

SiMODiSA: Accelerating growth of small and medium enterprises in South Africa

Policy recommendations for enhancing the start-up/SME ecosystem in South Africa

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THE SiMODiSA ASSOCIATION TRUST is a not-for-profit association currently registering as a Public Benefit Organisation

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¹ A table of stakeholders engaged through the process can be viewed in Appendix 1.



2 Executive Summary

“Entrepreneurship does not take place in a void, at random or under the general influence of homogenous economic conditions. It occurs in specific places that create the right conditions for it and within the context of a particular set of incentives, opportunities, and barriers”²

Growth in modern economies is increasingly aligned to efforts to increase productivity through innovation. Such innovation is considered to be an essential precondition for technological and structural change, as well as a contributor to growth and competitiveness³. Entrepreneurship, particularly its by-products of Small and Medium Enterprises (SMEs) and High-Growth SMEs (HG-SMEs), continues to be highlighted as a critical area of focus for policy. These by-products are universally found to be the main sources of job creation and in turn are considered of primary significance as economic growth contributors.

This is found to be true in South Africa, where SMEs employ 60% of the country’s work force and contribute roughly 34% of South Africa’s GDP⁴. However, South Africa has one of the highest SME failure rates in the world, which is indicative of the harsh environment in which SMEs operate in the country. With poor economics and an unsupportive policy environment, private sector investors are deterred from investing in start-ups and high growth enterprises in South Africa. Consequently, there is a very concerning gap in funding for South African businesses, which has also resulted in a substantial lack in skills to effectively deploy the little funding that does exist in the ecosystem.

The South African government cannot afford to ignore these barriers that cripple the growth of SMEs in South Africa’s economy. Not only is addressing and overcoming these roadblocks imperative if the objectives outlined in the country’s National Development Plan (NDP) are to be achieved, it is crucial in creating an ecosystem in which SMEs can grow and thrive, and in turn radically transform the lives of South Africans and the South African economy.

To achieve this, it is vital that government create incentive for private sector investment in SMEs and HG-SMEs; not only will this address the funding gap, it will attract private sector financial management skills to the country, and increase South Africa’s competitiveness in the global markets. In addition, significant foundational input is required for the South African SME sector to fully mature and realise its potential. It is important that government adopts an industry-building approach, as significant foundational aspects of the sector still need to be built or are currently dysfunctional. Suitably qualified funds don’t exist in the numbers that are required to fill the funding gap, and developing such funds in the country will require time, coaching and training.

It is within this context and pressing need that this Position Paper is presented. It is the culmination of a collaborative stakeholder engagement with entrepreneurs, practitioners, industry, academia and government, and research process, tailored to identify and design practical policy recommendations. These recommendations have been made in accordance with the country’s strategic development agenda and plan,

² Monitor Group. 2009. Paths to Prosperity, Promoting Entrepreneurship in the 21st Century, Pg 22.

³ Pelly, R. and Krämer-Eis, H. 2011. Creating a Better Business Environment for Financing Business, Innovation and Green Growth in OECD Journal: Financial Market Trends, Volume 2011 – Issue 1. OECD. www.oecd.org

⁴ The Banking Association South Africa. 2013. [Small & Medium Enterprise](#). The Banking Association South Africa.



the NDP, and aim to overcome existing barriers, implement appropriate incentives and take advantage of existing opportunities and assets to realise a vibrant and growing entrepreneurial ecosystem in South Africa.

This Position Paper is the first instalment of a longer-term engagement and research process that seeks to identify the policy measures that represent critical barriers. Through refinement and amendment, such policy may provide direct solutions and serve to enhance and reinforce other components of the ecosystem.

The broad research process and key stages include: initial stakeholder and expert engagement and analysis to determine the parameters of, and possible solutions to, the key issues to be addressed; desk-based research on existing policy details and international policy ideas including precedent; design, including deeper engagement with key expert advisors and stakeholders, as well as engagement with government officials and policy makers to determine design features and feasibility of recommendations; testing of the recommendations with the stakeholder group; and lastly, final refinement and design of recommendations compiled into this first Position Paper.

Each chapter of recommendations is constructed to operate as a stand-alone recommendation, and includes problem identification, an overview of the current status quo and the proposed solution with supporting rationale. The recommendations included within the scope of this first Position Paper are as follows:

1. Approval of an additional permissible loop structure under Exchange Control Regulation to enable business development and expansion in South Africa.
2. Refinement of the Venture Capital Company (VCC) Regime to improve attractiveness and uptake, and ultimately improve access to equity finance by SMEs and junior mining exploration companies.
3. Clarification around primary blockages and issues identified in relation to the IPR-PFRD Act.
4. Defining features for establishing a Pilot Funding Model and Programme to leverage government spending in order to attract private sector investment and skills to South Africa's nascent venture capital and SME investing industries.
5. Refinements to the South African Business Visa to attract and encourage entrepreneurs to immigrate to and establish enterprise in South Africa, positively contributing towards the local entrepreneurial ecosystem.
6. Labour reform to enable the labour market to respond to the particular skill requirements of start-ups and SMEs. The reform specifically considers special allowances for SMEs to enable appropriate processes and procedures for hiring/firing within this market.
7. Exploration of the relevance of R&D Tax Incentive and the barriers to its uptake by SMEs and start-ups.

This Position Paper has been submitted to government and will be made available to industry. Ongoing comments will be accepted and considered, with the potential of submitting additional refinements in the future.



3 Key Terminology

Basic research:

Experimental or theoretical work undertaken primarily to acquire new knowledge of the underlying foundation of phenomena and observable facts without any particular application or use in view⁵.

High-Growth Enterprises:

There is much contention regarding the definition of high-growth enterprises and Gazelles, with primarily two schools of thought: the first defines Gazelles as a sub-set of high-growth enterprises that are less than five years old that have a turnover or growth in employees greater than 20% per year over a three-year period⁶. This definition was formally defined by the European Commission and is commonly accepted in research and literature that addresses high-growth enterprises and SMEs.

The second school of thought defines Gazelles in the same way that the OECD defines high growth enterprises - as enterprises of any age that experience 20% growth in turnover or employees over a three-year period. Many practitioners in the marketplace have adopted this definition when referring to such high-growth ventures.

In this Position Paper, we have chosen to make use of the term high-growth enterprises, and specifically, high-growth SMEs for practical purposes and to avoid jargon. We believe that the term 'high growth' accurately suggests the key and desirable feature distinguishing such enterprises, which is their characteristic as fast-growing ventures, contributing to employment creation and/or economic growth.

Furthermore, this broader definition, encompassing both young and older or expanding fast growing firms, is valuable for our purposes as both young start-ups and older high-growth enterprises need supportive policy. However, their needs are different. For young start-ups, policy is needed to help reduce the risk of failure, attract investment and enable job creation. While older enterprises experiencing high growth need policy to help the already thriving business scale and create more jobs without failing. Our intention is not to exclude high-growth enterprises older than five years from policy support, but rather to practically inform policy recommendations that promote the creation of a supportive environment for all businesses that create jobs and contribute to the economy.

High-Growth SMEs:

SMEs with average annualised growth in employees or turnover greater than 20% per year, over a three-year period, and with ten or more employees at the beginning of the period⁷.

Innovative SMEs:

Innovative SMEs implement a “new or significantly improved product, process, marketing method, or organisational method in business practices, workplace organisation or external relations.”⁸

⁵ South Africa. NIPMO. 2012. Guideline 1 of 2012 Interpretation of the Scope of the Intellectual Property Rights from Publicly Funded Research and Development Act (Act 51 of 2008): Setting the Scene. Department of Science & Technology. Pg 12.

⁶ Eurostat & OECD. 2007. Eurostat-OECD Manual on Business Demography Statistics. OECD.

⁷ Adapted from Eurostat & OECD. 2007. Eurostat-OECD Manual on Business Demography Statistics. OECD.

⁸ Adapted from European Commission. 2011. Policies in support of high-growth innovative SMEs. An INNO-Grips Policy Brief by Empirica Communication and Technology Research. Principal author: Stefan Lilischkis. Bonn, June 2011.



Small and Medium Enterprise (SME):

The NSBA⁹ provides a general definition for “small business”, which is supplemented by a schedule of sector-specific definitions according to number of full-time equivalent (FTE) paid employees, total annual turnover and total gross asset value. The overarching definition encompasses micro, very small, small and medium enterprises that operate as separate and distinct business entities, including co-operative enterprises and non-governmental organisations. The supplementary schedule provides a relatively large range of what constitutes a “small business”. For example, a medium size enterprise in the agriculture sector classified with less than R4 million turnover is considered to be a small business. While a medium size enterprise in the wholesale trade, commercial agents and allied services sector may have up to R50 million turnover and still be considered a small business.

In the interests of a working definition for the purposes of this research, we have considered the relatively simple thresholds applied under the Broad-Based Black Economic Empowerment (B-BBEE) framework, which identify Qualifying Small Enterprises as those businesses with a turnover of up to R50 million.

Guidance and a departure point on a definition of the ‘medium’ portion of SMEs are more difficult to come by. Consequently, we have applied a practical approach that loosely considers medium-size enterprises as those with a turnover of R50 million to R100 million. R100 million is a relatively common distinguishing threshold that government applies in reporting statistics, such as R&D expenditure in relation to the R&D Tax Incentive discussed in this paper. Typically, R100 million denotes the start of ‘larger’ enterprises and by implication, the top end / limit of ‘medium-size’ enterprises.

Start-up:

An enterprise in the early stages of its life cycle. In this phase, the entrepreneur typically moves from the idea stage to securing seed finance, formally registering or establishing the business, and initiating operations.

Start-up and early-stage funding:

“Funding for new companies being set up or for the development of those which have been in business for a short time (one to three years)”¹⁰.

Seed Funding:

“Funding for research, evaluation and development of a concept or business before the business starts trading”¹¹.

Venture Capital:

Seed or start-up and early-stage capital¹². “A subset of the private equity asset class which deals with predominantly equity funding of high tech, high-growth-potential businesses, whose growth is typically achieved through radical global scaling. The need for venture capital stems from the specific requirements of such businesses in the start-up and early growth phases, and the part that experienced venture capital fund managers can play in structuring and nurturing investments into these businesses”¹³.

⁹ Republic of South Africa. President’s Office. 1996. No. 102 of 1996: National Small Business Act, 1996. www.info.gov.za

¹⁰ KPMG and SAVCA. 2014. KPMG and SAVCA Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2013 calendar year. Glossary. www.kpmg.co.za, Pg 67.

¹¹ Ibid, Pg 67.

¹² Ibid, Pg 67.

¹³ Lamprecht, S. J. and van der Walt, G (Venture Solutions). L. 2012. Southern African Venture Capital & Private Equity Association 2012 SAVCA Venture Solutions VC survey. www.savca.co.za, Pg 5.





4 Acronyms

AUTM	Association of University Technology Managers
BioTech	Biotechnology/Biological Technology
CGT	Capital Gains Tax
CRDF	Commercialisation of Research and Development Fund
DST	Department of Science and Technology
dti	Department of Trade and Industry
ED	Enterprise Development
EIS	Enterprise Investment Scheme
ERP	European Recovery Programme
ESVCLP	Early Stage Venture Capital Limited Partnership
ESVF	Early Stage Venture Fund
EVCA	European Venture Capital Association
ExCon	Exchange Control
FAIS	Financial Advisory and Intermediary Services
FCPI	Fonds Commun de Placement pour l'Innovation
FI	France Investissement
FinSurv	Financial Surveillance Department
FIP	Fonds d'Investissement de Proximite
FSB	Financial Services Board
FTE	Full-Time Equivalent
GDP	Gross Domestic Product
GP	General Partner
ID	Identity Document
IDC	Industrial Development Corporation
IIF	Innovation Investment Fund
IIFF	Innovation Investment Follow-on Fund
IP	Intellectual Property
IPAP	Industrial Policy Action Plan
IPO	Initial Public Offering
IPR-PFRD Act	Intellectual Property Rights from Publicly Financed Research Act No 51 of 2008
ISP	Incubation/Incubator Support Program
IT	Information Technology
LP	Limited Partner
NDP	National Development Plan
NGP	New Growth Path
NIPF	National Industrial Policy Framework
NIPMO	National Intellectual Property Management Office
NIS	National Innovation System
NSBA	National Small Business Act
NT	National Treasury
NZLP	New Zealand Limited Partnership
NZVIF	New Zealand Venture Investment Fund
REIT	Real Estate Investment Trust



R&D	Research and Development
SA	South Africa
samaf	South African Micro-Finance Apex Fund
SARS	South African Revenue Service
SAVCA	South African Venture Capital and Private Equity Association
SBIC	Small Business Investment Company
SBP	Small Business Project
SCIF	Scottish Co-investment Fund
Seda	Small Enterprise Development Agency
SEEDS	Start-up Enterprise Development Scheme
SME	Small and Medium Enterprise
S-ROI	Social Return on Investment
SR&ED	Scientific Research & Experimental Development
SSA	Sub-Saharan African
SSCF	Spain Startup Co-investment Fund
STEM	Science, Technology, Engineering and Mathematics
SVM	Silicon Valley Model
TAF	Technology Acquisitions Fund
TEA	Total Entrepreneurial Activity
TFP	Total Factor Productivity
TIP	Technological Incubators Programme
TIS	Technology Incubation Scheme
UK	The United Kingdom
USA	United States of America
VC	Venture Capital
VCC	Venture Capital Company
VCLP	Venture Capital Limited Partnership
VCT	Venture Capital Trust



5 Introduction

5.1 SiMODiSA's story

“Vision without action is just a dream, action without vision just passes the time, but vision with action can change the world” Nelson Mandela

We believe South Africa has many entrepreneurs and an inherent entrepreneurial culture, where problem solving is a frequent occurrence. South Africans are resourceful in the way that they overcome even the most basic obstacles.

In an optimal environment, we believe this entrepreneurial spirit can be channelled towards innovation, lead to new job opportunities, grow both foreign and domestic revenues and skills, and contribute towards the creation of an inclusive and prosperous nation. Supporting the expression and growth of this innovative, entrepreneurial culture will contribute to solving at least some of the many challenges the country faces today, and will enable the attainment of important development objectives as articulated within the National Development Plan (NDP).

South African small business entrepreneurs have a vital role to play in the development and upliftment of the country and its people, particularly through the establishment of viable, scalable businesses that create jobs, provide transformative solutions, and have a meaningful, sustainable socio-economic impact. However, small businesses and technology-enabled start-ups, especially those with high-growth potential, must have a conducive and enabling environment within which to operate. Such an environment needs to be coupled with the availability of financial, marketing and regulatory support as well as technical capacity building. The power and potential impact of government support through the creation of a vibrant and dynamic entrepreneurial ecosystem is frequently underestimated. Through public-private partnership we believe this potential can be realised.

SiMODiSA is an industry association, pursuing a collaborative research, policy design and stakeholder engagement effort to catalyse entrepreneurship in South Africa. It represents key stakeholders from both the public and private sector and focuses on strategies to address two core pillars of entrepreneurship. Through its research, advocacy and policy review, SiMODiSA engages with government and the private sector to tackle key constraints to success experienced by entrepreneurs. Tackling barriers includes the development of practical solutions that will best overcome barriers to success and so support the creation of a more enabling environment and entrepreneurial ecosystem in South Africa. Secondly, SiMODiSA's Entrepreneurial Amplification programmes aim to bridge the gap between investors and entrepreneurs, and ensure that entrepreneurs are “investor-ready” through tools, training and networking forum events

The stakeholder engagement arm of this initiative is built on a platform of networking, publicity, marketing and event-based discussion designed to enhance entrepreneurial exposure and further enrich the entrepreneurial ecosystem. This engagement programme, by design, seeks to ensure that all participants in the entrepreneurial ecosystem are able to participate in identifying and prioritising issues to be addressed and in voicing their experience and suggestions for resolution.



5.2 SiMODiSA's objectives

SiMODiSA's primary goal is to substantially increase the quantity, quality and success rate of start-ups and SMEs in the country, thereby contributing to the significant growth of human capital and the permanent creation of formal, well-paying "decent" jobs. This goal is achievable by:

- Enhancing interactions between government and the private sector
- Reducing the regulatory burden and cost of compliance in starting a business
- Identifying and implementing effective policy mechanisms that will assist in promoting a robust, entrepreneurial and innovative domestic economy
- Embedding a national culture of entrepreneurship through amplification and the celebration of entrepreneurs at all levels of society

These goals align strongly with the stated objectives of the NDP, and are fundamental to the success of its implementation. SiMODiSA believes successful entrepreneurs are in a uniquely opportune position to deliver solutions to the challenges that South Africa faces, spurring our interest in accelerating and encouraging South Africa's entrepreneurial ecosystem development, and ultimately contributing towards the creation of meaningful jobs, economic growth and reduced poverty.

"If countries fail at creating jobs, their societies will fall apart. Countries, and more specifically cities, will experience suffering, instability, chaos, and eventually revolution. This is the new world that leaders will confront.

*What would fix the world – what would suddenly create worldwide peace, global wellbeing, and the next extraordinary advances in human development, I would say the immediate appearance of 1.8 billion jobs – formal jobs. Nothing would change the current state of humankind more."*¹⁴

– Jim Clifton in *The Coming Jobs War*.

¹⁴ Clifton, J. 2011. *The Coming Jobs War*. Gallup Press.



5.3 Background

5.3.1 High-Growth SMEs: Potential and principles for policy considerations

5.3.1.1 Introduction

The term “gazelle” originated in David Birch's 1979 report titled "The Job Generation Process," wherein he identified small, young – by implication dynamic and nimble – companies as the biggest creators of new jobs in the economy. Birch estimated that gazelles accounted for only 4% of all USA companies but for 70% of all new jobs. He also noted that the growth of gazelle companies far outpaced that of the Fortune 500 "elephants" or Main Street "mice".

More recently, the term “gazelle” has been more formally defined for policy development purposes by Eurostat and the OECD¹⁵ (and adopted by the likes of the European Commission¹⁶) as a sub-set of High-Growth Enterprises, which are those enterprises¹⁷ that have demonstrated more than 20% annualised growth in turnover or employees for a period of three years. In this context, Gazelles are considered high-growth enterprises that are less than five years old¹⁸, though there is still a lack of consensus over the definition used by practitioners versus policy-makers. Consequently, for the purposes of this paper, we use the more inclusive and intuitively descriptive definition of High-Growth SMEs to denote the fast-growing and dynamic businesses we seek to support towards realising their potential of significant job creation and economic development.

Intransigent poverty, growing levels of inequality and the collapse of economies across the world has resulted in governments worldwide turning their attention to HG-SMEs in the hope that they will grow, evolve into large companies¹⁹ and generate multiple new jobs along the way. Some of the classic examples of this, such as Walmart, Starbucks and Amazon, demonstrate clearly that growth is predominantly driven by organisational innovation (as detailed in Section 3 above²⁰) and not necessarily high-technology operations²¹. High-growth SMEs are in fact found in many sectors of the economy²².

In recent years, policy makers from around the world have been increasingly interested in how to escalate the initiation, growth and success of high-growth enterprises. Such enterprises are seen as important drivers of economic growth, employment and social value. They offer potentially significant leveraged returns to government investment as their success creates further growth in the ecosystem and supply chain. This growth is often assumed to be based on innovation, which has resulted in a keen focus on identifying effective policy measures to foster innovation as a precursor to a fertile environment for High-Growth and Innovative SMEs²³.

¹⁵ Eurostat & OECD. 2007. Eurostat-OECD Manual on Business Demography Statistics. OECD.

¹⁶ European Commission. 2011. Policies in support of high-growth innovative SMEs. An INNO-Grips Policy Brief by Empirica Communication and Technology Research. Principal author: Stefan Lilischkis. Bonn, June 2011.

¹⁷ The SME must have more than ten employees at the start of the three-year growth period.

¹⁸ Eurostat & OECD. 2007. Eurostat-OECD Manual on Business Demography Statistics. OECD.

¹⁹ European Commission. 2011. Policies in support of high-growth innovative SMEs. An INNO-Grips Policy Brief by Empirica Communication and Technology Research. Principal author: Stefan Lilischkis. Bonn, June 2011.

²⁰ Innovative SMEs: Innovative SMEs implement a “new or significantly improved product, process, marketing method, or organisational method in business practices, workplace organisation or external relations.” – Lilishkis 2011. Pg 11.

²¹ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

²² SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

²³ European Commission. 2011. Policies in support of high-growth innovative SMEs. An INNO-Grips Policy Brief by Empirica Communication and Technology Research. Principal author: Stefan Lilischkis. Bonn, June 2011.



For HG-SMEs to flourish, they require more than just funding investments or market incentives. As importantly, they require comprehensive, systematic support in the form of an enabling regulatory and policy environment, business networks, coaching, labour market mobility²⁴ and facilitated internationalisation²⁵. This non-financial support by both the public and private sectors²⁶, coupled with the removal of the administrative and legislative barriers in the entrepreneurial and innovation ecosystems²⁷, is particularly important in stimulating the growth and progression of HG-SMEs through the necessary phases of development in order to realise their growth potential.

A 20% growth rate doubles the size of a firm in four years. This is a substantial achievement for any company, and in the case of gazelles, this occurs within their first five years of operation. The speed at which these companies move through growth phases is exceptionally rapid. Consequently, they are even more susceptible to the barriers and hurdles to growth, which other companies may be able to navigate more slowly. Furthermore, given that high growth is strongly correlated with innovation, effective government policy needs to create an institutional base for innovation through which firms can grow and progress unimpeded. Such a base includes Intellectual Property Rights (IPR) regimes and Research and Development (R&D) mechanisms, which attract private investment²⁸.

5.3.1.2 Global Status Quo

Given the difficulty in assessing and ‘qualifying’ high-growth-potential firms in advance of their demonstrated growth, an appropriate policy focus is to create an enabling environment for any firm to experience one or more periods of high growth²⁹. This can be achieved by various measures. To this end, HG-SME policies internationally generally include a balance between providing R&D funding or incentives and instituting measures to increase the attractiveness or efficiency of the corporate ecosystem. These respectively demonstrate the focus on innovation as a key driver for growth and the desire to provide a more enabling local operating environment for SMEs.

A plethora of assessment metrics exist for ecosystem-support policies. However, the common denominators, many of which are highlighted in the recent Organisation for Economic Co-operation and Development (OECD) report³⁰ dedicated to government policies targeting HG-SMEs, include measures that address and remove the barriers to growth in the business environment, including compliance costs, market concentration, and IP valuation/rights³¹; improve access to both debt and equity finance; foster an entrepreneurial cultural mindset; support training and education to develop managerial skills and promoting networks of incubators or skill-

²⁴ Goldberg, I.; Trajtenberg, M.; Jaffe, A.; Muller, T.; Sunderland, J.; and Blanco Armas, E. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study.

²⁵ Lilishkis. 2011. Policies in Support of High-Growth Innovative SMEs. European Commission INNO Grips.

²⁶ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

²⁷ Murray, G.; Cowling, M.; Liu, W.; and Kallinowska-Besczynska, O. 2012. Government co-financed “Hybrid” Venture Capital Programmes: Generalizing developed economy experience and its relevance to emerging nations. Kauffman IRPR.

²⁸ Goldberg et al. 2006. Public Financial Support for Commercial Innovation, Europe and Central Asia Knowledge Economy Study – Part 1. World Bank ECSPF.

²⁹ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

³⁰ Ibid.

³¹ This is a particularly relevant aspect of high-growth SME policy, given the increased pressure on human, technical and financial resources created by rapid growth.

transfer systems that companies can tap into for support and expertise³²; and promote innovation and internationalisation³³.

According to contemporary HG-SME literature, policy makers are extending their horizons beyond access to financing and supporting R&D³⁴, to a more holistic view of the innovation and entrepreneurial ecosystems, and removing the barriers to entrepreneurship and growth³⁵. Murray et al. (2012) stress that:

““Policy surges” funding rapid genesis of a nascent industry are only effective if equivalent focus and effort is applied simultaneously to improving key elements of the entrepreneurial and innovation ecosystems.”³⁶

Simplifying policies that affect SMEs and reducing regulatory hurdles has become a major trend among most progressive countries. This is because most small businesses, particularly in the early phase, lack the resources to monitor the many different forms of assistance available to them³⁷. Countries, including Canada, Japan, Mexico, UK, New Zealand, the Netherlands and Denmark, are working to reduce red tape, simplify SME policies, and restrict the use of policies to correcting existing market failures³⁸. One way in which this has been done is by facilitating venture capital (VC) financing into SMEs, which has been shown to increase growth rates³⁹ and innovation⁴⁰ amongst recipients.

A recent report by Bain & Company, focused on restoring Europe’s SMEs in the wake of the financial crisis, found that high growth was often driven by niche expertise or an early focus on internationalisation⁴¹. This extends the scope of ecosystem-focused policies, and is echoed by an OECD study that found that gazelles in “catch-up” countries, further from the tech-frontier, are far more export-focussed⁴². These gazelles are also able to grow faster than those in already developed countries as they are able to replicate many of the technologies and methods, and are not subject to the same diminishing returns as capital-rich countries⁴³.

5.3.1.3 South African Status Quo

The overall picture of South Africa’s HG-SME landscape is one of pressing concern. There are no specific policy measures dedicated to explicitly target and grow SMEs with high-growth potential beyond general SME policy. More importantly, it is clear that general SME policy and the overall SME environment is far from conducive. In this regard, most obvious concerns emanate from the observation that the discontinuation rate of 4.9% exceeds the established business rate of 2.9%. In other words, South Africa is experiencing a net loss of small businesses⁴⁴ at a time when policy rhetoric is focussed on growing them. Given the link between firm growth and

³² OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

³³ Ibid. Pg 10.

³⁴ Ibid.

³⁵ OECD. 2013. Economic Policy Reforms 2013: Going for Growth, OECD Publishing.

³⁶ Murray et al. 2012. Government co-financed “Hybrid” Venture Capital Programmes: Generalizing developed economy experience and its relevance to emerging nations. Kauffman IRPR. Pg 1.

³⁷ Mitusch, K. and Schimke, A. 2011. Gazelles. High-Growth Companies. Europe Innova, Task 4, Horizontal Report 5.

³⁸ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

³⁹ Lilishkis. 2011. Policies in Support of High-Growth Innovative SMEs. European Commission INNO Grips.

⁴⁰ Kortum, S. and Lerner, J. 2001. Does Venture Capital Spur Innovation? NBER Working Paper No. 6846.

⁴¹ Bain & Company. 2013. Restoring Financing and Growth to Europe’s SMEs. Four sets of impediments and how to overcome them.

⁴² OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

⁴³ Mitusch, S. 2011. Gazelles. High-Growth Companies. Europe Innova, Task 4, Horizontal Report 5.

⁴⁴ Herrington & Kew. 2013. South African Report. Twenty years of Democracy. GEM



employment, a focus on fostering firms with high-growth potential is clearly a key component of any job-creation mandate⁴⁵.

In comparison to other Sub-Saharan African (SSA) countries, South Africa performs poorly with regards to the rate of nascent and new entrepreneurs. While South Africa has a rate of 6.6% nascent and 4.1% new entrepreneurs, both of these rates fall substantially below the 15.2% and 17.1% of other SSA countries. Despite these shortcomings, there has been a distinct upwards trend over the last decade in both of these rates, which is somewhat encouraging⁴⁶. The SME failure rate, estimated at 75%, is one of the highest in the world⁴⁷ and a glaring symptom of the difficulties inherent in the SME environment. It is imperative that the needs of SMEs are prioritised and that their regulatory environment is transformed⁴⁸. High-growth SMEs face the same challenges as SMEs, but the barriers to growth in the environment hit them harder. It is therefore crucial that these barriers are addressed to enable them to continue on a high-growth trajectory⁴⁹.

In addition to addressing the obvious barriers to growth, it is important to focus on the primary driver of growth viz. innovation. To this end, the efforts and intentions of government to support innovation is a step in the right direction, despite the ongoing changes necessary to correct major deficiencies in existing policies.

5.3.1.4 Conclusion

Policies that target innovation, entrepreneurship and SMEs in general are without a doubt of benefit to HG-SMEs. However, alone they are insufficient to provide the kind of enabling environment in which the potential for success is optimised. Instead, or in addition, a range of policies and regulatory mechanisms that specifically and directly address the issues that HG-SMEs face is essential. While SME policies generally focus on the quantity of start-ups and stability within the ecosystem, HG-SME policies emphasize quality and dynamism of start-ups⁵⁰. Both policy aspects are integral and should coexist to correct market failures⁵¹, encourage new business activity and ultimately enhance social welfare⁵². The focus on innovation and internationalisation in HG-SME policy is self-evident; “Innovative companies that seek to grow quickly need large markets”⁵³ and in the 21st century, the largest markets are international.

For gazelles, as young HG-SMEs, the three most fundamental determinants of growth are when management actively targets company growth; they supply a rapidly growing market; and growth finance is readily available. However, these influences function most optimally amid the framework of a supportive and enabling business environment⁵⁴.

The recommendations put forward in this paper address key priority barriers within South Africa’s ecosystem through a holistic lens. They cover issues around Public-Private Funding mechanisms, the Venture Capital Company (VCC) regime, Exchange Control limitations to international expansion, Entrepreneurial Immigration,

⁴⁵ SBP. 2013. Developing a New Path for SMEs in South Africa. Reassessing for growth. www.SBP.org.za

⁴⁶ Herrington, M. and Kew, J. 2013. South African Report. Twenty years of Democracy. GEM

⁴⁷ Olawale, F. and Garwe, F. 2010. Obstacles to the growth of new SMEs in South Africa: A principal component analysis approach. African Journal of Business Management 2010. Vol 4(5).

⁴⁸ SBP. 2013. Developing a New Path for SMEs in South Africa. Reassessing for growth. www.SBP.org.za

⁴⁹ FinScope. 2011. South Africa Small Business Survey 2010. Finmark Trust.

⁵⁰ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

⁵¹ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study.

⁵² Lilishkis, S. 2011. Policies in Support of High-Growth Innovative SMEs. European Commission INNO Grips.

⁵³ Ibid.

⁵⁴ Ibid.



Intellectual Property (IP), R&D Incentives and Labour Market reform. The second phase of the research builds on this platform, and aims to recommend solutions to the critical long-term issues and barriers in this arena. Solutions explored in phase two include simplifying the regulatory framework, establishing a support network to enhance the skill level among small and young enterprises, and entrenching a cultural identity of research, innovation and entrepreneurship.

5.3.2 Introduction to Entrepreneurial Archetypes

Endeavour's State of Entrepreneurship in South Africa White Paper⁵⁵ draws on four Archetypes that were identified through research originally conducted by the Monitor Group in 26 countries. These Archetypes reflect the different natures of entrepreneurship and the conditions under which these may flourish in countries, regions and cities. They differ based on the special conditions or assets that form the ecosystems to foster entrepreneurship within local environments. Individually and collectively they are useful tools through which we can assess and describe the specific conditions in a given area and, based on this, develop practical, targeted strategies and policies to encourage entrepreneurship and ideal entrepreneurial ecosystems in that area. In this way, the best path to promoting entrepreneurship can be mapped out through an assessment of the local context. This will enable important resources and assets in the country, its cities and regions to be exploited for the purposes of fostering entrepreneurship.

A number of key principles were highlighted in this research that can be applied in identifying and developing policy measures / recommendations for refinement of existing policy measures. Some of these principles include:

- Develop policy measures / recommendations for refinement in line with existing local strengths.
- Consider 'clusters' (local, geographic and industry-based clusters that connect and form as a repository of specialist expertise, technology and institutions) that may be regionally specific and can form a platform to generate business and foster entrepreneurship.
- Engage with entrepreneurs to gain insight into the key resources needed in their local entrepreneurial environment.
- Focus on a specific set of mutually reinforcing policy measures that will yield the greatest returns, across entrepreneurial ecosystems⁵⁶.

The Entrepreneurial Archetypes, and most especially the Silicon Valley, Mothership and Trigger Models, represent an important departure point in the ecosystem approach taken, and the specific policy measures considered, in this Position Paper. Consequently, the key enablers inherent in these models constitute a critical component of our thinking in terms of analysing the key challenges, opportunities and existing assets to exploit in pursuit of innovative and growing entrepreneurial ecosystems in South Africa. The key features and enablers of the archetypes can be summarised as follows:

⁵⁵ Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org

⁵⁶ Monitor Group. 2009. Paths to Prosperity, Promoting Entrepreneurship in the 21st century.



Table 1: Summary Overview of the Entrepreneurial Archetypes⁵⁷

Archetype	Overview	Key enablers
The Silicon Valley Model	IP is developed at or near major research universities & research centres (Govt.-funded innovation), & is commercialized, often with the help of angel investors and venture capital.	World-class universities & research centres (Govt.-funded innovation) Community of angel investors and venture capitalists (VCs) linked to above institutions Efficient patenting & licensing of new products Education & support for inventors to understand IP rights & protection, how to approach funders & commercialise products Business skills support Access to global markets and export potential
The Mothership Model	Large local companies that spin off smaller entrepreneurial ventures; help employees set up new ventures. They support these smaller ventures as suppliers, customers or distributors.	Pool of large private sector or state-owned firms Talented/skilled executives within large corporates who have entrepreneurial edge Incentives for large companies to create & nurture spin-offs
External Trigger Model	External event/circumstances trigger entrepreneurship, releasing many skilled & experienced people into the market, freeing them to start their own businesses.	Government policy to mobilise these skills for creation of new businesses (e.g. B-BBEE – qualification for ED & supply-chain access) Availability of quick and efficient financing options for such businesses
Local Hero Model	The success of a great local hero inspires others to start businesses (inside or outside the local hero's industry).	Institutions & media houses that emphasise putting the spotlight on successful entrepreneurs Culture of celebrating entrepreneurship

5.3.2.1 Silicon Valley Model

Under the Silicon Valley Model (SVM) of entrepreneurship, intellectual property (IP) developed at or near major research universities and research centres is commercialised, often with the help of venture capital and angel investors⁵⁸. This model is inspired by Silicon Valley itself, located in the San Francisco Bay Area. Silicon Valley is home to successful companies such as Google, Apple and Facebook, which have excelled in turning technology, such as computers, web services and smartphones, into mass products.

Numerous factors came together to contribute to the success of Silicon Valley, including its entrepreneurial culture, massive government investment in the form of funded innovation, significant private sector investment, and the transfer of technology from academic centres, such as Stanford University and the University of California, Berkley, to industry.

A further significant contributor was the influx of highly educated and highly skilled personnel into the area. Additional successful examples of this model can be seen in Boston's Route 128, Singapore and Israel⁵⁹. It is

⁵⁷ Summary developed as composite of information sourced from Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org

⁵⁸ Jongwe, A. 2012, 1 November. Archetypes of Entrepreneurship, The Financial Gazette, Zimbabwe News.

⁵⁹ Rao, A. and Scaruffi, P. A History of Silicon Valley, The Largest Creation of Wealth in History: A Moral Tale: Conclusions.

important to note that even though Silicon Valley centres on high-tech IP, this model can be applied to all types of IP.

The key special conditions/enablers for this model include:

- Researchers at high-quality universities and/or research centres create breakthrough IP products and services
- These products and services are commercialised quickly and efficiently through investment and support of efficient and competent local venture capitalists (VCs), angel and seed investors
- Active connection and engagement, generally through networks, between the universities, research centres and academics, and the local VC community, angel and seed investors and funders
- Researchers (i.e. potential entrepreneurs) need full support from their educational institutions on understanding their IP rights and regarding education and support on how to protect their IP, approach funders and commercialise their products
- Government is fulfilling its role in leading increased transformation of entrepreneur's IP into practical and commercialised products, as well as the efficient patenting and licensing of new products
- Researchers/SVM entrepreneurs must have access to advice from a network of skilled professionals who are able and willing to give the advice
- Potential, through encouraging exports and access to global markets, to scale up the market or potential market using the IP⁶⁰

According to the White Paper from which these key enablers are derived, South Africa possesses the appropriate building blocks for the Silicon Valley Model, with academic institutions such as the universities of Pretoria, Stellenbosch and Cape Town "laying the foundations of the archetypal Silicon Valley Model"⁶¹.

5.3.2.2 Mothership Model

Under the Mothership Model of entrepreneurship, large companies create entrepreneurial ventures in a number of ways, including through spin-off companies, by helping entrepreneurial employees depart to start their own businesses or set up new ventures, or by buying out core functions that would be better outsourced through independent entities. These large companies offer support to these start-ups or support their own smaller suppliers, customers or distributors directly or indirectly⁶².

The key enabler characterising this form of entrepreneurship is the existence of large private sector or state-owned firms⁶³. Further enablers include:

- Talented/skilled executives within large corporates who have an entrepreneurial edge
- B-BBEE and ED legislations and mechanisms being used to create and nurture spin-offs. The White Paper suggests amendments to BEE and ED in its current form to achieve this end

⁶⁰ Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org

⁶¹ Ibid. Pg 12.

⁶² Ibid.

⁶³ Jongwe, A. 2012, 1 November. Archetypes of Entrepreneurship, The Financial Gazette, Zimbabwe News.

- Existing industry clusters that can be leveraged as platforms for spin-offs under the Mothership Model⁶⁴

South Africa's oligopolistic economy is dominated by the presence of large corporates and state-owned firms that have the potential to be motivated and incentivised through refinement of existing B-BBEE and ED legislation and mechanisms to create spin-offs. As such, the Mothership Model presents an additional opportunity to spur entrepreneurial-ecosystem development in South Africa. Fundamentally, this model could significantly assist in creating a more dynamic and competitive business culture, thereby in and of itself acting to stimulate an entrepreneurial culture in the country.

5.3.2.3 External Trigger Model

The External Trigger Model constitutes entrepreneurship that flourishes as a result of a specific event or circumstance, and releases many skilled and experienced people into the market, freeing them to start their own businesses. The model presupposes that there are other conditions in the environment that make new opportunities possible⁶⁵; for example, available business support services where needed⁶⁶. This Model was seen in the Washington DC area, where repeated government downsizing resulted in an increase in start-ups and entrepreneurship⁶⁷. In South Africa, international sanctions in the 1970s and 1980s acted as a trigger in the creation of many new South African-owned entities through managed buy-outs from international firms departing the country to meet sanction obligations.

It is our view that the main external trigger acting today and releasing many skilled people into the South African marketplace is the economic downturn as a result of the 2008 Financial Crisis, coupled with South Africa's B-BBEE policies. These have resulted in:

- Numerous retrenchments of skilled and experienced people in South Africa, freeing them into the marketplace
- Numerous unemployed skilled people in South Africa, including but not limited to, post-graduates in the marketplace
- An influx of skilled foreigners into South Africa and their desire to live or work in the country

In the South African context, there is a high level of overlap between the Mothership and the External Trigger models, with the former operating as a mechanism through which to harness the potential presented by the External Trigger Model. An important enabler in this context is government's responsiveness, approach and policies to channel these skills towards the creation of new businesses. In this regard, the existence of B-BBEE and ED legislation and mechanisms can be leveraged to mobilise the skilled and/or experienced to foster economic transformation through entrepreneurship. The White Paper proposes further development of the B-BBEE and ED legislation to foster entrepreneurship⁶⁸.

⁶⁴ Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org

⁶⁵ Ibid.

⁶⁶ Monitor Group, 2009. Paths to Prosperity, Promoting Entrepreneurship in the 21st century.

⁶⁷ Ibid.

⁶⁸ Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org

5.3.2.4 Local Hero Model

The Local Hero Archetype refers to entrepreneurship inspired by the success of others. “A “local hero” entrepreneur is admired by others and inspires others to start businesses within or outside the local hero’s industry”⁶⁹. What is fundamental to this model is the fact that the local hero influences the mindset and attitudes of potential entrepreneurs. An example of such a local hero is Nkhensani Nkosi, who started her fashion label in South Africa, Stoned Cherrie. She has acknowledged that she was influenced by township entrepreneurs despite tough operating conditions⁷⁰. A further example is evident in the case of Medronic, a global leader in implantable pacemakers. Medronic was founded by Earl Bakken in 1949 who, with the help of the government and the University of Minnesota, catalysed nearby medical device start-ups and service firms, ultimately establishing one of the largest medical device clusters in the USA. It is important to note that these occurrences are influenced by many factors, which makes this model difficult to replicate⁷¹.

It is important to understand the national cultural ethos that supports the development of the Local Hero Archetype. Anthony Jongwe in his article “Archetypes of Entrepreneurship” highlights that a crucial enabler of the Local Hero Model is the action of institutions and media houses that shine the spotlight on successful entrepreneurs⁷². Such celebration and exposure serves to foster a culture of entrepreneurship. The White Paper on The State of Entrepreneurship in South Africa highlights that a deliberate effort must be made to foster an entrepreneurship culture in South Africa⁷³.

