30 percent of firms and improved productivity in 12-19 percent. While it is difficult to link the marginal contribution of these regulations to the economy-wide or even manufacturing sector-specific employment losses

witnessed since the mid-1990s, it seems reasonable to conclude that their unintended consequences outweighed the intended ones and dampened labor demand.

***The implicit cost of working with labor – level at which collective bargaining occurs***

The type of labor regulations prevalent in South Africa are not unique to its labor market. Similar regulations exist in most countries. What distinguishes the South African labor market is the observed magnitude of enforcement of contractual agreements. In most labor surplus economies with a large pool of relatively less-skilled labor, enforcement varies inversely with the rate of unemployment, allowing employers greater flexibility in employment decisions. For the unemployed, having a job is preferable to not having one. The level at which collective wage and non-wage agreements are made is one measure of this flexibility. The lower the level, the more decentralized the decision making and the greater the scope for incorporating local area factors into the wage agreements. At the highest level, i.e. industry or sector, the employer has the least latitude to incorporate any firm or local area specific information into the contracts.

Survey data reveals that in tourism, about 33 percent of the firms are subject to company level agreements and only 12 percent of size 3 firms are subject to industry-wide agreements. The majority of the firms (67 – 87 percent ) in tourism and IT are relatively free of collective agreements. In most cases, employers have the flexibility to set the level of wages. While it remains difficult to isolate the positive impact of this labor market institution and link it to its employment outcome in the tourism and IT sectors, it is apparent that sectors which afford employers greater flexibility in wage setting have displayed extremely high (double digit) and sustained rates of job creation since 1994 in spite of overall low rates of economic growth.

**Table 4.2: Level at which collective bargaining agreements are made in the large firm sector**

	No agreements	Plant level	Company level	Sector/industry -wide	Wage determination board
<b>Manufacturing</b>					
Size 1	18	10	25	42	5
Size 2	14	12	24	47	2
Size 3	3	13	29	51	3
<b>Tourism</b>					
Size 1	70	15	15	0	0
Size 2	67	0	33	0	0
Size 3	87	0	0	12	0
<b>IT</b>					
Size 1	87	12	0	0	0
Size 2	81	11	0	7	4
Size 3	68	23	4	4	0

Clearly, obstacles to growth associated with collective bargaining agreements at levels higher than the plant or establishment apply more to the manufacturing sectors. Table 4.2 pinpoints that 42-51 percent of the employers in manufacturing are subject to collective bargaining at the industry-wide level and over half that percentage is subject to company level agreements. Only about a quarter of the employers enjoy a bargaining-free environment defined as one with no agreements or at most, plant-level agreements. Moreover, across the 8 manufacturing sectors surveyed, firm size as well as sector specificity begin to matter in an important way.<sup>18</sup>

### ***The implicit cost of working with labor – number of unions firms work with***

Transactions costs rise as the number of labor unions that employers work with in South Africa increases. As in the case of collective bargaining agreements, the 1999 GJMC-World Bank surveys reveal that the transactions costs of doing business with unions surface as a constraint on employers more in the manufacturing than in services. Evidently, the size of a firm is directly related to number of unions employers must work with (Chart 4.1). In the manufacturing sector in size 1 and 2 firms with 50 – 99 and 100 – 199 workers respectively; about 6 percent of firms enjoy a union-free work environment. The proportion of firms that works with only 1 union is 75 percent in size 1 firms but drops sharply to 44 percent in size 3 firms with over 200 employees. The implicit cost of working with unions is the steepest for size 3 employers as 32 percent of them work with as many as 3 – 7 unions. In contrast, as Chart 4.2 –4.3 show, the transactions costs of working with labor unions are significantly lower in the service sectors that work with mostly 1 –2 unions. In tourism around 50 percent of firms work with no unions and no more than 10 –12 percent work with 3 or 4 unions. Large IT firms enjoy even lower transactions costs – as many as 92 percent of size 1 and 65 percent of size 3 firms are union-free. Even among the largest employers in IT with over 200 workers, no more than 9 percent of the employers have to work with 3 unions. Apparently, in the South African labor market, as the level of skills or human capital endowed in workers increases in skill-intensive sectors such as IT and tourism, job security and work conditions also increase and concurrently improve worker-employer relations to the mutual benefit of both parties.

### ***Other factors that raise the implicit cost of doing business with labor***

Survey data shows that in 1997-98, there were relatively few strikes but employers incurred fairly high costs associated with disciplinary inquiries, and hiring and firing costs of workers. Again for reasons discussed in the preceding paragraph, since these factors are more pervasive and severe in the manufacturing as opposed to the service sectors, we focus mostly on the manufacturing sectors in this remainder of this section.<sup>19</sup> A strong size-class theme dominates the incidence of these cost-raising factors. For example, while 26 percent of the size 1 firms in manufacturing did not hold any disciplinary inquiries, only 5 percent of the size 3 enjoyed the same environment. Another 20 percent of all firms held an inquiry for more than 1 in every 10

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<sup>18</sup> For sectoral details, refer to the World Bank Discussion Papers numbers 14 and 15 (Constraints to Growth and Employment in South Africa, 2001) as well as a paper with a similar title (GJMC-WORLD BANK report) on the TIPS website.

<sup>19</sup> For details, especially at the inter-sectoral level, see World Bank Discussion Paper no. 14 and survey evidence from the Tourism surveys in Chandra, Rajaratnam and Rogerson (2001 forthcoming) and from the IT survey in Chandra, Nganou and Rogerson (also 2001 forthcoming).

workers. Disciplinary action also imposed fairly high costs on service sector employers. In tourism, 45-60 percent of all firms were affected and held between 6 – 20 disciplinary inquiries per year per firm, with the larger numbers occurring in size 3 firms. The IT sector remained relatively hassle-free although as many as 50 percent of its firms undertook some disciplinary action but the incidence per firm was limited to 4 – 6 per year.

**Table 4.3: Rand costs of hiring and firing an entry level worker in 1998, manufacturing firms**

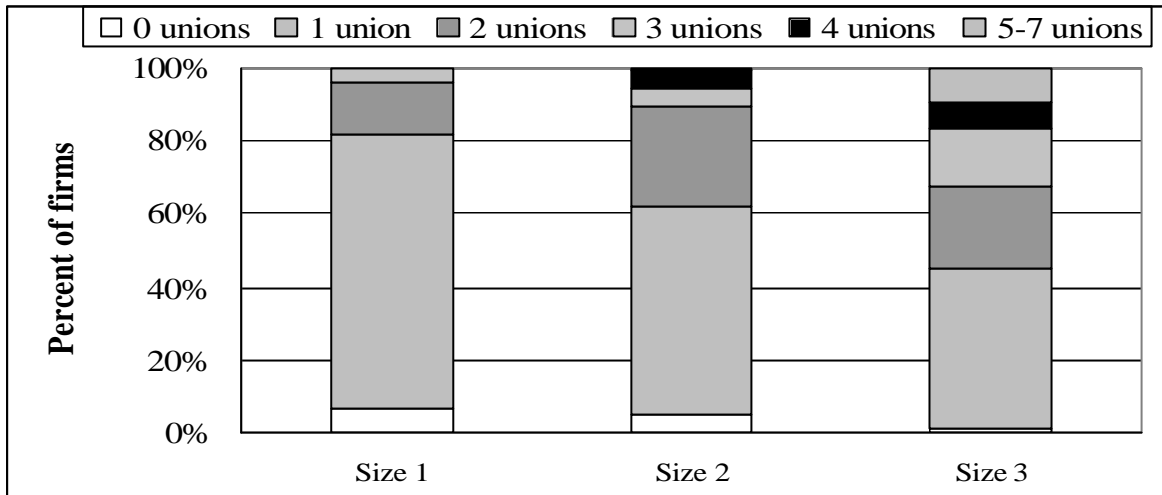
	Size 1	Size 2	Size 3
<b>Hiring costs</b>			
Craftsmen, mechanics, tradesmen etc.	R 5000	R 7500	R 9000
Plant and machine operators	R 5000	R 7500	R 9000
Laborers	R 2160	R 2000	R 2900
<b>Firing Costs</b>			
Craftsmen, mechanics, tradesmen etc.	R 15000	R 10750	R 11 800
Plant and machine operators	R 5250	R 4000	R 8813
Laborers	R 3250	R 13250	R 11 600

