Econ3x3

A web forum for accessible policy-relevant research and expert commentaries on unemployment and employment, income distribution and inclusive growth in South Africa

November 2012

How structural inequality limits employment and self-employment in poor areas (or: Why South Africa's informal sector is so small)

Kate Philip, TIPS and Advisor to the Presidency

Given South Africa's high levels of unemployment, the relatively small size of the micro-enterprise sector is a conundrum. This article argues that structural inequality is the reason for this – in particular, inequality in the structure of the economy, the legacies of spatial inequality and the continued inequalities in human development. Their combined effect is to limit the scope for poor people to escape poverty via self-employment. This explains the limited extent and small range of informal employment.

Introduction

Because unemployment in South Africa is at levels considered unthinkable in other parts of the world, it has been seen as something of a conundrum that the informal and micro-enterprise sectors remain as small as they are, that they are so dominated by retail activity and have so little apparent dynamism or scope for growth and employment creation. Surely economic initiative 'from below' in townships, informal settlements and rural areas should be making a greater contribution to creating employment and livelihoods?

Explanations for this state of affairs typically focus on the historical exclusion of black people from many forms of business activity; the consequent lack of a culture of entrepreneurship; the lack of access to credit and capital and skills; and red tape and regulatory barriers to entering the market.

None of these issues is irrelevant, but they overlook a bigger issue: the role of structural inequality in limiting economic opportunities in poor and/or remote areas in ways that limit the entry points and pathways into sustainable economic activity. For poor people this raises the bar for market entry far higher than in many other developing countries. Two key forms of structural inequality are the focus here: spatial inequality, and the structure of the economy.

While the roots of the many forms of inequality lie in the apartheid period and before it, the problem is that, despite the many changes since 1994, crucial underlying determinants of inequality persist. As long as they remain real, they will limit the scope for poor people to escape poverty via self-employment.

The decline of subsistence agriculture as a springboard for enterprise development

The consequences of spatial inequality in rural areas include an inter-generational decline in the roles of subsistence agriculture and land-based livelihood activity. This decline constrains a crucial path of entry into economic activity in the rural economy.

In many developing countries, including China, Tanzania and Brazil, the rural sector functions as a safety-net. Access to land-based livelihoods provides a basic level of subsistence, and operates as a fallback when other economic options fail. Moreover, the production of surpluses in this sector provides the first stepping-stone into market-based activity and the development of informal businesses or micro-enterprises.

In South Africa, the rural sector does not play this role to any significant extent. The figures are stark. By March 2004, less than 50% of rural households said they participated in agriculture. Of these, 88% used it as an extra source of food, but only 1.1% earned their main income from it while only 2.8% earned *any* income from it at all (Aliber, 2005). Research in Mount Frere in the

Eastern Cape reveals that 87% of households report that they depend on store-bought maize all year around (Du Toit 2009).

While there are many reasons for this situation, the bottom line is that very few rural households produce more than they need for their own consumption – and it is only when a household's food production exceeds its consumption that it can provide a platform for market entry, either from the barter or sale of fresh produce, or as a basis for the next key enterprise development milestone: agro-processing.

The lack of surplus production is not the only constraint facing the development of enterprise in poor areas. An even bigger hurdle is the structure of the economy and of key product markets.

The structure of the economy limits entry into small-scale manufacturing

The structure of the economy and of markets limits the capacity for any transition from subsistence agriculture into small-scale agro-processing and constrains the scope of an important part of small-scale manufacturing.

The South African economy is highly centralized, capital intensive and has high levels of vertical integration. It is a structure that tends to exclude SME participation and makes it difficult to create employment. Hence, the focus of policies such as the New Growth Path has been to address this issue within the core economy. Less well understood, however, is how this structure also has an impact on even the most survivalist of income-generating activity.

Markets in poor areas are 'thin'. Poor people (both rural and urban) buy a limited basket of consumer goods. Most of these goods are mass-produced in the core economy on a scale that makes it hard to compete with them in terms of price. Distribution systems in South Africa are highly efficient, with branded goods making their way to even the most remote spaza shops. In the past, the distance from commercial centres provided small producers in remote areas with some form of market protection but nowadays large-scale retailers (PEP, Shoprite, Pick 'n Pay, etc.) can be found in many townships and small towns. Branded goods, supported by advertising, also provide a level of quality consistency that people value.

In practice, it is hard to find a single item in a poor person's shopping basket that is not mass-produced in South Africa's core economy – as the following familiar list of products illustrates: maize meal (Iwisa, Ace, White Star), bread (Albany, SASKO, Blue Ribbon), sugar (Illovo, Tongaat-Hulett), milk and dairy products (Clover, Dairy Belle), sunflower oil (Nola, Epic), flour (SASKO, Premier Milling), tea (Joko, Glen, Five Roses), coffee (Ricoffy, Frisco), margarine (Flora, Rama), beer (South African Breweries), fruit juices (Ceres, Liquifruit, Oros), canned goods (Koo, Gold Crest, All Gold), rice (Tastic).