5.3.3 Innovative and Growing Entrepreneurial Ecosystems

Ecosystems involve a complex network of interconnected systems of elements or ‘organisms’, which constantly interact and ideally mutually reinforce one another in a positive way. Similarly, many believe that the entrepreneurial ecosystem involve a number of moving parts that are required to interact on an ongoing basis. These elements rely on each other in order to achieve success and yield growth and innovation as primary desired outcomes. Consequently, one should not view the components of the entrepreneurial ecosystem in isolation, particularly when considering policy measures that can stimulate and catalyse innovation and growth. Rather, the components should be considered in how they contribute in concert to the vitality of the ecosystem as a whole, and as individual parts.

In this context, consideration must be given to the full range of elements of the entrepreneurial ecosystem in South Africa, which is the overarching ecosystem within which SMEs and start-ups operate. Specific attention must be paid to how these elements interact and how they might be enhanced through policy action to mutually reinforce each other. Equally, cognisance of the specific elements and features of the Entrepreneurial Archetypes, as identified above, together with the more specific and localised entrepreneurial ecosystems they may represent, must be taken. This will aid in identifying a comprehensive suite of mutually reinforcing policy measures that work together to enhance these more specific ecosystems, as well as the entrepreneurial landscape in South Africa as a whole.

⁶⁹ Ibid. Pg 23.

⁷⁰ Ibid.

⁷¹ Monitor Group, 2009. Paths to Prosperity, Promoting Entrepreneurship in the 21st century.

⁷² Jongwe, A. 2012, 1 November. Archetypes of Entrepreneurship, The Financial Gazette, Zimbabwe News.

⁷³ Endeavour South Africa. No Date. The State of Entrepreneurship in South Africa, The Key Archetypes of an Entrepreneurial Culture, 3rd Edition, White Paper: Deliberations and Key Findings. www.endeavour.org



To this end, key components of Innovative and Growing Entrepreneurial Ecosystems are mapped in Figure 1 below. Following this is Table 2, which unpacks these core components further and correlates them to the SiMODiSA Task Teams and Entrepreneurial Archetypes.

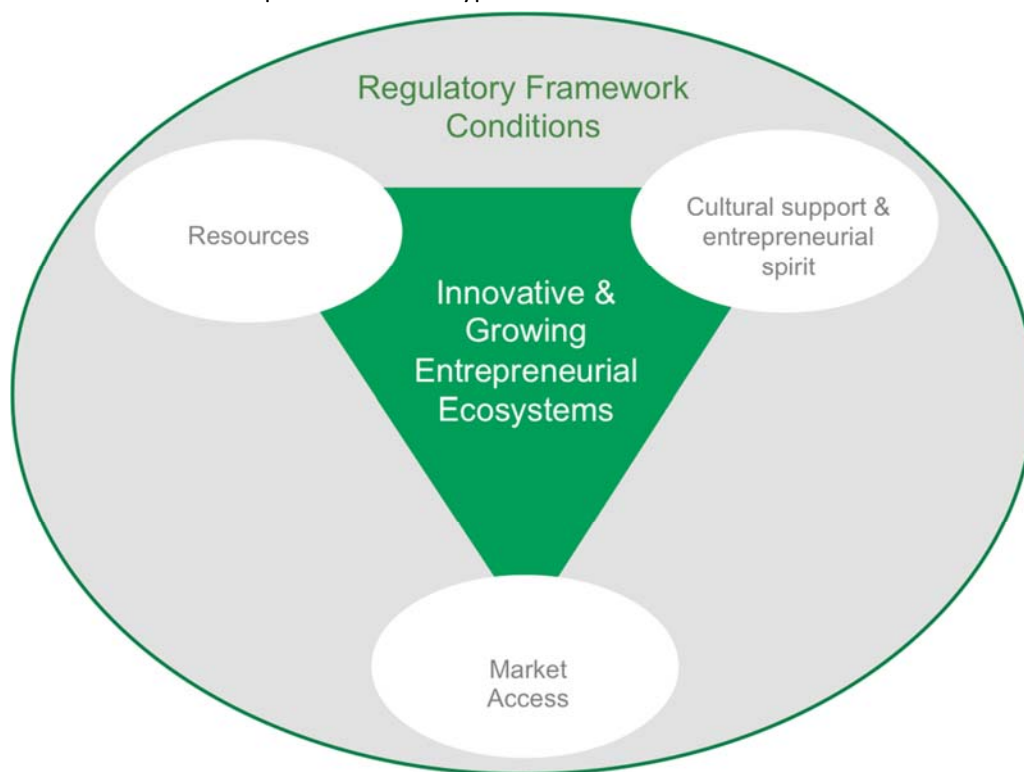


Figure 1: Components of Innovative and Growing Entrepreneurial Ecosystems⁷⁴

⁷⁴ Developed for this research as a composite of various types of entrepreneurial ecosystems considered in relation to local contexts and dynamics.

Table 2: Relationship Between Entrepreneurial Ecosystem Components, SiMODiSA Task Teams⁷⁵ and Entrepreneurial Archetypes⁷⁶

Entrepreneurial Ecosystem Components		Task Team	Silicon Valley	Mothership / Trigger	Local Hero
Regulatory Framework Conditions	Regulatory & compliance of start-up & running business	R&RT	□	□	□
	Major universities as catalysts	IP&T / T&V	□		
	South Africa's BBBEE Framework	R&RT		□	
	Access to infrastructure (telecoms, broadband, elect, water etc.)	N/A	□	□	□
	Educational system & infrastructure	T&V	□	□	□
	IP ownership & exportability	R&RT	□		□
Resources	Funding & incentives	F&I	□	□	□
	Exchange Control Loop limitations	R&RT	□		□
	Human Capital	T&V / F&I	□	□	□
	Support System (mentors/advisors, professional services, networks etc.)	T&V / F&I	□	□	□
Market Access	Ease of trade & access to global supply-chains	R&RT	□	□	□
Cultural Support & Entrepreneurial Spirit	Tolerance of risk & failure (e.g. bankruptcy laws)	R&RT	□	□	□
	Positive image of entrepreneurship/self-employment as a preference	T&V	□	□	□
	Local heroes & role models	T&V	□		□
	Culture of research & innovation	IP&T	□		

While this Position Paper, and the broader process of which it is a part, adopts an overall ecosystems view and applies it to the consideration of the various policies that relate to this complex ecosystem, it is equally important to recognise that at a practical level, one cannot effectively address multiple layers of policy simultaneously. Consequently, our research process is split into two phases (see 5.5 Research Process below). The first phase focuses on primary policy barriers that, if effectively addressed, are anticipated to have a disproportionate positive impact, unlocking the potential of the ecosystem. Subsequently, phase 2 is intended to address secondary layers of policy, where change will contribute towards more innovative and growing entrepreneurial ecosystems in South Africa.

⁷⁵ An overview of the SiMODiSA Task teams is included in Appendix 2.

⁷⁶ The components that encompass specific policy recommendations and focus points in this First Position Paper are highlighted.

5.4 Scope of Work

This Position Paper represents the first key milestone in a collaborative research, stakeholder engagement and policy design effort by key participants from both the public and private sectors in South Africa. Spearheaded under the banner of the SiMODiSA Association and supported by the Omidyar Network, this document represents a synthesis of research findings compiled by The Impact Trust. Through a holistic, ecosystems approach to policy consideration and design, it aims to define concrete actions for regulatory and policy amendments. These amendments aim to enable and accelerate entrepreneurship and the establishment, growth and scale of young and growing firms in South Africa.

The scope of work encompasses a research, stakeholder engagement and design process that combines precedent and best practice evidenced both locally and internationally, and considers these practices in the context of practitioner and stakeholder experience. Stakeholder engagement and policy consideration are organised through four work streams, identified as both complementary to each other and critical to the creation and success of a holistic policy framework. These work streams include (i) Regulatory and Red Tape; (ii) Funding and Incentives; (iii) Skills and Talent; and (iv) Intellectual Property and Technology.

Ultimately, the full scope of work will culminate in January 2015 in a single integrated Position Paper for consideration by the South African government. The Position Paper is anticipated to include 12 key policy opportunities. This First Position Paper represents the first seven recommendations for policy refinement and amendment, identified for their potential domino effect. Arguably, changes in these elements could have significantly greater impact beyond the boundaries of the element itself, thereby amplifying impact to multiple components critical to stimulating South Africa's entrepreneurial ecosystem.



5.5 Research Process

The recommendations included in this Position Paper are based on findings sourced via a variety of data collection and engagement methods employed to gain perspective and input from a broad range of key stakeholders and contexts within South Africa's entrepreneurial ecosystem, including:

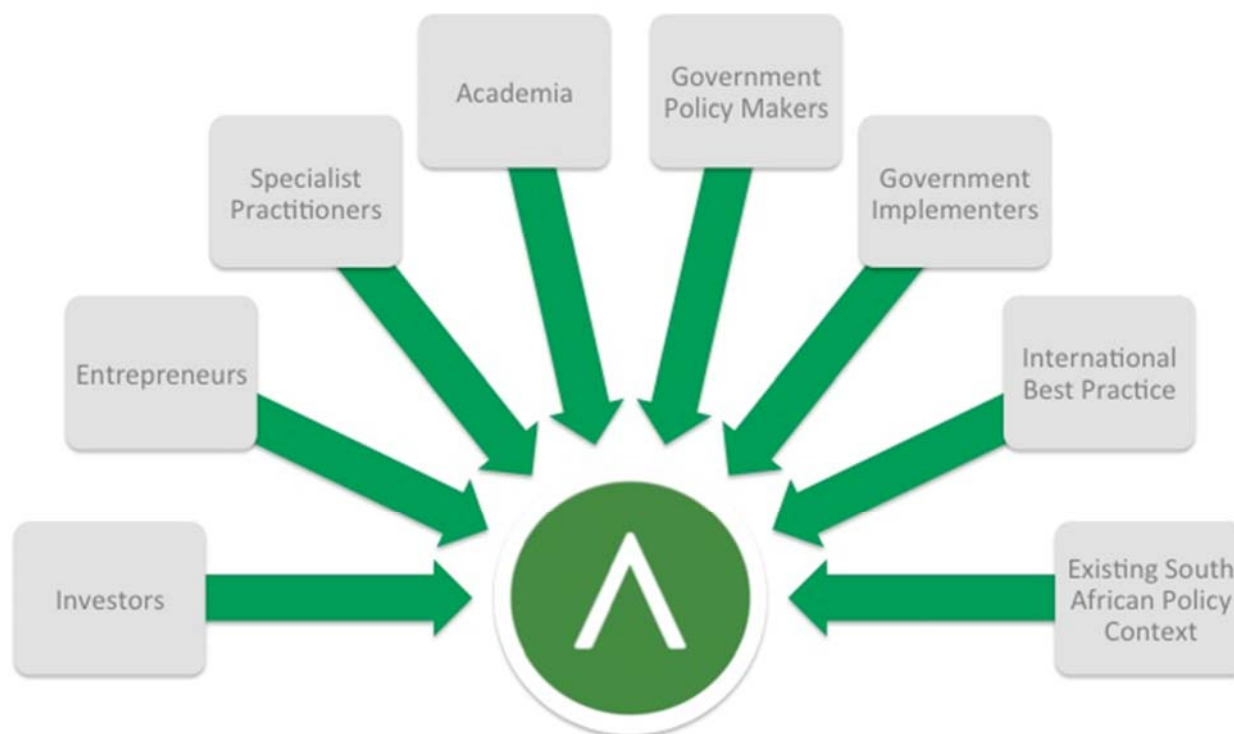


Figure 2: Research Inputs

The broad research process and key stages included (though in an iterative rather than purely linear process) initial stakeholder and expert engagement and analysis to determine the parameters of, and possible solutions to, the key issues to be addressed; desk-based research on existing policy details and international policy ideas including precedent; design, including deeper engagement with key expert advisors and stakeholders, as well as engagement with government officials and policy makers to determine design features and feasibility of recommendations; testing of the recommendations with the stakeholder group; and lastly, final refinement and design of recommendations compiled into this first Position Paper. Extensive engagement with stakeholders throughout the process is intended to ensure a viable suite of complementary recommendations can be submitted to government to inform Parliamentary policy decisions.

The research process will be duplicated in 2015, culminating in a second Position Paper. The recommendations from the second Position Paper will also be submitted to government and made available to stakeholders.



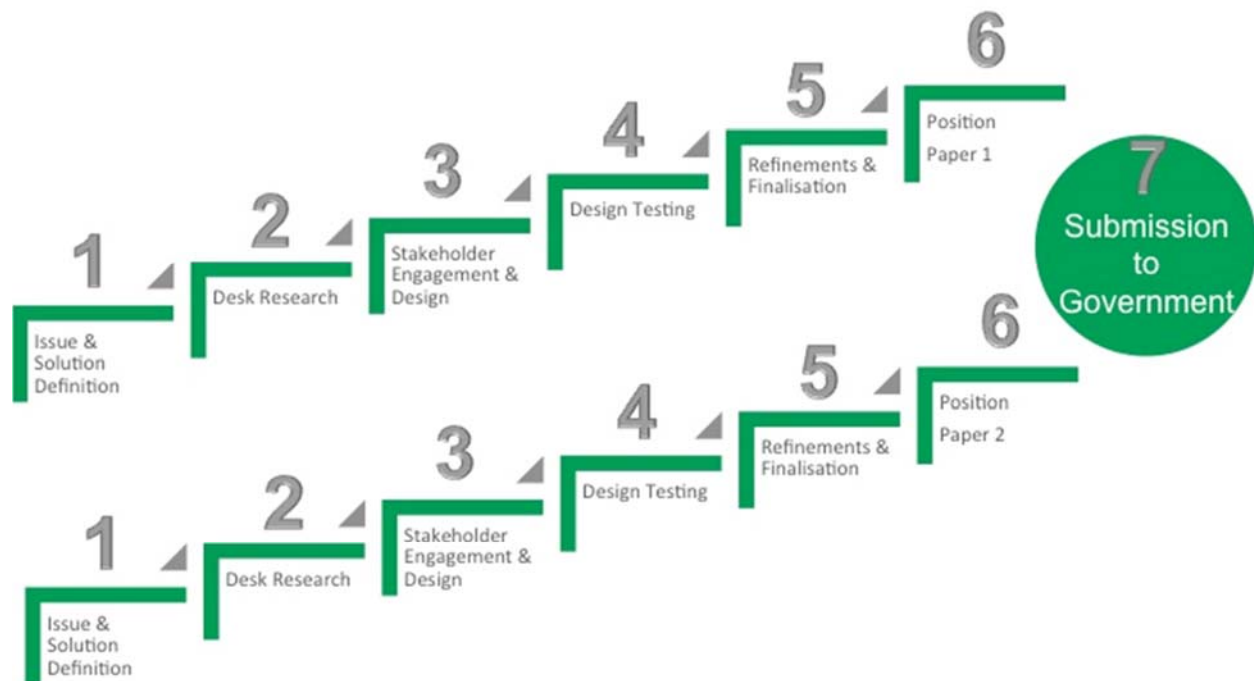


Figure 3: Overview of Overall Research Process and Milestones

Data collection methods have included secondary data based on literature review, complemented by primary data collected through individual interviews, focus group working sessions, working forums, conference calls, webinars and newsletters. SiMODiSA's core stakeholder group of 304 members was targeted in the data collection phase, with direct engagement with 198 stakeholders, per Figure 4 below:

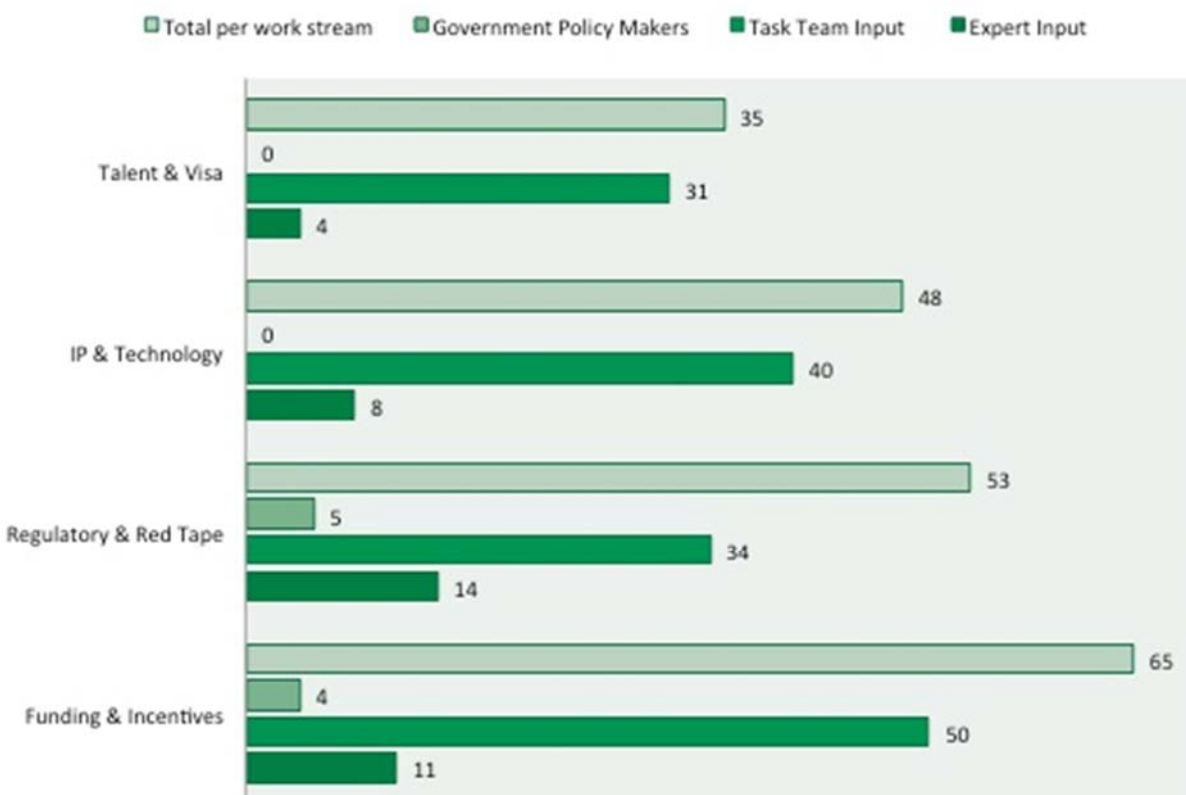


Figure 4: Direct Engagement (number of people) with Stakeholders During Phase 1

The primary role of the task teams has been to:

- Provide insight into the key challenges, opportunities and possible solutions at a local level in their areas of expertise and based on their efforts and practical experience of these
- Provide guidance and references to sources, examples and models of international precedent that could be relevant in a South African context
- Provide ongoing feedback and input into the design and testing of the policy recommendations within a South African context
- Participate in the critique and comment on documents submitted for task team review
- Communicate and advocate for the needs of SMEs and start-ups and how they can be supported through appropriate mechanisms for change

The research team has and will continue to liaise with government and relevant policy makers throughout the process to ensure recommendations pursued are practical, viable, and presented correctly. This high level of engagement seeks to ensure that all recommendations pursued have the highest potential for uptake and adoption by Parliament, and in turn, the potential to effect real change within the South Africa's entrepreneurial ecosystem.

5.6 South Africa's environment for small businesses and start-ups

5.6.1 The SME landscape in South Africa

"In South Africa, the environment for entrepreneurs is extremely regulated and hostile – ranging from unreasonable labour legislation to shoddy treatment by the state, parastatals and big business as clients. Unfair price squeezing and late payment for services are real issues. Even in the report of the National Planning Commission, the focus was on infrastructure spending while the development of an entrepreneurial culture was marginalised.

*Our goal for 2020 should be to create one million new businesses rather than five million jobs. It is the only way to create that number of jobs. Big business has changed its employment model and now subcontracts all its non-core activities to other companies; the government has not got the money to create five million extra civil servants; and public works programmes are a temporary solution."*⁷⁷

5.6.1.1 Status Quo

South Africa (SA) generates almost a quarter of Africa's Gross Domestic Product (GDP) and boasts the 18th largest stock exchange in the world. However, it also evidences the world's highest Gini coefficient, widespread unemployment among a largely unskilled and predominantly black populace and a tax base of just 10%⁷⁸. Poverty and joblessness on the one hand, and low level of skills on the other, demands a response that will drive inclusive growth and development. The acute problem of high unemployment suggests that young people are not acquiring the kinds of skills and experience needed to drive the economy forward. This inhibits entrepreneurship and the successful establishment of business activity; ultimately affecting economic development and the ability for South Africa to transition more readily to a developed world economy.

Growth in the much-documented "missing middle" of the South African SME ecosystem is widely acknowledged to be a critical priority in government and a focus of both the New Growth Path (NGP) and the NDP, the latter of which declares that "90% of jobs will be created in small and expanding firms" and "Regulatory reform will boost mass entrepreneurship"⁷⁹.

South Africa is especially lagging behind other developing countries in the area of entrepreneurship, and has experienced a marked decrease in entrepreneurial activity in recent years. The 2014 Global Entrepreneurship Monitor (GEM) states that South Africa's total entrepreneurial activity (TEA) rate decreased from 9.1% in 2011 to 7.3% in 2012. Though this rose again to 10.6% in 2013, it is still significantly below the average of countries with a similar economic development level, which average at a TEA of 14.4%. Perhaps more critically, the GEM 2014 report also found that South Africa's established business rate of just 2.9% is the fourth lowest in the world⁸⁰.

In addition to South Africa's low levels of entrepreneurship, it ranks only 41st in terms of the ease of doing business⁸¹. South Africa's overall business environment is fraught with unsupportive and disabling legislation,

⁷⁷ Sunter, C. 2012. Columnists: Clem Sunter: The latest South African scenarios. News24. www.news24.com

⁷⁸ Omidyar Network. 2013. Accelerating Entrepreneurship in Africa.

⁷⁹ National Planning Commission. 2011. National Development Plan: Vision for 2030. National Treasury. Pg 117 – 119.

⁸⁰ Amoros, J.E. & Bosma, N. 2014. Global Entrepreneurship Monitor 2014. GEM

⁸¹ The World Bank. 2014. Doing Business. Measuring business regulations. Doingbusiness.org



which favours large businesses and hinders access to affordable capital for SMEs⁸². The 2013 SME Growth Index produced by Small Business Project (SBP) corroborates this perception, reporting that participating firms experience the four largest impediments to growth as local economic conditions; a lack of skilled staff; difficulty accessing finance; and burdensome regulations⁸³.

Evidently, the success of entrepreneurship and small businesses in South Africa in the coming decades will be strongly contingent on innovative and decisive policy changes that shape a more supportive and enabling environment for SMEs and start-ups. There is a wide range of major challenges hindering SME growth in the current environment. These challenges are limiting the success of the sector as a whole. To achieve the goals stated in the NDP will require coordinated implementation of constructive solutions⁸⁴. Ultimately, no single policy change will effect transformation. Rather a suite of changes is necessary, incorporating both policies and intervention mechanisms that will serve to amplify and mutually reinforce business establishment and growth.

5.6.1.2 Key Challenges

There are numerous challenges facing SMEs in the current South African ecosystem. Among the most serious of these, as reported by various task team members in the working groups of this research, are access to stage-appropriate and affordable finance; lack of access to skilled labour; barriers to entry and operation; and complex and costly regulations. The most specifically damaging of these are believed to be the arduous process of starting a business in South Africa; South Africa's existing labour laws; Exchange Control prohibitions; and R&D restrictions.

5.6.1.2.1 Barriers to entry and operation

An open economy is a key driver of growth. According to a report by the UCT Centre for Innovation and Entrepreneurship, South Africa's market entry and participation remains difficult and unaffordable for new and growing businesses. In most cases, sectors are dominated by a few large, established businesses, which make it difficult for new and smaller businesses to compete⁸⁵. The NDP addresses the oligopolistic nature of South Africa's economy by stating government's intention to "decrease levels of economic concentration"⁸⁶; however, this will be significantly harder to achieve.

In most sectors, a consequence of this high industry concentration has been the development of a complex legislative system that is particularly punitive of non-compliance in order to regulate these big firms. This regulatory framework is exceptionally regressive so much so that smaller SMEs struggle to meet the demands or absorb the cost of compliance with such regulation. As a result, smaller SMEs are on the back foot relative to bigger companies. A recent report by the Omidyar Network found that "the complexity of legislation in South Africa, coupled with the harsh penalties imposed for non-compliance, is a significantly greater constraint for new entrepreneurial ventures than for those in peer [African] countries"⁸⁷. The same report found that compliance costs, which are easily absorbed by large businesses and make up 0.2% of turnover, are a considerable barrier to smaller firms, where such costs can comprise up to 8% of turnover.

⁸² Bergh, L. 2013. Sustainability-Driven Entrepreneurship. Perceptions of challenges and obstacles in a South African context. University of Cambridge.

⁸³ SBP. 2014. SME Growth Index. Easier, Harder for Small Business in South Africa. SBP. Johannesburg.

⁸⁴ National Planning Commission. 2011. National Development Plan: Vision for 2030. National Treasury.

⁸⁵ Herrington, M.; Kew, J.; Simrie, M. and Turton, N. 2012. Global Entrepreneurship Monitor 2011: South Africa. Global Entrepreneurship Monitor.

⁸⁶ National Planning Commission. 2011. National Development Plan: Vision for 2030. National Treasury.

⁸⁷ Omidyar Network. 2013. Accelerating Entrepreneurship in Africa.



5.6.1.2.2 Regulatory clarity

The clearer the regulatory framework within which SMEs operate, the lower the exposure to risk and uncertainty and the greater the level of confidence in forecasting and planning. The current regulatory system not only makes current SMEs less likely to succeed, it actively discourages many entrepreneurs from starting up in the first place⁸⁸. Many of the issues addressed in this paper feature persisting themes of a lack of clarity and insufficient guidelines around legislation and its interpretation and implementation. A blurry regulatory framework coupled with onerous compliance burdens further disadvantage small and early-stage businesses, removing what may be, perhaps, their single and unique advantage of being small, dynamic and more nimble than their larger, more established competitors.

5.6.1.2.3 Access to Finance

SMEs have four main funding channels to draw upon: personal, state, debt and equity. Debt and equity finance are both relatively well-developed sectors in South Africa; however, there are critical market failures in the provision of finance to both early-stage businesses and SMEs, particularly high-growth or high-tech SMEs⁸⁹. While entrepreneurs, wary of giving away equity too early, seem to frequently prefer debt financing if it's available⁹⁰, there are substantial benefits⁹¹ to obtaining equity financing from experienced investors⁹². Equity finance is more typically focused on large-scale investments and, where it is available to early-stage (pre-revenue) firms, there is a tendency to favour low-risk ventures⁹³. Debt finance, on the other hand, is generally contingent on demonstration of traction or revenue as well as on the provision of collateral. This leaves pre-revenue high-tech firms, whose primary assets are largely intangible (IP, Human Capital etc.) at a substantial disadvantage⁹⁴.

5.6.1.2.4 Skills development

Perhaps the major Achilles-heel of the South African SME ecosystem is the misalignment between the skills available in the populace and those required by the economy. This feature is worsened by draconian labour laws that inhibit flexibility in the easy removal of employees with skills that are not up to the task. It is important to note that there are two sides to this sword. Firstly, South Africa isn't creating entrepreneurs. This is evident in the inadequacy of business and entrepreneurial skills⁹⁵ and the paucity of critical thinking and problem solving capabilities generated by our schooling system⁹⁶. The second aspect of skills misalignment is that businesses are unable to draw on an existing or available pool of skilled labour, again due to failures in the schooling and training system. This puts smaller businesses at a particular disadvantage, as they do not have the resources available to train, mentor and develop talent; they need skilled labour, ready to hit the ground running and add value. Cultural factors play a large role in the prevalence of entrepreneurial ambition among

⁸⁸ SBP. 2014. SME Growth Index. Easier, Harder for Small Business in South Africa. SBP. Johannesburg.

⁸⁹ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

⁹⁰ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Publishing.

⁹¹ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

⁹² Sorensen. 2006. How Smart is Smart Money? A two-sided matching model of venture capital. Stanford Institute for Economic Policy Research.

⁹³ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

⁹⁴ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

⁹⁵ Endeavor. 2012. The State of Entrepreneurship in South Africa. Endeavor SA.

⁹⁶ Omidyar Network 2013. Accelerating Entrepreneurship in Africa.



the population, and a growing number of South Africans see entrepreneurship as a viable career choice⁹⁷. South Africa remains, however, a particularly risk-averse culture and one that is unforgiving of failure⁹⁸.

Beyond the issue of skills and entrepreneurial mindsets within the general workforce, and perhaps more significant in terms of willingness to engage in labour absorption and employment, South Africa's labour market dynamics are particularly stringent and are seldom ranked outside of the bottom 20% globally. For example, the 2013 World Economic Forum (WEF) Global Competitive Index ranks South Africa's labour-market efficiency at 113th out of 148⁹⁹. In the same ranking, South Africa fails dismally on a number of other labour measures including the health of the workforce (133rd out of 148); the quality of the educational system (146th out of 148); and labour market dynamics (ranging between 116th and 148th out of 148)¹⁰⁰.

5.6.1.3 In Summary

The NDP outlines a vision and potential policy response designed to facilitate the target of 6% unemployment by 2030. This job creation is a necessity if South Africa seeks to reach a high-growth trajectory. SMEs, particularly HG-SMEs, are a crucial source of this growth as contributors to job creation and economic prosperity. SMEs already account for 91% of formalised businesses and provide employment to about 60% of South Africa's labour force¹⁰¹.

The NDP demands the creation of 11 million jobs over the next 15 years and a target economic growth rate of 5.4% per annum. An important factor working to support this goal is the current demographic profile of the country, which suggests we are in "a sweet spot" given our proportionately high working age population and the lower level of old and young unable to contribute to this growth. This situation will change after 2030 when a greater proportion of the population ages¹⁰². However, it provides a unique window of opportunity for the private sector and government to capture the potential of the working force, including the youth, entrepreneurs and creativity that exist in the country. Harnessing this potential requires immediate interventions to increase the level of human capital in the labour force. Similarly, urgent action needs to be taken to address policy frameworks and mechanisms that currently hinder entrepreneurial growth and the start-up and success of new small businesses, which are capable of contributing significantly to jobs and livelihoods.

To achieve the goals laid out in the NDP, particularly of job creation and economic growth, will require considerable reshaping of the entrepreneurial ecosystem in which SMEs and start-ups operate. The recommendations in this paper specifically seek to address some of the fundamental barriers to SME establishment, growth and success given the inherent features of the overall South African business environment.

⁹⁷ Omidyar Network 2013. Accelerating Entrepreneurship in Africa.

⁹⁸ Endeavor. 2012. The State of Entrepreneurship in South Africa. Endeavor SA.

⁹⁹ WEF. 2013. Global Competitive Index: The Africa Competitiveness Report. WEF.

¹⁰⁰ Ibid.

¹⁰¹ The Banking Association South Africa. 2013. Small & Medium Enterprise. The Banking Association South Africa. www.banking.org.za

¹⁰² National Planning Commission. 2011. National Development Plan: Vision for 2030. National Treasury.



5.6.2 Government's strategic direction

“South Africa displays features of a low-growth, middle-income trap, characterised by lack of competition, large numbers of work seekers who cannot enter the labour market, low savings (hence a reliance on foreign capital inflows) and a poor skills profile. Many of these features are rooted in the evolution of the economy over the past 150 years. The net effect is high levels of unemployment and inequality, and low levels of investment”¹⁰³.

Acknowledging the value and significant economic growth and job creation contribution of the SME and start-up sectors within the entrepreneurial ecosystem, the South African government has committed to supporting SMEs and start-ups as growth engines and stabilizers in the economy. To this end, there have been a number of efforts over the last 20 years to create a regulatory framework that supports this critical sector.

Historically, the National Small Business Act¹⁰⁴ (NSBA) provided the legal framework and reference point for the small business sector in South Africa, as informed by the 1995 White Paper on National Strategy for the Development and Promotion of Small Business in South Africa¹⁰⁵. The NSBA was intended to provide for the establishment of the National Small Business Council and the Ntsika Enterprise Promotion Agency, and to provide guidelines for organs of state in order to promote small business in South Africa. This Act was amended in 2004¹⁰⁶, primarily to replace the Ntsika Enterprise Promotion Agency, along with additional designated agencies such as the National Manufacturing Advisory Centre, and provide for the establishment and incorporation of the Small Enterprise Development Agency (SEDA) to carry the promotion of small business in South Africa forward.

In 2005, the Department of Trade and Industry (dti) published the Integrated Small-Enterprise Strategy¹⁰⁷, building on the 1995 White Paper and presenting the way forward for small business development in South Africa for the period 2005 to 2014. In particular, the strategy aimed to address government's special development goals to improve equity in terms of race, gender and geographical location.

The strategy is based on the following three strategic pillars:

- Increasing supply of financial and non-financial support services
- Creating demand for small enterprise products and services
- Reducing small enterprise regulatory constraints¹⁰⁸

A key strategic departure from the 1995 White Paper involved the integration of a wider group of institutions into the small business development ecosystem and a more collaborative approach towards public and private sector partners. Examples of government entities and agencies envisioned as key actors here include the dti, which at the time was the mandated champion of small business development in South Africa in partnership

¹⁰³ Republic of South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission. Pg 28.

¹⁰⁴ Republic of South Africa. President's Office. 1996. No. 102 of 1996: National Small Business Act, 1996. www.info.gov.za

¹⁰⁵ Republic of South Africa. Parliament of the republic of South Africa. 1995. The White Paper on National Strategy for the Development and Promotion of Small Business in South Africa. The Department of Trade and Industry. www.thedti.gov.za

¹⁰⁶ Republic of South Africa. The Presidency. 2004. No. 29 of 2004: National Small Business Amendment Act, 2004. Cape Town: Government Gazette.

¹⁰⁷ Republic of South Africa. Department of Trade and Industry. 2005. The Integrated Small Enterprise Strategy: Unlocking the potential of South African entrepreneurs. www.thedti.gov.za

¹⁰⁸ Ibid.



with all spheres of government, the Seda, the South African Micro-Finance Apex Fund (samaf) and Khula Enterprise Finance.

More recently, the NDP, adopted in 2012, constitutes the strategic framework for South Africa's new growth trajectory. The NDP indicates the need for South Africa to build on social solidarity and to create a more caring South African society. It encourages efforts focused both on attacking poverty and on expanding a robust, entrepreneurial, and innovative economy. The NDP indicates, "South Africa needs an economy that is more inclusive, more dynamic and in which the fruits of growth are shared equitably. In 2030, the economy should be close to full employment, equip people with the skills they need, ensure that ownership of production is more diverse and able to grow rapidly, and provide the resources to pay for investment in human and physical capital"¹⁰⁹.

In relation to the promotion of employment in labour-absorbing industries, the NDP identifies that "most new jobs are likely to be sourced in domestic-oriented businesses, and in growing small-and medium-sized firms"¹¹⁰. This is consistent with global trends, where the vast majority of employment *creation* is attributed to small and expanding firms, with a disproportionate percentage attributed to High-Growth SMEs (HG-SMEs).

Transforming our economy is recognised as a challenging and long-term project, with the NDP recognising that South Africa needs to develop a more competitive and diversified economy. To this end, the plan proposes to:

- Raise levels of investment
- Improve skills and human-capital formation
- Increase net export levels

Such investment is anticipated to catalyse "rising employment, increased productivity, improved living standards and a decline in inequality. Rising rates of investment will be achieved initially through state spending on infrastructure, largely aimed at "crowding in" private-sector investment. The focus needs to be on infrastructure that promotes efficiency in the economy and reduces costs for business and for individuals"¹¹¹.

In support of realising the vision of the NDP, government has developed a range of supportive frameworks and policies that are informed by and intended to realise key objectives contained within the NDP. Of particular relevance here are The New Growth Path (NGP): Framework¹¹²; Accord 3: Local Procurement Accord¹¹³; Accord 4: Green Economy Accord¹¹⁴; and the Industrial Policy Action Plan IPAP 2013/14 – 2015/16¹¹⁵.

¹⁰⁹ Republic of South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission. Pg 28.

¹¹⁰ Ibid. Pg 29.

¹¹¹ Republic of South Africa. National Planning Commission: The Presidency. 2011. National Development Plan: Vision for 2030. Chapter 3: Economy and Employment. National Planning Commission. Pg 115.

¹¹² Republic of South Africa. Economic Development Department. 2011. The New Growth Path: Framework. Economic Development Department. www.economic.gov.za

¹¹³ Republic of South Africa. Economic Development Department. No date. New Growth Path: Accord 3: Local Procurement Accord. Economic Development Department. www.economic.gov.za

¹¹⁴ Republic of South Africa. Economic Development Department. No date. New Growth Path: Accord 4: Green Economy Accord. Economic Development Department. www.economic.gov.za

¹¹⁵ Republic of South Africa. The Department of Trade and Industry. 2013. Industrial Policy Action Plan: Economic Sectors and Employment Cluster: IPAP 2013/14 – 2015/16. The dti. www.thedti.gov.za



The NGP is described as South Africa's "vision to place jobs and decent work at the centre of economic policy"¹¹⁶. The Framework and its counterparts in the series are intended to stimulate a constructive discussion about South Africa's economic priorities in order to identify actions that can be undertaken by the private sector, labour and government towards addressing the country's employment and economic challenges¹¹⁷.

The Framework recognises that long-term structural change requires phasing in order to establish the prerequisites for success over time. For example, the Framework recognises the short, medium and long-term steps that can be taken over time to foster employment creation:

- Short-term: accelerate employment creation primarily through direct employment schemes, targeted subsidies and/or a more expansionary macro-economic package
- Short to medium-term: support labour-absorbing activities, particularly in the agricultural value-chain, light manufacturing and services. Here, government recognises it can encourage private investment in targeted sectors by a) prioritising labour-absorbing activities for the provision of infrastructure; b) implementing regulatory interventions that address market and state failures; c) implementing measures to improve skills systems; and d) in some instances, providing production and innovation subsidies
- Longer-term: increasingly support knowledge and capital-intensive sectors in order to remain competitive¹¹⁸

As such, the NGP considers drivers of employment, including substantial investment in infrastructure; targeting main economic (labour-absorbing) sectors of the agricultural and mining value chains, manufacturing and services; seizing the potential of new opportunities in the knowledge and green economies; investing in social capital and public services; and fostering spatial development through rural development and regional integration¹¹⁹.

The Local Procurement Accord is an accord developed through social dialogue between representatives of business, organised labour, community and government. The Accord focuses on encouraging local procurement towards promoting employment and industrialisation. This is recognised as a key contributor towards accelerating the creation of 5 million new jobs by 2020, as well as the goals of the Industrial Policy Action Plan (IPAP 2)¹²⁰.

The Green Economy Accord, also in support of the NGP employment target of 5 million new jobs by 2020, recognises the opportunity South Africa has to create large-scale employment and simultaneously address climate change concerns. This partnership focuses on promoting the green economy and harnessing the potential for the creation of 'green jobs'. Specifically, the Accord encompasses key messages about:

¹¹⁶ Zuma, J. No date. Foreword. New Growth Path: Accord 3: Local Procurement Accord. Economic Development Department. www.economic.gov.za, Pg 2.

¹¹⁷ Republic of South Africa. Economic Development Department. 2011. The New Growth Path: Framework. Economic Development Department. www.economic.gov.za

¹¹⁸ Ibid.

¹¹⁹ Ibid.

¹²⁰ Republic of South Africa. Economic Development Department. No date. New Growth Path: Accord 3: Local Procurement Accord. Economic Development Department. www.economic.gov.za

- Opportunity – that climate change provides new prospects for economic activity that were not previously pursued
- Innovation – that the country can draw on its technological, research and manufacturing base to generate new processes and products
- Responsibility – of government to create an enabling environment, and of businesses and citizens to do things differently
- Partnership – the combined efforts of all constituencies and all South Africans need to be harnessed to achieve the goals of the green economy¹²¹.

The IPAP is equally informed by the vision set for South Africa in the NDP, and aligns to the framework provided by the NGP and the National Industrial Policy Framework (NIPF) adopted by government in 2007. Within this context, IPAP has an overarching goal to promote the growth and diversification of South Africa's manufacturing sector and as such, prevent industrial decline. IPAP pursues manufacturing on the basis of reported international evidence that suggests manufacturing is the key engine of growth and employment in economies that have achieved high Gross Domestic Product (GDP) and employment growth¹²².

