



# Policy Brief

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## Unlocking Financial Inclusion for Small and Medium Enterprises (SMEs) in South Africa<sup>1</sup>

**Summary:** SMEs are essential to the economic fabric of every country, yet they often struggle to secure the affordable financing necessary to expand their businesses and seize new opportunities. Despite varying specifics across businesses, several common barriers hinder SMEs access to finance. These include a lack of collateral, insufficient auditable financial history, unreliable data, and gaps in financial literacy. Furthermore, the informal nature of many SMEs and the rapid evolution of the digital economy compound these challenges. While digital advancements offer new financing opportunities, they also demand greater financial and digital proficiency, highlighting the ongoing relevance of traditional financial solutions to support SMEs growth and integration into the digital era. In South Africa, a mere 33 percent of businesses report having access to credit, underscoring a significant obstacle to SMEs growth. This policy brief advocates for strategies to enhance the sustainability of SMEs in South Africa by improving their access to formal financial services. Drawing on successful policies from other emerging markets, this policy brief suggests adaptable strategies to boost financial inclusion for South African SMEs. These strategies aim to bridge the structural gaps that limit SME growth and enable them to fully leverage both traditional and digital financial avenues.

### 1. Introduction

There is widespread agreement that SMEs play a crucial role in the socio-economic development of emerging countries (Abor and Quartey, 2010). Numerous studies have underscored the importance of SMEs in fostering economic growth worldwide (IFC, 2017; Buri et al., 2019; Rasheed et al., 2019). In South Africa, SMEs are pivotal to the economy, evidenced by their contribution to 87 percent of employment (Motsomi et al., 2020). However, research consistently shows that SMEs face more significant financial constraints than larger enterprises (Abraham and Schmukler, 2017; IFC, 2017; World Bank, 2020a). Thus, emerging countries like South Africa are encouraged to ease these financial constraints to support SME growth and sustainability to help reduce inequality, poverty, and unemployment.

Access to formal financing such as loans, equity, and overdrafts allows SMEs to expand, acquire assets, and create jobs (IFC, 2020). Shihadeh (2021) adds that such funding enables SMEs to innovate, improve products, and invest in technology, boosting business performance. Financial inclusion of SMEs enhances economic growth, reduces poverty through job creation, and improves living standards (Barajas et al., 2020; Shihadeh, 2021).

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The views expressed in this policy brief are those of the SPAU and do not represent the views of UNDP, the United Nations or any of its affiliate organizations.

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However, one significant challenge that SMEs face in accessing finance from banks or financial institutions is the high transaction costs associated with processing, monitoring, and enforcing loans (Ayyagari et al., 2017). Yet, financial institutions stand to gain from offering increased credit access to businesses, as it helps diversify their loan portfolios and reduces the risk of non-performing loans and loan defaults (Mehrotra and Yetman, 2015; Morgan and Pontines, 2014). Despite these advantages, most SMEs use internal finance sources, which do not require collateral, are typically interest-free, and allow SME owners or managers to maintain complete control over financial decisions (Onubedo and Yusuf, 2018).

Recognizing the vital role of SMEs, South Africa's policymakers have become increasingly aware of the need to support the cultivation and growth of resilient, innovative and agile entrepreneurs as can be seen in the implementation of various legislations, policies and the National Integrated Small Enterprise Development (NISED) Masterplan (2022). The National Small Business Act of 1996 was amended in 2004 to establish the Small Enterprise Development Agency (SEDA) and the Small Enterprise Finance Agency (SEFA), tasked with providing development support to SMEs (National Small Business Amendment Act, 2004). Furthermore, the government has drafted the South African Small, Micro, and Medium Enterprises (SMMEs) and Cooperatives Funding Policy to deepen access to finance and in the process increase the number of SMMEs and cooperatives (Department of Small Business Development, 2023).<sup>2</sup> Nevertheless, SMEs still face significant challenges in accessing financial resources. Despite the progress made over the last 20 years, South Africa's financial sector has not fully bridged the access gap to financial services for underserved individuals and SMEs (National Treasury, 2023). Many SMEs continue to rely on informal or internal funding sources and remain entrenched in cash transactions outside the formal financial economy (World Bank, 2017; National Treasury, 2023).