The hiring costs of entry level production workers are another example of the resources that employers expend in working with labor to produce goods and services. A comparison across firm sizes indicates that the firing costs of an entry level worker for the same skill category rise with firm size for relatively less-skilled workers in the manufacturing sectors. For example, in 1997-98 the cost of firing an entry level laborer was R 3250 for an employer of a size 1 firm but as much as R 11600 for an employer of a size 3 firm. The cost of firing an entry level craftsmen was around R 11000 to R 15000 but in reverse order, i.e. for size 3 and size 1 firms respectively.

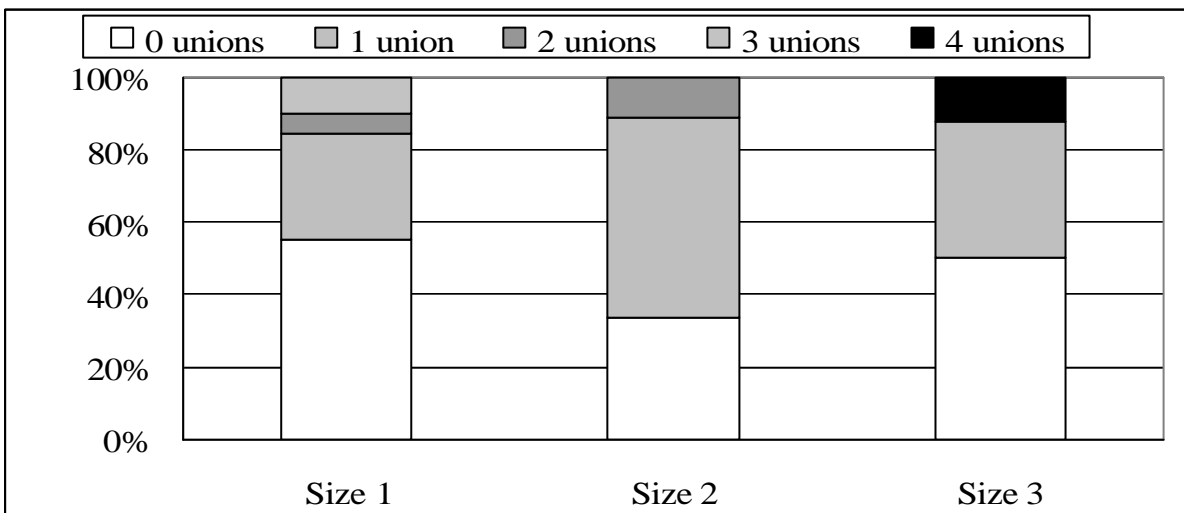
***The implicit cost of doing business with labor – why does it matter for South Africa’s large manufacturing employers?***

The preceding discussion in Section 4 reveals that in addition to the direct wage and non-wage payments that large South African employers make to their workers, they also incur a variety of indirect or implicit costs induced by transactions with organized labor. While these costs are not restricted strictly to manufacturing, they are far more pervasive in the latter than in the two service sectors surveyed. Clearly, the role of labor regulations in raising the implicit cost of labor is more pertinent to the formal employment problem in manufacturing than in services. No doubt keen differences prevail across sectors and firm sizes, but the fact remains that after aggregating across all these transactions costs, the grand total incurred by many employers can be significant enough to dampen the demand for formal labor in South African labor market. This statement assumes of course that the direct wage and non-wage costs of production workers in South Africa are at par with those of foreign producers. If not, that issue is also an imperative.

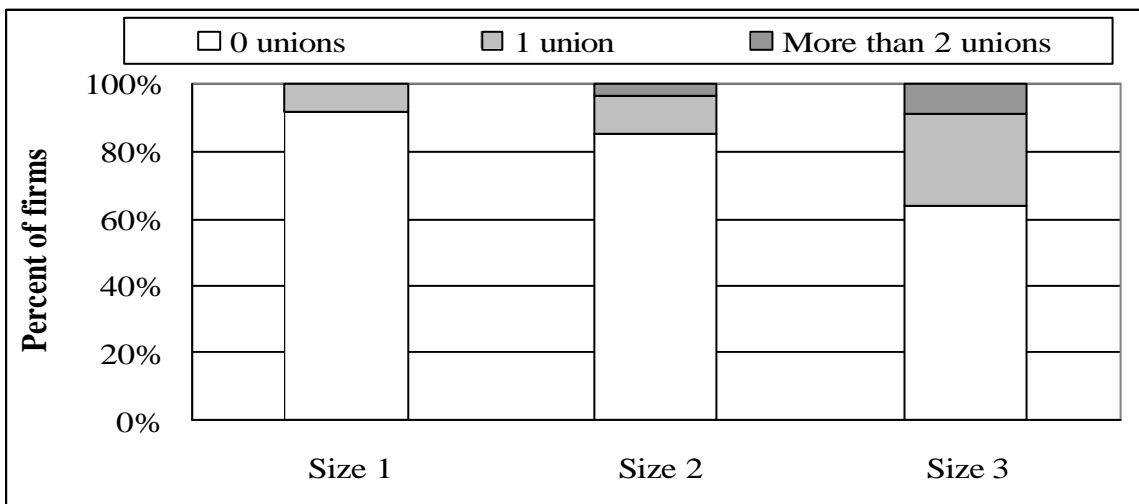
**Chart 4.1: Number of unions large manufacturing firms in GJMA work with**



**Chart 4.2: Number of unions large tourism firms in GJMA work with**



**Chart 4.3: Number of unions large and small IT firms in GJMA work with**



The comparison suggested here is not with respect to any absolute labor market standard but with respect to the *one and only* standard that makes sense for South Africa today – that of the global marketplace in which similar goods and services can be produced by competing foreign firms that do not have to incur similar implicit costs of working with labor.