Most recently, the 2014 Budget Speech also attributes its underpinning principles to the NDP, reiterating government's commitment to partnership and the "social compact to reduce poverty and inequality, and raise employment and investment"¹²³. The Budget Speech also indicates that in order to make more rapid progress in creating jobs and reducing poverty, we need an economic growth rate of at least five per cent per annum. Small business and entrepreneurship remain strongly linked with employment creation, and the Budget allocates R6.5 billion over three years to support small and medium enterprises¹²⁴.

In more recent developments associated with the cabinet appointments made by the President following the 2014 South African Elections, South Africa has a newly created Department of Small Business Development, led by Lindiwe Zulu, the department's first appointed Minister. The Department has long been called for from many quarters, and will be a dedicated champion for the small business sector and its interests. It is anticipated that the above-mentioned budget allocation will be deployed under the auspices of this new department. However, the Cape Chamber of Commerce has reportedly indicated concern about the introduction of another department, minister and deputy minister¹²⁵. The sole mandate of the Department of Small Business Development will be to represent and address the challenges faced by SMEs in South Africa. Zulu recently indicated that she would be focusing on providing effective support for small businesses to ease the regulatory and compliance burden on this sector.

Given government's commitment to, and recognition of, the critical role played by SMEs and start-ups in the country's new growth trajectory, there is a clear alignment to the goals and objectives of SiMODiSA and this policy initiative. This represents a clear opportunity to review, refine and supplement policies directed towards this ecosystem in order to stimulate and realise the beneficial role they can play in economic development.

¹²¹ Republic of South Africa. Economic Development Department. No date. New Growth Path: Accord 4: Green Economy Accord. Economic Development Department. www.economic.gov.za, Pg 6.

¹²² Republic of South Africa. The Department of Trade and Industry. 2013. Industrial Policy Action Plan: Economic Sectors and Employment Cluster: IPAP 2013/14 – 2015/16. The dti. www.thedti.gov.za

¹²³ Republic of South Africa. Minister of Finance Pravin Gordhan. 26 February 2014. 2014 Budget Speech. National Treasury. www.treasury.gov.za, Pg 17.

¹²⁴ Ibid.

¹²⁵ Homes, T. 2014, 24 June. Nene: Government is reducing cost of doing business in SA. Mail & Guardian. www.mg.co.za



6 Recommendations

Each chapter of recommendations is able to operate as a stand-alone recommendation submission, and broadly includes problem identification, current status quo (including relevant literature and international precedent where applicable), proposed solution and supporting rationale. These can then be submitted to relevant government departments for consideration.

6.1 Exchange Control: ExCon Loop and Foreign Investor Limitations

6.1.1 Current situation in South Africa

6.1.1.1 Problem identification and current status quo

South African Exchange Control regulations control the flow of money both in and out of South Africa. More specifically, the South African Reserve Bank (SARB), through its Financial Surveillance Department (FinSurv) controls and oversees all capital inflows and outflows¹²⁶. Certain banks have been appointed as Authorised Dealers to assist FinSurv in administering Exchange Control and thus can authorise Exchange Control transactions in the circumstances where they are permitted to do so^{127, 128}.

In terms of Regulation 10(1)(c) of the Exchange Control Regulations:

"10(1) No person shall, except with the permission granted by the Treasury and in accordance with such conditions as the Treasury may impose –....

(c) enter into any transaction whereby capital or any right to capital¹²⁹ is directly or indirectly exported from the Republic."¹³⁰

Loop structures may arise when South African residents acquire equity/interests in an offshore vehicle that then invests back into South Africa. They are prohibited based on Regulation (10)(1)(c) of the Exchange Control Regulations. However, loop structures are permitted for South African companies to the extent that they do not hold less than 10% and more than 20% of the shares and/or voting rights in the offshore entity. National Treasury has in recent years relaxed loop structures in specific instances. However, these relaxations do not go far enough to address the needs of South African businesses, in many cases technology companies, seeking to receive financing from international third-party investors to realise their business potential in international markets.

Unfortunately, the international investor “vanilla” structuring requirements, which typically include an offshore domiciled Holding Company and a South African Subsidiary with South African shareholders holding shares in the offshore Holding Company, is regarded as an unauthorised loop structure. The current status quo regarding loop structures results in investors choosing less constrained investment alternatives from other jurisdictions to avoid delays and problems, cutting out the potential expansion of South African businesses. In addition, start-

¹²⁶ Incompass Forex. 2014, 24 June. Exchange Control Regulations. Incompass Forex. www.money-transfers.co.za

¹²⁷ South Africa. SARB. 2014. Exchange Control Manual. Section D.4. SARB. www.resbank.co.za

¹²⁸ South Africa. SARB. 2014. Exchange Control Manual. Section B. SARB. www.resbank.co.za

¹²⁹ Supreme Court of Appeal Case of Oilwell (Pty) Limited v Protec International Limited and others 2011 (4) SA 394 (SCA) adopted a restrictive interpretation and defined “capital” to mean cash and money, and not “goods”. However, the President changed Regulation 10(1)(4) of the Exchange Control Regulations from 8 June 2012 to include in “capital” “any intellectual property right, whether registered or unregistered” (Strauss, B. 2012. Exchange Control: Oilwell does not end well. DLA Cliffe Dekker Hofmeyer).

¹³⁰ South Africa. President’s Office. 1933. No. 9 of 1933. Currency and Exchanges Act. Exchange Control Regulations of 1961: Regulation 10(1)(c). President’s Office. www.resbank.co.za



ups and SMEs do not have the resources to seek advice and prepare the costly applications necessary to surmount the current Exchange Control regulatory constraints.

The rationale for the loop structure prohibition is to block the setting up of channels for capital to be freely exported from South Africa. Specifically, this prohibition seeks to prevent the potential for a South African resident to export funds from South Africa in order to invest in assets or interests outside the Common Monetary Area (CMA), in turn creating channels for the export of four types of capital. The four types of capital are listed below:

- Loans can be made to the South African entity set up with the exported funds, and capital can be repatriated offshore in the form of loan repayments
- Interest payments can be repatriated on the loan
- The growth on the interest/asset/shareholding can be repatriated offshore
- The dividends on the shares can be repatriated

6.1.1.2 Overview of current Exchange Control regulations: Exchange Control loop structures

6.1.1.2.1 Individuals

Authorised Dealers may allow private individuals (i.e. natural persons) who are taxpayers in good standing and over the age of 18 years to invest up to a total amount of R4 million abroad per calendar year. However, the Exchange Control Manual expressly states that these individuals cannot use these funds or any other authorised foreign assets to enter into a “loop structure”. In other words, the individual cannot use these exported funds to directly or indirectly acquire assets (including shares) or other interests in the CMA. The CMA comprises Lesotho, Namibia, South Africa and Swaziland, and money may flow freely between these countries¹³¹.

6.1.1.2.2 Companies

Parastatals, private and public companies may make Foreign Direct Investments (FDIs) into companies, branches and offices outside the CMA¹³². A FDI is an investment in an entity resident outside of South Africa and implies the existence of a long-term relationship between the direct investor and the enterprise (foreign target entity), including a significant degree of influence on the management of the enterprise¹³³.

Where the total cost of such new investments does not exceed R500 million per company per calendar year, the entity may make the investment simply with the prior approval of the Authorised Dealer, which will consider the request based on the required information provided¹³⁴. However, stakeholders have reported that such cases are often referred to FinSurv in any event because of a lack of confidence in “authorising” approvals.

Where the applicant entity’s investment will exceed R500 million for the calendar year, specific approval is required from FinSurv and not just an Authorised Dealer. Once again, FinSurv will consider the application based on the required information provided by the applicant¹³⁵. Regardless of whether or not the FDI exceeds R500 million, the following conditions apply to both scenarios:

¹³¹ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.1 SARB. www.resbank.co.za

¹³² South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.2. SARB. www.resbank.co.za

¹³³ South Africa. SARB. 2014. Exchange Control Manual. Section A. SARB. www.resbank.co.za

¹³⁴ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.2. SARB. www.resbank.co.za

¹³⁵ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.3. SARB. www.resbank.co.za



- At least 10% of the foreign target entity's voting rights must be obtained.
- South African companies are permitted to acquire not less than 10% and not greater than 20% equity and/or voting rights, whichever is the higher, in a foreign target entity. The entity in turn may hold investments and/or make loans into any CMA country. In other words, a "loop structure" is permitted, but only to the extent that the South African Company does not hold less than 10% and more than 20% of the shares and/or voting rights in the foreign target entity.
- In the event of the foreign investment being disposed of, net sale proceeds must be repatriated to South Africa.
- Where dividends are declared by an offshore Subsidiary of a South African Company, those dividends may be retained offshore and used for any purpose. However, for all other purposes dividends must be repatriated to South Africa annually.
- South Africa must remain the place of effective management for the applicant company and under no circumstances may the applicant re-domicile without the prior approval of FinSurv^{136, 137}.
- All companies are required to annually submit financial statements for their offshore operations to FinSurv. In certain instances regular progress reports are also required¹³⁸.

6.1.1.3 Recent moves towards relaxation of loop structure prohibition

Exchange Control laws were introduced in South Africa during apartheid to prevent the flight of capital outside of South Africa due to the climate of political instability and unrest characterising this period¹³⁹. However, South Africa finds itself in a more stable political climate and thus, since 1994, government has taken a gradual approach to eliminate Exchange Controls. Following announcements made by the Minister of Finance, a logical sequence of Exchange Control Circulars were published and subsequently, Exchange Control regulations are slowly being relaxed¹⁴⁰.

Recent relaxations, some of which relate to loop structures, include the following:

- Private equity funds, that are members of the Southern African Venture Capital and Private Equity Association (SAVCA) and are mandated to invest into Africa, can apply to Exchange Control for an annual approval to invest into Africa. Funds can apply even if a portion of the business will be in South Africa. However, approval is subject to certain conditions. The reason for this relaxation is to ensure global competitiveness of these funds, create a steady base for dividend flows back to South Africa, and establish South Africa as a regional hub for investments into Africa. The following must be submitted as part of the application process: a copy of the partnership mandate or investment agreement; cash flow

¹³⁶ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.2. SARB. www.resbank.co.za

¹³⁷ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.3. SARB. www.resbank.co.za

¹³⁸ South Africa. SARB. 2014. Exchange Control Manual. Section F6.1.2.4. SARB. www.resbank.co.za

¹³⁹ Theobald, S. 2013, 14 June. SA's exchange controls: Put a stop to this perpetual own goal. BDlive. www.bdlive.co.za

¹⁴⁰ South Africa. SARB. 2014, 24 June. Published Notices – Circulars - Exchange Control Circulars. SARB. <https://www.resbank.co.za/publications/Circulars/Pages/ExcCirculars.aspx>



projections over a 36-month period of capital to be exited for investment into Africa; and confirmation that the fund will obtain a minimum of 10% of voting rights¹⁴¹.

- South African headquarter companies, termed “international headquarter companies”, that are tax resident and incorporated in South Africa and meet prescribed shareholding and asset criteria, may register for approval with FinSurv to hold African and offshore operations. Exchange Controls between the South African headquarter company and its offshore operations have been relaxed up to certain thresholds, provided that the transfers are subject to regular reporting and are not undertaken to avoid tax¹⁴². Furthermore, the headquarter company enjoys favourable tax treatment¹⁴³. This was introduced to make South Africa an attractive gateway for foreign multinationals investing in Africa to boost local tax revenue, dividends and jobs, while supporting economic growth across the continent¹⁴⁴.
- Companies listed on the JSE may freely list secondary listings and/or depository receipt programmes on foreign exchanges to facilitate both local and offshore FDI expansions. This is subject to reporting requirements¹⁴⁵. Due to the limited information in the Exchange Control Circular (number 3/2014) confirming this relaxation, it is difficult to ascertain to what extent it alleviates current challenges.
- Unlisted technology, media, telecommunications, exploration and other research and development companies may apply to FinSurv for approval for a primary listing offshore. The purpose of this listing is to raise foreign loans and capital for the company’s operations, and approval is subject to certain conditions¹⁴⁶. The companies will need to have a secondary listing on the JSE within 2 years following their successful offshore listing. The rationale is to enable these sectors, which have expanded their work in Africa and fast-growing emerging markets, to raise capital. Conditions to be complied with include registration with FinSurv, tax residence in South Africa, IP to remain registered in South Africa, and regular reporting to FinSurv, including details of funds raised offshore¹⁴⁷.

All of the above relaxations are welcomed and demonstrate a move towards the relaxation of loop structures motivated by the economic benefits that will result. The relaxations are permitted provided that conditions imposed by FinSurv are complied with to minimise export of capital from South Africa. However, these relaxations do not go far enough to address the needs and demands of South African businesses that seek to realise their full potential by globalising their businesses into international markets. For this they need to attract significant investment from international investors, many of which are located in primary markets. More specifically, the above relaxations concern foreign investment into Africa, rather than investment from South Africa into other international markets for the growth and benefit of South African entrepreneurs and their companies. Furthermore, they deal with investment by South African domiciled Holding Companies into offshore Subsidiaries, as opposed to offshore domiciled Holding Companies investing into South African Subsidiaries. Lastly, the relaxation to permit offshore listings by South African companies only benefits a few

¹⁴¹ South Africa. Financial Surveillance Department. 2010, 20 December. Exchange Control Circular No. 49/2010. South African Private Equity Funds. SARB

¹⁴² South Africa. SARB. 2014. Exchange Control Manual. Section C. SARB. www.resbank.co.za

¹⁴³ Lessing, D. 2012. SA Gains Ground on Mauritius in Race For African Gateway Status. Werksmans Attorneys. www.werksmans.com

¹⁴⁴ South Africa. Financial Surveillance Department. 2013, 27 February. Exchange Control Circular No. 5/2013 – Statement on Exchange Control. Website Annexure to the 2013 Budget Review. Gateway to Africa and Other Reforms. SARB

¹⁴⁵ South Africa. Financial Surveillance Department. 2014, 27 February. Exchange Control Circular No. 3/2014 – Statement on Exchange Control. Website Annexure to the 2014 Budget Review. Strengthening Trade and Investment Links with Africa. SARB

¹⁴⁶ South Africa. SARB. 2014, 27 February. Exchange Control Manual. Section C. SARB. www.resbank.co.za

¹⁴⁷ South Africa. Financial Surveillance Department. 2014, 27 February. Exchange Control Circular No. 3/2014 – Statement on Exchange Control. Website Annexure to the 2014 Budget Review. Strengthening Trade and Investment Links with Africa. SARB



companies that can afford to do this, and hence does not meet the needs of many South African businesses, particularly those in the earlier stages of development.

6.1.1.4 Typical Stages of funding in the Venture Capital Industry and the relationship to international growth strategies

Venture Capital (VC) funds need innovative, high-growth-potential companies to invest in. In order for the investee, often technology companies, to thrive, they equally need willing and skilled investors along the chain of their growth and development to take them from one step to the next. Each part of the value chain depends on the other and if early South African-resident investors are not able to reap risk-adjusted returns from internationalising their offering, they will be less likely to invest in innovation. If there is no viable international exit, entrepreneurs will not be motivated to take risk and innovate in the first instance. The diagram below provides an overview of the typical development cycle of a business in relation to investors, culminating in an international Initial Public Offering (IPO) or trade sale to a large global player¹⁴⁸.

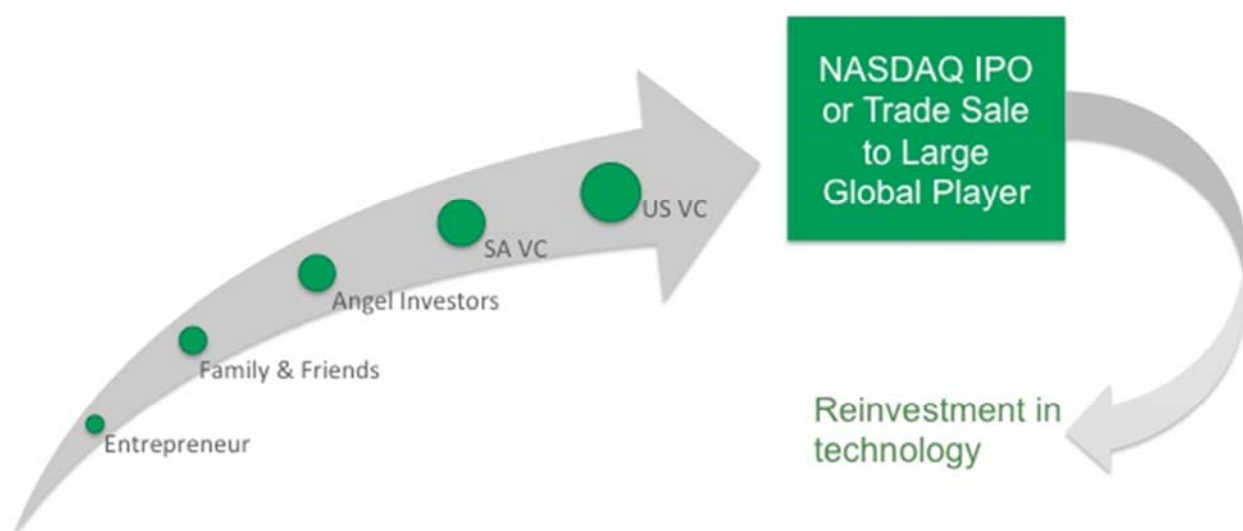


Figure 5: Funding Through the Development Chain¹⁴⁹

At early stages, seed investors in the form of government programmes or an entrepreneur's family and friends, for example, may be prepared to invest in the new idea. At the next stage, angel investors, who are prepared to fund the early commercialisation phases of these opportunities, are essential. Finally, VC firms step in at a critical stage in the funding supply chain and play a key role in commercialising these businesses and growing them into international markets¹⁵⁰.

Each player has a role in the company reaching its full potential. Each part of the value chain depends on the other and the chain is only as strong as the weakest link. If the chain lacks any of the stages, the company's development stagnates and participants, such as entrepreneurs, angel investors or VC funds, will exit the

¹⁴⁸ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁴⁹ Adapted from Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁵⁰ Ibid.

investment permanently. Where high technology (“high-tech”) companies are prohibited from reaching their full potential due to ecosystem and regulatory constraints, there is significant disincentive to invest in them due to these barriers. This, in turn, means a loss in terms of participation in the full value creation potential.

Successful technologies and certain other products and services, by their nature, cannot remain localised to specific geographic markets to achieve critical growth and realise their potential. It is at this critical point that the chain starts to weaken in the South African ecosystem. South Africa, like all other emerging markets, does not have capital markets that can fund the next stage of the roll out of new technologies into global markets, taking the business to its full global potential. There is a profound shortage of both venture and development capital in South Africa, with very few firms willing to invest in unprofitable businesses, even if they boast high growth and high potential¹⁵¹. In fact, even when compared with other emerging markets, other than Russia, South Africa’s private equity fundraising totals were the lowest in 2011 and 2012, with the difference in totals being significant¹⁵².

Optimal financing for technology businesses is found in only a few international markets, the most sophisticated and developed being the USA VC market. USA VCs are generally prepared to fund deserving opportunities, provided they are able to realise value on exit through a NASDAQ IPO or large trade sale. Not only is international US investment sought for the funds, US VCs have the know-how and experience in the sale, marketing and scaling up of these technologies. In addition, they have networks with the right customers and employees to penetrate critical mass and take these types of businesses to successful high value exits. Note that optimal financing and experience is not however limited to VCs in the US and can be found in other large international markets as well¹⁵³.

Access to these larger consumer markets as well as the necessary experience will give these businesses the best chance of delivering superior returns. Realising value on exit also ensures that value for all shareholders, including the South African funders who funded the opportunity through the early phases of the value chain, is maximised. The cycle then starts again as all the investors reinvest their capital in technology and other opportunities, with the assurance that they will be rewarded for the risk and effort¹⁵⁴.

Emerging high-growth companies with international potential would have to take one or more of the following corporate actions in order to successfully develop their business outside of South Africa:

- Raise money from international sources and set up an international Holding Company in the same market as the international investor, with the South African Company remaining as a South African Operating Subsidiary¹⁵⁵.
- Merge, through a share swap, with an international Holding Company operating in the same sector to gain strategic business advantage internationally, with the South African Company remaining as a South African Operating Subsidiary.

¹⁵¹ Ibid.

¹⁵² KPMG and SAVCA. 2013. Venture Capital and Private Equity Industry Performance Survey of South Africa covering the 2012 calendar year. KPMG and SAVCA

¹⁵³ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁵⁴ Ibid.

¹⁵⁵ Pokroy, S. 2014. Importance of Venture Capital and Investment in the South African market: A Specific Focus on Exchange Control. Unpublished

- List their shares on an overseas stock exchange in order to raise capital¹⁵⁶.

Sometimes a share swap will bring cash to the South African Company, but this is secondary. The primary purpose is to make the combined entity more competitive through inter alia economies of scale, international distribution capability and cross selling of products¹⁵⁷. The essential steps to a share swap in this scenario are set out below:

- o The South African Company receives an offer of funding from an international investor.
- o A new entity (Holding Company) is set up in the same jurisdiction as the international investor, the international investor capitalises this company and shares are issued by the new Holding Company to the international investor.
- o The new offshore Holding Company then acquires shares in the South African Company from the South African shareholders. In return, the South African shareholders receive shares in the offshore Holding Company.

In a share swap, the international investor typically injects funding via the Holding Company, but depending on the needs of the South African Company, money will flow from the Holding Company to the South African Subsidiary¹⁵⁸.

6.1.1.5 Exchange Control limitations affecting the VC industry in South Africa

Unfortunately, Exchange Control regulations prohibit the above-mentioned corporate actions by preventing the re-organisation of a South African Company into a non-resident Holding Company with a South African Operating Subsidiary, whether through a share swap or another analogous means of restructure that uses international investment to re-organise. In this instance, the share swap and investment into a foreign Holding Company leads to South African shareholders holding shares in a non-resident company, which in turn hold shares in a South African resident company¹⁵⁹. While this arrangement is in accordance with foreign investor's vanilla structuring requirements, it results in a contravention of the Exchange Control regulations by virtue of the creation of what is considered to be an unauthorised loop structure.

The consequences of such prohibition are as follows:

6.1.1.5.1 Investor reticence

Investors become reticent to invest in a South African entity for the following reasons:

- As Exchange Control regulations are extremely rare internationally, most international investors have no experience of such regulations and are not prepared to invest the time and effort involved in understanding this legislation in South Africa. A plethora of alternative investment opportunities become far more attractive, including those closer to home or in other more open emerging markets that do not have the same barriers and complexities, or require as much effort and risk as investing in

¹⁵⁶ Ibid

¹⁵⁷ Ibid.

¹⁵⁸ South Africa. President's Office. 1962. No. 58 of 1962. Income Tax Act. Section 42. President's Office. www.gov.za and expert advisor input

¹⁵⁹ Ibid.

the South African jurisdiction does¹⁶⁰. Furthermore, international investors tend to require their investments to conform to their vanilla structuring requirements¹⁶¹, and do not want to accept the variations on structuring that Exchange Control regulations prescribe. In fact, the World Bank study on Fostering Technology Absorption in Enterprises in Southern Africa reports South African exchange controls as of the major deterrents to foreign investment into South Africa¹⁶².

- Persuading US and certain other international VC firms to invest in South African incorporated entities has been largely unsuccessful. In fact, they are reluctant and often prohibited by their mandates from investing in companies that are not incorporated in their own jurisdictions¹⁶³.
- Trying to attract international investors into an international Subsidiary of a South African Company has not been successful, and in fact has been almost impossible. Unfortunately, such a structure leads to major conflicts of interest due to the different shareholdings in the parent and Subsidiary. New investors generally want to see all shareholders in the same vehicle to avoid these conflicts. In the context of a developing company entering challenging international markets, new investors also want some ownership of the existing South African business to reduce their risk¹⁶⁴.
- Investors want to see the headquarters of a company located in close proximity to their own offices, as well as in the same jurisdiction as the international market¹⁶⁵. This is also driven by the need to work within close proximity with head office management of the company¹⁶⁶. It should be emphasised that international investors are much less reticent about investing in an internationally domiciled new company with a South African Subsidiary. In fact, they are often attracted by the business model this presents, in which the cost advantage of South Africa relative to first world economies is leveraged by placing the operations, product development or manufacturing in the Subsidiary, while locating important head office functions, such as marketing and finance, within a new company in a major market. This means job creation locally to support larger foreign markets¹⁶⁷.
- The most effective way to re-organise so that there is an offshore Holding Company and a South African Subsidiary is generally through a share swap transaction, the elements of which have been outlined under heading 6.1.1.4 above: “Typical Stages of funding in the venture capital Industry and the relationship to international growth strategies”.

6.1.1.5.2 Impeding the development of the VC industry, entrepreneurship and innovation

The South African Exchange Control regulations leave South Africa at a competitive disadvantage with other nations and result in customers or investors, who are now reticent and uncertain, choosing the next alternative to avoid delays and problems. This inhibits foreign investment and obstructs multiple rounds of funding and

¹⁶⁰ Ibid.

¹⁶¹ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁶² World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank

¹⁶³ Pokroy, S. 2014. Importance of Venture Capital and Investment in the South African market: A Specific Focus on Exchange Control. Unpublished

¹⁶⁴ Ibid.

¹⁶⁵ Ibid.

¹⁶⁶ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁶⁷ Pokroy, S. 2014. Importance of Venture Capital and Investment in the South African market: A Specific Focus on Exchange Control. Unpublished

necessary internationalisation of portfolio companies¹⁶⁸. Fundamentally, this acts as a disincentive to the funding of high technology companies in South Africa because they cannot be taken to their full potential, and become attractive acquisition targets that will capture the full potential of investment returns available for investors¹⁶⁹. As a result, the growth of the VC industry, investment, entrepreneurship and innovation in South Africa is impeded, and in turn economic growth is negatively affected.

6.1.1.5.3 Loss of capital/value to South African shareholders and South African economy

- As a result of the difficulties for an emerging South African enterprise to raise capital internationally or to merge with an international company, the only regulatory possibility is for all South African resident shareholders to sell their shareholdings to non-residents at the time of the re-organisation¹⁷⁰. However, this is highly undesirable since it (a) sends the wrong signal to investors who believe they may lose the driving passion and force behind the business; (b) deprives the South African shareholders of the significant valuation upgrade that typically occurs once a company is valued by international yardsticks as opposed to those in South Africa; and (c) deprives the South African resident shareholders, typically the founding entrepreneurs or VC investors, of participating in the ongoing creation of value as the company penetrates international markets. Ultimately, the South African economy is prevented from benefiting from the value creation precipitated by such investments and partnerships, which could culminate in an international IPO or trade sale to a large global player, resulting in significant flow of benefit back to South Africa upon exit.
- The resultant capital inflows that would arise on exit of the company by the South African resident shareholders at the point where full investment returns can be captured are thus lost. South Africa is deprived of the foreign exchange and taxes on profits that could have been yielded. In addition, the early-stage investors and VC industry are deprived of these capital flows, further inhibiting the funding/investment cycle. This is the case despite contractual obligation that requires investors, who make investments on behalf of South African investors, to bring the proceeds back to South Africa and pay the South African investors their gains on their investments¹⁷¹.
- Furthermore, it can be impossible for South African resident shareholders to sell their shares at the time of the re-organisation as new investors will generally refuse to cash out the existing shareholders if the company is still cash consuming. They would rather see that money being invested into the growth and development of the company¹⁷².
- Unfortunately, given this range of factors and limitations, South African entrepreneurs are able to see the ceiling and limitations that are imposed before they even develop their product or idea, and decide to leave South Africa before starting a business. The result is that skills, innovation, entrepreneurship and capital inflows are lost altogether¹⁷³.

¹⁶⁸ Ibid.

¹⁶⁹ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd

¹⁷⁰ Ibid.

¹⁷¹ Ibid.

¹⁷² Pokroy, S. 2014. Importance of Venture Capital and Investment in the South African market: A Specific Focus on Exchange Control. Unpublished

¹⁷³ Pokroy, S. 2007. Annexures to Conceptual Discussion Paper Regarding the Reorganisation of Clickatell (Pty) Ltd. Clickatell (Pty) Ltd.



From the foregoing arguments, it can be seen that the only feasible method for a South African business to thrive through foreign investment and market development is if it can be re-organised such that the Holding Company is set up and domiciled in a large international market, and the original South African entity becomes a wholly owned Subsidiary of the Holding Company.

Although no value would leave South Africa as a result of taking any of these actions, and even though a Subsidiary would continue to be based in South Africa that contributes to manufacturing and economic growth here, the current Exchange Controls prohibit such a re-organisation¹⁷⁴. In the interest of good business practice, competitiveness, and contribution to economic growth and job creation, such actions should be made permissible without being subject to uncertain and costly application procedures and processes. The current status quo, which can only sometimes be surmounted at great cost, effectively cuts out the potential expansion of start-ups and SMEs, who simply cannot afford such an investment of time and capital.

By permitting structures that facilitate all phases of funding through the development chain set out in Figure 5 above, Exchange Control will play a critical role in enabling this investment cycle and in turn the VC industry to operate healthily in South Africa¹⁷⁵. As demonstrated above, this will impact the growth of start-ups and other businesses and in turn create economic growth and employment.

¹⁷⁴ Ibid.

¹⁷⁵ Ibid.



Exchange Control Loop Case Study: Clickatell Group

Background

The Clickatell Group was a business domiciled in South Africa that offered a bulk SMS service referred to as “enterprise alert messaging”. In 2007, the company secured US\$6 million investment to fund its international expansion from Venture Capital (VC) firm, Sequoia Capital, based in Silicon Valley, USA. Sequoia agreed to invest on condition that the equity investment is made into an entity set up by the Clickatell Group in the USA. For the cash investment to take place, the head office activities of Clickatell were required be in close proximity to Sequoia Capital and housed in a USA Holding Company. Furthermore, Sequoia Capital required that, for cost efficiencies, the manufacturing and operational activities continue in the existing SA Company, which would now become a SA subsidiary.

All necessary investor conditions had been met, and all that remained was to obtain Exchange Control approval for the proposed restructuring of the Clickatell Group into a USA Holding Company and a SA Subsidiary by means of a share swap transaction.

Exchange control

An exchange control application was made to the Financial Surveillance Department (FinSurv), which was eventually approved and the Clickatell Group was permitted to restructure through a share swap. However, the direct and indirect costs of the application were significant, and introduced distraction from strategy, affecting the successful growth of the company.

Benefits to the Clickatell Group, the Clickatell Group’s shareholders and SA resulting from the Exchange Control approval

Benefit to Clickatell SA (Pty) Ltd (Clickatell SA) and the Clickatell Group

- Increased revenue from the support services Clickatell SA provides for the other Clickatell Group companies.
- Increased employment for Clickatell SA by 200%, from 60 employees to 155.
- Increased investment in technology and systems.
- Technical and specialist skill transfer.
- The ability to render better services and to larger customers.
- Survival and growth of business.

Benefit to shareholders of Clickatell

- Lower investment risk, greater likelihood of success and higher gains on exit.
- Returns to a Broad Shareholder Base.
- Skills transfer to the SA resident Shareholders.

Benefit to SA

- Flow of foreign earnings.
- Prove the viability of investing in technology in SA.
- Investment case to attract more VC Funding for SA.
- Skills and technology transfer to SA.
- Build International awareness of SA technology and innovation through the SA success story.

Although Clickatell’s application was successful, had the board been aware of the full costs and risks introduced by this unnecessarily complex transaction, it is questionable whether it would have been supported. In addition, if FinSurv had not approved the transaction, the foreign investor would not have made the investment and all parties would have missed out on the benefits mentioned above. It is imperative that the current system is addressed to ensure that South Africa is not robbed of these benefits in the future.



6.1.2 Recommendations for additional permissible loop structure

It is within this context that a permissible loop structure is proposed to enable residents to domicile companies off-shore, in the form a Holding Company within an international market and a wholly owned South African Subsidiary, to attract international investors and access international markets.

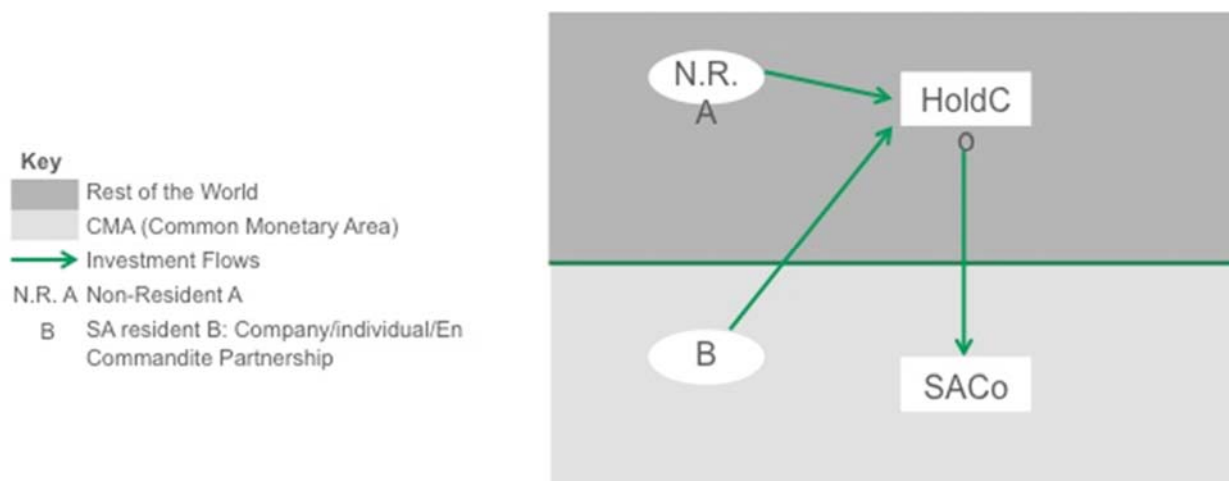


Figure 6: Key Features of Proposed Permissible Loop Structure

This additional permissible loop structure will enable South African business expansion in accordance with typical business development requirements and interests of foreign investors in international markets. These requirements are critical to the international expansion of South African businesses in the technology sector, as well as in other industries.

The key features of the proposed permissible loop structure can be explained as follows:

- Permit the re-organisation of the companies so that there is a foreign Holding Company and a South African Subsidiary. This should be permissible through:
 - Direct investments into the foreign entity by resident shareholders or resident Holding Company (i.e. not through off-shore trusts), and;
 - Re-organisation through a share for share, merger or other analogous transaction so that the new foreign Holding Company holds shares in the South African Subsidiary, and the South African Subsidiary in turn holds shares in the new foreign Holding Company.
- Extend approved South African resident shareholders in the new foreign Holding Company to include companies, individuals and en commandite partnerships, with no restriction on shareholder percentage.
- It is recommended that the concession be made subject to the following conditions:
 - Investments in the foreign entity must be made directly by the South African resident or South African resident Holding Company and not through offshore trusts. This is to ensure that gains on exit are repatriated to South Africa.
 - The foreign investor is a third-party, non-connected, arm's-length investor and introduces market value funding.

- o In the event of the foreign investment being disposed of on exit of the investment, the net sale proceeds must be repatriated to South Africa. As mentioned above, this is automatic in these circumstances, as all investors must receive the gains due to them on exit. Founding documents and contracts must specify that the net sale proceeds must be repatriated to South Africa on exit of the investment.
 - o Dividends must be repatriated to South Africa annually and founding documents and contracts must specify this.
 - o In the interests of foreign investor certainty and discouraging foreign investor reticence, as well as avoiding significant application costs, it is further recommend that the notifications go through an Authorised Dealer as opposed to FinSurv, and that the applicant submit the following documents:
 - Proof of international investor prospect via submission of business plan, and;
 - Detailed cash flow forecasts.
 - o Annual reporting would include submission to the Authorised Dealer of the audited Annual Financial Statements of the Foreign Holding Company.
- If the relaxation of the Exchange Control loop structure is approved for the circumstances outlined, to avoid discouragement of these types of transactions for tax reasons, it is recommended that:
 - o Section 42 of the Income Tax Act¹⁷⁶ is expanded to allow rollover relief for income tax and capital gains tax for cross border asset-for share transactions, which would include share swap transactions. In other words, any gains arising on the disposal of the shares by the South African residents to the Holding Company are deferred so that capital gains tax and any other taxes are paid on gains realised on eventual exit from the investment. This is in the interests of avoiding the negative impact of income taxes at crucial stages of development, when cash flow investment should be utilised for growth and development of the business.
 - o Along with the expansion of Section 42 of the Income Tax Act, paragraph 64B of the Eighth Schedule to the Income Tax Act, which deals with an exclusion for capital gains on disposal of shares held in a foreign company¹⁷⁷, would need to be removed. This enables National Treasury to benefit from the tax revenue yielded on eventual exit from the investment. In the event that paragraph 64B remained, National Treasury would not be able to benefit from gains realised on full development of the business and South Africa would not benefit in terms of economic growth.
 - o National Treasury has the security of the controlled foreign company provisions contained in Section 9D of the Income Tax Act to remove concerns around tax avoidance in this context.
- Additional requirements:
 - o Clarity on current policy related to Exchange Control loops and permissible loop structures.

¹⁷⁶ South Africa. President's Office. 1962. No. 58 of 1962. Income Tax Act. Section 42. President's Office. www.gov.za

¹⁷⁷ South Africa. President's Office. 1962. No. 58 of 1962. Income Tax Act. Paragraph 64B to the Eighth Schedule. President's Office. www.gov.za



- o Clear, easy guidelines to provide all parties with clarity and confidence on the permissible loop structures, particularly to improve foreign investor confidence and certainty in South Africa-related investments and the related Exchange Control regulations.

In both these cases, any guidelines and points of clarity should have broad industry distribution and online public access so that all parties have the relevant information they need to inform and guide decisions and actions.

6.1.3 Rationale

The rationale for government's prohibition on loop structures is to prevent the flow of capital outside of South Africa. Thus loop structures are only currently permitted for companies to the extent they do not hold less than 10% and more than 20% of the shares and/or voting rights in the offshore entity. However, recent relaxation of loop structures has been seen in certain instances. These relaxations were motivated by an interest in boosting local tax revenue, creating a steady flow of dividends back to South Africa, ensuring global competitiveness and creating jobs and economic growth in South Africa.

As has been demonstrated in this paper, there is empirical evidence that VC, as well as private equity, investment plays a crucial role in the growth and survival of investee businesses, and therefore increased employment, innovation and economic growth. However, a business' full potential cannot be reached without foreign investment and global scaling. This is particularly pertinent to technology businesses. Current Exchange Control prohibitions prevent South African resident investors holding an interest in an offshore Holding Company with a South African Subsidiary. The prohibitions also prevent South African resident investors from creating an offshore Holding Company with a South African Subsidiary through share swaps, mergers or other analogous transactions as this would create a loop structure. This leads to foreign investor reticence as investors do not understand South Africa Exchange Control and the current permissible structures do not comply with the investor's requirements of a foreign Holding Company, housing head office functions, and a South African Subsidiary, housing functions such as operations, product development and manufacturing. Currently, shareholders are forced to sell at lower value on initial investment by the foreign investor. This curtails the growth of the VC industry and other investors, further limiting investment and development prospects for businesses in South Africa.

National Treasury's relaxation of loop structures in certain instances has been coupled with applicants being required to meet certain conditions to ensure that capital is repatriated back to South Africa. Consequently, this recommendation recognises this concern and, in accordance with contractual practice within the VC sector and other investment industries, proposes that any gains on dividends or exit are repatriated back to the investors, including South African investors.

Allowing a loop structure in the circumstances proposed is advantageous to South Africa as full growth of the business can be realised on exit of the investment. This enables increased capital flow to the South African VC industry and other South African investors, and encourages further investment in businesses, including those in the technology sector. This ultimately culminates in greater employment and economic growth for South Africa.

6.1.4 Conclusion

In order to achieve critical growth in successful technologies, and other products and services, it is important to grow these products into international markets. However, a profound shortage of both venture and development capital in South Africa means that funding must be sought from international markets.



International investors tend to have vanilla requirements for structuring the investment, which stipulates that a Holding Company houses head office functions in the same jurisdiction as where they are located, while a South African Subsidiary houses operating, manufacturing and product development. As loop structures prevent South African investors from holding shares in the offshore Holding Company, they are forced to exit the business on investment by the international investor. They therefore lose out on the capital flows that arise on exit on full growth of the business, which then also stunts the investment cycle in South Africa.

In addition, South Africa is deprived of the foreign exchange and taxes on profits that could have been yielded, stunting the country's economic growth. It is also important to note that start-ups and SMEs do not have the resources to take up these Exchange Control matters, and as a result, lose out on potential growth and expansion when the foreign investor, put off by the uncertainty presented by the Exchange Control limitations, goes elsewhere.