Challenges to accessing external funding for SMEs include high interest rates, insufficient operating histories, limited collateral, and poor credit records (SME South Africa, 2018). However, these businesses critically need access to funding or credit to enhance their performance. Several studies have quantified the financial inclusion of SMEs in emerging economies (Abraham and Schmukler, 2017; IFC, 2017; World Bank, 2020a), yet few have specifically addressed SMEs in South Africa.

This policy brief argues that the drive to enhance the sustainability of SMEs in South Africa should coincide with improved access to formal financial services. By leveraging external finance, SMEs can secure the necessary funds for long-term investments and manage cash flow during financial challenges (Onubedo and Yusuf, 2018). Research by Triki and Faye (2013) and Msomi and Olarewaju (2021) highlights that access to finance is essential for the growth and sustainability of SMEs. Ultimately, enhanced financial inclusion can significantly boost the survival rates of SMEs by enabling them to capitalize on investment and growth opportunities previously out of reach (Barajas et al., 2020).

## **2. Literature Review**

Easing financial constraints for SMEs and individuals can impact economic inequality and growth positively in several ways. Firstly, when entrepreneurs and economically constrained individuals gain access to finance, they can establish businesses and invest in productivity-enhancing activities. Additionally, individuals can use financial resources to invest in human capital, improving their skills and making them more employable by entrepreneurial firms. However, as Rajan and Zingales (2003) point out, this can also widen inequality due to financial market imperfections like information asymmetry, which often requires collateral for finance that poorer entrepreneurs may not have.

On the positive side, easing financial constraints can spur growth and reduce inequality when access to finance is simplified and made available without the stringent need for social capital or collateral (Banerjee and Newman, 1993; Galor and Zeira, 1993). This accessibility allows credit-constrained entrepreneurs and poorer households to manage risky but high-return investments, and invest in research and development, potentially leading to income convergence as described by Clark, Cull, and Peria (2006).

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<sup>2</sup> <http://www.dsbd.gov.za/sites/default/files/Final%20Gazetted%20SMMEs%20and%20Co-operatives%20Funding%20Policy.pdf>

However, the initial effects of financial inclusion can disproportionately benefit the wealthy, creating a short-term increase in inequality before the benefits begin to reach the poorer segments of the population, as Greenwood and Jovanovic (1990) noted. Over time, though, as financial services become more widespread among lower-income groups, their ability to accumulate productive resources can lead to a reduction in income inequality.

The relationship between financial access and economic outcomes like output growth, wage increases, and poverty reduction is well-documented. For example, King and Levine (1993) and Levine (2005) have shown that financial access can increase the output growth rate, while Honohan (2008) and Lloyd-Ellis and Bernhardt (2000) have shown that it can raise wages. Moreover, studies by Beck et al. (2007) and Burgess and Pande (2005) indicate that financial access reduces poverty and income inequality.

Research focusing specifically on SMEs confirms a positive link between access to external finance, firm growth, and the efficient allocation of productive assets (Demirguc-Kunt and Klapper, 2012; Shihadeh, 2021). Dabla-Norris et al. (2015) argue that easing credit constraints for SMEs leads to reduced inequality, and Suri and Jack (2016) found that credit access enables the poor to move to higher-return occupations and businesses. Findings by Anga et al. (2021) and Negm (2021) further support these positive impacts of improved financial inclusion on SMEs.

However, much of the research uses static analytical frameworks that may not fully capture the dynamic institutional factors or the varied access to finance among different firms. A more dynamic approach, such as a general equilibrium model, may better reflect the complex realities of financial access in economies with a mix of formal and informal business sectors. Such models consider the non-linear benefits of finance and the diverse impacts on different economic agents based on their initial economic conditions.