Why is formal job creation in manufacturing so desirable? As noted earlier, the crux of the formal employment problem in manufacturing is that the bulk of the current labor force suitable for employment in the sector has no viable job alternatives elsewhere in the economy. The only other sectors which can employ similar labor skills are agriculture, and mining. Including informal employment and even domestic work, neither of these sectors pays wages that are anywhere close to manufacturing wages<sup>20</sup>. Moreover, a manufacturing firm creates a significant number of jobs per manager which are difficult to mimic in the service or any other sectors. In 1999, there were 4.8 – 7 laborers employed per manager across size 1 – size 3 firms respectively in the 8 manufacturing sectors surveyed. In GJMA, Size 3 firms with a minimum of 200 employees and as many as 10,000, employed the largest number of all skills per manager. In 1999, survey data indicates that size 3 firms represented 31 percent of all manufacturing firms but employed as many as 73 percent of all workers. The potential contribution of manufacturing employers in regaining their competitiveness and producing for exports, a la East Asia, should not be underestimated.

To raise the formal demand for relatively less-skilled workers such as those in the manufacturing sectors, these issue *must* be addressed in a manner that is beneficial for growth and job creation. Policy options include holding negotiated real wage costs constant while employers contend with foreign competition to increase the export competitiveness of South African manufactures which in turn will help increase manufacturing employment.

## **5. ROLE OF LABOR SKILLS SUPPLY IN CONSTRAINING LABOR DEMAND**

The discussion of section 2 reveals that the shortage of labor skills is assigned a high priority by CEOs in the IT sector followed by manufacturing and tourism (chart 1.1 – 1.3). Let us focus on IT – South Africa's new frontier that has a natural comparative advantage and can potentially service the rest of the African continent in IT exports. Over 80 percent of its HR managers noted extreme to moderate shortages in finding managerial and professional skills. About 44 percent noted a shortage of semi-skilled workers. A shortage of laborers was not listed. Between 20 – 30 percent of firms carried over vacant positions from 1998 to 1999. About 33 percent of size 1 IT firms and as many as 50 percent of size 3 firms noted that a high turnover of IT professionals was a problem. The leading reason for a high turnover was that after acquiring some work experience, IT professionals leave South Africa for more lucrative jobs overseas. The second most-important reason was that IT professionals like job-hopping in the desire to seek more challenging jobs. The third reason was their desire to work as private contractors rather than wage employees and lastly, they left IT firms in Johannesburg for other parts of South Africa to escape crime.

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<sup>20</sup> See Bhorat (2001) for a good discussion of the latest earnings numbers across these sectors.

**Chart 5.1: How large firms cope with a high turnover in IT, 1999**

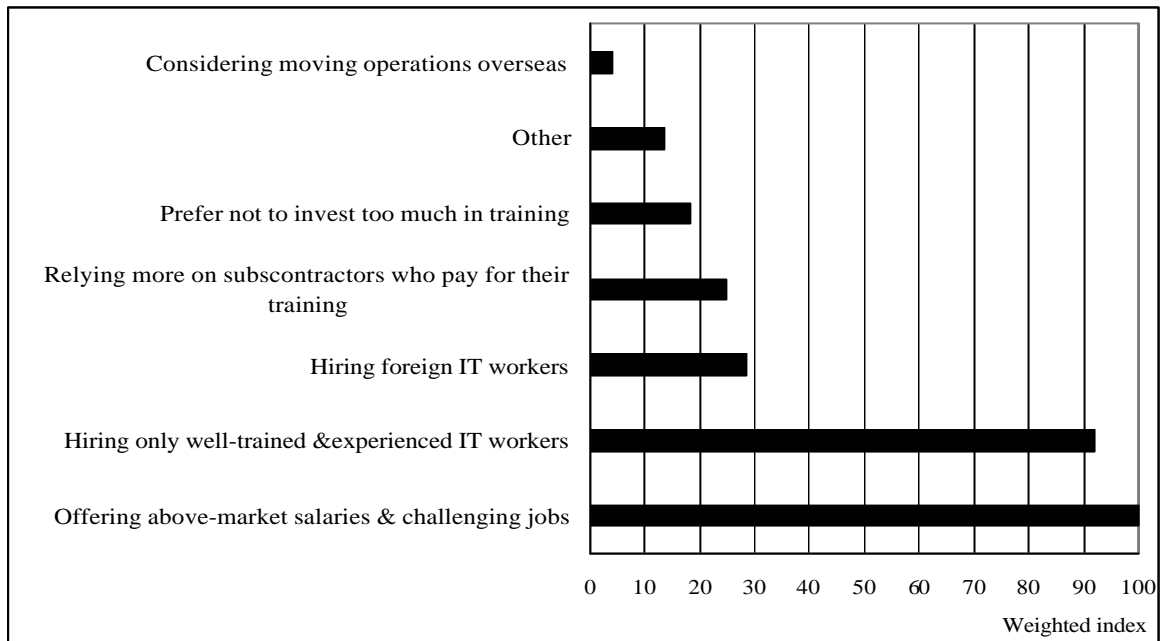
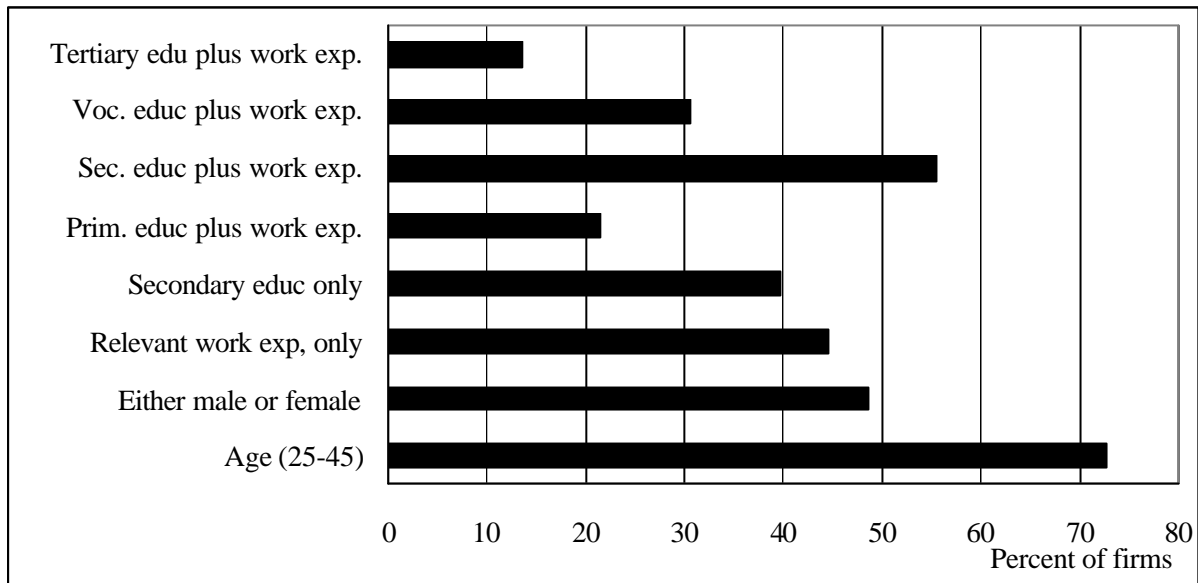


Chart 5.1 illustrates how large IT employers cope with the high turnover problem. While employers are optimizing given the difficulties at hand, their private actions collectively exacerbate the formal employment problem in IT. For example, practices such as preferring not to invest too much in training and preferring only well trained and elsewhere trained workers do not contribute towards increasing the supply of skilled IT workers. Evidently, there is a massive market failure in this sector. The demand for professionals in the South African labor market has grown by 250 percent in the past 25 years. Presumably, the IT sector occupies center stage in this type of growth. Since IT employers seem to willingly pay above market salaries to attract IT skills, one would imagine that this would have, over the past 25 years, led to a massive influx of workers into IT education and training. Not only has training failed to taken off on a sufficiently large scale and resulted in this mis-match of skills, but it has forced firms to turn to foreign professionals to fulfill demand. Worse, still, as Chart 1.3 reveals, in 1999, immigration restrictions on the import of skilled professionals seem to curtail growth in the sector.