Recent relaxation of loop structures in specific instances in South Africa recognise the need for greater tax revenue, steady flow back of dividends and global competitiveness, and the importance of these for economic growth and job creation. The possibility of a South African business receiving funding from a third-party, arm's-length investor to achieve its full potential in an international market must also be recognised as a circumstance creating economic growth and warranting an authorised loop structure. Furthermore, the limited resources of start-ups and SMEs should be recognised, and a simple process introduced that notifies an Authorised Dealer of the compliance of the transaction with the conditions imposed concerning the particular loop structure, without incurring substantial costs.



6.2 Increasing attractiveness of the Venture Capital Company Regime

6.2.1 Introduction

Financing is an essential component of innovative and growing economies, particularly at the seed and early stages of business development. Consequently, access to finance is a key concern for all actors within the entrepreneurial ecosystem. Typically, start-ups and SMEs are especially constrained in their access to finance due to the inherent riskiness and vulnerability relative to their stage of development, as well as the broader market imperfections. The risk associated with such investments reduces as they mature, with the critical need for support manifesting at the earlier stages of development¹⁷⁸.

These challenges, coupled with the significant growth potential represented by VC-backed companies, justify and indeed demand public intervention and support initiatives to encourage financial investment and involvement in SMEs and start-ups at their most vulnerable stages. In recognition of the important role played by VC, governments across the world make use of a variety of direct and indirect instruments towards this end, and often implement multiple complementary interventions. Such interventions include subsidised loans, tax incentives and public support to VC¹⁷⁹.

Supportive tax policies are a common choice of intervention, and in South Africa, the Venture Capital Company (VCC) Regime, which provides tax incentive for investors, falls under the jurisdiction of Section 12J of the Income Tax Act. The structure of these mechanisms can be broken down according to their key features and how they affect the three parties involved¹⁸⁰ viz. the investors, the VC firm(s) and the investee company.

Investors are typically incentivised to invest through tax deductions and/or tax credits, as well as Capital Gains Tax (CGT) exemptions and/or reductions that enhance the value of the investment's sale. Lower individual Income Tax rates attract and retain human capital and talent at all three levels, while lower Company Tax rates, particularly for SMEs, increase the forecasted profitability of the investee company¹⁸¹.

6.2.2 Current South African landscape

*"The VC asset class, a [small] sub-set of the R120 billion private equity asset class in South Africa, generally refers to funding (predominately equity or mezzanine funding) of high-growth potential businesses, whose growth potential is typically achieved through radical global scaling, and which normally have technological or other innovative concepts at their core."*¹⁸²

Although a large percentage of 2012 VC deals in South Africa involved technology (35%), they are not limited thereto. It is reported that deals in South Africa between 2009 and 2012 also involved start-up capital (37%), life sciences (biotechnology, medical devices, health technology) (25%) and energy (14%). In South Africa, VC is still an emergent asset class with just R0.83 billion invested therein, a small portion of the R100 billion under investment in the entire South African private equity class. Furthermore, the number of VC transactions in

¹⁷⁸ OECD. No Date. Financing business R&D and innovation. OECD. www.oecd.org

¹⁷⁹ Ibid.

¹⁸⁰ Da Rin et al. 2004. Public Policy and the Creation of Active Venture Capital Markets. Innocenzo Gasparini Institute for Economic Research.

¹⁸¹ Keuschnigg. 2008. Tax Policy for Venture Capital Backed Entrepreneurship. USG.

¹⁸² Lamprecht, S. J. and Van der Walt, G. L. 2012. 2012 SAVCA Venture Solutions VC Survey. South African Venture Capital and Private Equity Association. Pg 4.



South Africa is significantly lower than those in Israel, Australia, India and the USA¹⁸³. Thus, there is significant scope and indeed need for growth in the VC industry in South Africa in order for its potential and economic growth contribution to be realised.

Indeed, the VC industry, through its funding of early-stage high-growth ventures, is an important feature of any developing economy. In addition, there is significant evidence that the VC industry's growth will in turn contribute to the growth and development of the South African economy¹⁸⁴. A study commissioned by Development Bank of Southern Africa (DBSA) and the South African Venture Capital and Private Equity Association (SAVCA) examines the economic impact of private equity and VC investment in South Africa, and evaluates the measurable effects of these on investee businesses. The following positive impacts of private equity and VC investment on investee businesses were reported for the period July 2011 to July 2013:

- Companies with private equity and VC investors create employment. This was demonstrated by the 40% growth in staff among investee businesses.
- Private equity and VC investment stimulates innovation. Three quarters of investee businesses introduced new products or services following the private equity investment.
- The private equity allows the businesses to grow faster. The average growth experienced by investee businesses was 49%, while the top 20 in growth saw their profits increase by over 130%. A significant reason for this is that private equity and VC investors bring dynamism, operational experience, financial acumen, contacts, strategic partners and foresight to the growing business. Over half of the respondents (56%) reported that private equity investment sped up the pace of growth, and 46% reported that private equity was instrumental in keeping the business afloat.
- Private equity and VC investment improves B-BBEE performance. A third of the respondents indicated that B-BBEE performance had improved following investment¹⁸⁵.

In summary, there is significant evidence of the role of the VC industry in contributing to the growth and survival of small business and technological innovation, which in turn lead to economic growth. Consequently, it is well founded that the use of supportive tax incentives is an intervention strategy that government can use to encourage and realise the potential of VC investment in South Africa.

6.2.2.1 The introduction of the Venture Capital Company Regime

In 2008, the South African government identified that access to equity finance by SMEs and junior mining exploration companies was a major barrier to the growth of these sectors in the economy. In response, it established the VCC as a marketing and investment vehicle to attract retail equity investors to SMEs and junior mining exploration companies in South Africa. The VCC Regime was intended to bring together small investors, as well as to concentrate investment expertise in favour of the small business sector¹⁸⁶.

¹⁸³ Ibid.

¹⁸⁴ Lamprecht, S. J. and Van der Walt, G. L. 2012. 2012 SAVCA Venture Solutions VC Survey. South African Venture Capital and Private Equity Association

¹⁸⁵ Republic of South Africa. Development Bank of Southern Africa and SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. www.savca.co.za, P 1.

¹⁸⁶ Republic of South Africa. National Treasury and SARS. 2008. Republic of South Africa: Explanatory Memorandum on the Revenue Laws Amendment Bill. www.sars.gov.za

A successful VCC structure was envisioned to provide value by promoting investment activity; encouraging investor confidence through the establishment of a well-regulated but user-friendly structure for VCCs; generating and mobilising stakeholder awareness and support for the opportunities created by VCCs for investors, investees and VCC fund managers; creating a specialist VCC fund industry that would facilitate skills development and skills transfer in the South African economy and, in so doing, foster growth in entrepreneurship, employment, training and economic growth in South Africa¹⁸⁷.

Despite the intentions behind the establishment of the VCC Regime and the subsequent refinements made in 2011 that were intended to increase its attractiveness, the VCC offering has not provided a sufficient risk-weighted return offering to attract investors and off-set the registration and compliance burden associated with the vehicle. Uptake has consequently remained limited. At the end of 2013, SARS had only granted VCC status to three VCCs, Olivewood Resources and Emiscore, neither of which were actively trading, and Grovest, which is the first trading VCC under the Regime¹⁸⁸.

The 2014 tax proposals put forward by National Treasury in Budget Review 2014¹⁸⁹ represent a significant potential step forward and include the following measures, which have been welcomed by the South African VC community:

- “Making deductions permanent if investments are held for a certain period of time
- Allowing transferability of tax benefits when investors dispose of their holdings
- Increasing the total asset limit for qualifying investee companies from R20 million to R50 million, and from R300 million to R500 million in the case of junior mining companies
- Waiving capital gains tax on the disposal of assets, and expanding the permitted business forms”¹⁹⁰.

However, though a step in the right direction, these measures still need to be developed in detail and, accordingly, actually implemented in policy.

6.2.2.2 Overview of Key Features of Existing VCC Regime¹⁹¹

The VCC Regime is a tax incentive or relief scheme that aims to encourage investment into approved Venture Capital Companies (VCCs). These VCCs will, in turn, invest in qualifying small and medium-sized businesses and junior mining companies, thereby providing these sectors with the ability to better attract equity finance. The VCC policy was instituted with effect from 1st July 2009 and is governed by the Income Tax Act of 1962, Section 12J, and Tax Administration Act No. 28 of 2011.

Under this scheme, qualifying investors (now any taxpayers) will invest in approved VCCs in exchange for investor certificates. These certificates enable the investor to claim for income tax deductions in respect of the

¹⁸⁷ Grovest. 2013. Section 12J Objectives, Weaknesses & Recommendations Presentation to National Treasury. Unpublished.

¹⁸⁸ Grovest is an important stakeholder that has been involved in this research process as part of SiMODiSA’s stakeholder group, and as such, has provided valuable insights based on first-hand experience.

¹⁸⁹ Republic of South Africa. National Treasury. 2014. Chapter 4: Revenue trends and tax proposals in Budget Review 2014. National Treasury. www.treasury.gov.za

¹⁹⁰ Ibid. Pg 52.

¹⁹¹ This overview encompasses the VCC Regime as it currently stands as the tax proposals for 2014 have not yet been developed in detail and/or incorporated into formal documentation outlining the VCC Regime, and as such, are not reflected here.

expenditure incurred in their purchase of shares from approved VCCs¹⁹². There are no special tax rules applicable at the level of the VCC or the qualifying investee, and standard CGT rules apply in respect of VCC shares. Furthermore, the tax deduction claimed by investors is not permanent. If the investor disposes of the VCC shares pertaining to their initial VCC investment, the tax deduction claimed is subject to recoupment. The overall mechanics of the scheme can be depicted as follows:



Figure 7: Overview of How a Venture Capital Company Works¹⁹³

6.2.2.3 Key Challenges with the existing VCC Regime

6.2.2.3.1 In relation to investors

Under the present policy framework (pending the implementation of the 2014 tax proposals), an investor can receive an S12J income tax deduction on expenditure incurred on acquiring shares in approved VCCs. However, this deduction is subject to a recoupment of the deduction on disposal. This removes much of the incentive and benefit of the VCC as an attractive investment vehicle, most especially given the high risk of the underlying investments. In the UK VCT scheme, this income tax deduction is permanent unless shares are disposed of within a minimum five-year requisite holding period.

6.2.2.3.2 In relation to VCCs

A qualifying VCC investment vehicle must be established as a company. This adds additional taxes before any distributions are made to investors, such as dividend and CGT taxes. The addition of these “layers of tax” further reduces the benefit of the VCC structure for investors, especially when compared to other investment vehicles typically used by private equity and venture capital investors in South Africa, such as the REIT, en commandite partnerships or bewind trusts. It is anticipated that this issue will be addressed as part of the pending 2014 tax proposals.

VC investments utilise many investment instruments, including debt, to balance the interests of the parties. The intention of VC tax incentives is to encourage the allocation of risk capital, rather than a particular instrument, towards earlier-stage, riskier investments; in this case, SMEs and junior mining companies. However, limiting eligible investments to equity only may undermine the overall intentions and potential impact of access to ‘risk’ capital.

VCC registration processes, and in turn accreditation, is slow with uncertain turn-around times. In particular, the Financial Services Board (FSB) requirements, in addition to the time it takes to obtain the necessary Financial Advisory and Intermediary Services (FAIS) licence, are too extensive to be responsive to industry

¹⁹² Republic of South Africa. SARS. 2012. External Guide – Venture Capital Companies. SARS. www.sars.gov.za

¹⁹³ Adapted from Republic of South Africa. SARS. 2012. External Guide – Venture Capital Companies. SARS. www.sars.gov.za

needs. This creates too much uncertainty and limits VCs that seek to capitalise on immediate market opportunities.

Finally, the existing VCC policy requires that no more than 20% of the expenditure incurred by the VCC to acquire qualifying shares can be allocated to a qualifying investee company. Given the size of the VCC fund and/or the requirements of underlying investee companies, there may well be stages in the progression of the fund that make it difficult to maintain this percentage split across investments. The VCC therefore needs to have greater flexibility in terms of decisions regarding the allocation of capital.

6.2.2.3.3 In relation to qualifying investees

At present, a minimum of 80% of the expenditure incurred by the VCC to acquire assets must be for qualifying shares. In addition, each investee company must, immediately after the issuing of the qualifying shares, hold assets with a “book value” not exceeding R300 million in any junior mining company or R20 million in any other qualifying company. The current R20-million restriction is incongruent with the purpose of VCCs as it effectively excludes medium size enterprises. Per the 2014 tax proposals, this issue should be addressed with the pending changes and proposed increased thresholds.

Furthermore, the use of the term “book value”, applied above, is typically understood to mean the gross value of the assets less depreciation, and that it is not the “net value” of the assets after deduction of liabilities. In the VC industry, it is very difficult to achieve the current limitations on “book value”. In reality, after an issue of shares by the qualifying company in exchange for funds, a lender often loans a significant amount to the investee company. This effectively increases its “book value” in excess of the current thresholds. The investee company now has cash amounts, but still owes these amounts. The thresholds would not be exceeded if the provision was amended to read “net book value”.

As the VCC Regime stands, in order to qualify as an investee company, the company must not carry on any impermissible trades. One such defined ‘impermissible trade’ is ‘any trade carried on mainly outside the Republic’. Given the relatively limited size of the South African market compared to primary markets such as the UK and US, this restriction severely limits the potential of qualifying investees. It is also contradictory to government’s priorities around increasing exports and international competitiveness of South African businesses. In turn, by hampering the potential of qualifying investees, the value proposition and attractiveness for prospective VCC investors is reduced.

In addition, a qualifying investee company cannot be a “controlled Group Company in relation to a group of companies”. However, there may well be stages in the investment cycle where the VCC would take equity in excess of 70% in exchange for funds and the individual investor would own the remaining equity. Over time, other investors may be strategically brought in and have the effect of diluting the shareholding of the VCC.

6.2.3 International examples of Venture Capital Tax Incentive Schemes

Many countries implement special tax incentive regimes or structures for VC funds to reward investors and encourage VC investment. A comparative table of the key features of a sample of such regimes is included below:

Table 3: Key Features of International VC Tax Incentives¹⁹⁴

Country	Australia		France	UK
VCPE Ranking 2014 ¹⁹⁵	8		20	4
Tax Scheme	ESVCLP ¹⁹⁶	VCLP ¹⁹⁷	FCPI ¹⁹⁸	VCT ¹⁹⁹
Fund Size	\$10m - \$100m	> \$10m	-	-
Income Tax Relief	-	-	✓	✓
Max. Annual amt.	-	-	€2, 160 - €18,000	£200 000
Rate	-	-	18% (income tax) 30% (wealth tax)	30%
Capital Gains Exemptions	✗	✓ (Foreign LPs)	✓	✓
Min. Holding Period	-	12 months	5yrs	5yrs
Dividend Relief	-	-	-	✓
Flow-through Tax Treatment	✓	✓	-	Corporation Tax exemption on chargeable gains
Max. Fund Contribution/Investor	30%	-	-	-
Qualifying Investees				
Listed	✗	✗	✗	✗
Max. Fund Contribution/Investee	≤ 30%	-	-	≤ 15% (≤£5m)
Total Assets	≤ \$50m	≤ \$250m	-	≤£15m (gross assets prior) ≤£15m (gross assets immediately after)
Stage of Dev.	Early Stage	-	-	-
Localisation Requirements	≥ 80%	≥ 50% employees, ≥ 50% assets	≥ 60% in companies established in the EU	Permanent establishment in the UK; ≥70% into qualifying holdings
International Investments	≤ 20% to non-resident businesses	≤ 50% employees, ≤ 50% assets	-	-

Tax credits, to encourage individual investors to invest in VC funds, have long been a powerful tool for capital raising in the UK, France and Canada²⁰⁰. Interestingly, these three countries were among the early, if not the earliest, adopters of VC Tax Incentives dating back to the 1980s. In all three countries, however, there have

¹⁹⁴ Countries included in the table have been selected on the basis of having a long-standing history and current use of a tax vehicle or incentive to encourage VC investment, combined with a high overall VC and private equity attractiveness ranking.

¹⁹⁵ Groh, A; Liechtenstein, H; Lieser, K and Biesinger, M. 2014. The Venture Capital & Private Equity Country Attractiveness Index. IESE Business School. <http://blog.iese.edu/vcpeindex/ranking-2014/>

¹⁹⁶ Australia. AusIndustry. 2011. Early Stage Venture Capital Limited Partnership Fact Sheet. www.ausindustry.gov.au

¹⁹⁷ Australia. AusIndustry. 2011. Venture Capital Limited Partnership Fact Sheet. www.ausindustry.gov.au

¹⁹⁸ Omnes Capital. No Date. FCPI Funds. www.omnescapital.com

¹⁹⁹ United Kingdom. HM Revenue & Customs. No Date. About Venture Capital Trusts. www.hrmc.gov.uk

²⁰⁰ Canada has not been included in the comparative table as they are in the process of phasing out their Labour-sponsored Venture Capital Corporations Tax credit by 2017. This is reportedly due to changes in the economic environment, and the structure of the VC market since the credit's introduction in the 1980s in response to a critical need for access to VC for SMEs.

been questions raised around agency challenges (cost of intermediation) and the adverse effects of conditions imposed on these funds, such as investment limitations and the obligation to invest monies raised²⁰¹. More recently, Australia introduced tax incentive vehicles, which are similar to those implemented in the UK, France and Canada.

Other countries, such as New Zealand²⁰² and the US^{203,204}, take a different approach to tax incentives. One such noteworthy difference is that benefit is enjoyed by investors based on the particular corporate form typically used by VCs in those jurisdictions. In these instances, the particular corporate form being introduced is typically 'pass through', with gains or losses being attributed to investors without intervening taxation.

Depending on the overall structure and design of the tax system and the duration of the investments, either upfront incentives or capital gains exemptions may be more beneficial and in turn attractive. For example, in the UK, upfront incentives are perceived to be more attractive and therefore more important than capital gains exemptions, with upfront relief accounting for around 75% of the total advantage. In France on the other hand, where there are limited upfront incentives and heavy capital gains tax levels, the capital gains benefits account for approximately 90% of the advantage²⁰⁵.

Overall, it is evident that different countries employ different approaches to incentivising VC investment, one of which is the use of tax incentive vehicles like the VCC. In reviewing the various features of these tax incentives, as well as the corporate structure approach, it is evident that policy makers need to consider three levels of taxation implications when designing effective tax incentives so that they promote a favourable climate for risk capital. These include the tax treatment of the investor, the vehicle and target companies and the relative compliance and tax burden on each²⁰⁶.

6.2.4 Recommendations for refinement to enhance attractiveness and uptake of VCC regime

SiMODiSA has already made two submissions of recommendations to National Treasury, in January and April of this year (2014). These included, in the first instance, short-term amendments, which were incorporated into the 2014 tax proposals and are anticipated to greatly improve attractiveness of the regime once implemented. The second recommendation provided additional detail on highly desirable changes to further enhance the operation of the VCC Regime and align it more closely to the operations of VCs, thereby improving attractiveness and uptake of the VCC Regime.

This further submission suggests additional recommendations regarding features that still require attention in order to have a measure of success and uptake of the VCC offering. Specifically these include:

²⁰¹ Durufle, G. 2010. Government Involvement in Venture Capital Industry. International Comparisons. CVCA. www.cvca.ca

²⁰² Palladium Trust Services Limited. 2011. New Zealand Limited Partnerships as Vehicles for Private Equity / Venture Capital Investment. www.palladiumtrustservices.net

²⁰³ The US does have examples of deductions of initial capital invested being allowed against current income, though these are only at the state-level.

²⁰⁴ USA-Investment-Tax.com. 2014. The US Tax Regime for Venture Capital. www.usa-investment-tax.com

²⁰⁵ Magliocco, A. and Ricotti, G. 2013. The new framework for the taxation of venture capital in Italy. Banca D'Italia Eurosystema. www.bancaditalia.it

²⁰⁶ Ibid.



6.2.4.1.1 Recommendations affecting accredited VCCs

- Investments into qualifying companies in the form of loans should also be allowed; however, this is on condition that the size of the loan is limited to not more than the size of corresponding equity investment by the same investor.
- If true equity risk is being taken, capital invested into qualifying companies should be eligible under the VCC Regime, even if the investment is structured as a loan. In this regard, it is recommended that capital is invested under the following conditions:
 - It is patient capital – no repayments are made prior to positive cash flows for the business. Typically realised in the form of 1–3 year repayment holidays.
 - It is subordinated capital – senior lenders (if any) have prior claim over security and cash flows.
 - There is limited security – in the first 12 months, the effective fundable security is < 20 – 40% of the value of the capital exposure.
- Refine the VCC registration process to ensure accreditation can be achieved in no more than 30 working days. This includes the related FSB requirements and FAIS licence.
- Enable the VCC to have greater flexibility in the allocation of capital and decisions made in the progression of a fund. Currently, only 20% of the VCC's expenditure incurred when acquiring qualifying shares can be allocated to a qualifying investee company. Increasing the amount of expenditure a VCC can incur in one qualifying investee, if not completely doing away with the limitation all together, will help achieve greater flexibility for VCCs.

6.2.4.1.2 Recommendations affecting Qualifying Investees

- We recommend that the term “book value” in the definition of qualifying investee companies be amended to “net book value”. This will provide clear parameters and more practical alignment to the typical operations of VCs.
- If a qualifying investee company purchases shares in other small businesses, the cost of these shares should be excluded when determining the qualifying thresholds in accordance with the intentions of the VCC Regime to encourage investment in SMEs.
- The limitations on impermissible trades should be reviewed and amended, as these are contradictory to government's priorities around increasing exports and the international competitiveness of South African businesses. Amendments will increase the potential of qualifying investees, and in turn increase the value proposition and attractiveness for prospective VCC investors.
- Permit any qualifying investee to be a “controlled group company” in relation to the accredited VCC structure, in keeping with typical stages in the investment cycle and development of the VCC fund.



- Consider the inclusion of companies listed on the AltX²⁰⁷ with a total asset limit of up to R500 million as qualifying companies under the VCC Regime. This will provide investors with more options within the scope of SMEs²⁰⁸, while also potentially increasing liquidity on the AltX. Qualifying investee companies under the VCC Regime would then include:
 - SMEs with a total asset limit of up to R50m
 - Junior mining companies with a total asset limit of up to R500m
 - Companies listed on the AltX with a total asset limit of up to R500m

6.2.5 Rationale

South Africa's VCC offering has clear and well-intentioned objectives, and the policy establishes a strong regulatory framework that incorporates certain features of international best practice. However, as a policy designed to encourage high-risk venture capital investment activity, it has not been sufficiently attractive to offset the inherent risks of investment in this asset class. The commitment of government, expressed in the 2014 Budget Review and in many other public statements before and since, to implement critical amendments that will address the risk-weighted return of this sector and reward investors while addressing structural issues of the scheme, will significantly enhance the attractiveness and potential uptake of the regime.

However, stakeholders committed to this research process believe that, in complement, the additional refinements recommended above will further enhance attractiveness and speak to some of the practical and administrative challenges currently limiting uptake of the regime. Specifically, these additional refinements will improve turnaround times and associated administrative processes; enable appropriate flexibility and control over decision-making on the part of the VCC in relation to allocation of capital; enable South African companies to pursue international market expansion opportunities in order to enhance competitiveness and realise potential; and provide investors with a greater range of investible propositions, while increasing liquidity on the AltX.

6.2.6 Conclusion

As part of a broader strategy and suite of interventions designed to encourage VC investment and indeed, harness its benefits, the VCC tax regime provides a good foundation for action. However, it does require further refinement to adequately balance reward and compliance burden. The commitment evidenced in the 2014 tax proposals included in the 2014 Budget Review is anticipated to yield a critical tipping point in improving the attractiveness and uptake of the VCC Regime. The above-mentioned additional recommendations will further enhance the regime by addressing some of the more practical and administrative challenges currently limiting uptake. These are considered at the level of the investor, the VC firm and the qualifying investee, as well as in respect of the relative compliance and tax burdens in accordance with international precedent.

²⁰⁷ The AltX is the JSE's board for good quality, small and medium-sized high-growth companies. The AltX provides smaller companies with access to capital while providing investors with exposure to fast-growing smaller companies in a regulated environment. <https://www.jse.co.za/capital/altx>

²⁰⁸ Currently under the VCC, a junior mining company may be listed on the AltX and still qualify as an investee under the VCC Regime.



6.3 Uptake of government-funded IP under the IPR-PFR Act

6.3.1 Introduction

6.3.1.1 National Systems of Innovation

Extensive empirical evidence points to a general acceptance amongst academic economists that innovation, knowledge and research and development (R&D) are key factors that will drive sustained, long-term economic growth and market competitiveness²⁰⁹. Accordingly, government policy throughout the world seeks to ensure that these factors are shaped and generated through a suite of instruments, which are co-ordinated into a holistic National Innovation System (NIS).

This systems approach *“is based on the premise that firms do not innovate in isolation but rather in complex interactions with other firms, clients, universities, and government research institutes”* and, furthermore, that the relationship between firms and research institutions is nuanced with some interactions being more efficient than others²¹⁰. Goldberg et al report that at a minimum the NIS needs to have universities and/or research institutes that are linked to each other and to a strong private sector; a public-financing process to elicit the largest possible private sector R&D investment response; and, incentives such as a proper intellectual property rights regime and tax incentives²¹¹.

The overall purpose of the system and its instruments is the efficient connection between those who generate new knowledge and those who can benefit from its use, fostering all stages of the innovation chain from generation of ideas to commercialisation²¹². Below we outline two essential instruments of an innovation system, namely, public funding of R&D and promoting the protection and commercialisation of intellectual property (IP) from publicly funded research. We also explain the rationale for such instruments and what they aim to achieve.

6.3.1.2 Public funding of research and development for increased innovation and commercialisation

Public funding is regarded as an essential element of the innovation system; it is credited in many countries, including the USA, Finland, Israel and Ireland for stimulating private R&D investment and commercialisation by technology-orientated firms. This is particularly true for the start-up and small business sectors that are responsible for high levels of innovation and growth in these economies.

The early stages in technology research, development and commercialisation is characterised by a “funding gap”, even in the most advanced of economies such as the USA. The difficulty of ascertaining investment returns and risks at such an early stage has resulted in the absence of traditional sources of funding by banks, private equity and other institutional investors. This gap has created an opportunity for government to act as a key source of high-risk tolerant investment capital for early-stage technology start-ups. Not only does such

²⁰⁹ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist’s Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²¹⁰ Tuomi, K.; De Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technology Management & Innovation. Vol. 8 No. 2. Santiago. <http://dx.doi.org>, Pg 5.

²¹¹ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist’s Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²¹² Johnson, A.R. 2009. Accelerating Commercialisation and Innovation: The US Experience with the Triple Helix. KEVIII-INSEAD. Arnold & Porter LLP.



government investment reap significant social benefits for a country, it also provides entrepreneurs, start-ups and even more established businesses with the capital to develop new technologies, particularly at the early pre-revenue stage of technological development²¹³.

Public funding mechanisms that are effective in stimulating R&D investment and innovation in the private sector, as well as the commercialisation of such innovation, display certain characteristics. More specifically, they are designed to promote collaboration and linkages between businesses and research institutions. Furthermore, they adopt a neutral approach in the technological projects and areas that they support, responding to market demands rather than prescribed areas of focus. In fact, the success of such funding programmes in Israel and Finland is attributed to their neutrality²¹⁴.

Matching grants is one particular instrument of government support for investment in innovation and R&D. They are often aimed at small businesses and start-ups that are considered key players in bringing innovations to market²¹⁵. Matching grants have been increasingly used in OECD countries²¹⁶ and have two advantages over loans. Firstly, they reduce the entrepreneurs' risk, as their loss is limited to their own matching investment. Secondly, they can provide the funds for the high upfront investment needed for R&D and innovation without crippling the business before they have positive cash flow. Loans are considered unsuitable instruments for early-stage development technology projects; as such projects have uncertain cash flows and unknown prospects of success²¹⁷.

6.3.1.3 Legislation promoting commercialisation of Intellectual Property from Publicly Funded Research

A key instrument in the innovation system visible in numerous countries has been the introduction of legislation to systematise and promote the protection and commercialisation of IP created as a result of publicly funded research. Much of this legislation has been modelled on USA legislation, viz. the Bayh-Dole Act of 1980 (PL 96-517, Patent and Trademark Act Amendments of 1980)²¹⁸. The Bayh-Dole model has established a framework that aims to drive interactions, insights, collaborations and solutions among research institutions, government and industry to accelerate commercialisation across the knowledge supply chain and the entrepreneurial ecosystem²¹⁹.

A key rationale for a Bayh-Dole model of legislation is the empirical evidence that R&D cooperation between firms and research institutions, and the interdependent exchange of knowledge, along with government support, can increase the rate of technological progress and diffusion of technological knowledge in industry

²¹³ Goldberg et al. 2006 Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²¹⁴ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

²¹⁵ Wessner, C.W. 2008. Converting Research into Innovation & Growth. SBIR, the University and the Park. Investing in Innovation: Promoting New Opportunities in the United Nations Economic Council for Europe Region. The National Academies.

²¹⁶ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

²¹⁷ Tuomi, K.; De Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technology Management & Innovation. Vol. 8 No. 2. Santiago. <http://dx.doi.org>

²¹⁸ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²¹⁹ Johnson, A.R. 2009. Accelerating Commercialisation and Innovation: The US Experience with the Triple Helix. KEVIII-INSEAD. Arnold & Porter LLP.

and among research institutes²²⁰. The basis for much of this empirical evidence comes from studies demonstrating that the success of Silicon Valley and the Boston region in becoming innovation hubs / clusters, attracting and circulating technology locally and internationally, was based on the interactive relations between these players. This relationship is referred to as the “triple helix”. The main impetus for these regional innovation clusters was the “entrepreneurial university” within which strategies were pursued to encourage new industries and start-up creation, and to market technology to industry. This, together with US Government support through funding of the technology and start-up creation, led to the success of these regions.

The legislative model enhances the “triple helix” by introducing formal structures at research institutions, such as technology transfer offices (TTOs). These structures act to ensure technology transfers²²¹ and knowledge flows between research institutions and industry so that technology is further developed and commercialised²²². In addition, the legislation clarifies the locus of ownership of IP that results from publicly funded research, and seeks to increase the social rate of return / public benefit on US government investment²²³. At its heart, therefore, the Bayh-Dole model is a competitiveness and economic revitalisation initiative. It intends to reconnect academic research and innovation to the mainstream economy.

6.3.2 Current South African landscape

6.3.2.1 Problem identification and current status quo

South Africa’s programme for public funding of early-stage technology development is impacted by the South African Intellectual Property Rights from Publicly Funded Research Act No 51 of 2008 (IPR-PFRD Act). The Act is South Africa’s comparable legislative framework to the “triple helix” relational ecosystem that seeks to promote the commercialisation of IP from publicly funded research. South Africa’s funding programmes have received low uptake by industry²²⁴. Stakeholders engaged in this research indicated that insufficient clarity and poor industry perception related to the IPR-PFRD Act exacerbate the unattractiveness of public funding for industry and entrepreneurs, culminating in the low uptake.

As problematic is the lack of capacity, competence and funding of TTOs set up under the IPR-PFRD Act. These offices and personnel are not yet achieving their required goals of strengthening the currently weak relationships between academia and business. The result is that technology transfer from research to industry and commercialisation of such research by industry falls short of its potential in South Africa. Due to the fact that the IPR-PFRD Act has only been in existence for just over four years, it is argued that there has not been sufficient time for the TTOs to build the requisite capacity and competence to support the aims of the IPR-PFRD Act in strengthening the “triple helix” relational ecosystem and thus increasing the commercialisation of IP.

²²⁰ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

²²¹ Etzkowitz, H. 2013. Silicon Valley: The Sustainability of an Innovative Region. Stanford University, Human Sciences and Technologies Advanced Research. Institute Centre for Entrepreneurship Research, Edinburgh University Business School. Department of Management, Birkbeck, University of London.

²²² Wessner, C.W. 2008. Converting Research into Innovation & Growth. SBIR, the University and the Park. Investing in Innovation: Promoting New Opportunities in the United Nations Economic Council for Europe Region. The National Academies.

²²³ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²²⁴ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

6.3.2.2 Public support programmes for technology innovation / R&D

South Africa has two main programmes offering public funding to technology-orientated firms: the Support Programme for Industrial Innovation (SPII), and the Technological Human Resources for Industry Program (THRIP). The programmes are designed to increase the firm's engagement in R&D and ultimately translate it into new products and services through innovation and commercialisation²²⁵. The Department of Trade & Industry (dti) manages both programmes. Additional programmes are in existence and are summarised in Appendix 3.

The SPII seeks to promote technology development within South Africa through the provision of matching grants for the development of innovative, competitive products and/or processes. The funding is focused on the development phase, which begins on conclusion of the research and ends when a pre-production prototype has been developed. The SPII provides grants to large companies, small businesses and start-ups. The percentage of expenditure that qualifies for the grant depends on shareholdings representing BB-BEE, women and people with disabilities at the time of application. There are three main schemes within SPII:

- o The Product Process Development Scheme (PPD) provides non-repayable grants for small, very small and microenterprises, as defined in the scheme rules. Grants can be between 50% and 85% of qualifying costs²²⁶.
- o The SPII Matching Scheme provides a non-repayable grant of between 50% and 75% of qualifying costs incurred in pre-competitive development activity, up to a maximum grant amount of R5 million. The scheme caters for both large and small businesses; however, large companies only qualify for 50% of qualifying costs²²⁷.
- o The SPII Partnership Scheme is based on similar rules as the Matching Scheme but aimed at funding for large-scale technology development within South African industries. The grant is conditionally repayable and is up to 50% of the qualifying costs incurred in the development activity. There is a minimum grant amount of R10 million²²⁸.

The THRIP is funded by the dti and managed by the National Research Foundation (NRF). THRIP supports projects on a cost-sharing basis with industry. It supports science, engineering and technology research collaborations between research institutions and industry, and focuses on addressing the technology needs of participating firms. It also enhances the quality and quantity of skills necessary for research and technology development²²⁹. Despite certain shortcomings, the THRIP programme was reported in a 2007 OECD study as being very effective in fostering university links and integrating research-capable human resources in projects²³⁰.

²²⁵ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²²⁶ South Africa. Support Programme for Industrial Innovation. 2013. Support Programme for Industrial Innovation: Product Process Development Scheme (PPD) Rules document. Version 4. Support Programme for Industrial Innovation. www.spil.co.za

²²⁷ Ibid

²²⁸ South Africa. Support Programme for Industrial Innovation. 2013. SPII Rules Document. Matching and Partnership Schemes. Version 3.1. Support Programme for Industrial Innovation. www.spil.co.za

²²⁹ South Africa. Department of Trade & Industry. 24 June 2014. THRIP – The Technological Human Resources for Industry Programme. Department of Trade & Industry. www.thedti.gov.za

²³⁰ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

6.3.2.3 The Intellectual Property Rights from Publicly Financed Research and Development Act, No 51 of 2008

The IPR-PFRD Act, like similar legislation in many other countries, uses the same framework as the USA Bayh-Dole Act. The IPR-PFRD Act aims to enhance the “triple helix” by introducing formal TTOs at research institutions. It is intended that these TTOs promote technology transfer of appropriately protected IP from research institutions to industry²³¹, and encourage knowledge flows between research institutions and industry so that technology is further developed and commercialised²³². In accordance with the Bayh-Dole model, the legislation clarifies the locus of ownership of IP that results from publicly funded research, and seeks to increase the social rate of return/public benefit on government investment²³³.

In South Africa, the ownership is with the “recipient” of the public funding for R&D, which is in most cases the research institution, as with the USA. This places responsibility on the TTOs at the research institution to protect and licence IP, as well as ensure that it is commercialised. In addition, “recipients” of public funding have obligations to report to the National Intellectual Property Management Office (NIPMO), established to promote the objectives of the IPR-PFRD Act. NIPMO ensures that IP emanating from publicly funded research is identified, protected, utilised and commercialised for the benefit of the people of South Africa and in the public interest²³⁴. The South African government retains “march in” rights so that government has the power to override and intervene in arrangements that do not serve the public interest and the intention of the funding allocation²³⁵.

The key features of the IPR-PFRD Act are as follows:

- **Establishment of the National Intellectual Property Management Office (NIPMO)**
 - o The Act establishes NIPMO, an office whose main function is to promote the objects of the IPR-PFRD Act, namely the statutory protection, management and commercialisation of IP from publicly funded R&D²³⁶. NIPMO’s role is, thus, ultimately to facilitate the commercialisation and utilisation of publicly funded research for the benefit of the people of South Africa, in accordance with the objectives of the Act²³⁷.

²³¹ Etzkowitz, H. 2013. Silicon Valley: The Sustainability of an Innovative Region. Stanford University, Human Sciences and Technologies Advanced Research. Institute Centre for Entrepreneurship Research, Edinburgh University Business School. Department of Management, Birkbeck, University of London.

²³² Wessner, C.W. 2008. Converting Research into Innovation & Growth. SBIR, the University and the Park. Investing in Innovation: Promoting New Opportunities in the United Nations Economic Council for Europe Region. The National Academies.

²³³ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²³⁴ South Africa. NIPMO. No date. OTT Framework: Striving towards a technology transfer orientated nation. Department of Science & Technology.

²³⁵ So, A.D.; Sampat B.N.; Rai A.K.; Cook-Deegan, R.; Reichman, J.H.; Weissman, R.; Kapczynski, A. 2008. Is Bayh-Dole Good for Developing Countries? Lessons from the US Experience. Vol 6 Issue 10. PLOS Biology www.plosbiology.org.

²³⁶ South Africa. President’s Office. 2008. No. 51 of 2008: Intellectual Property Rights from Publicly-Financed Research and Development Act (IPR-PFRD Act), 2008. Section 9. President’s Office. www.info.gov.za

²³⁷ Note that “research and development” (R&D) is not defined in the IPR-PFRD Act. In practice, NIPMO applies the OECD definition of R&D, which includes Basic Research, Applied Research and Experimental Development. An R&D activity is distinguished from a non-R&D activity “by an element of novelty and the provision of a solution to a problem, which was not obvious to a person with basic common knowledge of the field in question”. Education and training as well as administration and other supporting activities are excluded (South Africa. NIPMO. 2012. Guideline 1 of 2012 Interpretation of the Scope of the Intellectual Property Rights from Publicly Financed Research and Development Act (Act 51 of 2008): Setting the Scene. Department of Science and Technology)

- **Ownership**

- o The “recipient” own IP developed from state-funded research. The “recipient” in the IPR-PFRD Act is anyone who undertakes R&D using funding from the state.
- o In many cases the recipient is a university or research institution, although it is not limited to such. Where the recipient does not wish to own the IP, they must notify NIPMO.
- o Should NIPMO decide not to acquire ownership of the IP, the private entity funder (if any) is given an option to acquire ownership.
- o In the event that the funder does not want to acquire ownership, the creator of the IP is then given the option to acquire ownership.
- o The party who has ownership and licenses the IP must give preferential licensing to B-BBEE concerns and SMEs and for non-exclusive licences²³⁸.
- o Should a party acquire ownership through outright purchase of the IP for purposes of commercialising the IP, they are then the owner and are consequently not subject to management under the IPR-PFRD Act²³⁹.

- **Obligations of the recipient**

- o The recipient is obliged to assess the IP and determine whether it merits statutory protection.
- o The recipient must disclose the IP to NIPMO and provide full reasons to NIPMO if it decides not to commercialise the IP.
- o In addition, a recipient must report to NIPMO twice a year (on a form IP7²⁴⁰) on all matters pertaining to the IP governed by the IPR-PFRD Act, including statutory protection and commercialisation thereof²⁴¹.

- **Government ‘march-in’ rights under IPR-PFRD Act**

There are three main instances in which the IPR-PFRD Act empowers the South African government to override and intervene in IP arrangements that do not serve the public interest and the intention of the funding allocation. In only one of the instances is the South African government entitled to take ownership of the IP, and this is after consultation with the IP owner. The three instances are outlined below:

- o Each IP transaction must provide the state with an irrevocable and royalty-free license to use the IP throughout the world for health, security and emergency needs of South Africa. In other words, government has the right to use IP developed pursuant to the IPR-PFRD Act and not pay royalties for such use. This is only exercisable in limited and extreme circumstances, namely, by Proclamation by the President, pursuant to a determination by Parliament and only until the need is alleviated. That is, government does not obtain ownership, only temporary use of the IP in emergency circumstances.