Using an extension of the Dabla-Norris et al. (2015) general equilibrium model to consider the effects of financial constraints on households' ability to participate in the credit market and how access to credit can influence entrepreneurial talent; Nanziri and Wamalwa (2021) found that enhanced credit access for human capital development significantly boosts firms' productivity, thereby contributing to GDP growth in South Africa.<sup>3</sup> This impact is particularly evident from an intensive margin perspective, suggesting that when collateral constraints are loosened, talented but wealth-constrained entrepreneurs may still opt to rely on savings rather than taking on new debt, possibly due to a pecking order preference or lack of awareness of available credit.

### **3. Unlocking Finance for the SMEs in South Africa**

The FinScope MSME<sup>4</sup> Survey South Africa conducted in 2020 revealed that the country is home to approximately 2.6 million entrepreneurs, 46 percent of whom are women, operating 3.2 million SMEs.<sup>5</sup> Among these entrepreneurs, 37 percent are young business owners.<sup>6</sup> Over the last decade, the level of entrepreneurship and the number of SMMEs in South Africa have remained relatively stable.

According to the National Development Plan (NDP), SMEs play a crucial role in addressing poverty and creating employment. Currently, SMEs contribute 40 percent to South Africa's Gross Domestic Product (GDP), with the majority (84%) operating in the personal services (such as hairdressing, landscaping, auto repair) or wholesale/retail trade sectors. These sectors generally offer limited opportunities for value addition and, consequently, a limited impact on GDP.

In terms of structure, 54 percent of South African SMEs are micro-enterprises, mostly operating informally. Only 37 percent of SMEs are formally registered with the Companies and Intellectual Property Commission (CIPC) or local government bodies, and just 30 percent are registered for tax. Nonetheless,

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<sup>3</sup> The study investigated three specific financial inclusion constraints: participation constraints, collateral requirements, and intermediation efficiency. By relaxing these constraints, the model predicts that economic growth can be accelerated and inequality reduced.

<sup>4</sup> Micro, small and medium and enterprises.

<sup>5</sup> FinScope MSME Survey South Africa 2020.

<sup>6</sup> Global Entrepreneurship Monitor, 2016/2017.

those SMEs that are formally registered play a significant role in the economy, contributing over R2.9 trillion to GDP.

SMEs provide 87 percent of employment opportunities in the country, with business owners constituting 20 percent of this employment figure. Two out of three SME owners run their own enterprises and do not have any employees, while 32 percent provide between one and ten jobs. This trend is particularly pronounced in micro and informal businesses, as highlighted in the 2020 MSME Voice report by the IFC, which noted that rising unemployment levels are a major driver behind the pursuit of informal self-employment opportunities.

Most SMEs in South Africa are in the startup or growth phase of their development, with 70 percent failing within the first five to seven years of inception (Bushe, 2019)—a rate of business mortality that raises concerns given the sector's potential contribution to inclusive economic growth. The latest data from the Global Entrepreneurship Monitor (GEM) report for South Africa reveals some significant trends in entrepreneurship as of 2022/2023. The Total early-stage Entrepreneurial Activity (TEA) in South Africa has seen fluctuations in recent years, recording 11.1 percent in 2023, which is up from 8.5 percent in 2022 but still below the 17.5 percent peak seen in 2021 during the pandemic. This rise indicates a recovery, though the entrepreneurial environment remains challenging.<sup>7</sup>

Entrepreneurs face several significant challenges, with the FinScope SME Survey 2020 identifying access to finance (73 percent), access to markets (32 percent)<sup>8</sup>, and regulatory red tape (28 percent) as the top hurdles to starting and running a business. While 84 percent of South African SMEs were found to be financially included<sup>9</sup> in 2020, with 81 percent formally served<sup>10</sup>, this level of formal financial inclusion is primarily due to business owners using financial products and services for personal rather than business purposes.