**Chart 5.2: Employers preferences in hiring production skills in manufacturing, 1999**



The skills shortage in manufacturing is also quite serious, especially because it is occurring at time that is preceded by a fairly long span of persistent lay-offs in manufacturing. This trend should have led to the accumulation of a pool of skilled but recently retrenched workers that can fill vacancies in existing firms. Yet, almost 50 percent of all HR managers noted a shortage of managerial and professional workers, and about 33 percent noted that service workers and craftsmen were in short supply in 1999. This suggest that firms are not just seeking *any* skilled professionals – they are seeking a special type of skilled professionals, even in sectors like manufacturing. Chart 5.2 reveals the profile they prefer at recruitment. Evidently, workers in the age-group of 25-45 with secondary education and relevant work experience are the most preferred candidates. For those who are too young (15 – 24) and have never held a first job or those who are over 45 and were recently laid off, employment prospects are dim.

In sum, the prevailing skills shortage simmering in the South African labor market since the past 25 years or so, at least in the service sectors, and more recently in the manufacturing sector underlies the formal employment problem in a critical way and underscores that

1. there is massive market failure in this labor abundant economy at the level of the skills training and education processes that are unable to transform efficiently pools of unskilled workers into skilled ones, even over a period of 4 – 5 years. Given the externality associated with training and skills, it is apparent that human capital accumulation in South Africa is not going to occur privately, as is clear from the responses of managers in the IT sector. It requires public policy support.
2. the skills shortage is no longer limited to the newly emerging service sectors – it is now fairly pervasive in manufacturing, South Africa’s traditional sector, too.
3. while labor demand is undoubtedly constrained by low overall demand and further by high implicit labor costs, it is equally constrained by the paucity of appropriate skills in large firms across all sectors. In deciding where to invest, this factor alone is adequate to lure foreign investors to the East and South Asian markets that have abundant skills at competitive prices.

### *Policy options for skills accumulation*

So what are the options for policy makers? Clearly, in a labor abundant economy like South Africa's, there is no substitute for the domestic accumulation of appropriate skills to support growth and propel formal job creation. However, the accumulation of skills does not happen overnight and requires serious public policy commitment, resources and careful monitoring to ensure that the skills that firms seek are indeed being produced. Consider the pay-off from an aggressive human capital accumulation policy. Not only will it alleviate the skills shortage but it will also improve the quality of the workforce, engender a sense of greater job security and reduce for employers the implicit costs of doing business with labor. One does not need further evidence – the contrasts in the levels of these costs in manufacturing and IT speak for themselves. This will have a significant effect in addressing several key constraints to growth and investment that were validated by the 1999 firm survey data.

How can policy makers spur the human capital accumulation process to yield targeted and timely results?

- ◆ One option is for government to strengthen its existing skills development programs supported by the Departments of Labor, Education and DTI. The disadvantage of this approach is, as recent experience shows, that progress has been too slow to cater to market demand.
- ◆ Another option for policy makers is to simply relax the restrictions on the import of skills. Most OECD economies repeatedly invoke this option when certain skills become scarce in the domestic market. The most recent example of this is the late 1990s rat race among the G-7 with respect to the import of IT professionals from labor surplus as well as skills-surplus developing economies like India, China and even South Africa.
- ◆ One attractive policy option is to design creative public-private partnerships that utilize part-public-part private resources for the private provision of skills. Of course, like any publicly provided service, this too will require a significant element of public subsidy. However, unlike other publicly provided programs, this option does not require additional set up time, fixed costs of establishing new infrastructure and program design and organization. The government could simply use its existing network of reputed universities, technikons and private skills providers (businesses) and harness their existing facilities in the creation of practical skills for business growth. Examples from the East Asian Tigers and Malaysia might be helpful in this context<sup>21</sup>.

## **6. THE FORMAL EMPLOYMENT PROBLEM AND THE SMME SECTOR**

In the mid-1990s, policy makers aptly pinned their vision for Black empowerment, i.e. large scale job creation and poverty reduction on the engine of the SMME development. It was hoped that by promoting SMME development through numerous government programs including credit channeled by Khula and training by Nsika, there would emerge a generation of previously disadvantaged small firm owners whose jobs and income generation ability would not only reduce household poverty but also contribute to a more equitable distribution of income. This vision was a natural one and probably the most effective instrument for the objectives at hand.

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<sup>21</sup> For a brief discussion of how these public private partnerships worked in Malaysia and other East Asian economies, see World Bank Discussion Paper No. 14.

Moreover, it was not so different from a similar vision pursued by many governments worldwide as a means to reduce poverty and inequality. Almost 4-5 years into government's SMME development program, the 1999 GJMC-World Bank SMME survey of 800 firms in Johannesburg suggests that this vision may not be achieved in the medium to longer term.

Consider the statistics available. In 1999, in the set of 800 SMMEs interviewed, the share of Black SMMEs owners<sup>22</sup> was only 7 percent relative to a share of 9 percent for Asians, 2 percent for Coloureds, 9 percent for foreigners and 56 percent for Whites.<sup>23</sup> Only 30 percent of all firms were post-apartheid - defined as those born after 1995 (less than 4 years old), another 30 percent were 4 – 10 years of age and the remaining 40 percent were over 10 years old. Contrary to the policy makers vision, only 13 percent of all post-apartheid firms were owned by Blacks. Relative to their share in the labor force, the emergence of Black SMME owners has stalled. 64 percent of the Black SMMEs were concentrated in the service sectors, especially retail that requires low skills. And even though 60 percent of the Black-owned SMMEs were post-apartheid, the overall numbers were disappointing.

Besides the social imperative, the success of the SMME development programs also merits attention from an economic perspective. In the context of the formal employment problem, there are two issues of interest: one, were SMMEs associated with investment growth in the recent past? And two, were SMMEs a vehicle for job creation at the same time? The assumption is that neither investment without jobs nor jobs without investment are either desirable or sustainable. At first brush, survey evidence from existing firms is deceptive. For aggregate employment in 1997-99 grew at 23 percent from 9400 jobs in 1997 to 11,600 jobs in 1999. Except for construction and metals, growth was impressive across the remaining 6 sectors<sup>24</sup>. But closer analysis reveals that this growth was deceptive and associated with new firms that are born and die within the first two years of birth. In the more stable SMME sector, the dynamics was quite different. Upon controlling for firms that were less than 3 years<sup>25</sup> old, and focusing exclusively on the set of firms that were at least 2-3 years old with many being over 10 years old, the survey shows that total employment actually declined by 7 percent, a statistic that exceeds the rate of job-shedding in formal manufacturing during the same period. Jobs losses in SMMEs occurred across all production sectors and construction. Retail, IT and tourism were the only ones that created jobs at 10, 25 and 9 percent respectively.