²³⁸ South Africa. President’s Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 11. President’s Office. www.info.gov.za

²³⁹ South Africa. President’s Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 4. President’s Office. www.info.gov.za

²⁴⁰ South Africa. President’s Office. 2010. Regulations to the IPR-PFRD Act, 2010. Regulation 14(1)(a). President’s Office. www.info.gov.za

²⁴¹ South Africa. President’s Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 5. President’s Office. www.info.gov.za



- o If the holder of an exclusive licence (a licence limited only to use by him or her) to IP discontinues or delays commercialisation of this IP, the state may request conversion to a non-exclusive licence (use by anyone) or require the holder to grant the licence to a third party. In such a case, NIPMO must first consult with the holder to understand the reasons for their discontinuation or delay in commercialisation. Thereafter, NIPMO must provide the holder with 6 months to make progress in commercialising, and will only exercise its rights under this section if the holder does not take the necessary steps in this time. Note that the interventions by NIPMO do not amount to the taking of *ownership* of the IP, and NIPMO has no authority to do so in these circumstances²⁴². Any such decision of NIPMO regarding conversion or licensing is subject to review by a Dispute Panel.
- o Lastly, the state may only demand that the IP owner transfers ownership of the IP to the state if the holder did not disclose the IP as required under the IPR-PFRD Act. NIPMO must first ask for reasons from the holder why ownership of the IP should not be transferred to the state, and then make a decision based on these reasons and any further information provided by the IP owner. In other words, the IP owner can motivate why the IP should not be taken by the state. NIPMO's decision to have the IP transferred to the state is subject to review by a Dispute Panel²⁴³.

- **Technology transfer offices (TTOs)**

Universities and other institutions as defined in the IPR-PFRD Act must establish a TTO²⁴⁴. The TTOs are responsible for developing, protecting and commercialising IP, and for receiving and analysing disclosures of potential IP from state-funded research. Disclosures must thereafter be referred to NIPMO. TTOs are also responsible for fostering relationships and knowledge flows between industry and academia²⁴⁵.

6.3.2.4 Innovation and commercialisation in South Africa

Using the number of researchers and patents granted as indicators, South Africa's innovation performance is relatively low when compared with other countries. Furthermore, levels of licensing fees accruing to research institutions indicate that the commercialisation of publicly funded IP in South Africa is also relatively low.

As the IPR-PFRD Act is largely based on the Bayh-Dole model, which has shown significant success in increasing innovation and commercialisation of IP in countries such as the USA, it is reasonable to assume that the IPR-PFRD Act also has the potential to increase innovation and commercialisation of IP in South Africa. However, as the IPR-PFRD Act has only been in existence for over four years, time is needed to build the requisite capacity, networks and infrastructure in order to support the aims of the IPR-PFRD Act.

- **Researchers and patents**

The table below reflects a comparison in the number of researchers for South Africa, Japan, UK and USA from 2004 to 2010 based on the number of researchers per 1000 FTE employed. Although it is a priority in South

²⁴² South Africa. President's Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 11 and 14. President's Office. www.info.gov.za

²⁴³ South Africa. President's Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 14. President's Office. www.info.gov.za

²⁴⁴ South Africa. President's Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 6. President's Office. www.info.gov.za

²⁴⁵ South Africa. President's Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 7. President's Office. www.info.gov.za



Africa to increase the number of South African researchers, Table 4 highlights the low proportion of researchers in South Africa as compared with these other countries²⁴⁶.

Table 4: Comparison of indicators of Researchers in SA, Japan, UK and USA between 2004 and 2010²⁴⁷

	2004	2005	2006	2007	2008	2009	2010
South Africa	1.5	1.4	1.4	1.4	1.4	1.5	1.4
Japan	10.1	10.4	10.4	10.4	10.0	10.1	10.2
United Kingdom	7.4	7.9	8.0	7.9	7.9	8.1	8.2
USA	9.8	9.6	9.6	9.5	-	-	-

Similarly, in comparing the number of patents, it is evident that South Africa's patent activity has been low²⁴⁸, especially in comparison to other "equivalent" BRICS countries, which have shown large increases in patent application figures. The relationship between patents and economic growth is suggested in the World Bank report, which shows that a 1% increase in the annual number of US Patent and Trademark Office patents granted is associated with a 0.9% increase in annual economic growth²⁴⁹.

Table 5 below reports on the number of patent applications and patents granted in the BRICS countries, as well as Japan, UK and USA from 2010 to 2011:

Table 5: Patent Applications and Patents Granted for SA and Selected Countries 2010 / 2011²⁵⁰

	South Africa	Brazil	China	India	Russia	Japan	United Kingdom	United States
Patent Applications	1 761	6 363	436 144	15 860	31 463	474 984	50 749	440 433
World Share of Patents Published	0.08	0.29	19.99	0.73	1.44	21.77	2.33	20.19
Patent Applications per Million Capita	35	32	324	13	155	3708	809	1 413
Patents granted	1 124	947	118 164	2 884	22 179	384 848	18 374	202 207
Patents Granted per Million Capita	22	5	88	2	155	3004	293	649

Excluding India and Brazil, it is apparent from the above that the number of patents granted in South Africa is significantly lower than those granted in the other countries cited. Furthermore, the South African Science and

²⁴⁶ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science and Technology.

²⁴⁷ OECD. 2011. Main Science and Technology Indicators. Volume 2011/2. OECD.

²⁴⁸ Tuomi, K.; De Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technology Management & Innovation. Vol. 8 No. 2. Santiago. <http://dx.doi.org>

²⁴⁹ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²⁵⁰ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science and Technology.



Technology Indicators 2013 reports a sharp decline in patents granted at the South African Patent Office between 2003 and 2011.²⁵¹

The South African National Research & Development Strategy has suggested indicators such as patents are key to monitoring technological improvements and innovation²⁵². However, some academics and industry practitioners have cautioned that patents are not a perfect measure of innovation and should not be considered in isolation²⁵³. They argue that certain innovations, such as process innovations and know-how, are generally not patented and other forms of protection may be more relevant, particularly in technology companies. In addition, the high costs of applying for and maintaining a patent may deter many from filing for their protection²⁵⁴. Input from expert advisors has suggested that costs of registration and maintaining of patents in South Africa are too high. Furthermore, the quality of patents tends to be poor. These problems may fundamentally discourage IP creators from registering patents on their IP in South Africa, and thus the number of patents reported as granted may possibly not be an accurate reflection of innovation taking place in South Africa.

- **Commercialisation of IP from publicly funded research**

While patents are one measure of innovation and R&D outputs that are protectable, they are not necessarily a measure of the commercialisation of new IP²⁵⁵. Licensing receipts that accrue to research institutions are a valuable source of data that reflects the commercialisation of IP.

NIPMO reports that as at 6 May 2014, its database consisted of approximately 470 active IP statuses and commercialisation reports. This reflects IP resulting from R&D activity through publicly funded research institutions after 2 August 2010 (relative to the implementation of the IPR-PRFD Act), and does not include IP funded on a full cost basis by private entities and organisations for which the institution retained ownership. The total licensing revenue received by research institutions in South Africa for IP emanating from a publicly financed R&D activity and generated after 2 August 2010 is about R1,5 million. Although licensing revenues are increasing in South Africa²⁵⁶, this is low compared to the USA's gross licensing revenues, which were reported to be \$200 million in 1991, \$250 million in 1992²⁵⁷, and \$3.4 billion in 2008²⁵⁸.

²⁵¹ Ibid. Figure 20

²⁵² South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science and Technology.

²⁵³ Other indicators utilised in the South African National R&D Strategy include: Human capital (researchers per thousand workforce, Science, Engineering & Technology (SET) demography), Technological progress (patents, high-tech start-ups, business innovation investment, key technology missions), publications, imported technology etc. South Africa. The Government of the Republic of South Africa. 2002. South Africa's National Research and Development Strategy. Government of the Republic of South Africa www.esastap.org.za

²⁵⁴ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²⁵⁵ Loof, H and Hesmati, A. 2005. The Impact of Public Funding on Private R&D Investment. New Evidence from a Firm Level Innovation Study. Paper No. 6. The Royal Institute of Technology. Centre of Excellence for Studies in Science & Innovation.

²⁵⁶ South Africa. Weyers, J. 6 May 2014. E-mail: Request for Information-The SiMODiSA Initiative. NIPMO.

²⁵⁷ Syracuse University. Syracuse University Homepage. What is Bayh-Dole and why is it important to technology transfer? Syracuse University. www.techtransfer.syr.edu

²⁵⁸ Loise, V and Stevens, A.J. 2010. The Bayh-Dole Act Turns 30. Boston University. www.bu.edu



A survey by the Association of University Technology Managers (AUTM) conducted in 2010 reported the following for the USA²⁵⁹:

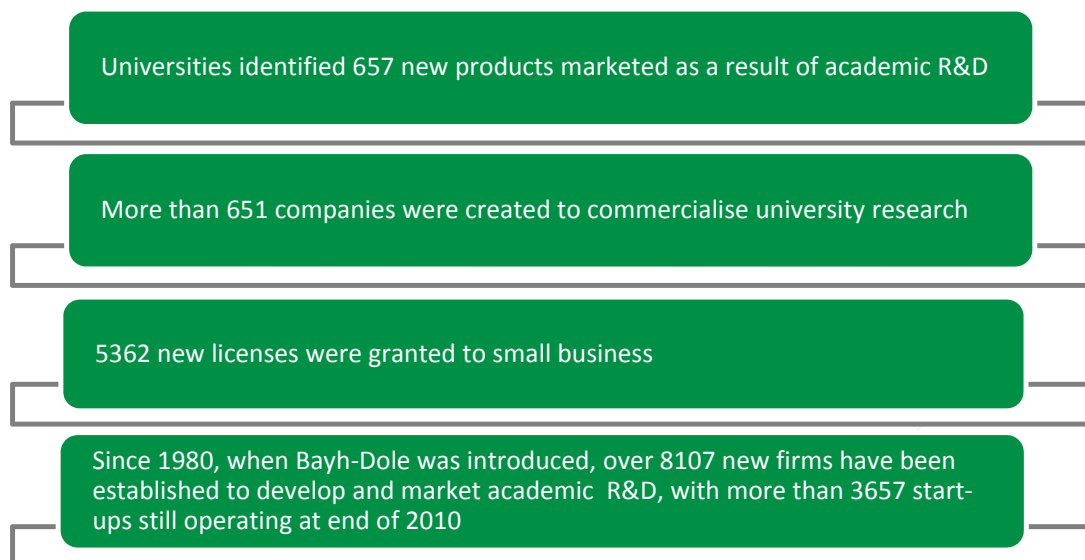


Figure 8: AUTM Survey Results: Licensing Activity and Start-Up Creation

Unfortunately, other than the amount of licensing fees accruing to research institutions, South Africa does not yet have figures indicating new products marketed and start-ups and companies created to demonstrate commercialisation as a result of academic research. Engagements with NIPMO have confirmed that they are about to embark on a study that will provide South African figures related to the above. Although additional measures are necessary to gain a real sense of the impact of the IPR-PFRD Act on commercialisation of IP, based on the licensing fees that accrue to South African research institutions, the commercialisation level of government-funded research is considered to be very low. The World Bank study on Fostering Innovation Absorption in Enterprises in Southern Africa confirms this perception by reporting that there is evidence to suggest that there may be considerable scientific knowledge, residing in the universities and research organisations in South Africa, which is not being accessed by firms²⁶⁰.

Other than the significant size difference between the USA and South Africa's economies, there are numerous context-specific reasons for the low rate of commercialisation of IP in South Africa. The Bayh-Dole Act has been in existence since 1980, giving TTOs at research institutions significant time to establish themselves, attract the required staff and build links with the business sector to promote the commercialisation of IP, which have resulted in increased licensing flows²⁶¹. In addition, technology transfer in the USA has evolved enormously as a profession over the 30 years since Bayh-Dole was passed, and the average number of employees in TTOs in the USA has grown significantly during this time²⁶².

²⁵⁹ Schacht, W. H. 2012. The Bayh-Dole Act: Selected Issues in Patent Policy and the Commercialisation of Technology. CRS Report for Congress. Congressional Research Service. www.crs.gov

²⁶⁰ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

²⁶¹ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²⁶² Loise, V and Stevens, A.J. 2010. The Bayh-Dole Act Turns 30. Boston University. www.bu.edu

On the contrary, South Africa's IPR-PFRD Act has been in existence for only four years and consequently, insufficient time has passed for TTOs to build requisite capacity, networks and infrastructure in order to support the aims of the IPR-PFRD Act, and at the very least, testing thereof. Expert advisors and stakeholders have further reported that the technology transfer profession in South Africa is still in its infancy, and as a result, these skills are still in short supply. It is estimated that it takes approximately 5 to 7 years to acquire the necessary skills and experience required by this profession. At this stage the TTOs cannot perform at the levels of output required to maximise commercialisation of publicly funded IP. In addition, TTOs can take a number of years to be effective and "at times it can be more than twenty years before real accomplishment is seen"²⁶³.

There is a school of thought that believes that the stimulating of business sponsorship of university research and increase in licensing activity in the USA is due to many factors, and not just the Bayh-Dole Act. However, the overwhelming view is that Bayh-Dole has been a success in leading to significant stimulation of these activities²⁶⁴. One can consequently deduce that the structure of the legislation itself has potential to create a workable system for the commercialisation of IP. Therefore, structure and wording of the legislation aside, it is important to consider what the key blockages are in South Africa to the growth in the transfer and commercialisation of innovation from research institutions to the business sector, and to a perceivable increase in the measures of innovation. These key blockages are briefly outlined immediately below.

6.3.2.5 Challenges with public funding: the South African Triple Helix relational ecosystem

South Africa's potential for innovation, commercialisation and economic growth is not being met. Key obstacles to the uptake of government funding to develop IP, as well as commercialisation of IP, are set out in more detail below.

6.3.2.5.1 Low uptake of public funding of R&D for increased innovation and commercialisation

According to the World Bank study on Fostering Technology Absorption in Enterprises in Southern Africa, public funding for technology development is rarely accessed in South Africa, with only 5% of firms receiving support for this activity. This is concerning since firms reported that a lack of internal funds was, after market domination by established firms, the second highest constraint to innovating. Numerous reasons were cited for low uptake of public funding, namely, lack of awareness of government programmes for technology support; the difficulty experienced in accessing such programmes due to overburdening paperwork requirements; and the inefficiency of the programmes. Furthermore, an insufficient number of programmes available to incentivise investment in R&D were also reported. Although the THRIP programme has been reported as being very effective in fostering links between research institutions and industry, there is clearly also low uptake and limited awareness regarding this programme²⁶⁵. In addition, even though THRIP fosters collaboration between research institutions and industry, it is not clear whether SPII has this focus and related outcomes.

²⁶³ South Africa. NIPMO. 2013. OTT Framework. Department of Science and Technology.

²⁶⁴ Schacht, W.H. 2012. The Bayh-Dole Act: Selected Issues in Patent Policy and the Commercialisation of Technology. CRS Report for Congress. Congressional Research Service. www.crs.gov

²⁶⁵ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.



6.3.2.5.2 Challenges with the Triple Helix relational ecosystem leading to low commercialisation

Challenges with the triple helix relational ecosystem include insufficient clarity in industry, poor industry perception related to the IPR-PFRD Act, as well as a lack of capacity, competence and funding of TTOs set up under the IPR-PFRD Act. These challenges can be further understood as follows:

- The lack of clarity around the workings of the IPR-PFRD Act results in insecurity and poor perceptions of the Act and its implications. Lack of clarity and resultant persisting myths are primarily concentrated around ownership of the IP and government walk-in rights. This uncertainty results in a reluctance to be exposed to and/or managed by the IPR-PFRD Act, and because the Act applies to IP developed using State funding, there is a belief that the use of State funding will “contaminate” the IP. Indeed, there appears to be a fundamental breakdown in government understanding of the IPR-PFRD Act versus industry understanding. This is in contrast to the USA where it is reported that the general perception is that many welcome Bayh-Dole for clarifying ownership rules²⁶⁶.

NIPMO is aware of the uncertainty and plans to publish and distribute nine guidelines to provide clarity on the IPR-PFRD Act. More specifically, the following key misunderstandings and myths among industry, academia, advisors and inventors’ have been identified in relation to the IPR-PFRD Act:

- Only the university or research institution can own the IP, and it is not possible for any other party to own the IP.
 - Where there is ownership by the recipient of IP developed through State funding, the state can exercise its “march-in” rights at any time and confiscate the IP. Furthermore, it can be confiscated with no compensation.
 - There is a lack of awareness that it is possible to acquire the IP from the university or research institution for commercialisation, and in that event the IP will no longer be subject to the management of NIPMO and the IPR-PFRD Act.
 - There is a lack of clarity around the timing of contracting in co-ownership arrangements between research institutions and the private sector regarding IP emanating from publicly funded research. It is not clear whether contracts must be concluded before the IP is developed. The disadvantage of such timing is that as the IP is not yet developed, and the value of the IP that will be generated is not yet known.
- As demonstrated above, the IPR-PFRD Act is based on the Bayh-Dole Act, which is reported to have been successful in strengthening industry and university relations, stimulating commercialisation of IP, and increasing licensing flows. Despite South Africa adopting the Bayh-Dole model, its implementation is still in its infancy and the relationship between South African research institutions and industry is weak. The weak links between industry and research institutions in South Africa have been further confirmed by the World Bank study²⁶⁷.

²⁶⁶ So et al. 2008. Is Bayh-Dole Good for Developing Countries? Lessons from the US Experience. Vol 6 Issue 10. PLOS Biology www.plosbiology.org.

²⁶⁷ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.



A key role of TTOs is to promote relationships with industry on behalf of the research institutions in order to build flows of technology to industry; ensure that IP being developed meets industry needs; and attract commercialisation funding to ensure that new processes and products are taken to market, thus stimulating economic growth. As the relationship between industry and research institutions is weak and the triple helix system is not operating adequately, there is considerable research and technology within research institutions that is not being accessed and commercialised by industry²⁶⁸.

- TTOs must be equipped with the necessary skills, capital and infrastructure to enable them to build relationships with industry and ensure technology flows. However, the technology transfer profession is still in its infancy in South Africa, and thus the nature of the skills required by TTOs is in short supply. Stakeholders suggest that the required skill set should include experience in licensing and commercialization, coupled with an entrepreneurial nature, the requisite ability to foster successful spin offs and take products to market. In addition, it is recommended that skills in engineering, science and chemistry would prove of significant additional value. Without these essential skills, it is difficult for TTOs to build credible and strong business relationships with industry. It is reported that TTOs are not only under-capacitated but that many staff do not yet have the required skill set, which will take a number of years to attain. Indeed, estimates of 5 to 7 years in order to acquire the necessary skills and experience have been reported. Because of this, it is unlikely that R&D commercialisation flows will significantly improve in the near term without significant intervention. Although there are emerging courses and institutions beginning to train people specifically in the commercialisation and licensing of technology, there is insufficient awareness of these courses, as well as a lack of incentives for people to take up these courses.
- The IPR-PFRD Act gives NIPMO the power to fund TTOs, develop the appropriately skilled personnel for the TTOs²⁶⁹ and develop guidelines to assist the public in understanding the Act²⁷⁰. However, NIPMO is itself too under-staffed and under-funded to adequately meet the required goals in this regard. As mentioned above, relationships between research institutions and industry cannot be significantly improved without adequate staff and skill levels at the TTOs. However, this is unlikely to improve if the current status quo regarding understaffing and underfunding at NIPMO continues. Further, the lack of staff at NIPMO will also mean that the publication of the guidelines, urgently required to alleviate the current misconceptions in industry, will be slow.
- Lastly, the Public Finance Management Act No 1 of 1991 (PFMA) requires public entities to obtain approval from National Treasury to set up a new entity, such as a spin off start-up enterprise. Although this is not directly within the scope of the IPR-PFRD Act, such a process will severely inhibit the potential of certain public entities, such as research institutions, to be able to commercialise innovations, as is intended under the IPR-PFRD Act and the mandate of NIPMO. Approval can take up to two years because the application goes via the Department of Science and Technology (DST)²⁷¹.

²⁶⁸ Ibid

²⁶⁹ South Africa. President's Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 6. President's Office. www.info.gov.za

²⁷⁰ South Africa. President's Office. 2010. Regulations to the IPR-PFRD Act, 2010. Regulation 3. President's Office. www.info.gov.za

²⁷¹ South Africa. National Treasury. 1999. No. 1 of 1999. The Public Finance Management Act. Section 51(g) President's Office. www.treasury.gov.za



6.3.3 International precedent for government-funded IP

Consideration of international precedent, relating to public funding programmes and policies designed to increase innovation and commercialisation of IP, is given below. An overview of the two main models of legislation systematising and promoting commercialisation of IP from publicly funded research is also included.

6.3.3.1 Public funding programmes for innovation and commercialisation

Internationally there are many public support programmes aimed at stimulating technological development and commercialisation by firms, most particularly start-ups and small businesses. The two most successful programmes are the Small Business Innovation Research (SBIR) programme in the USA and the TEKES programme in Finland. Both are matching grant programmes and funding ends when a pre-production prototype has been developed. Although their selection process focuses on programmes that are more likely to generate innovation that can be commercialised, their approach is neutral and they do not prescribe in advance which technological areas or projects to support. Both instruments are used to promote cooperation between the private sector and universities or research institutes by favouring collaboration on research or consortia²⁷².

6.3.3.1.1 SBIR Programme

The SBIR programme supports research by early-stage technology start-ups in scientific and engineering areas. The eligibility criteria are that the small business must be for-profit, American-owned, be independently operated and have no more than 500 employees. Grants are made in two phases, which include the exploration of feasibility of the technology (awards of up to \$100,000 for approximately 6 months), and expanded R&D work to evaluate commercialisation potential or to develop a prototype (awards of up to \$750,000)²⁷³.

A study of the SBIR by the National Research Council of the National Academies reported that 20% of respondent companies said they were founded as a result of a prospective SBIR award. For 70% of respondents, SBIR awards played a key role in the decision to pursue a research project and resulted in significant firm growth²⁷⁴. Along with a successful rate of commercialisation of products, it has contributed to building cooperation between industry and research institutions, and thus fostered the transition of university research to the marketplace. Due to its success, a number of countries have adopted programmes modelled on SBIR, including Sweden, Russia, UK, the Netherlands, Japan, Korea, Taiwan and other Asian countries²⁷⁵.

6.3.3.1.2 TEKES

The Finnish programme is modelled on the SBIR and is administered by the Finnish Agency, TEKES. The emphasis of TEKES is on grant funding for start-ups and projects with high technological and commercial risks. Evaluation of the programme has shown positive returns for the promotion of R&D cooperation and coordination between the relevant players, and is considered to be a great success. In 2004, 82% of the support funds administered by the agency were in the form of neutral grants, and 42% were allocated towards technology programmes. In

²⁷² Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²⁷³ Ibid.

²⁷⁴ Wessner, C.W. 2008. Converting Research into Innovation & Growth. SBIR, the University and the Park. Investing in Innovation: Promoting New Opportunities in the United Nations Economic Council for Europe Region. The National Academies.

²⁷⁵ Squillante, M. 2011. The SBIR Programme-It is Working! SBTC Board Chair Testimony before the House Committee on Small Business. Appendix D. Small Business Technology Council of the National Small Business Association.

2006, TEKES was considered to reflect international best practice in support of innovation through grants, according to Goldberg et al²⁷⁶.

6.3.3.2 Legislation promoting commercialisation of Intellectual Property from Publicly Funded Research

Two models of legislation designed to systemise and promote the commercialisation of IP from publicly funded research are described below. The first model is the Bayh-Dole model originating in the USA and followed in many countries; the second model is the “professor’s privilege” model used in Sweden.

The main features of the USA Bayh-Dole Act are laid out below in comparison with the South African IPR-PFRD Act in order to demonstrate their significant similarity.

- o Under Bayh-Dole, universities, non-profits and small business can elect to retain ownership of IP that is developed using public funding²⁷⁷. According to the IPR-PFRD Act, the recipient of the state funds, which generally (but not exclusively) includes research institutions, may elect to retain ownership.
- o In both sets of legislation the above-mentioned owners/recipients of state-funded IP must seek to commercialise the IP, and are required to report to government so that it can determine whether the IP is being adequately commercialised and is serving the public interest²⁷⁸.
- o Both legislations vest responsibilities in the recipients of state funding to manage and promote the commercialisation of IP²⁷⁹.
- o Bayh-Dole encourages universities to issue exclusive licences to business²⁸⁰. The IPR-PFRD Act requires owners to give preference to non-exclusive licensing, but allows exclusive licensing.
- o It is reported that there is generally a positive perception of Bayh-Dole in relation to its clarification of ownership rules²⁸¹. In contrast, there is much uncertainty around the IPR-PFRD Act.
- o Under both Acts, the government retains the right to use the IP temporarily in emergency or extreme circumstances. However, this does not entitle the government to ownership of the IP²⁸². Other government rights under the IPR-PFRD Act are the same as those under Bayh-Dole.²⁸³
- o Both the Bayh-Dole Act and the IPR-PFRD Act allow the “assignment” of IP. In other words, once IP has been developed, it does not necessarily have to be licensed but can be purchased. The IPR-PFRD Act

²⁷⁶ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist’s Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

²⁷⁷ So et al. 2008. Is Bayh-Dole Good for Developing Countries? Lessons from the US Experience. Vol 6 Issue 10. PLOS Biology www.plosbiology.org.

²⁷⁸ Ibid.

²⁷⁹ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²⁸⁰ So et al. 2008. Is Bayh-Dole Good for Developing Countries? Lessons from the US Experience. Vol 6 Issue 10. PLOS Biology www.plosbiology.org.

²⁸¹ Ibid.

²⁸² Ibid.

²⁸³ Schacht, W. H. 2012. The Bayh-Dole Act: Selected Issues in Patent Policy and the Commercialisation of Technology. CRS Report for Congress. Congressional Research Service. www.crs.gov

generally allows this; however, the Bayh-Dole Act allows this in only limited circumstances. In this respect, the IPR-PFRD Act is more favourable than the Bayh-Dole Act.

- o Under both Bayh-Dole Act and the IPR-PFRD Act, preferential licensing is given to SMEs²⁸⁴.

The Association of University Technology Managers reports that the following countries have similar legislation to Bayh-Dole: Brazil, China, Denmark, Finland, Germany, Italy, Japan, Malaysia, Norway, Philippines, Russia, Singapore, SA, South Korea and the UK²⁸⁵. While there is some flexibility in their content depending on the country context, many countries are adopting the Bayh-Dole framework, where research institutions mainly own the IP and are responsible for managing the commercialisation thereof²⁸⁶. The Bayh-Dole model has therefore become the norm in the developed world and is now spreading to the developing world, with Brazil, India and SA having most recently adopted it²⁸⁷.

Sweden in contrast, is the only major European country where the “professor’s privilege” model is still in place. This model was traditionally used by European countries before widespread adoption of the Bayh-Dole model.. According to the professor’s privilege model, researchers retain the ownership rights to their inventions.

The professor’s privilege model is criticised for a number of reasons. Firstly, faculty members frequently cannot afford to pay for patent protection, in which case their inventions go unprotected and are often not further developed and commercialised. Secondly, they do not have the business skills necessary to commercialise the product. Thirdly, often IP has multiple inventors and thus it is left up to the parties to agree on the centralised management of the commercialisation of that IP²⁸⁸.

Despite these potential difficulties, Sweden has implemented various supportive programmes and structures that overcome these and foster the commercialisation of research. For example, Sweden founded the Technology Link Foundation that aims to commercialise university research and stimulate co-operation between SMEs in joint projects. The country also allows universities to form “Patent & Exploitation Offices”, which are responsible for the commercialisation of university research by the private sector. The Patent & Exploitation Offices are similar to TTOs²⁸⁹. These programmes have undoubtedly been successful judging by the results of Sweden’s innovation activities. Indeed, the Innovation Union Scoreboard for 2014 reported Sweden as having the best performing innovation system in the European Union (EU), covering the whole spectrum from innovation inputs and business innovation activities to innovation outputs and economic effects²⁹⁰.

²⁸⁴ Johnson, A, R. 2009. Accelerating Commercialisation and Innovation: The US Experience with the Triple Helix. KEVIII-INSEAD. Arnold & Porter LLP.

²⁸⁵ Association of University Technology Managers. 24 June 2014. Bayh-Dole Act: Bayh-Dole Talking Points. Association of University Technology Managers. www.autm.net/Bayh_Dole_Act.htm

²⁸⁶ Graff, G.D. 2006. Echoes of Bayh-Dole? A Survey of IP and Technology Transfer Policies in Emerging and Developing Economies. Department of Agricultural and Resource Economics. University of California, Berkeley. USA

²⁸⁷ Loise, V and Stevens, A, J. 2010. The Bayh-Dole Act Turns 30. Boston University. www.bu.edu

²⁸⁸ Ibid.

²⁸⁹ Sieppmann, T, J. 2004. Global Exportation of the US Bayh-Dole Act. Vol. 30.2 University of Dayton Law Review

²⁹⁰ European Commission. 2014. Innovation Union Scoreboard 2014: The Innovation Union’s performance scoreboard for Research and Innovation. Executive Summary. EN Version. European Commission

6.3.4 Recommendations to improve understanding of legislative environment for government-funded IP and the uptake of industry participation

NIPMO has indicated that, other than administrative changes, there are unlikely to be any changes to the IPR-PFRD Act over the next two years, as the Act is new and requires sufficient time to develop the appropriate ecosystem and be fully tested. Discussions with NIPMO have confirmed their awareness of the general lack of clarity around the IPR-PFRD Act. To counter this, NIPMO is proactively undertaking strategies to engage with the public and resolve uncertainties. One such step includes publishing and distributing guidelines to explain the IPR-PFRD Act. In total there will be nine guidelines released. Guideline 1 has already been released and deals with the scope of the IPR-PFRD Act²⁹¹. As NIPMO is understaffed and underfunded, publication of the guidelines will likely be slow.

With this position in mind, broad recommendations are detailed below that have been designed to improve uptake of government-funded innovation in relation to the IPR-PFRD Act. These recommendations centre on issues of public funding, improved clarity around the IPR-PFRD Act and the strengthening of TTOs.

6.3.4.1 Public support programmes

The following recommendations in relation to public funding programmes for innovation and commercialisation by industry are made:

- o Awareness-raising programmes are necessary to build an accurate understanding of the public funding programmes that are available to firms for innovation and commercialisation.
- o The procedures to access these programmes must be simplified so that they are less cumbersome.
- o As far as possible, programmes must foster increased collaboration between research institutions and industry, and a neutral, market driven approach to funding criteria should be taken. The World Bank recommends, in this regard, that a study be undertaken to assess how THRIP may be extended for wider use to foster collaboration between research institutions and industry²⁹².

6.3.4.2 The IPR-PFRD Act and South Africa's Triple Helix relational ecosystem

Many of the recommendations below seek to bridge the gap between industry, research institutions and the government, fostering collaboration and providing industry with access to IP developed in research institutions in order to commercialise it.

6.3.4.2.1 Ownership:

- The “recipient” owns IP developed from state-funded research. The “recipient” includes anyone who received the state funding. The market perception myth regarding the scope and definition of ‘recipients’ in determining ownership must be addressed as a fundamental issue. Clarifying that this is

²⁹¹ South Africa. NIPMO. 2012. Guideline 1 of 2012 Interpretation of the Scope of the Intellectual Property Rights from Publicly Financed Research and Development Act (Act 51 of 2008): Setting the Scene. Department of Science and Technology

²⁹² World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank



not exclusively applicable to universities and research institutions is likely to at least ameliorate, if not remove, the reluctance that the misperception seems to cause in the market.

- The IP is only acquired by government where the “recipient” *prefers* not to retain ownership of the IP or *prefers* “not to obtain statutory protection for” the IP²⁹³. This is often the case where the recipient does not want to incur costs in relation to the IP. Clarity is needed that this devolution in ownership does not entitle the state to arbitrarily “take” the IP. Further clarity is also needed for industry stakeholders regarding the role of NIPMO at this point, who would give the third party private funder the option to acquire ownership, and thereafter the creator in the event that they will commercialise the IP.
- Regarding co-ownership arrangements between research institutions and the private sector, NIPMO must confirm what contracting is required upfront. In this regard, NIPMO recognises that, as there is no clarity what IP will be generated upfront and what its value might be, contractual terms are difficult to determine at this early stage. Greater clarity on the contractual terms required at this stage, including who will take the lead on commercialisation of the IP produced, is essential.

6.3.4.2.2 Government ‘walk-in’ rights under IPR-PFRD Act:

- It is imperative that awareness be raised around government’s rights under the IPR-PFRD Act, particularly confirming that:
 - o The State can only exercise its rights to *use* its royalty-free licence in very limited circumstances of health, security and emergency needs of South Africa, is required to make a public announcement, can only exercise such rights pursuant to a determination by Parliament, and can only make use of its royalty-free licence until the need is alleviated. Government does not obtain ownership of the IP, but rather temporary use of the IP in emergency circumstances.
 - o If the holder of an exclusive licence (a licence limited only to use by him or her) to IP discontinues or delays commercialisation of this IP, the state may request conversion to a non-exclusive licence (use by anyone) or require the holder to grant the licence to a third party. This is only after first consulting with the holder to understand the reasons for their discontinuation or delay in commercialisation. Thereafter, NIPMO must provide the holder with six months to make progress in commercialising, and will only exercise its rights if the holder does not take the necessary steps in this time. This intervention by NIPMO does not amount to the taking of ownership of the IP.
 - o Where a “recipient” of public funding has used the funding to create IP, they are obliged to disclose the IP to the state. If the “recipient” does not make this disclosure, the state may take ownership of the IP. However, NIPMO must first ask for reasons from the holder why ownership of the IP should not be transferred to the state, and make a decision based on these reasons and any further information provided by the IP owner. The IP owner has an opportunity to motivate why the IP must not be taken by the state. The decision of NIPMO is subject to review by the Dispute Panel.

²⁹³ South Africa. President’s Office. 2008. No. 51 of 2008: IPR-PFRD Act, 2008. Section 4(2). President’s Office. www.info.gov.za

6.3.4.2.3 Technology Transfer Offices:

- Adequately equip TTOs with sufficient and appropriately qualified personnel with skills and experience in licensing and commercialisation of technology and entrepreneurship. In this way TTOs will be equipped with the resources needed to build stronger relationships with industry, ensure technology transfer to industry and attract industry funding for commercialisation of IP, ultimately better enabling TTOs to meet the intentions of the IPR-PFRD Act.
- Increase the awareness and attractiveness of courses to train people in commercialisation and licensing of technology in order to provide the appropriate labour force to supply TTOs within this relatively new profession.

6.3.4.2.4 Resources:

- Awareness building and guidelines are crucial to reducing the uncertainty and insecurity around the IPR-PFRD Act. In addition, NIPMO's responsibility in ensuring adequately trained and skilled TTO staff is crucial in establishing strong relationships with industry and the resultant commercialisation of IP. It is suggested that NIPMO receive further funding in order to meet these urgent needs.

6.3.4.2.5 Complementary Policy:

- To foster the creation of spin-offs by research institutions, amend the PFMA Act so that approval does not have to be sought from National Treasury for new entities under a certain size.

6.3.5 Conclusion

The NDP includes innovation as a key broad strategy to fostering economic growth and creating jobs²⁹⁴. This is consistent with international recognition of innovation as a key strategy for growth and competitiveness. In addition, it aligns with the proliferation of policy initiatives designed to enhance and foster innovation ecosystems so as to maintain competitive positions in the global economy.

However, South Africa's performance on innovation is relatively low, especially when compared with other countries across the board. Furthermore, in the absence of availability of information in South Africa on further indicators of commercialisation, the relatively low levels of licensing fees accruing to research institutions supports the view that commercialisation levels of government-funded research are low. This is further confirmed by the World Bank study, which reports weak links between industry and research institutions in South Africa. As a result of the disconnect, research institutions house research and technology that is not being accessed by industry²⁹⁵.

Overwhelmingly, input suggests there is significant scope in South Africa for better incentives and stronger relationships between research institutions and industry to foster greater technology transfer and commercialisation. Attention must be given to key barriers arising from under-capacitated TTOs with inexperienced and inadequately skilled staff; and an underfunded, under-resourced NIPMO, which is responsible

²⁹⁴ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission

²⁹⁵ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank



for funding and up-skilling TTOs. Maturation and professionalisation of the TTO profession through advocacy and awareness-raising around available courses would increase its attractiveness and uptake.

The uncertainty and poor, negative industry perception around the technicalities of the South African IPR-PFRD Act are significant contributors to the weak transfers between research institutions and industry, and the low uptake of state-funding for research. The result is that government funding for R&D is considered by many to be an “untouchable”, with the perception that such IP is or will be “contaminated” by the Act. Ownership rules and government “march-in” rights are of particular concern regarding IP “contamination”. These poor perceptions and misunderstandings are being addressed by NIPMO, but again under-staffing and under-funding means that this urgent blockage cannot be speedily addressed. Given the need to bolster uptake and commercialisation of state-funded IP and reap its potentially positive impact on the South African economy and jobs, we suggest that the above recommendations be given attention and addressed urgently.



6.4 Pilot Public Funding Model: Venture Capital and SME Investing

6.4.1 Introduction

6.4.1.1 The role of SMEs

It is well established that small and medium size enterprises (SMEs) are the only known engine for job growth. SMEs create a significant number of jobs; on average, an SME can create 200 new jobs. These jobs also tend to be higher paying²⁹⁶. As key drivers of economic growth and poverty reduction²⁹⁷, SMEs will be responsible for the creation of the greater part of much needed new employment opportunities in South Africa, and not large corporations or multinationals. This will have substantial benefits and ripple effects that will flow to other stakeholders in the ecosystem and to the economy overall²⁹⁸. These benefits will typically be generated through both employment creation and the delivery of products and services to new customer groups, extending these benefits further to the broader ecosystem within which SMEs reside and operate. However, without a concerted focus on supporting entrepreneurship and the growth of SMEs, job creation strategies will not be successful and economic growth will not be achieved

6.4.1.2 The needs of SMEs

In order for SMEs to generate the growth and yield which they are capable of, and in order for investors to have the confidence to invest in them, they require high-skilled, high-touch fund management intervention. This should comprise of both high-risk capital commitments for a sustained period of time and significantly more non-financial support than other sectors.

However, hands-on management expertise is expensive and may render SME investment a less lucrative proposition for investors than the risk profile requires. The catch-22, therefore, is that without intervention, neither the SME nor the VC sectors will yield the kind of returns to attract high-risk investors; with intervention, the additional cost burden may reduce returns if these are not subsidised to some extent at the early stage of industry building. This loop of causality is the market failure that our recommendations address, and an investment into these sectors by government will yield long-term returns, both to the Fiscus and the economy as a whole.

SMEs, particularly high-growth-potential start-up ventures, face significant difficulties in accessing funding²⁹⁹ and fulfilling potential, most especially in South Africa. Indeed, the SME ecosystem is particularly underdeveloped in South Africa, where the most recent data reports an Early-stage Entrepreneurial Activity level less than half the average for Sub-Saharan Africa³⁰⁰. SMEs are core to the existence of an entrepreneurial and innovative ecosystem that generates the kind of growth necessary to enhance development and prosperity. Because of this, these challenges need to be overcome.

In order to support the growth and development of SMEs, a dynamic and vibrant angel and venture capital market ecosystem is essential. In addition to crucial injections of funding at a stage when other forms of

²⁹⁶ Djordjevic, J. 2012. Why Becoming Large Matters: How Scalable, High-Growth Entrepreneurs Can Help Solve the Jobs Crisis. Endeavor Insight, New York.

²⁹⁷ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

²⁹⁸ SEAF. 2011. Impact Beyond Investment. 2011 Development Impact Report. Washington.

²⁹⁹ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³⁰⁰ GEM. 2014. Global Entrepreneurship Monitor 2014 Report. GEM.



finance are difficult to obtain, angel investors and VCs bring a substantial amount ‘high-touch’ management expertise to the table, which hugely enhance the business’s prospects of success³⁰¹.

SME investment in South Africa has significant potential to grow rapidly if it were to receive the kind of catalytic support necessary to enable it to reach critical mass. Essential in this regard is government intervention; targeted activity that will “prime the pump”, develop the expertise, track record and confidence in investment advisors with experience in this sector. Such intervention will unlock important financial capital that can provide both positive returns and significant economic growth contributions.

6.4.1.3 Rationale for recommendation

International precedent and case studies suggest that establishing a mechanism through which private sector investment, skills and high-risk private sector capital can be attracted at scale can be a powerful tool in establishing strong foundations for an SME and VC growth market. Evidence illustrates that government interventions aimed at attracting private skills and capital to early-stage SMEs take a variety of forms. Indirect measures to increase the attractiveness of the sector include tax incentives and the removal of barriers within the ecosystem. Alternatively, direct measures target the supply-demand relationship by providing loans or subsidies to stimulate activity³⁰². It is important to acknowledge the inextricable duality of the problem at hand and to ensure that interventions are not restricted to just one facet of this equation, but instead are part of a complementary set of policies that work together to catalyse growth.