Many other basic non-food items are also mass produced, with recognized brand names, for example: paraffin, matches, soap, washing-powder, shoe polish, candles, cigarettes, fencing wire, metal window-frames, and cement bricks. Even school uniforms – grey trousers for boys and black tunics for girls – are mass-produced in vertically-integrated supply chains.

The net effect is that small-scale producers targeting poor consumers have a hard time competing in terms of price, quality and brand recognition. This is borne out by the high failure rate of many enterprises and local economic development strategies that have relied on promoting 'local production for local consumption': mini-bakeries, sewing co-ops, poultry abattoirs, maize mills, peanut butter co-ops, atchar production, and more.

In South Africa, the challenge is not how to tap into the wealth at the bottom of the pyramid; rather the challenge is how to keep it there. Currently, local spending re-circulates very little amongst local business and is being sucked back to the core formal economy all too quickly. This limits its impact on local economic development.

This reality limits the opportunity for growth in the micro-enterprise sector. For new entrepreneurs, one of the easiest entry points into markets is to produce and sell goods to their neighbours and local communities, drawing on their own product knowledge, relying on localized distribution and trust relationships, and building and expanding their businesses step by step. In South Africa, this classic entry point into markets and the scope to move up the ladder to bigger and better things are highly constrained.

Accessing wider or external markets and supply chains?

Given the limits of the concept of 'local production for local consumption', enterprise development strategies have started to change their focus to:

1. strategies to gain access to retail supermarkets with fresh produce;
2. higher-income markets outside the local community, with niche/artisanal products that target higher value but relatively low volume external markets, e.g. designer craft, goats milk cheese, rooibos tea, mushrooms, essential oils and snails; and
3. strategies to enter high-volume but low-value commodity markets such as timber, sugar, maize, beans and sunflower oil.

Accessing wider and/or external markets in this way brings a new set of challenges. Firstly, small-scale producers have to enter into formal value chains or supply chains, and the option of informality – and the ease and simplicity of entry it offers - simply falls away. Participation in value chains and supply chains means compliance with standard business practices – involving invoices, delivery notes, receipts, a bank account, preferably business premises – and a legal entity. Without these, formal businesses cannot even recognize a transaction in their books, because neither their auditors nor SARS will do so. Participation in wider value chains also requires greater quality consistency and that a complex sets of standards be met.

Secondly, access into external markets can require massive increases in volume. Entry into these markets does not allow for incremental growth in risks and returns. When a KZN craft producer managed to secure an order from the Spanish department store *Il Corte Inglese*, it was for

17,000 beaded bracelets! The entrepreneur had to employ 200 beaders and mortgage his house to raise the working capital for the beads and labour. In agriculture, achieving volumes requires co-ordination amongst small producers – while agricultural marketing co-ops still are all but absent in many former Bantustan areas.

Finally, the great advantage of producing for local consumers is that the (local) producer usually understands the market and consumer needs. Often this is not the case when goods are being produced for a foreign target market. How many snail producers in the Eastern Cape eat snails themselves; or understand the preferences of snail-eaters in remote markets? This has been a major issue in the craft sector, for example, where the latest (seasonal) design aesthetic in Sandton or New York may be neither obvious nor accessible to rural crafters. This creates a reliance on intermediaries because the producers are unfamiliar with preferences and tastes in their target market.

In sum, while there may be good market opportunities in these areas, they do not present easy entry points for new entrepreneurs. Viability requires relatively high levels of business acumen, capital, credit and skill from the start, as well as intermediary institutions and high levels of ongoing support – *all the things that poor, often informal, first-time-entrant entrepreneurs do not have*.

For most unemployed people who hope to escape poverty on their own initiative by means of self-employment, this combination of requirements simply raises the bar for market entry too high – especially when skills constraints are considered.

Conclusion

For poor or remote communities, there are key elements of structural inequality that combine to curtail the scope for successful economic initiatives and small-enterprise manufacturing from below. This has knock-on effects on the services sector. Without a manufacturing base in the local economy, the demand for business services is restricted. The result is that services in the micro-enterprise sector are dominated by personal services – hairdressing, shining shoes, washing cars, and catering (with the taxi industry and related services being the exceptions).

It is small wonder then that South Africa's informal and micro-enterprise sectors are dominated by retail activity. Even in the retail sector, however, there are limits to the scope for growth – with little opportunity to move up the ladder by formalising and expanding in a situation in which 'big retail' is currently coming down the very same ladder, combined with an increasing presence of imported Chinese goods.

What does all this mean for development strategy? That will be the subject of another article.

References

Philip, K. 2010. Inequality and economic marginalisation: How the structure of the economy impacts on opportunities on the margins*. Law, Democracy and Development*, Volume 14 [www.ldd.org.za].