Whether SMMEs can be sources of sustained income and employment generation rests critically on whether they attract investment and how much. Again, after controlling for age and turnover, survey data shows that in 1998 and 1999, about 32-38 percent of the stable SMMEs (defined as those that were at least 2-3 years old) increased investment in excess of 10 percent. Furthermore, about 23 – 30 percent of the stable SMMEs also increased employment in excess of 5 percent. However, only 13 percent of the stable SMMEs that has existed for at least 3 years or more increased both investment and employment. The remainder that increased investment but not employment, displayed a pattern of job-less growth. Clearly then, there is no evidence to support the fact that 5-6 years into SMME policy reform, the SMME cluster has is performing either as a source of significant growth or job creation.

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<sup>22</sup> For every 100,000 Blacks in the population, there were 0.14 SMMEs owned by Blacks in 1999.

<sup>23</sup> About 17 percent of the owners did not wish to indicate their race.

<sup>24</sup> Employment in these was as follows: 12% in clothing and garments, 23% in furniture, 54% in prepared food and beverages, 61% in tourism, 50% in retail, and 53% in IT.

<sup>25</sup> It is well known that SMMEs worldwide have a high turnover. In fact almost 50% collapse in the very first year. To adjust for this, we only examined firms that had been in business for 2-3 or more years.

*Why has formal employment and income creation in the SMME cluster stalled?*

**Initial entrepreneurial capital is scarce among Blacks.** In trying to unravel why the emergence of new, especially Black, SMMEs has stalled, it is useful to examine the factors that lead to their establishment. One of the most critical determinants of SMME development and indeed even growth is the initial endowment of entrepreneurial capital and formal business/work experience vested in the new SMME owner. Survey evidence demonstrates the overwhelming dominance of this factor among present SMME owners in Johannesburg (Chart 6.1).

**Chart 6.1: Main motivation of owner for starting an SMME – by firm size (number of employees)**

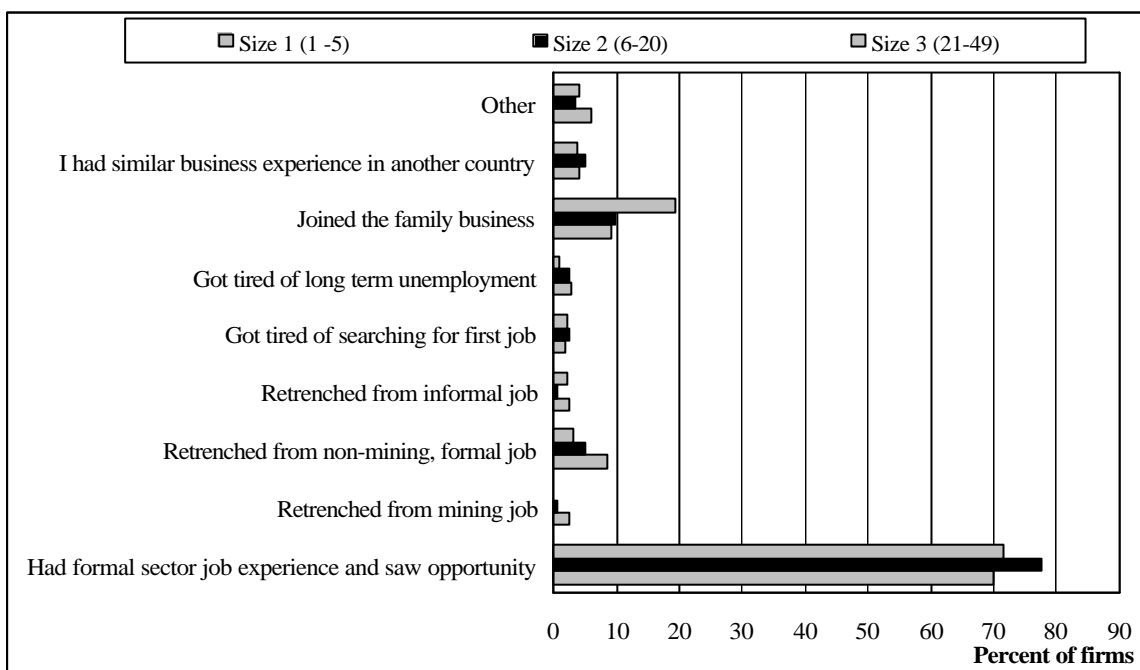


Chart 6.1 explains one of the key reasons underlying the slow development of new Black SMMEs in Johannesburg. Over 70 percent of the present 800 owners surveyed had formal sector experience in business or work and started an SMME when they perceived a profitable opportunity. Another 10 percent joined the family business and 5 percent came endowed with business experience from another country. In sum, about 85 percent of the present owners did not emerge from the pool of long term unemployed for whom the SMME development program was envisioned as the vehicle for job and income creation. In fact even less than 5 percent did. Since prior individual or family owned entrepreneurial capital or work experience seems to be the main motivation underlying SMME creation, and there is a crucial paucity of such capital his among Blacks, primarily because of the historical reasons that denied them the opportunity to own businesses, it is not surprising that Black SMMEs have been very slow to emerge even after 1995. Recall, the share of Black SMMEs in the set of post-apartheid SMMEs is only 13 percent. Clearly, race is a strong determinant of SMME development.

Similarly, present SMME owners in Johannesburg indicated that the main reason why they chose to start business in their particular sector was that they had prior work/business experience in that sector and that business in that sector was growing rapidly. Again, this information suggests that

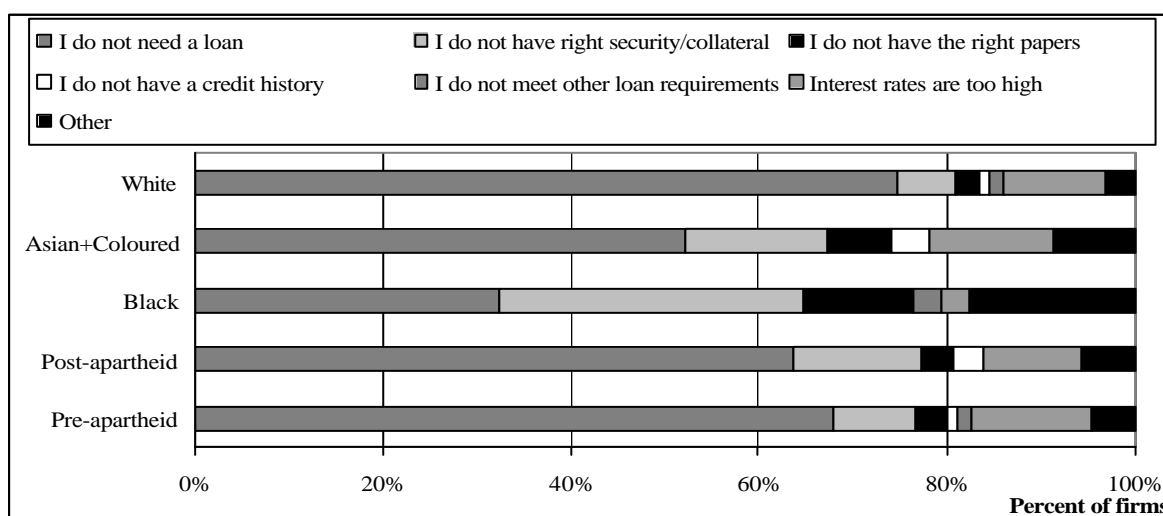
given the background of the majority of unemployed Blacks, it will be a challenge for policy makers to promote the development of new SMMEs in the short to medium term.