A co-investment programme represents a more innovative and effective catalytic tool that could significantly “change the game” for this sector if applied in South Africa. In the programme, private sector managers match committed government funding by raising capital from private investors. The capital is then invested into high-growth-potential companies. The managers are appointed according to their high level of skill and expertise in managing growth in the SME and VC areas respectively. The matching of private sector investor and government sector funds serves to share the risk of investment, a significant benefit in light of the information asymmetry that investors face in assessing potential investments into SMEs³⁰³; and enhance the potential returns for investors.

Figure 9, below, illustrates the difference in exit performance between companies based on the source of their VC funding. This finding, based on over 20,000 companies from 25 countries, clearly portrays the power of co-investment schemes³⁰⁴. The combined VC inputs from government and private sectors achieved higher exit rates than either sector operating in isolation. Government’s involvement fulfils a “certification” role and increases the amount of private VC, which the firm attracts due to the preferential risk/return structure of the investment created by government’s investment³⁰⁵.

³⁰¹ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

³⁰² OECD. No Date. Financing business R&D and innovation. OECD. www.oecd.org

³⁰³ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review. Page 80.

³⁰⁴ Lerner, J., Leamon, A., and Garcia-Robles, S. 2012. Best Practices in Creating a Venture Capital Ecosystem. FOMIN, Washington.

³⁰⁵ Brander, J., Du, Q. and Hellman, T. 2012. The Effects of Government-Sponsored Venture Capital: International Evidence. NBER



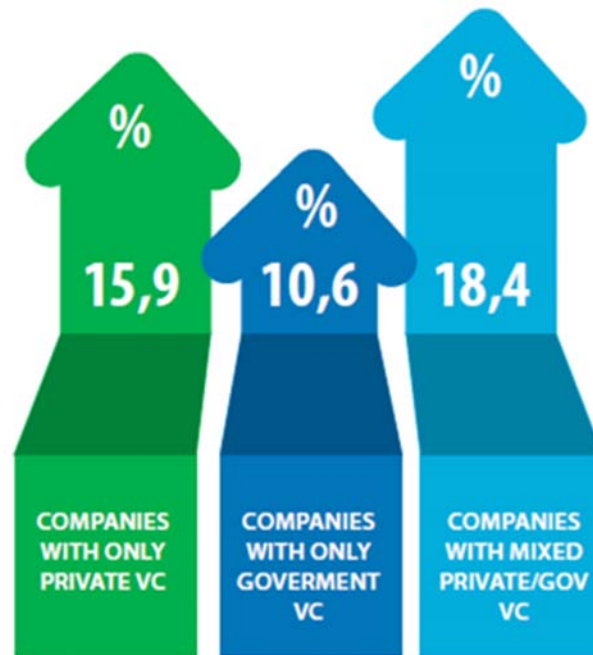


Figure 9: Exit Rate Comparison of Private, Public and Mixed VC³⁰⁶

6.4.2 Current South African Venture Capital Landscape

The VC asset class represents a very minor portion of the local private equity market³⁰⁷ and there is a substantial shortage of VC in the ecosystem³⁰⁸. This current underinvestment has the impact of stunting long-term innovation³⁰⁹, which is of fundamental concern as innovation is a primary driver of long-term economic growth³¹⁰. In addition, high-risk venture capital is essential for innovation potential to be realised.

6.4.2.1 Market Failures

A recent European Venture Capital Association (EVCA) report stated that exploiting Europe's potential for innovation and entrepreneurship would be impossible without the creation of a thriving private equity and VC industry³¹¹. Policy makers, experts and industry stakeholders alike have echoed that sentiment in South Africa. However, there is a range of barriers to the growth of these industries that are the result of several market

³⁰⁶ Lerner, J., Leamon, A., and Garcia-Robles, S. 2012. Best Practices in Creating a Venture Capital Ecosystem. FOMIN, Washington. Adapted from Brander, J., Du, Q., and Hellman, T. 2012. The Effects of Government-Sponsored Venture Capital: International Evidence. NBER

³⁰⁷ Tumoi, K. & de Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technological Management and Innovation 2013. Vol 8. Issue 2.

³⁰⁸ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³⁰⁹ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

³¹⁰ Agenor, P.R. 2004. Growth and Technological Progress: The Solow-Swan Model. Harvard University Press.

³¹¹ EVCA. 2010. Closing Gaps and Moving Up a Gear: The next stage of Venture Capital's evolution in Europe. Brussels.

failures in this ecosystem. On the demand side, barriers include insufficient entrepreneurial skill and experience³¹²; while on the supply side, barriers include paucity of specialised early-stage fund managers³¹³.

Most SMEs prefer private equity to other forms of equity funding for numerous reasons³¹⁴. The role that private equity and VC play in filling the “funding gap” that early-stage entrepreneurs face is crucial to the development of a vibrant small business community³¹⁵. It is thus particularly concerning that both a lack of investor funding and a shortage of specialised early-stage fund managers rank as the two biggest factors impacting VC in South Africa³¹⁶.

A market failure identified as central to contributing to the current shortage of early-stage equity financing is the reported lack of exit opportunities and illiquid equity markets³¹⁷. Additionally, small-scale risk capital is often just not worth it for investors. There is an implicit minimum investment threshold between R5 million and R10 million, which implies business valuations of around R20 million³¹⁸. Most businesses valued at R20 million are already beyond the “Valley of death” funding gap³¹⁹.

Lerner highlights two key target issues for public policy. The first is the attraction of more private venture funds into the equity market, and the second is the correction of the abovementioned market failure of limited early-stage investments³²⁰. Government interventions can achieve these targets by two distinct approaches: demand-side interventions, which increase the attractiveness or lower the burden of entrepreneurship; and supply-side measures, which entail direct or indirect stimulation through the injection of venture funding into the ecosystem³²¹. There have been numerous demand-side mechanisms utilised by government³²², including tax incentives and regulatory relaxations; however, these have only had limited success. At the same time, the lack of supply-side interventions has led the Small Business Project (SBP) to conclude “the development of the small business economy was something that has been assumed rather than encouraged. A little like a farmer waiting for rain and forgetting to irrigate”³²³.

The market failures, which prevent early-stage private equity and VC investments, are not unique to South Africa. Every major market in the world has required public funding of some form to “kick-start” these

³¹² The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³¹³ Jones, M. & Mlambo, C. 2013. Early Stage Venture Capital in South Africa: Challenges and prospects. South African Journal of Business Management. 2013, 44(4).

³¹⁴ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

³¹⁵ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

³¹⁶ Jones, M. & Mlambo, C. 2013. Early Stage Venture Capital in South Africa: Challenges and prospects. South African Journal of Business Management. 2013, 44(4).

³¹⁷ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³¹⁸ Jones, M. & Mlambo, C. 2013. Early Stage Venture Capital in South Africa: Challenges and prospects. South African Journal of Business Management. 2013, 44(4).

³¹⁹ Bain & Company. 2013. Restoring Financing and Growth to Europe’s SMEs. Four sets of impediments and how to overcome them. Institute of International Finance.

³²⁰ Lerner, J. (2009). Boulevard of broken dreams: why public efforts to boost entrepreneurship and venture capital have failed - and what to do about it. Princeton University Press.

³²¹ Ibid.

³²² The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³²³ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg. Pg 3.

industries³²⁴. Public funding to facilitate the provision of equity to SMEs is vital to catalyse SME growth³²⁵. The most effective channel through which this can be achieved is to prioritise the promotion of qualified, informed VC investors³²⁶. This supply-side mechanism will trigger a demand-side reaction, enhancing the currently poor quality of deal flow through the value added by these skilled investors working with the investee companies in an intensively hands-on, high-touch role. The resultant increase in pipeline deal flow quality and investible propositions will in turn crowd in additional skilled investors.

6.4.2.2 Market Trends

South Africa has the second-lowest established business rate in the world (2.3%)³²⁷. In addition, total economic activity is also decreasing, despite the NDP's anticipation that small and growing businesses (SGBs) in South Africa will create 90% of new jobs³²⁸. Indeed, this is now less than half of comparably developed economies³²⁹. In addition, there is also a substantial gap in the number medium sized enterprises, often referred to as the "missing middle".

Similarly, SME and VC investing appears to have stagnated over the last decade³³⁰, worsened by the general tendency for VC firms to shift their focus away from start-ups or risky sectors³³¹ to later-stage companies in times of economic uncertainty. In South Africa, this has resulted in an even greater gap in funding-availability, most especially for high-tech, early-stage start-up ventures³³². These enterprises are also typically considered too risky for institutional debt financing³³³. The overall impact is to depress business growth further, thereby hampering South Africa's job creation and economic growth objectives.

6.4.2.3 Cost of Compliance

The regulatory environment for South African SMEs and early-stage businesses is overly complex and particularly regressive³³⁴ with compliance costs typically representing around 8.3% of turnover for small enterprises but only 0.2% for large businesses³³⁵. SMEs are already faced with a struggle to access stage-appropriate finance³³⁶ and the erosion of their cash flow and capital base in unnecessary, over burdensome regulation is thus particularly detrimental.

³²⁴ EVCA. 2010. Closing Gaps and Moving Up a Gear: The next stage of Venture Capital's evolution in Europe. Brussels.

³²⁵ Falkena, H; Abedien, I.; von Blottnitz, M.; Coovadia, C.; Davel, G; Madugandaba, J; Masilela, E; and Rees, S. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review. Task Group of the Policy Board for Financial Services and Regulation.

³²⁶ EVCA. 2010. Closing Gaps and Moving Up a Gear: The next stage of Venture Capital's evolution in Europe. Brussels.

³²⁷ GEM. 2014. 2013 Global Report: Fifteen years of assessing entrepreneurship across the globe. GEM Consortium.

³²⁸ National Planning Commission. 2011. National Development Plan: Vision for 2030. National Treasury.

³²⁹ Turton, N and Herrington, M. 2013. Global Entrepreneurship Monitor 2012: South Africa. GEM.

³³⁰ Tumoi, K and de Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technological Management and Innovation 2013. Vol 8. Issue 2.

³³¹ Ernst & Young. 2013. Turning the Corner. Global Venture Capital Insights and Trends 2013. EYG Ltd.

³³² The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³³³ Jones, M and Mlambo, C. 2013. Early Stage Venture Capital in South Africa: Challenges and prospects. South African Journal of Business Management. 2013, 44(4).

³³⁴ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

³³⁵ Omidyar Network. April, 2013. Accelerating Entrepreneurship in Africa.

³³⁶ Mobius, M and Templeton, F. SBP. 2013, February. SBP SME Growth Index: Easier, Harder for Small Business in South Africa.



6.4.3 International examples and principles of Public Funding Models

6.4.3.1 Overview

Public-Private co-investment funds are extensively used in developed markets as a contra-cyclical mechanism to ensure early-stage financing is accessible in situations when VCs are forced to lower their exposure to high-risk, long-term investments. They came to prominence in the 2006-2010 period of global financial uncertainty as part of stimulus packages designed to harness innovation as a driver of growth and employment, thereby aiming to establish a path out of economic recession³³⁷. There has been a range of configurations and structures in evidence with no single apparent “silver bullet”. Indeed, the effectiveness of these tools and policies appears to be highly context-specific. However, when adapted correctly to the domestic environment, they have the potential to draw significant private capital into high-potential start-ups, catalysing growth and innovation.

6.4.3.2 Trends and Differences

A distinct trend that has emerged is the shift towards private sector management of public sector funding, whether this is grant or investment capital³³⁸. This has three distinct benefits: firstly, it removes any political influence over the funding process, establishing an arm’s length management system with specific governance criteria; secondly, it attracts specifically employed, highly skilled management that implement best practices; and lastly, it provides much better leverage to attract private sector co-investors³³⁹.

The fact that more experienced private sector managers and VCs have more successful investments is due to two factors: the direct influence of their managerial expertise, and the effect³⁴⁰ that their selection has given that they are more likely to pick higher potential companies at the outset³⁴¹. Their talent for identifying companies with the most potential is reportedly twice as important as their added value through ongoing support, and is a compelling reason to utilise their skills in the management of government funds³⁴².

A key structural difference in international co-investment policies is the nature of the recipient organisation responsible for distributing the funds. Organisations apply or qualify to receive the funds and in turn select the portfolio companies in which to invest. The most common structure is for these organisations to be VC funds, or individual angel investors. This is the case in Israel’s Hezek, Scotland’s SCIF³⁴³, Australia’s IIF³⁴⁴, France’s FI³⁴⁵ Enterprises, Germany’s ERP³⁴⁶ Startfonds, Singapore’s SEEDS³⁴⁷ and ESVF³⁴⁸, Brazil’s INOVAR, Spain’s SSCF³⁴⁹ and New Zealand’s NZVIF³⁵⁰. An interesting addition, gaining popularity, are co-investment schemes, where the recipient organisations are incubators or accelerators that allocate the investment to companies

³³⁷ Durufle, G. 2010. Government Involvement in the Venture Capital Industry. International Comparisons. CVCA.

³³⁸ Durufle, G. 2010. Government Involvement in the Venture Capital Industry. International Comparisons. CVCA.

³³⁹ EVCA. 2013. Venture Capital White Paper, “Closing gaps and moving up a gear: The next stage of venture capital’s evolution in Europe”, Brussels, 2010.

³⁴⁰ Sorensen’s 2006 two-sided model isolates the sorting bias from the value-adding effect.

³⁴¹ Sorensen, M. 2006. How Smart is Smart Money? A two-sided matching model of venture capital. Stanford Institute for Economic Policy Research.

³⁴² Ibid.

³⁴³ Scottish Co-investment Fund

³⁴⁴ Innovation Investment Fund

³⁴⁵ France Investissement

³⁴⁶ European Recovery Programme

³⁴⁷ Start-up Enterprise Development Scheme

³⁴⁸ Early Stage Venture Fund

³⁴⁹ Spain Start-up Co-investment Fund

³⁵⁰ New Zealand Venture Investment Fund



enrolled in their programs. Thus far, co-investment schemes have emerged in countries that already have a functional VC, SME or angel co-investment programme, including Singapore (TIS)³⁵¹, New Zealand (ISP)³⁵² and Israel (TIP)³⁵³. Incubator/Accelerator Programmes are a riskier investment option for the Limited Partners (LPs). This is reflected in the matching ratio: the NZIF contributes up to 75% of the start-up's investment, while the TIP and TIS contribute up to 85%.

While most of these programmes focus on seed-stage investments, there is often a sector-specific focus too. For example, Singapore's SEEDS gives preferential funding to firms with demonstrable potential for international scalability, while the USA's proposed SBIC³⁵⁴ has two branches, one offering 2:1 matching for clean energy or areas of economic distress, and the other matching 1:1 for seed-stage firms. Australia's IIF and subsequent IIFF³⁵⁵ aim to commercialise R&D in IT and BioTech. The latter is also the focus of Israel's Heznek, one of the most successful co-investment initiatives of this type, and successor to the Yozma programme³⁵⁶.

6.4.3.3 Structures

The structure of co-investment funds depends on the priorities that they are intended to address. The most common distinction is whether they aim to mitigate the investor's risk of loss, enhance their returns, mitigate risk and enhance returns, or do neither. If the funds aim is to neither mitigate risk nor enhance returns, they are invested "parri passu", i.e. with the two sources of capital being treated equally for the duration of the investment. This is illustrated in the following table, which outline the basic distribution on exit of a 1:1 co-investment of R200 (R100 per partner), and a 20% manager carry³⁵⁷:

Table 6: Exit Distribution of Parri Passu Co-Investment

Principle	R 200.00	Parri Passu				
Total Fund IRR		LP		Govt		ManCarry
-30%	R 140.00	-30%	R 70.00	-30%	R 70.00	R -
-20%	R 160.00	-20%	R 80.00	-20%	R 80.00	R -
-10%	R 180.00	-10%	R 90.00	-10%	R 90.00	R -
0%	R 200.00	0%	R 100.00	0%	R 100.00	R -
10%	R 220.00	8%	R 108.00	8%	R 108.00	R 4.00
20%	R 240.00	16%	R 116.00	16%	R 116.00	R 8.00
30%	R 260.00	24%	R 124.00	24%	R 124.00	R 12.00
40%	R 280.00	32%	R 132.00	32%	R 132.00	R 16.00

If there is differential treatment of the two, as seems universally to be the case, this is accounted for upon exit in the distribution of the funds. Typically referred to as a "waterfall" of returns, the priority of each return

³⁵¹ Technological Incubation Scheme

³⁵² Incubator Support Programme

³⁵³ Technological Incubators Programme

³⁵⁴ Small Business Investment Company

³⁵⁵ Innovation Investment Follow-on Fund

³⁵⁶ Israel. Ministry of Trade, Industry and Labour. 2011. Government-Supported Incentive Programmes. Office of the Chief Scientist.

³⁵⁷ Management fees have been excluded for simplification.

determines the order in which the funds are distributed. Protecting the LP's capital from the risk of loss is done through the subordination of the government's investment. This subordination is illustrated in the table below, where the return of the LP's principle capital and hurdle are prioritised above any return of funds to the government as General Partner (GP). The table also illustrates a return enhancing structure, which limits government's return to their principal and hurdle, and subordinates government's funds. This is a very aggressive and stimulating structure. Both examples include a 5% hurdle, and 20% manager carry on a 1:1 co-investment of R200³⁵⁸.

Table 7: Exit Distribution of Subordinated and Return Enhancing Co-Investments

Principle	R 200.00	Subordinated				Return Enhancing					
Total Fund IRR		LP		Govt		Carry	LP		Govt		Carry
-30%	R 140.00	5%	R 105.00	-65%	R 35.00	R -	5%	R 105.00	-65%	R 35.00	R -
-20%	R 160.00	5%	R 105.00	-45%	R 55.00	R -	5%	R 105.00	-45%	R 55.00	R -
-10%	R 180.00	5%	R 105.00	-25%	R 75.00	R -	5%	R 105.00	-25%	R 75.00	R -
0%	R 200.00	5%	R 105.00	-5%	R 95.00	R -	5%	R 105.00	-5%	R 95.00	R -
10%	R 220.00	9%	R 109.00	9%	R 109.00	R 2.00	13%	R 113.00	5%	R 105.00	R 2.00
20%	R 240.00	17%	R 117.00	17%	R 117.00	R 6.00	29%	R 129.00	5%	R 105.00	R 6.00
30%	R 260.00	25%	R 125.00	25%	R 125.00	R 10.00	45%	R 145.00	5%	R 105.00	R 10.00
40%	R 280.00	33%	R 133.00	33%	R 133.00	R 14.00	61%	R 161.00	5%	R 105.00	R 14.00

In addition to the “limited upside” structure illustrated in Table 7 above, there is a range of other methods used to enhance the LPs returns. A “buy-back” structure is used in Israel's Heznek and Singapore's Technology Incubation Scheme (TIS), where the incubator or LPs have the option to purchase the government's shares at a pre-specified rate. In the TIS, this is at a 10% return for the first two years, or a 15% return in the third year³⁵⁹. The New Zealand ISP and Israeli TIP extract 3 – 5% royalties on turnover until the funding (with interest) has been repaid. Brazil's INOVAR restricts government's returns to only the principle and hurdle, as illustrated above in the return enhancing columns of Table 7, on up to 50% of its investment³⁶⁰. Malaysia has two funds: the Commercialization of Research and Development Fund (CRDF), and the Technology Acquisition Fund (TAF). Both funds run through the Malaysian Technological Development Corporation, which provides 40 – 70% matching funding through non-repayable grants to approved Malaysian companies that commercialise R&D or acquire foreign technologies.

6.4.4 Proposed Model and key features for Pilot in South Africa

6.4.4.1 Overview

The overarching goal of this recommendation is to attract and increase private investment and private sector skills, talent and capital to develop the VC sector and related ecosystem broadly in South Africa, with a specific focus on SMEs and VC Fund Managers. SME and VC fund management approaches are skill-intensive in the South African context, but can grow to be self-sustaining if the right initial investment is injected. Stimulating growth in this way is not an unusual goal, and the most common mechanism used internationally to achieve

³⁵⁸ Management fees have been excluded for simplification.

³⁵⁹ This is calculated relative to the principle investment (K): Government's investment can be bought for (1.1)*(K) within two years, or (1.15)*(K) in the third. There is no compounding in this rate.

³⁶⁰ Lerner, J., Leamon, A., Garcia-Robles, S. 2012. Best Practices in Creating a Venture Capital Ecosystem. FOMIN, Washington.



this is a catalytic co-investment programme, as illustrated above³⁶¹. The source of this investment would be a government fund overseen by a programme manager who is responsible for the selection of, and distribution to, qualifying SME and VC Fund Managers. This structure is aligned with the global precedent of government co-investment programmes, although the specific details are context-dependent and will need to be specifically tailored to South Africa's ecosystem.

6.4.4.2 Structure

The recommendation is to implement a pilot programme of three years of government contribution (part of a total programme lifecycle of 13 years) to a co-investment fund, with each annual round of investment being allocated to 2–4 SME Fund Managers and 2–4 VC Fund Managers. Fund managers will, in turn, invest into 5–15 of the most promising companies in each round. These managers will raise private capital from Limited Partners (LPs) to match government's contribution. Government's capital will be subordinated, hugely reducing the risk-of-loss to which the LPs' capital is exposed and so increasing attractiveness of investment allocations to the fund. Further investigation is required to establish which particular return-enhancing mechanism will be most effective in the South African context. However, initial input from expert advisors indicates that either a non-repayable grant or an aggressive LP return enhancing mechanism, such as a buy-back or upside-limit, is likely to be most effective in establishing a programme attractive enough to draw in the required level of private sector expertise. Examples of non-repayable grants include Malaysia's CRDF and TAF, while LP return mechanisms include Israel's Heznek and Singapore's TIS.

6.4.4.3 Programme and Fund Managers

One of the market failures currently contributing to the underdevelopment of the VC and SME investing environments is a lack of qualified, skilled SME and VC fund managers investing into these areas. Consequently, ensuring that the right fund managers are brought into each round of this pilot programme is critical to the success of the initiative. The programme manager is directly responsible for selecting and appointing SME and VC fund managers, and supervising the distribution of funds to them. One of the programme manager's key challenges is likely to be maintaining a pipeline of potential fund managers in each stream for the three rounds of investment. Should the fund manager be underperforming, the programme manager would have the power to receive a vote of no confidence from the LPs and replace the manager.

The fund managers will have to raise the matching funds from private investors, and the difficulty of this will depend on the structure of the investment scheme, and the principles of distribution on exit. Given the preferential risk profile that investors face if government's funding is subordinated and/or better still has limited returns, most funds reach their maximum amount and close fairly soon. In South Africa, a critical limiting factor on SME and VC investment is reported to be risk-aversion, from both private investors and large institutions. This risk-aversion is often coupled with a disconnect between the cost of the "high-touch" support required and the relatively low average returns possible by such portfolios. This decreases the attractiveness of SME and VC investment greatly. However, in the early stages of industry building, a drastically reduced LP risk achieved through government-supported funding will do much to attract these investors, and may even be considered safe enough to tap into institutional and pension-fund investments. Limiting the returns to government hugely leverages the returns to the LPs and can be accompanied by an aggressive carry for the fund manager. The initial injection of government capital is necessary to catalyse growth in this industry, but over time and with a successful track record, it will build long-term momentum and become self-sustainable.

³⁶¹ Durufle, G. 2010. Government Involvement in the Venture Capital Industry. International Comparisons. CVCA



6.4.4.4 Flow of Capital

The proposed co-investment model is kick-started by the allocation of government funds to a programme manager. The programme manager then distributes the funds to approved fund managers that are active and skilled in high-touch SME and VC investment. It is envisaged that the pilot will consist of three annual rounds of funding, each with an estimated life cycle of ten years. Each round is expected to provide funding to 3–5 VC managers and 3–5 SME managers. The specific figures and parameters involved will differ between the two streams of the programme, as the SME and VC landscapes each have nuanced approaches and strategies employed.

The fund managers will raise matching funds from private investors, and each invests the combined amount in 5–15 portfolio companies. Feedback from expert advisors suggests that investments into portfolio companies would range from R10 million to R20 million each, being comprised of 1:1 matching funds. This is intended to provide for a relatively small portfolio, due to the level of additional support required by each firm and the intentional, more targeted and high-touch approach. The VC stream is likely to have a lower hurdle rate, but more aggressive carried interest for the fund manager. On exit, due to the subordination of government's funding, the first stage of the "distribution waterfall" is the return of the LP's capital and hurdle. Subsequently, government's returns, if any, are allocated out of the remaining fund value. The profit after these capital returns is split according to the carry. Government's return, whether comprised of principal, hurdle or carry, is intended in this model to "roll-over" into another round of similar investment.

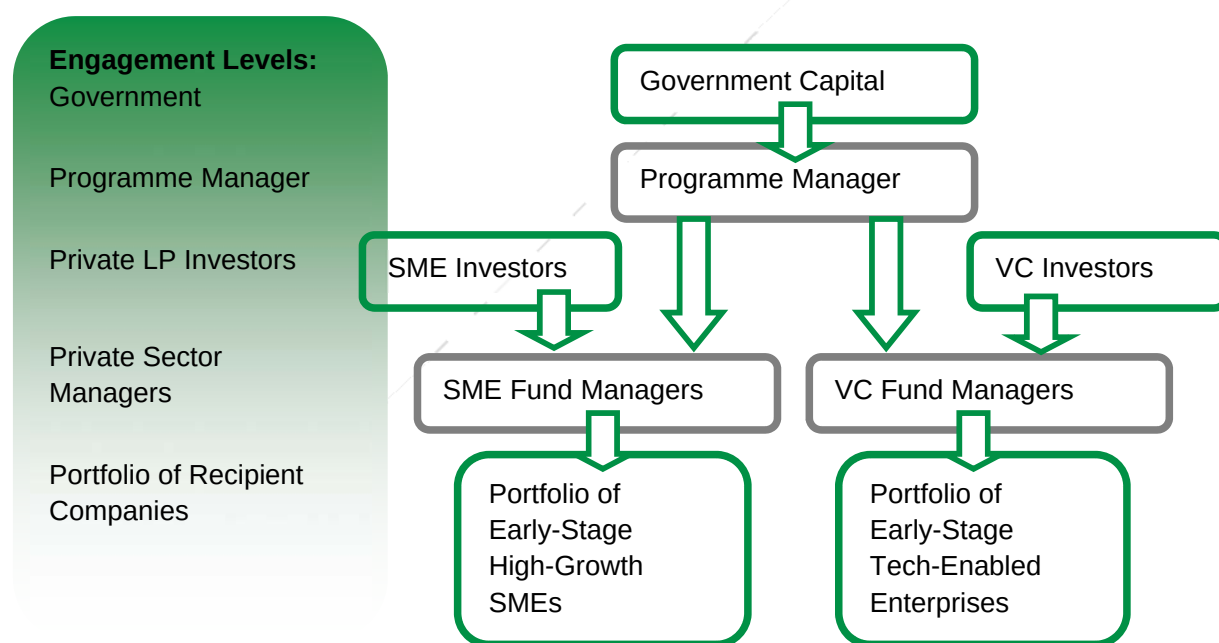


Figure 10: Structure of Co-investment Programme Demonstrating Flow of Capital

There are three distinct options regarding the utilisation and repayment of government's funds viz. (1) a non-repayable grant; (2) a return allocated back to government; or (3) a return rolling over for future reinvestment. A grant is likely to be the most stimulating form of funding; however, the rollover alternative would serve to lower the required investment amount in any subsequent year. This return would comprise some combination of the principal capital investment, the hurdle on that investment, and a carry on the final profit.

The specific percentages of these will, of course, depend on the final structure of the programme. Our research and engagement with expert advisors suggests that a grant will likely be the most suitable and certainly most attractive form of funding. In addition, if there is any return on government's investment, it should not participate in the carry and should ideally roll over into future investment rounds.

6.4.4.5 Regulatory Limits and Measures

There will have to be a set of regulatory limitations on the structure and scope of the VC and SME management firms, which are selected by the programme manager to receive this funding. LPs must be truly private organisations or agents³⁶², and cannot include government agencies or departments; however, government pension funds may well invest in this programme as LPs. Additionally, in order to diversify the risk profile of the investments, there would be prudential limits that a maximum of, for example, 20% of the fund can be invested in any one company.

The success of this programme is directly measurable by a range of conventional metrics. These include the outcomes per R1 million of government input in terms of the number of sustainable SMEs and jobs created, and the returns generated to the LPs and to the Fiscus (through tax from recipient companies).

An interesting avenue for consideration is developing an incentive mechanism that aligns the fund managers' interests with an overall Social Return on Investment (SROI). This goes beyond the current mechanism, which incentivises fund performance via the carried interest but does not specifically incentivise social value creation.

6.4.4.6 Source and Jurisdiction

There has been a range of government policies that have targeted various aspects of the SME ecosystem that have fallen under a handful of agencies or departments. These policies have been met with varying degrees of success. This pilot programme reflects a shift in structure, in line with global best practice, towards more performance-orientated private-sector management of government funds³⁶³. Additionally, it embodies a shift in mentality wherein government funding is focussed beyond the inputs of policy instruments, and on the outputs it achieves. In this case, outputs include the attraction of expertise and talent into SME and VC investing sectors, and the provision of finance and support to approximately 180 young enterprises by the fund managers over a 13-year period, through three years of initial government investment³⁶⁴.

Within the government, there are a handful of agencies and departments under which this programme could potentially run. These are listed below, with extracts from the official mandate of each entity:

- The Jobs Fund, through **National Treasury**, has an established precedent of granting funding in order to create employment opportunities, and has a current surplus to invest; "At its core, the Jobs Fund seeks to operate as a catalyst for innovation and investment in activities which directly contribute to sustainable job creation initiatives, as well as long term employment creation."³⁶⁵

³⁶² Lerner, J., Leamon, A., Garcia-Robles, S. 2012. Best Practices in Creating a Venture Capital Ecosystem. FOMIN, Washington.

³⁶³ Durufle, G. 2010. Government Involvement in the Venture Capital Industry. International Comparisons. CVCA.

³⁶⁴ 180 firms is the product of three rounds of investment, each into three SME and three VC fund managers, who in turn invest in an average of ten portfolio companies over the ten-year life-cycle of their portfolio.

³⁶⁵ JobsFund.org.za. About the Jobs Fund.

- The Incubation Support Programme (ISP) was initiated by the **Department of Trade and Industry (dti)**, and also has a precedent of co-investing with private sector partners; “It is available for infrastructure and business development services necessary to mentor and grow enterprises to ensure that within 2 to 3 years the enterprises will graduate to a level of self-sustainability by providing products and services to the market.”³⁶⁶
- The **Industrial Development Corporation (IDC)**, supervised by the Economic Development Department, has the following three core strategies:
 - “Serve as a catalyst for balanced, sustainable development.
 - Identifying and supporting opportunities not addressed by the market.
 - Providing risk capital in partnership with the private and public sector.”³⁶⁷

It is clear that this initiative could fall within the scope of any of these agencies, or indeed the recently created **Department of Small Business Development**. Ongoing consultation with government is under way to determine the appropriate departmental jurisdiction for this programme.

6.4.5 Conclusion

There is general consensus and recognition of the value of the role that SMEs play to foster economic development and growth. While recent government interventions reflect efforts to foster SMEs, the ecosystem still exhibits a shortage of SME and VC investors, and a consequent lack of adequate funding for many SMEs³⁶⁸. International best practice in this situation is to implement a co-investment programme, which provides a platform to use private investor capital to leverage government’s investment, accelerating the development of an entire industry by addressing the market failures that hamper it. There is a range of co-investment schemes operational in various countries, with parameters tailored to their specific contexts and market failures they are seeking to address. They are often used as a contra-cyclical intervention to catalyse growth and investment into innovative or export-orientated sectors. Harnessing the private sector expertise needed to unlock the value of these sectors requires government involvement and support to attract private sector skills and investment.

In his 2014 State of the Nation Address, President Jacob Zuma emphasised that “the most effective weapon in the campaign against poverty is the creation of decent work ... [but] creating work requires faster economic growth”³⁶⁹. Attracting private sector fund managers and investors into the SME and VC investing sectors will stimulate this development and growth, ultimately creating businesses that contribute sustainably to the economy and create jobs. An intensive intervention of this nature is vital for the emergence of an active and enabling investment market through which small and growing businesses are able to access stage-appropriate funding. With these businesses, the job-creation goals outlined in the NGP and NDP might just be attainable³⁷⁰.

³⁶⁶ DTI.gov.za SMME Development Financial Assistance (Incentives). Incubation Support Programme (ISP).

³⁶⁷ IDC.co.za. About the IDC.

³⁶⁸ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.

³⁶⁹ South African Presidency. 2014. State of the Nation Address By His Excellency Jacob G Zuma. President of the Republic of South Africa on the occasion of the Joint Sitting Of Parliament Cape Town. <http://www.gov.za/speeches/view.php?sid=46120&lid=1>

³⁷⁰ Economic Development and Growth EThekweni (EDGE). 2012. Juggling Jobs. Assessing the NGP and NGP Job Targets.



Investing in attracting appropriate skills for SME and VC investing has proven internationally to be a highly effective mechanism to catalyse investment and business growth. The notion of allocating spending to the creation of a long-term self-sustainable sector, instead of spending directly on short-term arm's length policies, provides a multiplied future benefit to the spending. Furthermore, by investing in the nascent VC and SME Investment industries now, the contribution from government is anticipated to yield a significant multiplier effect over time. This effect is further enhanced by the growth that the portfolio companies create within the industry by developing other firms along the supply chain, increasing the human capital and skill level of the ecosystem, increasing employment opportunities, and contributing to Gross Domestic Product (GDP) through their operations. Given the clear correlation between investment activity and innovation in SMEs³⁷¹, and the evidence of the extent to which experienced investors unlock growth and value in their investees³⁷², it is not surprising that co-investment programmes have been met with such success internationally³⁷³.

³⁷¹ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

³⁷² Sorensen, M. 2006. How Smart is Smart Money? A two-sided matching model of venture capital. Stanford Institute for Economic Policy Research.

³⁷³ Durufle, G. 2010. Government Involvement in the Venture Capital Industry. International Comparisons. CVCA.



6.5 Increasing the attractiveness of South Africa's Business Visa for international entrepreneurs.

6.5.1 The South African immigration visa landscape

South Africa is being outperformed in attracting the scarce skills and talents of international entrepreneurs. The opportunity cost of limiting the growth of human capital in the country means South Africa is losing out on the significant potential gains that would, in all likelihood, be derived from an influx of diverse, highly skilled, innovative and dynamic entrepreneurs. These skills are much needed to achieve growth, reduce poverty and close the innovation and development gap that exists between South Africa and other developing nations.

The attraction and retention of entrepreneurial talent to and in South Africa has significant potential to benefit the domestic economy. Directly, potential contributions include tax flows to the Fiscus; the creation of jobs for local workers, as a majority local staff complement is a fundamental requirement in obtaining a Business Visa; as well as capital investment into the domestic economy. The indirect benefits may extend much further, providing a multiplier effect through increased innovation and competition within industries; enhancing the skills and employment of South Africans; and fostering supply networks, both upstream and downstream, that will also ultimately boost the capacity of the domestic ecosystem.

The surge in focus on small business and entrepreneurship following the 2008 financial crisis is part of a global realisation of the role that these entities can and do play in enhancing employment and ultimately driving economic growth, prosperity and well-being. While many foreign governments have emphasised their desire to boost entrepreneurship, effective policies to do so are elusive and their success is highly dependent on the context of the local environment within which they are embedded³⁷⁴. Immigration, however, is increasingly considered to be a direct means to grow the supply of entrepreneurs in the local ecosystem³⁷⁵. Indeed, a functional entrepreneurial immigration system is vital to at least partially mitigate the loss of skills and expertise due to emigration of South African entrepreneurs overseas³⁷⁶.

There are a handful of countries that have actively and even aggressively targeted entrepreneurial immigration over the last decade. Typically, this takes the form of a temporary visa for immigrant entrepreneurs. They are screened on application to determine credibility and potential contribution, monitored over time, and reassessed after a predetermined period according to a specific set of indicators of success and long-term business viability. Eventually, they may become eligible for permanent residency. Typically, a range of incentives is offered for the duration of this process.

6.5.1.1 Overview of the South African Business Visa

South Africa has a functional version of this concept in the Business Visa, which is structured similarly to the “formula” described above. At present, the Business Visa allows entrepreneurs and their families into South Africa for three years. During this initial period, it is anticipated that the entrepreneur will establish a new business or work for an existing one. The requirements for this visa are fairly well structured in principle,

³⁷⁴ OECD. 2010. High Growth Enterprises. What Governments can do to make a difference. OECD Entrepreneurship & SME studies. <http://www.oecd.org/fr/cfe/pme/high-growthenterpriseswhatGovernmentscantomakeadifference.htm>

³⁷⁵ Sumption, M. 2012. Visas for Entrepreneurs: How countries are seeking out immigrant job creators. www.MigrationPolicy.org

³⁷⁶ Falkena et al. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review. Task Group of the Policy Board for Financial Services and Regulation.

though in practice they are experienced as overly onerous. The recent 2014 regulation amendments to the 2002 Immigration Act³⁷⁷ make inroads into some of the problems experienced, as illustrated in the following table:

Table 8: Previous, Current and Recommended Business Visa Structures

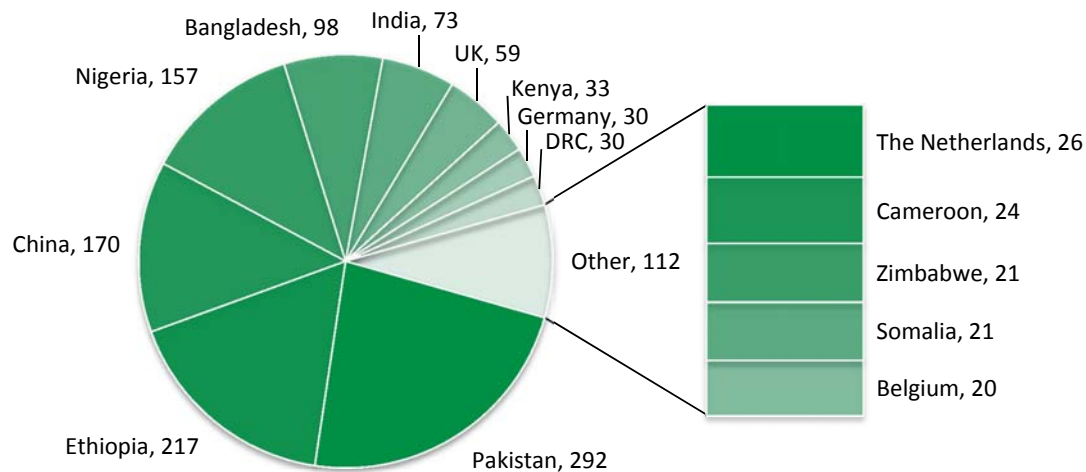
	Previous Act	2014 Act	Recommendation
Requirements:			
Local Employees	5	60% in 1 year	30% in 2 years, 60% in 5
Credibility	Business Plan	Business Plan	Business Plan
Capital Investment	R2.5M	R2.5M	R2.5M
Reduced if	National Interest	National Interest	Nat. Int or Foreign Graduate
Structure:			
Duration	2 years	3 years	5 years
Application	Hardcopies	In Person	Online & tracked
Authority	DoHA, DOL, dti	DoHA, DOL, dti	Single Point of Contact
Scope	Applicant + Family	Applicant + Family	Up to 5 applicants per venture
Restrictions	No outside work	No outside work	No outside work

However, while the 2014 changes are definitely a step in the right direction, the amendments do not go far enough and retain features that remain a substantial barrier to entry for many prospective entrepreneurs. Importantly, the processing of applications is hamstrung by administrative inefficiencies, which makes the process difficult to anticipate and adds significant additional uncertainty for immigrants. Indeed, unpredictability is reported to be the major barrier restricting the supply of potential entrepreneurs, who are put off by the lack of clarity in the processing system.