The lack of funding is a critical barrier to growth in the SME sector, with only 33 percent of businesses reporting access to credit. Collateral-based lending prevalent in the South African economy impedes SME financing due to issues like the absence of auditable performance records, unverified data, and financial illiteracy.<sup>11</sup> These issues are exacerbated by the informality of many SMEs and rapid growth of the digital economy, which, while opening new financing avenues, also demands enhanced financial and digital capabilities from SMEs, reinforcing the importance of traditional financial solutions in supporting their growth and enabling them to benefit from the digital age.

To address financial inclusion challenges for SMEs, South Africa can adopt various strategies informed by international experiences:

- **Expansion of Digital Financial Services:** Inspired by Kenya's M-Pesa, South Africa could enhance mobile banking and digital payment solutions tailored for SMEs. Prioritizing user-friendly interfaces and secure transactions would be crucial.
- **Financial Literacy and Capacity Building:** Drawing from Indonesia and South Korea experiences, South Africa should launch targeted financial education for SME owners. Workshops and online courses could cover credit management, investment, and financial planning, empowering entrepreneurs to better utilize financial products.
- **Credit Guarantee Schemes:** Inspired by the Korea Credit Guarantee Fund (KODIT) and Malaysia's Credit Guarantee Corporation, South Africa should implement schemes that provide partial credit guarantees to financial institutions. This would encourage lending to SMEs that typically do not meet traditional lending criteria.

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<sup>7</sup><https://www.gemconsortium.org/economy-profiles/south-africa>

<sup>8</sup>This could be a result of the monopolistic and oligopolistic characteristics of the South African economy.

<sup>9</sup> Financially included refers to business owners who have/use both formal and informal financial products and/or services for business purposes.

<sup>10</sup> Formally served refers to business owners who have/use formal financial products and/or services provided by a formal financial institution (bank and/or non-bank).

<sup>11</sup> <https://sundayworld.co.za/tag/small-and-medium-sized-enterprises/>

- **Regulatory and Policy Reforms:** Learning from Brazil, Chile, Colombia, Peru, Rwanda and Singapore, South Africa should streamline business registration and licensing processes to reduce the administrative burden on SMEs and facilitate easier start-up financing.
- **Innovative Financing Models:** Inspired by Colombia, South Africa could support the growth of fintech startups offering alternative financing models like peer-to-peer lending, crowdfunding, and microloans through mobile platforms. These would provide SMEs with access to non-traditional funding sources.
- **Partnerships for Financial Access:** Following the example of Bangladesh Bank's SME and Special Programmes Department, South Africa could enhance partnerships between the government, banks, and financial institutions to provide SMEs with better access to funding and training.
- **Use of Data and Technology:** Mirroring practices in the European Union, leveraging Big Data and Artificial Intelligence (AI) could help South African financial institutions perform more accurate credit risk assessments and develop tailored financial products for SMEs.
- **Specialized Financial Institutions:** Similar to South Korea's Industrial Bank and Brazil's Development Bank (BNDES), establishing or supporting financial institutions focused on SME financing could provide targeted services like low-interest loans and investment capital.
- **Microfinance and Microcredit Programmes:** Strengthening microfinance institutions to offer small loans to entrepreneurs, particularly those who are underserved by traditional banks, can significantly aid SMEs development as shown by the experience of Bangladesh.
- **Development of SME-focused Banking Products:** Encouraging banks to develop products specifically for SMEs, such as microloans, factoring, and leasing options similar to Turkey's approach could address unique financial needs.
- **Public-Private Partnerships (PPPs):** Promoting PPPs to invest in sectors critical to SMEs could improve their operating environments, as demonstrated by Brazil's infrastructure developments.
- **Incentives for Venture Capital and Private Equity:** Offering tax incentives and regulatory support to attract investments into SMEs, similar to Israel's approach, could bolster the startup ecosystem.
- **Enhanced Legal Frameworks for Secured Transactions:** Reforming laws to allow SMEs to use movable assets as collateral, akin to Ghana's initiatives, could increase their access to credit.
- **Integrating Traditional and Alternative Data:** Adopting the Universal Trusted Credentials framework could help financial institutions build comprehensive credit profiles for SMEs, incorporating both traditional and alternative data points like digital transaction histories and utility bill payments.<sup>12</sup> An Experian study showed that including utility data allowed 20 percent of "thin-file" credit customers with scant documentation to support their credit application to become "thick-file" customers who have higher loan approval rates.<sup>13</sup> For small businesses, this can increase access to financing, provide greater convenience, and improve product options.<sup>14</sup>