**Shortage of skills is a serious constraint but labor regulations are not.** Another critical determinant of SMME development but even more of their growth is the scarcity of business skills and the programs in place to address it. Like large firms, in 1999 when the vast majority of firms were not expanding and there were abundant retrenched workers available, 30–45 percent of SMMEs reported a skills shortage. And only about 24–30 percent of firms with over 5 employees, and less than 10 percent of firms with less than 5 employees invested in formal skills training to compensate for this shortage. For those that trained, the median amounts invested in training per employee decreased sharply from R1700 per annum for the size 1 firms to R938 and R400 per annum for the larger SMMEs.

In contrast to the results from the large firm surveys, especially in the manufacturing sectors, the SMME survey results suggest that labor regulations are not a sizable constraint for most firms, especially the micro ones with less than 6 employees. Similar to large firms, IT and tourism SMMEs do not appear to be affected very much by labor regulations. The latter seem to affect mostly larger SMMEs with 21 – 49 employees. When small SMMEs do incur higher implicit costs of doing business with labor, they respond in ways quite similar to larger firms with over 50 employees: they create fewer jobs, and the jobs they do create are more likely to be non-permanent. Nevertheless, it would appear that the most critical labor market problem for SMMEs remains the skills scarcity, rather than the degree of regulation.

**Inadequate access or high interest rates.** In general, survey data shows that the investment and working capital needs of SMMEs are met by individual or family savings and retained earnings. Half the SMMEs have access to formal bank loans but they prefer to use their own capital most of the time. So high interest are a constraint only for firms that use them, however infrequently and as such are not a leading constraint. However, access to bank loans is more of a constraint for micro SMMEs (1 – 5 employees) and Black firms. Between 1994- 99, only 33 percent of the Black SMME owners had used bank loans compared to 50 percent of the White owners and 43 percent of all post-apartheid firm owners.

**Chart 6.2: Reasons for not using bank loans in 1994-99**

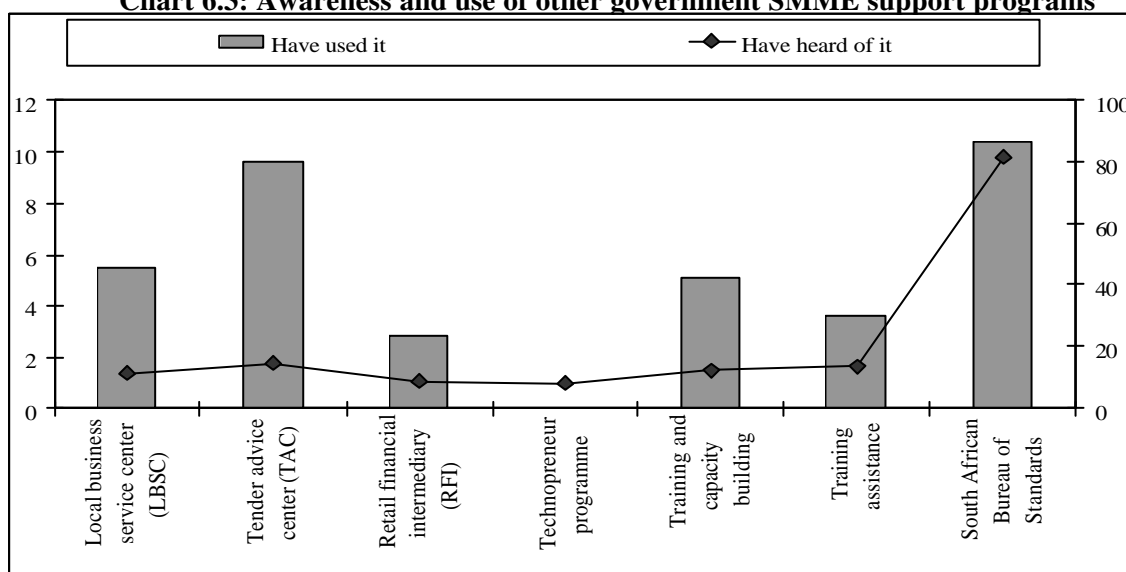


Approximately 50 percent of all SMMEs did not borrow from banks during 1994-99. Their main reasons for doing so shed an interesting light on the extent to which access to bank capital is a constraint for firm growth (Chart 6.2). Clearly, for the bulk of the SMMEs across all races except Blacks – access was not a problem because they did not need a loan. Only 32 percent of the Black SMME owners fell in this category. For the remaining 47 – 64 percent access to bank capital is an issue as displayed by Chart 6.2 when we sum up across categories that imply this in one way or another.

In a nutshell, SMME development *can* be constrained directly by high interest rates for no more than 50 percent of firms who use bank loans; however since the bulk of them prefer to rely on their private capital, this direct impact is low. For the remaining 50 percent, especially Black firms, the crucial issue is predominantly one of access to credit rather than its price. However, for all SMMEs, the indirect effect of high interest rates as manifested in low demand is serious and a key cause of slow firm growth.