Both the previous and current Business Visa requirements include a capital investment of R2.5 million by the applicant into the Republic. The legislation stipulates that this investment must specifically contribute to the book value of the business, which in private SMEs may include Director's Loans. The regulation doesn't specify which other vehicles for investment might qualify. However, this amount may be reduced if the area of operation falls under the Department of Trade and Industry's (dti) published list of National Interest Sectors. Categories in the list include Crafts, Tourism, Chemical works and Biotechnology, Agricultural Processing, Clothing and Textiles, Information and Communication Technology, Metal and Mineral Processing, Automotive Works and Transport Operation. The distribution of Business Visas issued by South Africa, as illustrated in Figure 11 below, demonstrates overrepresentation of a few source countries, and the noticeable absence of major first-world hotspots. Visible in Figure 11 is the fact that the top five recipient countries, accounting for 60% of the 1585 visas issued, are all similar emerging economies.

³⁷⁷ South Africa. Department of Home Affairs. 2014. Immigration Act, 2002. Immigration Regulations.

Figure 11: Top 15 Recipient Countries of RSA Business Visas in 2012³⁷⁸



Of the 1585 Business Visas granted in 2012, Pakistan received the most (292), which was more than the whole of Europe (238). Six countries were allocated more than the combined amount of North, Central and South America, the Middle East and Australasia, which had only 72 between them³⁷⁹. Since no quota is operational in determining this distribution, the natural assumption points to a lack of appetite for the visa among the developed world. Indeed, this distribution, and the lack of immigrants from first world “hot-spots” like the US and Europe, may have as much to do with our value proposition as it does with the marketing of that proposition.

In this regard, an oft-overlooked aspect to immigration is the advertising and promotion of visa programmes in target countries. South Africa, by all accounts, falls significantly behind on this front. In addition, the 2014 shift to “in-person” application mirrors the low level of ease of doing business that is argued to prevail in the country, and is an indicator of the lack of emphasis placed on user-friendliness and marketing of a clear value proposition. This proposition is already at a competitive disadvantage given the regular poor showing of South Africa on important measures of desirability to entrepreneurs, including ease of doing business³⁸⁰, socioeconomic stability, global competitiveness and the conduciveness of the environment to enabling entrepreneurial growth³⁸¹.

6.5.2 International examples of visa programmes to attract foreign entrepreneurs

There has been a proliferation of entrepreneurial visa programmes in the last decade, which reflects a realisation at government level of the value that SMEs and innovation inject into any economy. The structure and features of these visas across the globe are examined below.

Table 9: Overview of Selected Global Entrepreneur Visa Programmes³⁸²

Country	Sources	Funds	Assessment	Jobs	Time Granted
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³⁷⁸ StatsSA. 2012. Documented Immigrants in South Africa, 2012. www.StatsSA.gov.za

³⁷⁹ StatsSA. 2012. Documented Immigrants in South Africa, 2012. www.StatsSA.gov.za

³⁸⁰ SBP. 2014. SME Growth Index. Growth and Competitiveness for Small Business in South Africa. SBP. Johannesburg.

³⁸¹ GEM. 2014. Global Entrepreneurship Monitor 2014 Report. GEM.

³⁸² Sumption, M. 2012. Visas for Entrepreneurs: How countries are seeking out immigrant job creators. www.MigrationPolicy.org



South Africa	Abroad	Up to \$250K	Feasible Business Plan	60% in 1 year	3 Years
Canada	VC Fund	\$186K	Letter of Support	None	Permanent
	Angel Group	\$70K			
	Incubator	None			
Chile	\$40K Government Grant	None	Accepted by Start-up Chile	None	1 Year
Peru	\$20K - \$50K Government Grant	None	Accepted by Start-up Peru	None	1 Year
Ireland	Anyone	\$102K	Recognised as High-Potential	None	2 Years
UK	Own	\$340K	Genuine Entrepreneur Test	2 in 2 years	3 years
	VCs, Incubators.	\$85K			
Singapore	Own	\$40K	Recognised Innovation	2 each year	1 Year
	VC/ Angel	\$80K			
	Incubator	None			
New Zealand	Anyone	\$87K	Significant Contribution	None (3 for Fast-track residency)	1 Year
Australia	Prior Business	\$1.4M	Extensive Experience & State/ VC Nomination	2 in 3 years	4 Years
	VC	\$940K			
Italy	Own/ VC	\$68K	Innovative/ R&D-Based	None	1 Year
	Incubator	\$68K			

6.5.2.1 Requirements

In most instances, the application involves various process demands and submissions, as well as the determination of performance against specific “benchmarks” designed to assess credibility of the entrepreneur’s value to the local ecosystem. There is usually a threshold of funding that is compulsory, either from personal reserves or provided by 3rd party backers, although the intricacies of this differ markedly between countries. Besides the residency-related paperwork (biometrics, police clearances, etc.), most countries also require the submission of a detailed business plan, demonstrating short- and long-term viability.

6.5.2.1.1 Eligibility and Application Process:

Clear, objective application processes and criteria are reported to be far more attractive than unclear guidelines, as these not only increase the transparency and predictability of the process for the entrepreneur; they also reduce the administration burden and thus, the turnaround time. The UK Home Office currently has a backlog of over 9000 applications and finds itself returning an application outcome in 9 weeks against its initial commitment of one³⁸³. The cost to the country in terms of foregone immigrants is undoubtedly substantial. More concerning, however, is the resultant uncertainty around processing. For any entrepreneur, immigration is essentially a business decision. However, if applicants are uncertain as to how long processing will take, they have to factor that uncertainty into that business decision as risk. Reports indicate that the processing time, whether it is 7 days or 30 days, is of far less consequence to the immigration decision than if the processing duration and deadline are unknown.

In specific examples, Australia operates according to a points-based eligibility rating, which includes a broad range of measures, such as English language proficiency, business experience, patents/ trademarks etc., as proxies for credibility. This acts as a filter through which only the most promising candidates progress. Italy has arguably the most efficient version of this process, with an exclusively online and free application. The US's proposed system, currently stalled in congress despite bipartisan support, is heavily criticised because of what is considered to be a superfluous review process, which relies on investment or revenue requirements and business plan evaluations³⁸⁴. Such an approach relies on the subjective assessment by government officials of the entrepreneurial talent and business potential, as opposed to a more objective points-based system of assessment. In most countries, however, both approaches are still required.

However, not all programmes fit this traditional mould. Chile, and subsequently Peru, are both currently pioneering a unique “competition-based” approach to the application structure, offering an exceptionally attractive package for which entrepreneurs or ventures “compete” for visa entry and support. Applications are judged by a panel and the winners are inducted into a support network, which includes government grants, incubators, and a range of generous benefits. Brazil and Greece have early-stage spin-offs of this concept too.

6.5.2.1.2 Capital:

While many countries have “entrepreneurial visa” programmes in place, there is a distinction between regimes that attract established entrepreneurs and those designed for early-stage entrepreneurs who do not yet have either capital backing or a proven track record. The former is a much simpler regime to implement, although a singular focus on this alone is, understandably, reported to reduce the supply of potential entrepreneurs. In most instances, a dual approach is optimal. Indeed, the UK has a specific tiered visa system customised to target each of these groups, as well as one specifically for foreign graduates from local tertiary institutions. Sweden and New Zealand also have entrepreneurial visa programmes targeting the early-stage entrepreneur, which does not require any capital or investment amount for acceptance. Overall it appears that the most conventional capital requirement is similar to the structure currently required in South Africa, viz. one that requires the entrepreneur to invest a specified amount into the business, reducing the amount in certain cases, as illustrated in Table 9, above.

³⁸³ Independent Chief Inspector of Borders and Immigration. 2013. An Inspection of Applications to Enter and Remain in the UK under the Tier 1 Investor and Entrepreneur Categories of the Points Based Systems. UKBA

³⁸⁴ Bier, D. 2014. America Needs a True Entrepreneurship Visa. www.CEI.org

Typically, entrepreneurs that do not have sufficient personal funding to invest or the collateral with which to access debt financing, seek equity funding in the destination country. This is often sourced from an angel or venture capital (VC) investor. However, equity funding may be extremely difficult to obtain, as funders are often scarce and highly selective. In recognition of this, Canada has reduced capital requirements if the funding source is a recognised VC or angel group, and has waived this requirement if the business manages to enrol in an incubator. The UK and Australia also have a reduced threshold if funding is received through a VC, Incubator, or the state. South Africa's funding requirement is eligible for reduction if the business falls into a "National Interest" category, as periodically determined by the dti; however, there is no differentiation in requirements between sources of funding.

The reduced capital requirements for VC or angel funding also reflect the fact that VC's and angels specialise in identifying successful businesses. Their investment into the company is considered to be a credible enough signal of the businesses' potential for government to reduce the threshold amount. Relying on approved third-party professionals to screen and identify entrepreneurial talent in this way is advantageous to all parties. It reduces the burden on government officials³⁸⁵ and enables the entrepreneur to tap into a local network of funding and support, resulting in a healthier, more integrated local ecosystem.

6.5.2.1.3 Local Jobs Creation:

There are two key approaches typically employed to encourage job creation in the context of entrepreneurship visa programmes: a) the creation of permanent local employment as a *requirement* of the visa, and b) the creation of permanent local employment through *supporting and encouraging* the attractiveness and benefits of employing "locals" while not making it obligatory to do so.

- a) The UK, Australia, Singapore, Germany and South Africa all require the creation of permanent employment for citizens or, in some cases, permanent residents over a period of time.
- b) New Zealand, Sweden and Ireland don't require job creation. However, entrepreneurs in New Zealand who do employ three locals and have invested NZ\$500K, five times the base investment amount, can apply for fast-tracked permanent residence as an added incentive. Chile and Peru's competition-based programmes don't directly require that the successful companies create jobs, but they both (as well as Canada³⁸⁶) subsidise wages for local hires. In addition, the incubator and accelerator process that recipients go through places a strong emphasis on integrating them into local networks of funders, suppliers and potential employees. This "soft-landing" is an important incentivising feature of many programmes, including Chile, Peru, Canada, UK and Nigeria.

The timing of these requirements is pivotal. If companies are forced to employ locals too early on it may force them to prioritise regulatory compliance above good business sense or best practice. This in turn negatively affects their commercial viability and may jeopardise the success of their venture and their visa investment. Singapore and the US's proposed regimes both have staggered requirements to address this issue. Singapore requires companies to create two jobs in their first year, and four jobs in the second, while the US is proposing a less onerous two jobs in the first year, and five jobs within four years. Given that start-ups don't typically grow in a linear fashion, and that companies differ in size, having a staggered approach based on a percentage

³⁸⁵ Sumption, M. 2012. Visas for Entrepreneurs: How countries are seeking out immigrant job creators. www.MigrationPolicy.org

³⁸⁶ Canada's wage subsidies are independent of the Startup Canada Entrepreneur Visa, and are implemented through other Government agencies / programmes, such as the Scientific and Experimental Development (SR&ED) Tax Incentive Programme and, the Canada Media Fund (CMF).



of employees that are local is a more appropriate system than specifying an absolute quantity at one point in time. The Department of Home Affairs is to be commended for this positive amendment in the legislation.

6.5.2.2 Scope:

Identifying tomorrow's successful entrepreneurs today is a highly erratic practice and many countries try to avoid "narrowing the net" by systematically excluding any particular group. There are many aspects in which entrepreneurs differ, and providing as fair a chance as possible for acceptance is an admirable goal. An example of this is the UK's system, which provides separate visas for "prospective" and "proven" entrepreneurs, with an important subset of the "prospective" entrepreneurs being recent foreign graduates from local tertiary institutions.

Foreign graduates from local tertiary institutions are a particularly significant demographic group because they, by definition, are less exposed to the risks that usually affect new foreign entrepreneurs. They are already immersed in the culture, have often been integrated into local professional and personal networks, and don't have to contend with the personal difficulties of relocating on top of the challenge of starting a business. Increasingly, these advantages are being recognised and targeted programmes to retain foreign graduates are emerging in the UK, as well as elsewhere in the world. Indeed, the proposed system in the US aims to offer reduced and deferred requirements to graduates of local tertiary institutions if they graduated with a Science, Technology, Engineering or Mathematics (STEM) qualification. Due consideration should be given as to whether South Africa requires a multi-tiered visa system of this nature, particularly given the popularity of local universities for top-calibre students from other African countries.

Reducing certain requirements or offering additional incentives in specific instances based on identified targets is not uncommon, and is typically applied to companies operating within targeted sectors. Ireland, for example, has lower requirements for export- or innovation-intensive companies, while Canada offers a host of incentives, including wage subsidies, for local high-tech employees. Australia contrasts markedly with this position, only accepting entrepreneurs who have substantial personal wealth and experience in a large company.

6.5.2.3 Duration

One of the fundamental vulnerabilities of entrepreneurial immigration visas worldwide is that many entrepreneurs fail. Even venture capitalists, who specialise in identifying high potential businesses, accept high failure rates as par for the course. Exacerbating this, however, is the fact that entrepreneurs immigrating to any country face additional hurdles in terms of language barriers, a lack of local knowledge and an absence of established business networks³⁸⁷. In addition, the people tasked with identifying and assessing entrepreneurial talent are generally not qualified experts or VCs³⁸⁸, but rather government officials who lack the necessary skills,³⁸⁹ or work in departments constrained by administrative issues³⁹⁰. When one considers all of these

³⁸⁷ Sumption, M. 2012. Visas for Entrepreneurs: How countries are seeking out immigrant job creators. www.MigrationPolicy.org

³⁸⁸ Ibid.

³⁸⁹ Omidyar Network. 2013. Accelerating Entrepreneurship in South Africa. Understanding Africa's challenges to creating opportunity-driven entrepreneurship. Monitor Group and Omidyar Network.

³⁹⁰ EY. 2014. Worldwide R&D Incentives Reference Guide. Ernst and Young Global Limited.

barriers, it is not surprising that the failure rate of immigrant entrepreneurs is often much higher than their local peers.

Failure though, is certainly not always a bad thing. Goube notes that failures are often valuable in that they are indicative of development and competitive growth in the ecosystem³⁹¹. Indeed, in this regard both Canada and the UK have accommodated a “2nd chance” opportunity for entrepreneurs in recognition of this. The UK has a 40-month visa, one of significantly longer duration than many other countries, which provides immigrant entrepreneurs with sufficient time to rebuild a second venture and meet the original funding and job-creation targets³⁹². Canada goes further, explicitly encouraging entrepreneurs who fail in their original venture to attempt another, and granting permanent residency at the outset to all successful applicants³⁹³, which is not contingent upon success in an entrepreneurial venture.

The duration of the visa ranges from a year in Chile, Italy and Singapore, to 40 months in the UK and four years in Australia. The trend seems to be that those countries with less arduous policies offer shorter visas but incorporate a compulsory demonstration of business traction or progress for renewal. Canada’s programme is an exception in this regard, as it grants permanent residence immediately upon acceptance, and also offers an attractive range of incentives. In most countries there is a clear path to permanent residence, which is conditional upon a continuing contribution to the economy.

6.5.2.4 Marketing and Promotion

Marketing and promotion styles differ distinctly between the demand-side focus, i.e. countries that are “pulling” applicants inward, and the supply side, countries that are filtering out applicants trying to “push” their way in.

The trend seems to be that more recently initiated programmes are more actively marketed, and most of them have dedicated, functional websites that provide applicants with guidelines and information. Countries that actively market their programmes include Canada, Chile, Italy and New Zealand. Canada has gone as far as to advertise on highway billboards in Silicon Valley, California, while New Zealand has an aggressive online advertising campaign. The UK and Australia both have user-friendly online approaches, with published guidelines and application templates that successfully avoid jargon when presenting relevant legislation to applicants.

Other promotional aspects that more recently implemented programmes use to differentiate themselves against their competitors for entrepreneurial talent include the structure of incentive packages and regulatory relaxations. Canada, Peru and Chile all offer fantastic incentive value propositions, including grants and subsidised labour costs. The latter extends this contribution in some instances to relocation, rental and due diligence costs. Italy, on the other hand, takes an alternative view by offering fiscal perks, such as remuneration of workers and consultants with tax-free equity or stock options, tax credits for local, qualified hires, and loosening labour laws for the first four years. New Zealand is the exception in this regard, though its failure to provide incentives is compensated by the waiving of any capital investment. Recent research has,

³⁹¹ Goube. 2014. Will Europe dare to be bullish on immigration for entrepreneurs? www.Tech.eu

³⁹² Gov.uk. 2014. Tier 1 (Entrepreneur) Visa Guide. www.Gov.uk

³⁹³ Citizenship and Immigration Canada. 2013. Permanent Residence - Startup Business Class.

however, shown that regulatory relaxations play less of a role in an entrepreneur's relocation decisions than other factors such as the availability of a skilled labour force³⁹⁴.

The reception that entrepreneurs receive on arrival can play a substantial role in their likelihood of success³⁹⁵, and the fertility of the local environment is a function of many inter-related determinants, from funding access to labour laws and the availability of skilled labour. The likelihood of a business realising its potential and contributing to the growth of the economy is increased when it is provided with a "soft-landing", created by facilitating links to funder networks and other local entrepreneurs, and encouraged to participate in a national network of incubators and accelerators. Chile, Peru, Canada, Italy, Singapore and the UK have reduced requirements for entrepreneurs who are enrolled in approved incubators or linked with local VCs. These networks and initial support are immensely helpful in the early development of the enterprise, and thus its long-term chance of success³⁹⁶.

6.5.3 Recommendations for refinement of the Business Visa to attract more foreign entrepreneurs to South Africa

Stakeholder engagement coupled with an analysis of international precedent and innovative new approaches to attracting international entrepreneurs suggest that there are a number of potential refinements that could be made to enhance the attractiveness and effectiveness of the current South African Business Visa. Despite recent amendments that have more closely aligned South Africa's policy to international standards, further measures are possible that would form the foundation for an objective, transparent and predictable Business Visa programme. The features of these refinements are detailed below.

6.5.3.1.1 Establish a Clear and Predictable Eligibility and Application Process

A few factors would substantially improve the functionality of the Business Visa programme, such as unambiguous eligibility criteria; a clear, predictable application process; and a single point-of-contact with government.

Processing is a critical component of any visa. If a lack of capacity leads to lengthy handling times, it can exact a reputational cost on the system as a whole. There is certainly an argument to be made for reducing South Africa's visa processing times overall, particularly in the innovation/technology arena where progress is so rapid and business ideas have excessively short "shelf-lives"³⁹⁷. However, the immediate priority needs to be increasing the predictability and transparency of the handling procedure. South Africa is particularly susceptible to this, and anecdotal evidence suggests that many potential immigrant entrepreneurs are being put off by the continued uncertainty and "postponements" of processing deadlines. Fortunately, South Africa does have the infrastructural capacity to incorporate an already functional digitised processing interface, with an email-tracking system, as is currently used by the Department of Home Affairs' document-procurement systems, most notably in Identity Document applications and renewals. The appointment or formation of a single co-ordinator within government, who is responsible for screening applications, liaising with the relevant

³⁹⁴ Endeavour Insight. 2014. What do the best entrepreneurs want in a city? Lessons from the founders of America's fastest-growing companies. www.Endeavour.org

³⁹⁵ Sumption, M. 2012. Visas for Entrepreneurs: How countries are seeking out immigrant job creators. www.MigrationPolicy.org

³⁹⁶ SAVCA. 2013. The Economic Impact of Venture Capital and Private Equity in South Africa. SAVCA & DBSA.

³⁹⁷ Jones, M.V. 1999. The Internationalisation of Small High-Technology Firms. Journal of International Marketing.



departments, and reporting back regularly to the applicant, is an important part of “sharpening-up” the system. An online, email-tracked application process is also well within governmental capacity.

While it is necessary to submit a business plan, this should serve only to identify the area of activity of the company and demonstrate its job-creation potential and projections, and not be assessed by officials, but rather an alternative skilled agency. Subjective judging of these business plans by government officials is problematic and time-consuming. The mandate of the point-of-contact agency should include filtering applications through other channels prior to forwarding them on to this more skill- and time-intensive screening process.

The requirement for applications to be made in person implemented in the 2014 regulations³⁹⁸ is the exact opposite of the simple, user-friendly approach that has yielded successful results internationally. Fundamentally, this serves to alienate potential applicants by presenting a significant barrier to application. Given that visas have to be collected in person in order to obtain biometrics, there doesn’t seem to be any reason that applications can’t be submitted online or via courier, as they are in most other countries.

6.5.3.1.2 Clarify the Capital Investment Requirements for International Entrepreneurs:

The current R2.5 million investment requirement into the Republic serves to filter out many prospective entrepreneurs; however, those who qualify through an Area of National Interest are eligible to have this reduced. The legislation needs to be more explicit regarding the forms of investment that qualify under this regulation. A director’s loan, for example, is included in the book value of private SMEs but not in public companies. Furthermore, there is a lack of clarity around the amount and conditions of the National Interest reduction to the capital investment requirement.

It is additionally recommended that recent foreign graduates of local tertiary institutions be eligible for a reduction in capital requirement overall, and particularly if they are seeking a visa as entrepreneurs operating in sectors of National Interest. The retention of these graduates is an important aspect in a number of the foreign programmes, including those in the UK, USA and Canada. Retaining talent that has recently gained professional links and an exposure to South Africa’s landscape through our institutions is highly desirable.

6.5.3.1.3 Include staggered job creation requirements more appropriate for start-up and early-stage businesses:

In recognition of the fact that companies often undergo a lag phase of slow growth prior to gaining traction and experiencing positive growth, the recommendation is that the 60% local requirement, as recently implemented in the regulations to the Act³⁹⁹, be amended to a staggered requirement of 30% within the first two years and 60% by the end of four years. This staggering is a more realistic expectation to impose on a young business. The implications of this rule for micro-enterprises with only one or two employees does need to be addressed, and it is recommended that for companies with fewer than 5 employees in total, the five year requirement is 50% local employees.

As an avenue for future consideration, it would be beneficial to incentivise local employees to become skilled workers attractive to immigrant entrepreneurs wherever possible, as the current legislation includes a loophole for these jobs to be employees in menial positions. Canada and Chile subsidise the wages of highly

³⁹⁸ South Africa. Department of Home Affairs. 2014. Immigration Act, 2002. Immigration Regulations.

³⁹⁹ Ibid.



skilled local employees. This sort of system would increase the exposure of South Africans to the foreign knowledge base, and put them in a better position to disseminate this within the local environment.

6.5.3.2 Allow up to five applicants per venture

Accepting multiple entrepreneurs per venture is common in other countries but under current conditions in South Africa they would have to apply separately to work together. Given that company management is often a team-effort, it is intuitive and simpler to allow them to apply together through the venture. The recommendation is to allow up to five applicants per venture, with the company still subject to the recommended job-creation criteria.

6.5.3.3 Offer a five-year visa for foreign entrepreneurs that meet the requirements

The proposed five-year visa duration⁴⁰⁰ is anticipated to allow recipients sufficient time to “settle-in” and come to terms with the local environment. This is a more pressing issue in South Africa than many other countries because of the scarcity of funding available to start-ups in South Africa, and the relative volatility of the business environment, including socio-political, economic and currency factors. Equally, it is intended to provide those who do fail early in their first attempt with an opportunity to start a second company and make up the lost time, thus meeting the original requirements by five years and qualifying the entrepreneur for a visa renewal or an application for permanent residence.

6.5.3.4 Implement proactive marketing and promotion campaigns

An important feature that is lacking in South Africa’s programme is a marketing drive that seeks to “sell” South Africa to international entrepreneurs. An online application portal and single point-of-contact co-ordinator would significantly facilitate applications by providing guidelines and templates for prospective applicants, as well as clear, reliable deadlines for decision outcomes.

The distribution of recipients as illustrated in section 6.6.2 is concerning, indicating a lack of engagement with developed world markets and the need for an aggressive marketing push targeting potential mobile entrepreneurs in these regions. The “compulsory basics” include a functional, user-friendly online portal projecting a professional image to potential entrepreneurs in “supply” countries, coupled with a clear lifestyle value proposition and an environment that is enabling and conducive to new business creation. The current disabling environment and the range of barriers to entrepreneurship in South Africa, addressed in this paper, requires immediate attention if South Africa is to compete seriously in the global “market for entrepreneurs” as well as locally, to retain entrepreneurs already in country. Research suggests that the three main drivers of entrepreneurial relocations are a talented labour force, new markets, and lifestyle propositions⁴⁰¹. Any policy intended to foster immigration needs to seriously address the lack of skilled workers and limitations imposed on internationalisation.

6.5.4 Rationale

It is a stated intention of government to foster small businesses and high-impact entrepreneurs in the immediate future. This forms part of the government’s policy commitment outlined in both the NGP and the

⁴⁰⁰ The visa duration was increased from 2 to 3 years in the 2014 regulations to the Immigration Act of 2002.

⁴⁰¹ Endeavour Insight. 2014. What do the best entrepreneurs want in a city? Lessons from the founders of America’s fastest-growing companies. www.Endeavour.org



NDP, outworked in supporting policies and strategies, as well as in numerous public sector press releases made since President Zuma's second inauguration. Implementing these refinements is an important step in this process and presents an important opportunity to directly channel in and transfer skills and expertise to locals. The NDP includes objectives such as a reduced economic concentration, higher levels of competition, more diversified economic activity and a more open approach to skilled immigration⁴⁰². The recommended refinements to the Business Visa are the next step in that direction.

6.5.5 Conclusion

Schumpeter notes that economic growth occurs in "a perennial gale of creative destruction"⁴⁰³. For South Africa to achieve the growth so often touted as a national goal, it requires that these waves of continuous innovation and entrepreneurs break on our shores.

President Jacob Zuma acknowledged in his State of the Nation Address recently that the key to job creation is economic growth⁴⁰⁴. Entrepreneurship is a crucial driver of this growth, and SMEs are the drivers that will generate the majority of GDP and employment expansion in South Africa in the near term⁴⁰⁵. SiMODiSA has presented recommendations to government based on extensive research and stakeholder engagement around the creation of a more enabling entrepreneurial environment. Channelling entrepreneurial talent through a Business Visa programme is an important driver of both economic growth and job creation. The recommended refinements will enhance both the attraction and retention of this talent, and in doing so foster innovation and job creation in the South African economy. A summary of the recommended refinements include:

- Offer a five-year visa for entrepreneurs who meet the capital-funding and job-creation requirements.
- Allow up to five applicants per venture to apply together, and accept applications online / by courier, but collections in person.
- Process applications timeously through a single online interface, with email tracking through the processing phases.
- Include foreign graduates from a South African tertiary institution along with the National Interest sectors as eligible for reduced capital investments.
- Allow staggered job-creation requirements, of 30% local employees by two years, and 60% within five years.
- Actively market the visa overseas as an exciting opportunity for entrepreneurs to start promising new ventures in South Africa.

It is anticipated that these refinements will significantly improve the attractiveness, relevance and uptake of South Africa's Business Visa, enhancing the potential for realising government's objectives in the form of foreign entrepreneurs that contribute to South Africa's economy, employment creation and skills base.

⁴⁰² NPC. 2011. National Development Plan. Vision for 2030. The National Planning Commission. Pg 113.

⁴⁰³ Schumpeter, J. 1942. Creative Destruction. Capitalism, socialism and democracy. Harper. Pp 82.

⁴⁰⁴ South Africa. 2014. State of the Nation Address.

⁴⁰⁵ The Task Group of the Policy Board for Financial Services and Regulation. 2006. SMEs Access to Finance in South Africa. A supply-side regulatory review.



6.6 Labour reform to enable labour market to respond to skill requirements of start-ups and SMEs

6.6.1 Current South African landscape

6.6.1.1 Problem identification and current status quo

Government's overriding objective, expressed in the NDP, is to reduce the unemployment rate to 6% by 2030. To achieve this, 11 million new jobs must be created. Basing its forecast on the FinScope survey⁴⁰⁶, which reported that 90% of jobs created between 1998 and 2005 were in micro, small and medium firms, the NDP projects that approximately 90% of new employment opportunities will emanate from small and expanding firms. Overall, this sector is anticipated to grow significantly in output by 2030⁴⁰⁷. This is consistent with global norms that evidence SMEs and HG SMEs to be the only real driver of new employment opportunities. As a result, there has been increasing interest by policy makers in South Africa in identifying mechanisms that will foster the growth of SMEs and HG SMEs⁴⁰⁸.

Sustainable job creation of this nature will require economic expansion and growth exceeding an average of 5% per annum, according to the NDP. Various activities and measures to achieve this are proposed, including "A labour market that is more responsive to economic opportunity"⁴⁰⁹. More specifically, the NDP identifies, amongst other components, SME labour regulation as a key constraint that needs to be removed and, perhaps more pertinent to this discussion, that active labour market policies and dispute resolution institutions need to be strengthened⁴¹⁰.

South Africa's labour market is frequently cited, both locally and internationally, as amongst the world's most rigid⁴¹¹. The World Economic Forum's 2013 Global Competitiveness Report ranks South Africa 143rd out of 144 countries on the Global Competitiveness index in relation to hiring and firing practices⁴¹².

The reality in South Africa is that current labour market dynamics and the regulation governing them fundamentally discourage SMEs from hiring new employees. This is evident across the board and glaringly apparent in the SBP's SME Growth Index, which confirms that, second to the current economic climate, labour regulations was the top factor preventing SMEs from growing their employee numbers⁴¹³. The SBP survey highlights that this reluctance to hire has resulted in a significant skill shortage, which further curbs the growth of SMEs and the development of the SME sector. In addition, labour regulations create significant and burdensome costs for SMEs, which has the same effect on curbing their growth⁴¹⁴. This is concerning if SMEs are assumed to be, and indeed required to be, the primary job creators in South Africa. Notwithstanding the current economic climate, it is evident that SMEs would employ more people if labour laws were more conducive.

⁴⁰⁶ FinMark Trust. 2006. Finscope South Africa: Survey Highlights Including FSM model. FinScope.

⁴⁰⁷ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁴⁰⁸ Lilischkis, S. 2011. Policies in support of high-growth innovative SMEs. An INNO-Grips Policy Brief by Empirica Communication and Technology Research. European Commission.

⁴⁰⁹ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission. Pg 30.

⁴¹⁰ Ibid.

⁴¹¹ FinMark Trust. 2006. Finscope South Africa: Survey Highlights Including FSM model. FinScope.

⁴¹² World Economic Forum. 2013. The Africa Competitiveness Report. The World Bank.

⁴¹³ SBP Business Environment Specialists. 2011. Headline Report of SBP's SME Growth Index: Priming the Soil: Small Business in South Africa. SBP Business Environment Specialists.

⁴¹⁴ Ibid.



Consequently, the inflexibility and overly burdensome nature of South Africa's labour laws should receive due consideration, particularly in how they negatively impact SMEs, given government objectives for job creation.

The principal theme emerging from stakeholder feedback on barriers emerging from the South African labour market, further supported by academic research, relates to red tape surrounding the onerous dismissal procedures that apply in South Africa. The demands associated with these, together with the time demands, delays, loss of productivity and actual monetary costs expended in defending dismissal disputes at an overwhelmingly overburdened Commission for Conciliation, Mediation and Arbitration (CCMA), negatively impact on the cost of doing business in South Africa. Resultant apathy and avoidance dominate the behaviour of entrepreneurs and SMEs, reflected in their low level of willingness to hire.

6.6.1.2 The South African regulatory environment with respect to unfair dismissal, the CCMA and flexibility of these laws for SMEs

An overview of the Labour Relations Act No 66 of 1995 (LRA) and the CCMA is perhaps useful to highlight key components of both, specifically as they relate to unfair dismissal in the context of misconduct and performance.

6.6.1.2.1 Key features of the Labour Relations Act No 66 of 1995 (LRA) concerning unfair dismissal

The LRA was established in South Africa in 1995 to define, among its other purposes, what constitutes an unfair dismissal, and to establish the obligations and standards that an employer is required to follow with respect to employee dismissals for them to be regarded as fair. Furthermore, the LRA sets out additional specific rules that apply to the dismissal of an employee serving a probation period, the time frame during which an employee is "tested" before confirming the permanent employment of that employee⁴¹⁵. The key rules applying to dismissals during permanent employment and the additional rules applying during the probation period are set out below.

General rules for unfair dismissals applying to both permanent employment and probation include:

- The LRA defines "dismissal" as the termination by an employer of a contract of employment with or without notice. Included in this definition is the failure of the employer to renew the contract of employment when the employee expects it⁴¹⁶.
- Every employee has the right not to be unfairly dismissed⁴¹⁷. For a dismissal to be fair, the employer must fulfil the following two requirements on dismissing an employee:
 - The reason for dismissal must be fair in that factually it must relate to the employee's conduct (i.e. misconduct or performance)⁴¹⁸.
 - Fair procedures must be followed on dismissal.

⁴¹⁵ As the focus of reports from SMEs and other stakeholders, as well as academic research is on the unwillingness of SMEs to hire due to onerous dismissal procedures, the overview of the LRA is limited to unfair dismissal related to misconduct and performance. Furthermore, although covered briefly in the overview below, dismissal related to operational requirements (i.e. retrenchment) and the Basic Conditions of Employment Act No 75 of 1997 (BCEA), falls outside the scope of this paper. The reason is that the LRA already includes simpler rules for retrenchments in businesses with 50 employees or less and the BCEA deals with conditions of employment and not dismissals.

⁴¹⁶ South Africa. President's Office. 1996. No. 102 of 1996: National Small Business Act, 1996. President's Office. www.gov.za

⁴¹⁷ South Africa. President's Office. 1995. No. 66 of 1995. Labour Relations Act. Section 185. President's Office. www.gov.za

⁴¹⁸ Another reason for a fair dismissal is that the dismissal was based on the operational requirements of the business (economical, technological, structural or other similar needs of the employer). Ordinarily, this is referred to as retrenchment and is beyond the scope of this paper.

If the employer cannot demonstrate this, the dismissal is considered an “unfair dismissal”⁴¹⁹.

- Where dismissals relate to a breach of the employee’s Constitutional rights, they are *automatically* deemed unfair. In terms of the LRA, dismissals for the following reasons are considered a breach of the employee’s fundamental rights and are deemed automatically unfair: participation in a lawful strike, intended or actual pregnancy, and acts of discrimination (unless the act of discrimination was based on an inherent requirement of the job)⁴²⁰.
- The Codes of Good Practice⁴²¹ to the LRA (“the Codes”) provide guidelines on norms and “standards of behaviour” that the employer must follow when dismissing an employee, and are to be read in conjunction with the LRA. The Codes do not specifically refer to SMEs and are intentionally general, and intended to be flexible so that departures from them can be justified where there are proper factual circumstances warranting such departure⁴²². In expanding on the factual circumstances that can warrant a departure, the Codes state that “a different approach” to dismissal may be warranted, depending on the number of employees in an establishment⁴²³.

Additional rules for unfair dismissals specifically in the context of probation;

- The above general principles related to unfair dismissal also apply in relation to probation. However, as the purpose of the probation period is to allow the employer to assess the competence and suitability of an employee for the job before confirming the permanent employment of that employee⁴²⁴, there are additional specific rules that apply to probation.
- South Africa permits a probation period to be agreed upon between the employer and employee. The Codes do not set a period for probation but state that it must be of a reasonable duration. Whether the probation period is of reasonable duration depends on the nature of the job and the time it would take to assess performance and suitability of the employee.
- The Codes also stipulate that the employer is obliged to provide the employee with the appropriate training, instruction and opportunity to improve during the probation period, so that the employee is enabled to meet the performance standards, at least by the end of the probation period⁴²⁵.
- Effectively, unfair dismissal laws apply during the probation period so that the employee can only be dismissed for a fair reason and following fair procedure. However, according to the Codes, the CCMA is required to accept “less compelling reasons” for a dismissal based on poor performance during this period. This is in recognition of the probation period being a temporary period during which the

⁴¹⁹ South Africa. President’s Office. 1995. No. 66 of 1995. Labour Relations Act. Section 188. President’s Office. www.gov.za

⁴²⁰ South Africa. President’s Office. 1995. No. 66 of 1995. Labour Relations Act. Section 187. President’s Office. www.gov.za

⁴²¹ South Africa. President’s Office. 2014, June. No. 66 of 1995. Code of Good Practice to the Labour Relations Act: Dismissal for conduct and incapacity: Schedule 8. President’s Office. www.gov.za

⁴²² Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. <http://www.commerce.uct.ac.za/dpru/>

⁴²³ South Africa. President’s Office. 2014, June. No. 66 of 1995. Code of Good Practice to the Labour Relations Act: Dismissal for conduct and incapacity: Schedule 8. President’s Office. www.gov.za

⁴²⁴ Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. <http://www.commerce.uct.ac.za/dpru/>

⁴²⁵ South Africa. President’s Office. 2014, June. No. 66 of 1995. Code of Good Practice to the Labour Relations Act: Dismissal for conduct and incapacity: Schedule 8. President’s Office. www.gov.za



employer is given an opportunity to test the competence and suitability of the employee before confirming permanent employment. In other words, where the employee has performed poorly during probation, the employer, theoretically, has a lower hurdle in demonstrating facts indicating poor performance during probation than during permanent employment. However, the fair procedures required are the same for dismissal during the probation period and dismissal during permanent employment⁴²⁶.

6.6.1.2.2 Dispute Resolution Structure: Commission for Conciliation, Mediation and Arbitration (CCMA)

Unfair dismissal disputes can be referred to the CCMA for resolution through mediation and/or arbitration, and thus it is important to outline the CCMA's purpose, functions and powers. The CCMA is a dispute resolution body established in terms of the 1995 LRA. It is an independent body and adopts a model of dispute resolution that aims to promote greater co-operation, industrial peace and social justice in labour relations. This approach represents a departure from the adversarial model employed under the previous LRA (viz. the Conciliation Boards and the Industrial Court), which resulted in a very low settlement rate of disputes (only 20%). Since its inception under the new LRA of 1995, the CCMA has achieved a national settlement rate of 70% and greater.

The CCMA's policy making structure is representative of labour, government and business⁴²⁷. This structure is referred to as the Governing Body and is the supreme policy making body of the CCMA⁴²⁸. The functions of the CCMA include, amongst others, the conciliation (mediation) of workplace disputes; arbitration of disputes that remain unresolved after conciliation; facilitation of the establishment of workplace forums and statutory councils⁴²⁹; the publication of guidelines on any aspect of the LRA; and the making of rules⁴³⁰.

In mediating a dispute, the CCMA Commissioner will work with the parties in order to identify and agree on a settlement. In arbitration, the CCMA Commissioner ultimately makes a decision, which is final and binding on the parties. During arbitrations, the CCMA Commissioner can order remedies in favour of the aggrieved party in an unfair dismissal, including reinstatement, re-employment or compensation⁴³¹. The CCMA Commissioner is also authorised to make costs orders against the losing party based on the merits of the case being arbitrated⁴³². This would also include the authority to make costs orders in frivolous or petty cases. Adverse costs orders would mean that the losing party, for example, the frivolous party, must bear a portion of the winning party's costs related to the arbitration. The CCMA rules state that the costs to be borne by the losing party are set in Schedule A of the prescribed Magistrates' Court tariff, which is a relatively low scale of costs⁴³³.

6.6.1.2.3 South African special recognition of and concessions for small business

⁴²⁶ Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. <http://www.commerce.uct.ac.za/dpru/>

⁴²⁷ Southafrica.info. 2014, 20 June. Regulating Labour Relations. Southafrica.info. www.southafrica.info

⁴²⁸ CCMA. 2014, 20 June. About Us. CCMA. www.ccma.org.za

⁴²⁹ Ibid

⁴³⁰ South Africa. CCMA. 2013. Annual Report. Department of Labour. www.ccma.org.za

⁴³¹ South Africa. President's Office. 1995. No. 66 of 1995. Labour Relations Act. Section 193. President's Office. www.gov.za

⁴³² South Africa. President's Office. 1995. No. 66 of 1995. Labour Relations Act. Section 138(10) and Rules for the Conduct of Proceedings Before the CCMA. President's Office. www.gov.za

⁴³³ South Africa. President's Office. 2003. No. 66 of 1995. Labour Relations Act: Rules for the Conduct of Proceedings Before the CCMA. President's Office. www.gov.za

There are laws in South Africa that recognise that small businesses have less resources and are less able to meet standards imposed in terms of these laws. Consequently they act to exclude or limit small businesses from the application of certain laws or standards that may apply to others. These include:

- The Ministerial Determination for Small Business, which varies the application of employment conditions set by the Basic Conditions of Employment Act No 75 of 1997 (BCEA), regards small businesses as those employing less than 10 employees⁴³⁴;
- The Employment Equity Act No 55 of 1998 (EEA), which deals with affirmative action⁴³⁵, excludes employers with less than 50 employees from Chapter III; and
- The LRA provides for simpler procedures to be followed by the employer on retrenchment of employees where the business has 50 employees or less. More complex retrenchment procedures apply where businesses have more than 50 employees⁴³⁶.