By adapting these policies to the South African context, the government can significantly enhance financial inclusion for SMEs, fostering growth and innovation within the sector.

#### 4. Concluding remarks, recommendations and suggestions for further research

This policy brief underscores the critical role of SMEs in fostering economic growth and employment and outlined several strategies to enhance their financial access and inclusion. Drawing from successful international experiences, particularly those implemented in emerging economies, the policy brief

<sup>12</sup> The UTC seeks to fundamentally transform the provision of financial services to MSMEs by aggregating and authenticating a comprehensive set of alternative data that reflects the business's willingness and capability to fulfill financial obligations. It covers detailed information about the business's identity, activities, both trade-related and general behavioral aspects, and its financial history and current standing. By presenting a more rounded and verified financial profile of MSMEs, the UTC is designed to address the vast financing gap and foster economic growth by making financial services more accessible to these pivotal economic players. See <https://www.undp.org/policy-centre/singapore/publications/universal-trusted-credentials>

<sup>13</sup> Experian (2015). "Let there be light: The impact of positive energy-utility reporting on consumers," Available at <https://www.experian.com/content/dam/marketing/na/assets/im/consumer-information/white-papers/cis-energy-utilities-tl.pdf>

<sup>14</sup> McKinsey Global Institute, (2021). "Financial data unbound: The value of open data for individuals and institutions," <https://www.mckinsey.com/industries/financial-services/our-insights/financial-data-unbound-the-value-of-open-data-for-individuals-and-institutions#/>



recommends the following measures including those noted in section 3 for South African policymakers to alleviate financial barriers for SMEs:

- **Government-banks collaboration:** Strengthen partnerships between the government, banks, and formal financial institutions to create a more equitable financial landscape for SMEs. Initiatives like the Bangladesh Bank's SME and Special Programmes Department have proven effective in other contexts by increasing SME inclusion through access to long-term funding, startup capital, and targeted training for SME owners.
- **Data-driven insights:** Enhance the collection and analysis of data on the financial activities of SMEs. Utilizing tools like the FinScope MSME surveys could provide regular updates and a comprehensive database that aids in crafting targeted policies and interventions.
- **Boosting financial infrastructure that helps under-financed SMEs:** An open data framework, for instance, can enable financial institutions to use nontraditional data sources for credit underwriting, targeted at a range of underfinanced companies including SMEs. This can streamline the Know Your Business (KYB) and due diligence processes, reducing costs and time for SMEs and financial institutions alike. This initiative would require collaboration among FinTechs, tax authorities, and credit bureaus to ensure data access and privacy are maintained.

Furthermore, the South African government should promote the development of a financial system that not only boosts entrepreneurship but also aligns income with skills, thereby stimulating labor demand through more efficient capital allocation. A comprehensive, pro-poor development strategy, as outlined in the National Treasury's (2023) "An Inclusive Financial Sector for All," should be a priority.

Lastly, there is a vital need for further research, in particular employing a computable general equilibrium model to explore the impacts of easing financial constraints on economic growth, productivity, and inequality. Future studies should also investigate the social factors influencing digital payment adoption and assess the potential of digital payments to enhance the long-term growth and sustainability of SMEs.

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