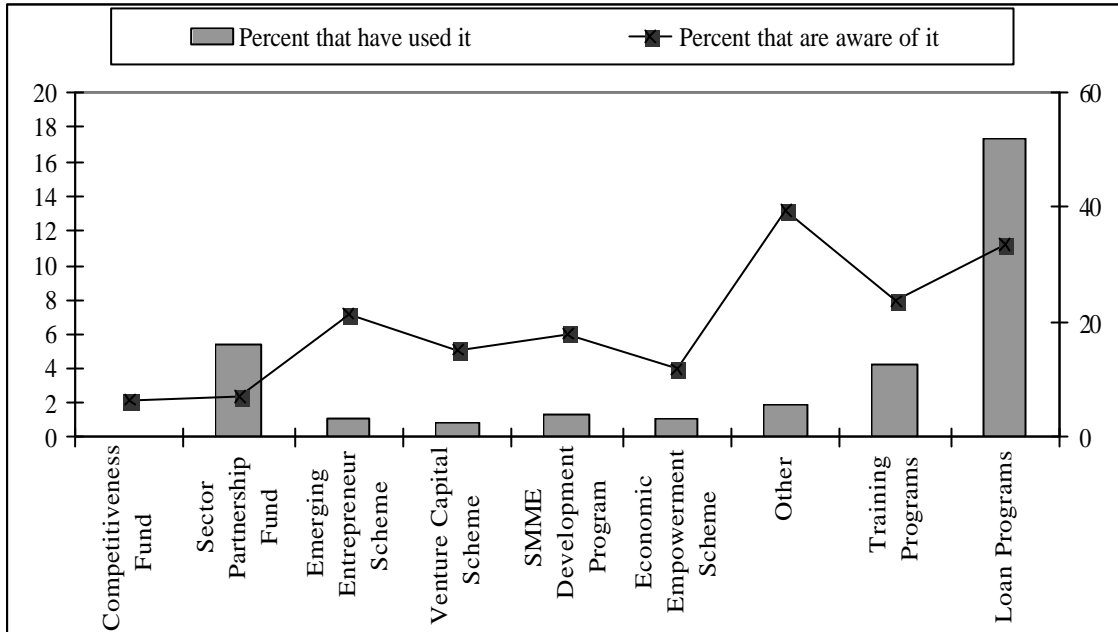
**Insufficient government support for SMME promotion.** Recognizing the enabling role that government can play in SMME development, government instituted a series of programs in the 1990s to promote SMME development.<sup>26</sup> These were aimed at improving competitiveness, marketability, and visibility of SMMEs. There were two types of support programs: DTI programs and programs administered by its apex institutions, Khula (credit) and Ntsika (training). Survey evidence indicates that awareness of DTI programs is only about 7-34 percent and usage is even lower at about 0.5 percent for many programs. No more than 20 percent of SMMEs are aware of Khula and Ntsika programs. The only popular program is the one managed by the South African Bureau of Standards. Less than 10 percent of firms that have heard of these programs have ever used them.

**Chart 6.3: Awareness and use of other government SMME support programs**



<sup>26</sup> For an in-depth analysis of the use, awareness and reasons for not using SMME promotion programs, see World Bank Discussion Paper No. 15, 2001.

**Chart 6.4: Awareness and use of DTI SMME promotion programs**



Government support systems were also instituted in the form of export promotion programs to facilitate entry into international trade. The survey reveals that the 3 most well-known programs were tax exemptions, export credit guarantees and forward foreign exchange cover. These suggest that direct monetary returns are preferred to other types of export assistance provided by government. With the exception of these three programs, no more than 4 percent of SMME exporters use any of the numerous other programs in place. Evidently, the benefits of these programs reach a much smaller proportion of SMMEs than intended by government and in this respect have not been successful in nurturing the enabling environment they were envisioned to promote.

**What do SMME owners need to employ 10 more workers?**

The preceding discussion delineates some of the leading reasons for the slow growth of Black SMMEs in the post-apartheid period when policy makers had pinned their vision of Black empowerment on the engine of new SMME development. To understand what constrains existing SMMEs owners from creating additional employment, they were asked to enlist the key constraints to creating 10 new jobs. Their responses are enlisted below.

**Chart 6.5: Necessary conditions for SMME owners to create 10 new jobs in 1999**

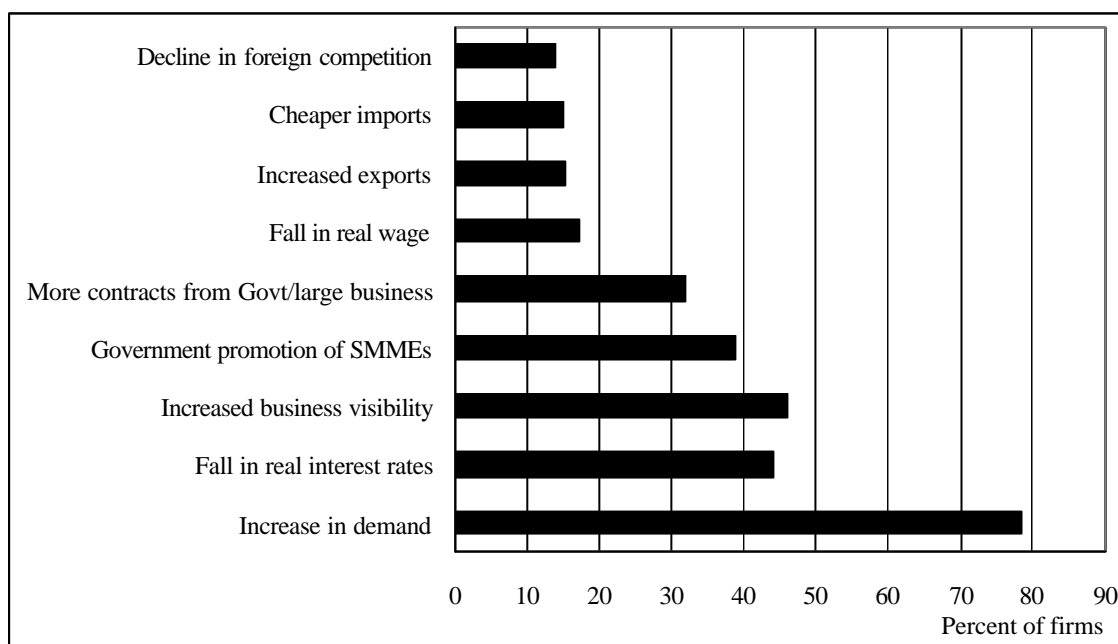


Chart 6.5 illustrates that for almost 80 percent of firms, the main obstacle to job creation is “insufficient demand.” For 40–45 percent of firms, there are three factors ranked equally: “fall in real interest rates”, “increased business visibility” and “increased government promotion of SMMEs”, followed by “more contracts from government/large business.” Two pertinent points arise. One, the most critical constraint to job creation and presumably firm growth is an increase in overall economic demand. Together with the constraints associated with business visibility, decline in foreign competition and increased exports, this implies that the general economic growth of the larger South African economy is as vital to employment creation in the SMME sector as in the large firm sector. SMMEs cannot grow and create new jobs in a vacuum – they are intrinsically part and parcel of the same national economy. And two, SMME owners expect government to provide the enabling environment government itself identified as necessary for SMME promotion in the 1990s. So what slipped? Apparently, as the preceding section showed, widespread implementation of the programs stalled.

### ***Role of policy makers***

The discussion in section 6 raises a few key issues regarding the prospects for SMME development, especially among Blacks, and the extent to which the emergence and growth of new SMMEs can indeed deliver the government’s objective of Black empowerment. There is a belief that aggressive SMME growth through the creation of new SMME entrepreneurs is a solution to the current unemployment and income inequality problem, especially among Black South Africans who represent the bulk of the long term unemployed. The SMME survey shows that this view is misplaced. While growth in the SMME sector appears to be impressive, much of it is unsustainable and most of it during the later 1990s was actually negative. Worse still, there is clear evidence of job-less growth, even in the SMME sector. Apparently, because of historical factors, the South African labor market today does not have the essential ingredients required for a rapid and large scale expansion of the SMMEs sector, particularly among Blacks. Key among the essential ingredients are an initial stock of entrepreneurial business capital, formal sector

work experience, and basic skills to manage and operate a small business once it has started. So what can policy makers do about this historical legacy? Compelling evidence from the contemporaneous informal firm survey suggests that the answers to overcoming the lack of initial entrepreneurial business capital among Blacks may lie beyond the SMME sector and in the dynamics of Black informal firms<sup>27</sup>. But discussion of this is beyond the subject of this paper.

Among the essential ingredients for SMME development is the equally crucial role of existing government programs. The thrust of existing government promotion programs has been on the development of new firms as opposed to the nurturing of existing firms, especially those that have survived the first 4 –5 years and have the potential for growth and sustainable job creation. There seems to be a compelling case for policy makers to re-think the SMME policy and programs focusing on a few of these key issues.

## 7. MAIN FINDINGS

The 1999 firm surveys indicate that South Africa has a formal employment problem. Since the demand for labor is a derived demand, the crux of slow job creation lies in unraveling the *structural constraints* to investment and growth in the real sectors. This is necessitated by two factors: one, in spite of a market-approved macroeconomic policy stance since the mid-1990s, growth in domestic or foreign private investment has been weak. This suggests that the obstacle to growth lie elsewhere. Second, in the last decade, South Africa underwent a spate of structural shocks and changes both internally and externally – these created a series of complex structural constraints with their attendant economic costs for growth. In a globally integrated open economy like South Africa's, there are no easy substitutes for understanding these and systematically addressing them.

The constraints to growth and job creation at each tier of the industrial spectrum are unraveled in this paper to diagnose the formal employment problem. An analysis of the key constraints to growth, as identified by the CEOs of large firms in manufacturing, IT and Tourism, shows that they are diverse and complex. Across the board, the leading one is crime and theft, but following closely behind are exchange rate depreciation, corruption in government and high interest rates. In manufacturing, recent labor market regulations are identified as the number two constraint, ranked jointly with exchange rate depreciation and interest rates. However, in IT and Tourism, recent labor market regulations are ranked sixth or even lower. Government's expedient policy response to exchange rate depreciation and interest rates confirms that the special nature of macroeconomic constraints enables relatively straightforward policy solutions. However, the same does not apply to the structural constraints, key among which are crime, labor market regulations that raise the price of labor, corruption and a scarcity of skilled-labor. The remainder of our findings focus on the formal employment problem with respect to two sets of issues: (1) the two fundamental structural constraints in the South Africa labor market: recent labor market regulations and scarcity of skills; and (2) factors underlying the slow take-off of SMME development, especially among Black South Africans. It may be noted that survey evidence indicates that although labor market constraints are fundamental and paramount, they are by *no* means the *only* constraints to formal employment creation in the South African economy today.

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<sup>27</sup> For empirical evidence on this issue, see World Bank Discussion Paper No. 17, 2001 (forthcoming).

In South Africa's large firms, the employment problem is exacerbated by a low demand for formal labor caused by recent labor regulations which have raised, for employers, the implicit cost of doing business with labor *over and above* the negotiated or legislated wage and non-wage costs. While this finding is generally applicable across *all* large *manufacturing* firms, undoubtedly with inter-sectoral differences, recent labor regulations are only weakly binding on firms that are relatively skilled-labor intensive. They are far less pervasive in the highly skills-intensive large IT firms and even tourism firms. In the semi- or less-skilled labor intensive manufacturing firms, the implicit costs of labor regulations increase positively with firm size. So even though the majority of the large employers assert that these regulations have had no effect on their employment levels, hard employment data from their HR managers reveals that firms made a concerted decision to hire fewer workers, substitute capital or machinery for labor, replace permanent workers with temporary workers and place a greater reliance on subcontracting than in-house production. These decisions occurred in 33 – 42 percent of the manufacturing firms with many firms undertaking more than one action. Survey data records a significant downward trend in formal employment growth during 1994-99. These trends are also supported by official statistics during 1994-99. This evidence suggests that South Africa's largest manufacturers, who happen to create significantly more less-skilled jobs per manager than other firms, are, *ceteris paribus*, most likely to curtail formal job creation if the unintended cost-increasing effects of these regulations are not moderated. Worse still, the employment problem in large manufacturing firms is likely to mount as formal jobs continue to be shed and replaced by informal work arrangements.

In contrast, the most acute labor market constraint hampering formal employment in all large firms but especially those in IT is a shortage of skilled labor. In IT over 80 percent of the large firms noted a severe shortage of professionals. A significant proportion also reinforced the crucial importance of this factor by noting that in addition to the shortage of skilled labor, they also faced a high turnover of IT professionals, immigration restrictions on importing foreign IT workers to ease the skills shortage, lack of government training programs to create IT -specific skills etc.. The phenomenal economic growth and employment record set by the IT sector in the past 25 years in South Africa notwithstanding, in the medium term, the cumulative impact of these factors can become the single most important constraint to formal employment creation in this sector. This would indeed be unfortunate given that IT has the promise of South Africa's new export frontier, the African continental market to exploit, and the potential of a major source of economic growth.

It bears noting that the negative effect of the skills shortage on formal employment creation is not confined to the IT sector alone. Almost 50-60 percent of the large manufacturing firms, a significant proportion of tourism firms and 30-45 percent of SMMEs reported a skills shortage in 1999.

Findings from the 1999 SMME survey reveal that like large firms, this sector too has a significant formal employment problem albeit of a very different nature. The policy makers in the new South African envisioned rapid, large scale SMME development driving Black empowerment in post-apartheid South Africa and providing the panacea for Black unemployment. The GJMC-World Bank survey of 800 SMMEs shows that in 1999, the overall share of Blacks in the sample was only 7 percent. The share of post-apartheid SMMEs was 30 percent but the share of Blacks in these was only 13 percent. Worse still, impressive aggregate employment growth rates in SMMEs notwithstanding, the data reveals that in the set of SMMEs that are at least 2 –3 years old, employment growth rates during 1997-99 declined by 7 percent.

This implies that aggregate employment growth was deceptively generated by the emergence of new SMMEs rather than job creation and expansion of existing ones.

The paramount constraint to the emergence of Black SMMEs in post-apartheid South Africa is the paucity of the initial stock of entrepreneurial capital/business experience that appears to be a pre-requisite for starting a business. About 85 percent of the existing 800 firm owners surveyed in Johannesburg had this endowment before they started their businesses. They did not emerge from the pool of long term unemployed. In fact, no more than 5 percent of the existing SMME owners were unemployed before they started their business. Since individual or family owned entrepreneurial capital or work experience is a pre-requisite for an SMME start-up, and there is a crucial paucity of such capital among Blacks, primarily because of historical reasons, it is no surprise that Black SMMEs have been very slow to emerge, even after 1995. Overall, survey data suggests that the government's existing policy stance towards the creation of new Black SMMEs may be misplaced. It seems that continued government nurturing and support to existing SMMEs to help them graduate to the next size-class so that they can create more sustainable growth and jobs may be a more productive endeavor than the simple promotion of new SMMEs that have a high turnover. So what about new Black SMME firm growth? Insights from the 1999 informal firm survey suggest that the answers may lie in that sector, but that discussion is beyond the scope of this paper.

The other important obstacles to SMME development are a basic business skills shortage, lack of access to credit and low support from existing government programs. Survey evidence reveals that no more than a third of the SMMEs are aware of most programs and a negligible proportion use them. Given government commitment towards SMME development, the awareness and usage of these programs suggests that they have failed to have their intended impact.