Furthermore, the Codes of Good Practice to the LRA, mentioned above, also state that “a different approach” to dismissal may be warranted, depending on the number of employees in an establishment⁴³⁷. In short, certain South African laws and the Codes demonstrate that South Africa acknowledges that legislative standards may differ according to the size of the business, and might well warrant limitation or exclusion to recognise the particular interests of SMEs.

In addition, and along with the affirmative action provisions in the EEA and the retrenchment provisions in the LRA that recognise special treatment of SMEs of a certain size, the National Small Business Act provides for the establishment of certain statutory bodies to promote and implement government’s policy for small business development. It defines a “small enterprise” as a distinct business entity that can be classified as micro, very small, small or medium. The schedule to the Act houses a sector-dependent metric for classification of SMEs and includes small businesses that have 50 or less full-time employees⁴³⁸.

6.6.1.3 Key regulatory factors resulting in strains on SME resources and a reluctance to hire new staff

In the context of an already challenging operating environment, industry stakeholders indicate that there are a number of factors that are primarily responsible for the general reluctance of SMEs to hire new staff. These factors characterise the current status quo, and are explored in more detail below.

6.6.1.3.1 Complex and costly unfair dismissal procedures during permanent employment and probation:

The current labour regulations, particularly those related to fair procedures on dismissal, are experienced as overly restrictive, burdensome and costly. SMEs do not have the resources to carry these costs. In many instances, legal advice related to unnecessarily complex procedures, the procedures themselves and compensation payments could undermine the growth and jeopardise the survival of a small business.

⁴³⁴ South Africa. Department of Labour. 1999. No. 75 of 1997. Basic Conditions of Employment Act: Ministerial Determination No. 1: Small Business Sector. Department of Labour. www.labour.gov.za

⁴³⁵ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit

⁴³⁶ South Africa. President’s Office. 1995. No. 66 of 1995. Labour Relations Act. Section 189 and section 189A. President’s Office. www.gov.za

⁴³⁷ South Africa. President’s Office. 2014, June. No. 66 of 1995. Code of Good Practice to the Labour Relations Act: Dismissal for conduct and incapacity: Schedule 8. President’s Office. www.gov.za

⁴³⁸ South Africa. President’s Office. 1996. No. 102 of 1996: National Small Business Act, 1996. President’s Office. www.gov.za



Furthermore, while recognition is taken of less compelling reasons for dismissal due to competency during the probation period, this is nullified by the equal obligation on employers to provide training support to non-performing employees. The result is that SMEs are reticent to hire permanent employees due to the risk of taking on a new employee who cannot be dismissed without severe consequences. These complex dismissal procedures apply whether the employee is in permanent employment or serving a probation period.

This current status quo is the result of legal advisers and the CCMA interpreting and applying the unfair dismissal procedures in an unnecessarily complex way, which is stricter than what is required in the LRA and the Codes of Good Practice. The focus in application tends to be that a formal hearing be required on dismissal. Thus disputes centre upon the technicalities and detail of the hearing, as opposed to the substantive fairness of the dismissal. There is, in fact, no absolute requirement in South Africa's LRA or the Codes for a formal hearing on dismissal, whether during permanent employment or the probation period⁴³⁹. The Codes simply require that there should be "an investigation, proper notification of the allegations, reasonable time for the employee to prepare a response, the right to be represented by a fellow employee or shop steward, an opportunity to respond to the allegations, and communication of the decision, preferably in writing"⁴⁴⁰. Most importantly, an opportunity to "respond to allegations" is an opportunity to express his/her point of view and not a formal hearing⁴⁴¹. The supporting policy intends that the employee should have an opportunity to put facts forward that demonstrate that the dismissal is not justified⁴⁴².

Furthermore, even though there is a lower hurdle for the employer in proving poor performance as a reason for dismissal during probation, there is uncertainty in the CCMA on how to interpret this within the broader framework of the LRA. Therefore, the CCMA has failed to consistently apply this aspect of the Code, and hence cases within the probation period are often not treated any differently to those cases under permanent employment⁴⁴³. Consequently, the purpose of the probation is undermined, as the SME employers cannot test competency and suitability of the employee with ease⁴⁴⁴. In addition, as mentioned above, the same complex procedures apply during the probation period as in permanent employment. The result is risk to the employer in hiring as the employer is "stuck" with an unsuitable or poor performing employee.

6.6.1.3.2 An overburdened CCMA

Stakeholders and research have reported that the CCMA is overburdened with disputes. It is reported that when the LRA was implemented, the CCMA's caseload was anticipated to be 36,000 referrals. Over 120,000 disputes were referred to the CCMA in 2005⁴⁴⁵, and in 2013 this figure stood at 168,434. This backlog causes delays, which add to SME costs and loss of productivity for those involved in disputes. In fact, a 2005 "Report on Dispute

⁴³⁹ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁴⁰ Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. Page 28. <http://www.commerce.uct.ac.za/dpru/>

⁴⁴¹ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit. Pg 27.

⁴⁴² Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. <http://www.commerce.uct.ac.za/dpru/>

⁴⁴³ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁴⁴ Cheadle, H. 2006. Regulating Flexibility and Small Business: Revisiting the LRA and the BCEA. Working paper 06/109. Development Policy Research Unit. <http://www.commerce.uct.ac.za/dpru/>

⁴⁴⁵ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

Resolution in South Africa” by Tokiso estimated that around 1.6 million man-days were spent in hearings for misconduct cases⁴⁴⁶; the majority of these referrals are unfair dismissal disputes⁴⁴⁷. These inefficiencies have a particularly negative impact on SMEs as they do not have the same resources available as big business to address these burdens⁴⁴⁸.

Even though the CCMA has the authority to make costs orders in frivolous or petty cases, the main concern is that the CCMA very rarely exercises its authority here. In fact, in 2005, costs were awarded in only 0.07% of cases. The absence of adverse costs orders in frivolous cases brought to the CCMA has led to a “nothing to lose” attitude in referring cases to the CCMA. The result is that there is no disincentive in the system for discouraging the filing of frivolous claims with the aim of reducing burdens on the CCMA. Employers thus expend unnecessary costs and time defending cases that do not warrant dispute resolution in the first place⁴⁴⁹.

6.6.1.3.3 Lack of flexibility in unfair dismissal laws for SMEs

Except for the simpler retrenchment procedures that apply to employers that have 50 or less staff, the LRA applies to both small and large business in the same manner and does not provide exclusions and/or simpler standards for SMEs⁴⁵⁰. However, there is a reference in the Codes to the standards set out therein regarding dismissal being flexible depending on the size of the business⁴⁵¹. It is unfortunate that this guideline is often overlooked and is not being actively applied by the CCMA and the legal profession to SMEs. The result is that even though SMEs do not have the same resources as big business, they do have to meet the same standards as big business regarding unfair dismissal, with the result that their growth and survival is undermined.

6.6.2 International examples and precedent of labour practice

The OECD reports that between 2008 and 2013, over one third of OECD countries relaxed their “employment protection legislation”, the rules governing hiring and firing of workers, in some way⁴⁵². Countries reviewed in this report include, *inter alia*, the UK, New Zealand, France, Italy, Spain, Portugal, Lithuania, Slovakia and Croatia. Depending on the country, reform has centred on limiting the possibility of reinstatement in the case of unfair dismissals, capping the back pay, cutting levels of severance pay and, in certain countries, the introduction or extension of a qualifying period⁴⁵³.

In general, international labour standards, regulations and practice allow for greater flexibility and selective application of labour standards, and importantly, recognise the special or different circumstances and requirements of SMEs⁴⁵⁴. These international labour standards, regulations and practice recognise that this selective application of labour standards to SMEs is in the interests of increasing SME potential for growth and

⁴⁴⁶ Ibid

⁴⁴⁷ South Africa. CCMA. 2013. Annual Report. Department of Labour. www.ccma.org.za

⁴⁴⁸ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁴⁹ Ibid

⁴⁵⁰ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁴⁵¹ South Africa. President’s Office. 2014, June. No. 66 of 1995. Code of Good Practice to the Labour Relations Act: Dismissal for conduct and incapacity: Schedule 8. President’s Office. www.gov.za

⁴⁵² South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁴⁵³ European Commission. 2014. Employment Protection Legislation. European Commission. www.ec.europa.eu

⁴⁵⁴ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

stability, and economic contribution both in terms of their own success, as well as employment creation. We demonstrate here that there is ample international precedent for the same approach to be extended to the LRA. We begin by demonstrating how international standards allow for differing standards for SMEs in relation to work security rights. Thereafter, we set out a summary of the relevant international examples of labour standards or mechanisms for consideration in the South African context.

6.6.2.1 International labour standards' selective application of labour standards to small business

The International Labour Organisation Termination of Employment Convention 1982 No 158 (ILO Convention 158) recognises that different standards and rules can apply to SMEs in relation to work security rights and, more particularly, unfair dismissals.

The International Labour Organisation (ILO) is a specialised agency of the United Nations that seeks the promotion of social justice and internationally recognised human and labour rights. As part of its functions in furthering this aim, ILO constituents (governments, employers and workers) draw up Conventions. These Conventions are legal instruments that set out international labour standards on rights at work. Once the ILO adopts a Convention, a State can elect to ratify it with the result that it commits to applying the Convention in its national laws and reporting to the ILO on its application at regular intervals⁴⁵⁵.

ILO Convention 158 sets standards in respect of the termination of a worker's employment. It states that the employment of a worker cannot be terminated unless there is a valid reason for termination connected to the employee's conduct or performance⁴⁵⁶. The Convention then goes on to list the circumstances that do not constitute valid reasons for dismissal⁴⁵⁷. It also sets out procedures to be followed at the time of termination of employment⁴⁵⁸. Very importantly, the Convention allows the exclusion of these standards where necessary. More specifically, the Convention states that *"measures may be taken by a competent authority ...to exclude from the application of this Convention...other limited categories of employed persons in respect of which special problems of a substantial nature arise in the light of the particular conditions of employment of the workers concerned or the size or nature of the undertaking that employs them"*⁴⁵⁹. As this Article permits exclusion of standards based on the size of the business, many States that have ratified ILO Convention 158 have followed suit by excluding employees engaged in small business from certain labour laws⁴⁶⁰. Among the countries that have ratified ILO Convention 158 are Australia, Spain, Finland, Sweden and France⁴⁶¹.

South Africa has not ratified ILO Convention 158. However, as it serves as persuasive authority in a South African court of law,⁴⁶² academic and legal stakeholder input into this research has concluded that it is legitimate to

⁴⁵⁵ International Labour Organisation. 2014, 20 June. Ratifications. International Labour Organisation. www.ilo.org

⁴⁵⁶ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 4. ILO. Geneva. www.ilo.org

⁴⁵⁷ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 5. ILO. Geneva. www.ilo.org

⁴⁵⁸ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 7. ILO. Geneva. www.ilo.org

⁴⁵⁹ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 2(5). ILO. Geneva. www.ilo.org

⁴⁶⁰ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁶¹ International Labour Organisation. 2014, 20 June. Ratifications. International Labour Organisation. www.ilo.org

⁴⁶² South Africa. President's Office. 1996. No. 108 of 1996. Constitution of the Republic of South Africa. Section 39(1)(b). President's Office. www.gov.za



assume that employees engaged in small business may be excluded from certain labour laws, including unfair dismissal laws⁴⁶³. In this regard, it is proposed that the LRA is amended to introduce a one-year qualifying period during which unfair dismissal laws do not apply to new employees employed in a small business. It is further proposed that where unfair dismissal laws do apply, simple dismissal procedures be required. Both the qualifying period and the simple dismissal procedures are applied and supported by international standards, practice and precedent. Also outlined is international practice relating to the size threshold of the small business qualifying for exclusion or limitation with respect to unfair dismissal laws.

6.6.2.1.1 Qualifying period

A qualifying period, being a fixed period on commencement of employment, is different from a probationary period in that for the duration of the qualifying period, the application of unfair dismissal laws is excluded. Thus employees are not protected against dismissal for any reason except insofar as they are protected against the infringement of their fundamental rights, and thus protections against automatically unfair dismissals will still apply⁴⁶⁴.

The qualifying period should enable employers to assess the suitability and competency of new employees for permanent employment, and dismiss them for failing in these areas without having to undergo costly and time-consuming dismissal procedures. For the most part, the trend towards the relaxation of the hiring and firing rules in OECD countries has been reflected in a move towards the introduction or extension of the qualifying period in certain OECD countries. The rationale for this is the empirical evidence demonstrating that overly regulated hiring and firing rules curb hiring, and that the application of a qualifying period can lead to a much needed increase in employment. Pries and Rogerson, in a comparative analysis of Europe and the USA, confirm that there is a strong relationship between dismissal laws, worker turnover and unemployment durations. The study found that worker flows in the USA, which is far less regulated than Europe regarding its dismissal laws, exceed those in Europe by a factor of at least 1.5. The study demonstrates the value of flexibility in encouraging worker flows and job-to-job transitions, thus increasing hiring and employment⁴⁶⁵.

The relationship between greater flexibility and increased employment is also evident from studies undertaken in two countries a short while after they introduced a qualifying period for SMEs. A study undertaken in New Zealand in 2009, six months after it introduced a three-month qualifying period for SMEs, confirmed that the qualifying period increased hiring by SMEs. In fact, hiring was 6% higher than expected⁴⁶⁶. Spain introduced flexibility measures into unfair dismissal laws in 2012, including a one-year qualifying period for SMEs. A 2013 OECD report confirms that the measures have been responsible for approximately 25,000 new hires per month in permanent employment, and that the effect is concentrated in SMEs. The Spanish measures have also shortened unemployment spells due to faster transitions into permanent contracts⁴⁶⁷. The Pries and Rogerson study also demonstrates that the longer these periods of exemption from employment protection are, “the greater is the propensity of firms to hire and experiment with new workers and activities”⁴⁶⁸. Thus the

⁴⁶³ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁶⁴ Ibid

⁴⁶⁵ Pries, M and Rogerson, R. 2005. Hiring Policies, Labor Market Institutions, and Labor Market Flows. Journal of Political Economy. Vol. 113. No. 41. University of Chicago.

⁴⁶⁶ Dr Kaye-Blake, B. 2011, January. 90 Day Trial Periods Appear Successful - NZIER Insight 25. New Zealand Institute of Economic Research. www.nzier.org.nz

⁴⁶⁷ OECD. 2013. The 2012 Labour Market Reform in Spain: A Preliminary Assessment: Executive Summary. OECD

⁴⁶⁸ OECD Employment Outlook. 2013. Chapter 2: Protecting jobs, enhancing flexibility: A new look at employment protection legislation. OECD. www.oecd.org. Pg 67.



introduction of a qualifying period is valuable for any country wishing to encourage hiring and reduce unemployment rates.

There are a number of countries that have recognised the positive impact of qualifying periods on the propensity of firms to hire. In most of these countries, the employees' fundamental rights are still expressly protected in that automatically unfair dismissals still apply. In other words, employees cannot be dismissed where the reason amounts to a breach of their fundamental rights, for example strike action, pregnancy or discrimination. Table 10 below provides further detail on the practices of countries that make use of qualifying periods.



Table 10: International Practice: Qualifying Periods Without Right of Recourse For Unfair Dismissal

Country	Law
United Kingdom	Employees are not eligible to make an unfair dismissal claim in the first 24 months of employment. This is the case whether the employer is a small business or not. However, the employee can claim for automatically unfair dismissals ⁴⁶⁹ .
Australia	Employees are not eligible to make an unfair dismissal claim in the first 12 months of employment where the employer is a small business (with less than 15 employees), and six months where the employer is not a small business. Automatically unfair dismissals apply in Australia ⁴⁷⁰ .
Canada	In terms of Canadian Federal law, which applies to certain businesses, employees are not eligible to make an unfair dismissal claim in the first 12 months of employment. However, provinces are permitted to make their own employment laws ⁴⁷¹ . In this regard, two provinces have longer qualifying periods: in Quebec, the qualifying period is 24 months; and in Nova Scotia, it is 10 years. Automatically unfair dismissals apply in Canada ⁴⁷² .
Ireland	Employees are not eligible to make an unfair dismissal claim in the first 12 months of employment. However, automatically unfair dismissals still apply ⁴⁷³ .
Japan	No minimum qualifying period is specified. The employer can dismiss the employee without stating any reason during the qualifying period. Automatically unfair dismissals apply in Japan ⁴⁷⁴ .
Spain	The qualifying period, during which no claims may be made for unfair dismissal, varies according to the skill level of the employee ⁴⁷⁵ . However, a new type of employment contract was created in 2012 called the Permanent Employment Contract to Support Entrepreneurs. This is available exclusively to SMEs with less than 50 employees and sets the duration of the qualifying period to one year, during which the employee cannot claim unfair dismissal. Employees can claim for automatically unfair dismissals ⁴⁷⁶ .
New Zealand	Employees are not permitted to make an unfair dismissal claim in the first 90 days of employment, although employers and employees can agree on a shorter qualifying period. This was originally only for SMEs but has been extended to businesses of all sizes ⁴⁷⁷ . There is no specific provision for automatically unfair dismissals; however, an employee who believes his/her rights have been infringed may lodge a complaint under the human rights laws ⁴⁷⁸ .
Sweden	A qualifying period up to six months is allowed, during which the employer and the employee may terminate the contract without providing any specific reasons. The employer shall notify the employee and, if applicable, the relevant trade union two weeks in advance if he/she wishes to terminate the contract prior to six months ⁴⁷⁹ .

Although qualifying periods vary in length between different countries, some qualifying periods are as long as two years; the UK recently extended its qualifying period from one to two years. Spain and New Zealand have

⁴⁶⁹ United Kingdom. Gov.UK. 20 June 2014. Dismissing Staff. Gov.UK. www.gov.uk. From 1999 to 2013, the qualifying period in the UK was 12 months. In 2013, the period was extended to 24 months and is the longest in any OECD country. However, the employee can claim that their dismissal was automatically unfair during this period. The scope of unfair dismissals here includes: pregnancy (including all reasons relating to maternity); family (including parental leave, paternity leave (birth and adoption), adoption leave or time off for dependants); acting as an employee or trade union representative; joining or not joining a trade union; discrimination.

⁴⁷⁰ OECD. 2013. Detailed Description of Employment Protection Legislation: 2012 – 2013. OECD EPL database update. OECD. www.oecd.org

⁴⁷¹ Canada. Government of Canada. 20 June 2014. Labour Programme: Federal Labour Standards. Government of Canada. www.labour.gc.ca

⁴⁷² OECD. Detailed Description of Employment Protection Legislation: 2012 – 2013. OECD EPL database update. OECD. www.oecd.org

⁴⁷³ Ibid

⁴⁷⁴ Ibid

⁴⁷⁵ Ibid

⁴⁷⁶ Ibid. (This is only available to an SME that did not make an unfair or collective dismissal in the six months before hiring)

⁴⁷⁷ Ibid

⁴⁷⁸ New Zealand. Ministry of Business, Innovation & Employment Hikina Whakatutuki. 20 June 2014. Labour Information: Research: International provision on unfair dismissal protection. Ministry of Business, Innovation & Employment.

⁴⁷⁹ OECD. Detailed Description of Employment Protection Legislation: 2012 – 2013. OECD EPL database update. OECD. www.oecd.org

both introduced qualifying periods in recent years. Both Spain and Australia have longer qualifying periods for SMEs only, thus recognising the burdens on their limited resources caused by onerous unfair dismissal laws. New Zealand on the other hand has extended the qualifying period from SMEs to businesses of all sizes.

The ILO Convention 158 recognises qualifying periods and states the work security standards imposed in the Convention can be excluded during qualifying periods of reasonable duration⁴⁸⁰. Thus, international standards and practice recognise the legitimacy of qualifying periods, and the introduction of them would be consistent with these standards and practices, introducing greater flexibility into South African labour law⁴⁸¹.

6.6.2.1.2 Simple procedures on unfair dismissal

Of all the OECD countries, as well as Brazil, Russia, India, China and SA (the BRICS countries), only South Africa and India are expressly cited in the OECD Detailed Description of Employment Protection legislation as requiring a hearing for an employee on dismissal. At most, a number of countries require notification of reasons for dismissal and an opportunity for consultation regarding dismissal, which allows the employee an opportunity to respond to the allegations made⁴⁸².

Convention 158 provides that “the employment of a worker shall not be terminated for reasons related to the worker's conduct or performance before he is provided an opportunity to defend himself against the allegations made, unless the employer cannot reasonably be expected to provide this opportunity”⁴⁸³. In this regard, the ILO's Committee of Experts have, in the “Protection Against Unjustified Dismissal” General Survey (International Labour Conference 82nd Session 1995), interpreted this to mean that “any decision to terminate employment is preceded by dialogue and reflection between the parties”, and does not require a formal hearing⁴⁸⁴. It is evident, then, that international standards set by the ILO and international regulations and practice of OECD and BRICS countries do not require a formal hearing on dismissal.

6.6.2.1.3 Size of small business qualifying for exclusion from unfair dismissal laws

International standards and practice support the limitation and or exclusion of unfair dismissal laws for small businesses of a certain size. Furthermore, international practice determines size of a concern warranting limitation or exclusion from unfair dismissal laws based on the number of employees in that concern. The international standards and practice are outlined below:

- o ILO Convention 158 contemplates the selective application of labour standards to concerns based on size. However, it does not define or limit the meaning of “size” to numbers of employees, turnover or any other limitation⁴⁸⁵, making it somewhat difficult to translate policy into practice.

⁴⁸⁰ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 2(b). ILO. Geneva. www.ilo.org

⁴⁸¹ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle's Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit

⁴⁸² Ibid

⁴⁸³ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 7. ILO. Geneva. www.ilo.org

⁴⁸⁴ International Labour Organisation. 1995. Protection Against Unjustified Dismissal: General Survey: International Labour Conference 82nd Session. International Labour Organisation

⁴⁸⁵ International Labour Organisation. 1982. Termination of Employment Convention No 158 of 1982. Article 2(5). ILO. Geneva. www.ilo.org

- o International practice demonstrates that it is common for dismissal laws to be excluded based on the number of workers⁴⁸⁶. This is evident from Table 10 above where Spain has a longer qualifying period for small businesses with less than 50 employees; Australia provides a longer period for small businesses with less than 15 employees; and Germany totally excludes all employees from unfair dismissal laws in enterprises employing 10 or less workers⁴⁸⁷.

Thus it is recognised that small businesses of a certain size, determined by the number of employees in a concern, have a more limited ability to bear the costs associated with unfair dismissal laws. The threshold number used to determine the size of the business warranting limitation or exclusion differs depending on the country context⁴⁸⁸.

6.6.3 Recommendations for labour reform applicable to SMEs to encourage hiring of appropriate resources and in turn responsiveness to start-up and SME needs

The recommendations propose a dispensation regarding dismissal laws that takes into account the different circumstances faced by SMEs and, as recognised by the NDP, supports the need in South Africa for a balance “between enabling faster expansion of employment opportunities and the protection of human rights”⁴⁸⁹. In this regard, it is proposed that a qualifying period be introduced into the LRA for the first 12 months of an employee’s employment in a SME; after the qualifying period, simpler dismissal procedures govern dismissal of employees from an SME; and that the CCMA commissioners make use of costs orders for frivolous cases in order to discourage the abuse of the CCMA and the resultant burden on SME costs.

6.6.3.1 Introduce a qualifying period

There is evidence that qualifying periods free of dismissal laws increase worker flows and that the longer they are, the greater the propensity of employers to hire. Thus qualifying periods result in an increase in employment. In this context, and in order to increase employment and the rate of hiring, it is recommended that Chapter VIII of the LRA (which deals with unfair dismissals) be amended to introduce a qualifying period that will apply for 12 months to a new employee of an SME. The automatically unfair dismissal rules will apply in this period, but the unfair dismissal rules will not.

6.6.3.2 Simplify pre-dismissal procedures

The South African laws on pre-dismissal procedures are being interpreted to include a formal hearing on dismissal. This is not consistent with the LRA, the Codes of Good Practice and international standards and practice, which require only that the employee be given an opportunity to respond to the allegations made by the employer. The CCMA, particularly the Governing Body, is authorised to make Guidelines on the LRA and policy at the CCMA. It is recommended that the Governing Body of the CCMA:

- Issue Guidelines that specify clearly that there is no need for a formal hearing in the LRA and the Codes of Good Conduct, and that simpler rules apply to SMEs, as defined. This should include guidelines

⁴⁸⁶ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁸⁷ OECD. 2013. Detailed Description of Employment Protection Legislation. 2012 – 2013. OECD EPL database update. OECD.

⁴⁸⁸ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁸⁹ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.



specifying that an employee must simply be given an opportunity to respond to allegations made, namely, to put facts forward that demonstrate that the dismissal is not justified.

- Train CCMA Commissioners regarding the importance of this simple industrial justice in relation to SMEs and how to apply this simpler industrial justice with regard to SMEs.

6.6.3.3 Ensure more frequent use of adverse costs orders for frivolous claims

The CCMA Commissioners are not applying their authority to make adverse costs orders in frivolous or petty cases. Therefore, the filing of such cases with the CCMA is not being discouraged. The result is that the resources of SMEs are unnecessarily burdened through time wastage, costs and loss of manpower days in dealing with these cases, which is a burden that threatens the growth and survival of SMEs. It is recommended that the Governing Body of the CCMA:

- Issue Guidelines clarifying what constitutes a frivolous case and specifying that adverse costs orders will be made against parties who bring such claims to the CCMA against SME employers.
- Train CCMA Commissioners regarding what constitutes frivolous cases and the importance of making costs orders in such cases.

6.6.3.4 Introduce and apply a consistent definition of small business

It is recommended that a definition of “small business” be introduced in the context of the LRA that will include enterprises with 50 employees or less. This will ensure that the selective application of labour standards and mechanisms outlined above apply to concerns at or below this size. International practice demonstrates that it is common for dismissal laws to be excluded or limited based on the number of workers. Furthermore, during stakeholder discussions, there was much support for a threshold of 50 employees in South African law. In addition, this figure serves as the threshold for exclusion of employees from the EEA and certain retrenchment procedures in the LRA. These factors demonstrate that this size of business warrants exclusion from certain laws and standards in South African law, and does not have the resources to withhold the red-tape burdens of these laws and standards⁴⁹⁰.

6.6.4 Rationale

Smaller sized employers are typically disadvantaged through onerous labour regulations, as they do not have the capital reserves to meet the same obligations and standards as big businesses. These regulations generally strain the resources of SMEs and threaten their survival⁴⁹¹. Both international and local legislation recognises the compliance burdens that SMEs face, and proactively make provisions to reduce such burdens. Indeed, OECD reports demonstrate a trend internationally towards the relaxation of labour legislation, with over one third of OECD countries relaxing their “employment protection legislation” in some way⁴⁹². The rationale for this trend is that relaxation of labour legislation positively affects worker flows, thus increasing hiring and employment⁴⁹³.

⁴⁹⁰ Van Niekerk, A. 2007. Regulating Flexibility and Small Business: Revisiting the LRA and BCEA: A Response to Halton Cheadle’s Concept Paper. DPRU Working paper 07/119. Development Policy Research Unit.

⁴⁹¹ Ibid.

⁴⁹² OECD Employment Outlook. 2013. Chapter 2: Protecting jobs, enhancing flexibility: A new look at employment protection legislation. OECD. www.oecd.org. Pg 67.

⁴⁹³ Pries, M and Rogerson, R. 2005. Hiring Policies, Labor Market Institutions, and Labor Market Flows. Journal of Political Economy. Vol. 113. No. 41. University of Chicago.

South Africa's own context mirrors that of international trends. The LRA was passed in 1995. Since then, there have been significant changes in the economic context, which have significantly affected domestic economic growth, development and socio-economic transformation. Government is ambitiously looking to SMEs to create 90% of the jobs to achieve its goals of reducing unemployment to 6% by 2030⁴⁹⁴. The NDP suggests that, in order to achieve this, there is a clear need for greater flexibility in labour legislation, asserting that "a balance is needed between enabling faster expansion of employment opportunities and the protection of human rights"⁴⁹⁵.

Clearly there is an urgent need to reconsider the regulatory burden (in this context, in relation to labour regulations) imposed on SMEs. There is empirical evidence that these onerous regulatory burdens are obstructing job creation in South Africa as they disincentivise SMEs from hiring, adversely affecting worker flows and potential employment creation that might otherwise be realised⁴⁹⁶. In this context, it is imperative that selective application of labour standards be introduced for SMEs in accordance with the above recommendations.

Lastly, the rationale behind the CCMA is to provide a participative, cooperative dispute resolution service to those involved in labour disputes. This model was supposed to be more efficient and expedient than the previous system, but is overburdened with disputes⁴⁹⁷. The strain on the CCMA must be reduced; this can be achieved by discouraging frivolous cases so that efficient and expedient dispute resolution can be available for those who need it, and that the resources and survival of SMEs is not unduly compromised.

6.6.5 Conclusion

As complex unfair dismissal procedures and inefficiencies of the CCMA strain resources in SMEs, it is imperative that selective application of labour standards be accepted for SMEs⁴⁹⁸. It is recommended that a qualifying period be introduced, less stringent and simpler dismissal procedures be applied to employees of SMEs for misconduct and poor performance, and that the CCMA makes use of adverse costs orders in frivolous claims brought against SMEs.

There is empirical evidence that overly restrictive labour laws reduce worker flows and hiring, and hinder productivity and economic growth. Furthermore, there is empirical evidence that these onerous regulatory burdens are obstructing job creation in South Africa and thus growth of enterprises. Government has a targeted unemployment rate of 6% by 2030, and government is relying on SMEs to create 90% of the jobs set to be filled by then. Unless the onerous labour laws in South Africa are relaxed for SMEs, it will be impossible to meet this target.

⁴⁹⁴ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁴⁹⁵ Ibid. Pg 113

⁴⁹⁶ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁴⁹⁷ Ibid

⁴⁹⁸ Ibid



6.7 Relevance of the R&D Tax Incentive for the Start-up/SME Market

This submission seeks to provide industry insight and feedback into the relevance and applicability of the existing Research & Development (R&D) Tax Incentive to and for SMEs and start-ups at the specific request of National Treasury.

6.7.1 Current South African landscape

6.7.1.1 Problem identification and current status quo

Due to the wealth of empirical evidence, there is acceptance among academic economists that innovation, knowledge and R&D are key factors in driving sustained, long-term economic growth and competitiveness⁴⁹⁹. As a result, government policy throughout the world seeks to ensure that these factors are shaped and generated through a suite of instruments, co-ordinated into a holistic National Innovation System (NIS)⁵⁰⁰. Goldberg et al reports that, at a minimum, the NIS needs to have universities or research institutes that are linked to each other and to a strong private sector; a public-financing process to elicit the largest possible private sector R&D investment response; and incentives, such as a proper intellectual property rights regime and tax incentives⁵⁰¹. R&D is positively correlated with innovation through the introduction of new processes, products and changes in organisations, and thus also with firm and economic growth⁵⁰². An essential element of any innovation system is the stimulation of R&D through direct government funding, as well as indirect support through tax incentives. In fact, tax incentives have been widely used across countries to stimulate R&D activities and investment across a wide range of firms⁵⁰³.

R&D investment is risky and it is uncertain whether the time and money invested therein will result in payback in the form of marketable goods and services. Because of these uncertain outcomes, financial institutions are unable to judge the quality of the R&D investment and are not frequently forthcoming with finance⁵⁰⁴. Government support for R&D through tax incentives aims to reduce the costs associated with R&D, and therefore the risks associated with R&D investment, thereby encouraging R&D investment by firms⁵⁰⁵. Evidence and input in South Africa has identified the lack of funding and the high costs associated with R&D as key constraints on R&D spending⁵⁰⁶. Consequently, a tax incentive to encourage R&D spend and minimise associated costs, is imperative if the country wants to increase innovation and economic competitiveness.

⁴⁹⁹ Goldberg, I.; Trajtenberg, M.; Jaffe, A.; Muller, T.; Sunderland, J.; Armas, E.B. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

⁵⁰⁰ Tuomi, K, De Castro Neto, L. 2013. Innovation and Venture Capital Policy in Brazil and South Africa. Journal of Technology Management & Innovation. Vol. 8 No. 2. Santiago. Page 5 <http://dx.doi.org>

⁵⁰¹ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

⁵⁰² Moses, C, Sithole, M, Blankley, W, Labadarios, D, Makelane, H, Nkobole, N. 2012. The State of Innovation in South Africa: Findings from the South African National Innovation Survey. South African Journal of Science. <http://www.sajs.co.za>

⁵⁰³ Goldberg et al. 2006. Public Financial Support for Commercial Innovation. Europe and Central Asia Knowledge Economy Study Part 1. Chief Economist's Regional Working Paper Series. Vol 1 No. 1. Private and Financial Sector Development Department. ECSPF. World Bank.

⁵⁰⁴ OECD. 2010. R&D Tax Incentives: rationale, design, evaluation. OECD

⁵⁰⁵ Deloitte. 2013. 2013 Global Survey of R&D Tax Incentives: Analysis of National R&D Incentives. Deloitte

⁵⁰⁶ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.



South Africa's target for gross expenditure on R&D as a percentage of Gross Domestic Product (GDP) was set at 1% for 2008. Unfortunately, this target was missed and, in fact, according to figures for the years 2008 to 2010, South Africa's gross expenditure on R&D as a percentage of GDP has been steadily dropping. This figure is already relatively low when compared to other countries, except for India. This is consistently the case in comparison to all the countries cited in Table 11 below throughout the years from 2006 to 2010⁵⁰⁷. Without significant improvement in R&D spend, South Africa is unlikely to achieve the 2% target set for 2018. Consequences of this, including the reduced potential for domestic economic growth or declining global competitiveness, have serious implications for the country, especially given South Africa's current socio-economic conditions.

Table 11: Gross Expenditure on R&D as Percentage of GDP (Selected Countries)

	Brazil	Russia	India	China	SA	Japan	UK	Canada	Norway	France	Korea	Australia
2010	1.16	1.13	-	1.76	0.76	3.25	1.77	1.85	1.68	2.24	3.74	2.20
2009	1.17	1.25	-	1.70	0.87	3.36	1.82	1.94	1.76	2.27	3.56	-
2008	1.11	1.04	-	1.47	0.93	3.47	1.75	1.92	1.58	2.12	3.36	2.26
2007	1.10	1.12	0.76	1.39	0.92	3.46	1.75	1.96	1.59	2.08	3.21	-
2006	1.01	1.07	0.77	1.32	0.93	3.41	1.72 ⁵⁰⁸	2.00	1.48	2.11	3.01	2.01 ⁵⁰⁹

South Africa government's contribution to business expenditure on R&D through direct and indirect incentives was only approximately 0.05% of GDP in 2010; again, very low in comparison to Russia (0.41%), Brazil (0.15%) and China (0.10%) and developed countries such as Australia (over 0.10%), Japan (0.10%), Canada (0.25%), France and Korea (both over 0.35%). This contribution has also been declining since 2008⁵¹⁰. Of particular concern is that the National Budget Review for 2014 reports that the R&D tax deduction under Section 11D (relinquishment of revenue by SARS) declined by 65% from R685 million in 2010/2011 to R241 million in 2011/2012⁵¹¹.

According to the National Survey on Research and Experimental Development in South Africa, in the period 2010 to 2011, the highest percentage of expenditure on R&D occurred in the business sector (49.7%) as compared with Higher Education (26.8%) and government (22.7%). For purposes of the survey, "business" includes large, medium, small and State-owned enterprises. "Government" includes National and Provincial Departments, Local government, museums, government research institutions and other councils with an R&D component⁵¹². It is concerning, however, that R&D expenditure by the business sector has also been declining since 2008⁵¹³. The Department of Science and Technology (DST) Ministerial Review Committee on Science, Technology and

⁵⁰⁷ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science & Technology.

⁵⁰⁸ Ibid. Table 13.

⁵⁰⁹ OECD. 2013. Gross Domestic Expenditure on R&D as a Percentage of GDP. OECD

⁵¹⁰ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science & Technology.

⁵¹¹ South Africa. National Treasury. 2014. National Budget Review. Annexure C. Table C.2 Tax expenditure estimates. National Treasury. www.treasury.gov.za

⁵¹² HSRC. 2010. National Survey on Research and Experimental Development: Main Results 2009/10. Department of Science & Technology.

⁵¹³ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science & Technology.

Innovation attributes this decline to the economic crisis, with the private sector scaling down, postponing or cancelling their R&D investments due to reduced cash flows⁵¹⁴.

The capacity of businesses to exploit the knowledge generated through new products and process development makes R&D expenditure by the business sector important to the economy⁵¹⁵. In recognition of this, government strategies embodied in the NDP and the Ministerial Review Committee regard the private sector as the most important source of finance for and performer of R&D in South Africa^{516,517}. Indeed, the Ministerial Review Committee identifies the triple helix relational ecosystem between government, research institutions and the private sector, and the interdependent exchange process between these organisations, as an important instrument in fostering innovation. It especially highlights government and private sector relations as needing to be strengthened so that the decline in R&D investment by the private sector is reversed and R&D private investment is promoted in South Africa⁵¹⁸.

6.7.1.2 South African R&D Tax Incentive Programme

In 2006, the South African government introduced the R&D Tax Incentive Programme. This was designed to encourage private sector investment in scientific and technological R&D activities. The R&D Tax Incentive is an indirect approach to increasing national R&D expenditure and complement direct government expenditure on R&D activities. The programme provides for two types of incentive 1) a deduction of 150% of expenditure on eligible R&D activities in the year of assessment; 2) accelerated depreciation of assets used for the purposes of R&D. Capital expenditure on R&D assets is deductible over three years at 50% in the year in which the asset is brought into use, and 30% and 20% respectively in the following two years of assessment⁵¹⁹.

6.7.1.2.1 Qualifying expenditure

Qualifying R&D expenditure must (i) be intended to be used by the taxpayer claiming the incentive in the production of income, and (ii) be used for R&D activities undertaken in South Africa⁵²⁰. The R&D activities must also constitute a qualifying activity in order to be eligible under the tax incentive. A qualifying activity comprises the discovery of novel and non-obvious information of a scientific or technological nature, or the creation of an invention, design, and computer programme of a scientific or technological nature or knowledge essential to its use⁵²¹. Also included is the making of significant improvements to the aforementioned for the purposes of improved function, performance, reliability or quality, although routine testing, analysis, collection of information or quality control in the normal course of business is excluded⁵²².

⁵¹⁴ South Africa. Department of Science & Technology. 2012. Department of Science and Technology Ministerial Review Committee on the Science, Technology and Innovation Landscape in South Africa. Final Report. Department of Science and Technology.

⁵¹⁵ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science & Technology.

⁵¹⁶ South Africa. National Planning Commission: The Presidency. 2011. National Development Plan 2030: Our Future – make it work, Executive Summary. National Planning Commission.

⁵¹⁷ South Africa. Department of Science & Technology. 2012. Department of Science and Technology Ministerial Review Committee on the Science, Technology and Innovation Landscape in South Africa. Final Report. Department of Science and Technology.

⁵¹⁸ Ibid.

⁵¹⁹ South Africa. Department Science and Technology. 2011. A Guide to Scientific and Technological Research and Development Tax Incentives (The Guide). Department of Science and Technology. www.dst.gov.za

⁵²⁰ Ibid.

⁵²¹ Ibid.

⁵²² South Africa. President's Office. 1962. No. 58 of 1962. Income Tax Act. Section 11D. President's Office. www.gov.za



6.7.1.2.2 Sub-contracting arrangements

Research funded by a third party enjoys the same 150% deduction but only in circumstances where the party that is contracted to carry out the research is a tax exempt body or is the Council for Scientific and Industrial Research (CSIR). A deduction of only 50% of the R&D expenditure is allowed where the party sub-contracted to carry out the research is in the same group of companies, as defined in the Income Tax Act, as the funder of the research. The deduction is claimable by the funder of the R&D if they have control over the research methodology⁵²³. The 2014 Budget Speech acknowledges that there are uncertainties regarding eligibility for claiming of the R&D Tax Incentive in these sub-contracting arrangements, and confirms that the legislation will be amended retrospectively to 1 January 2014 to ensure clarity in this regard⁵²⁴.

6.7.1.2.3 Pre-approval process

As from 1 October 2012, the responsibility to determine the eligibility of R&D for the tax incentive has shifted from the South African Revenue Services (SARS) to the DST, and the taxpayer must obtain prior approval for R&D in order to make use of the allowance⁵²⁵.

6.7.2 International examples of R&D Tax Incentive Schemes

Most countries throughout the world have an R&D Tax Incentive Programme in order to encourage private investment in R&D. The rationale for such programmes is that the stimulation of R&D investment will result in the creation of new processes and products, thus leading to both the growth of the firm and the economy⁵²⁶. Set out in Table 12 below are the defining elements of the R&D Tax Incentive Programmes in 8 OECD countries, namely Australia, Canada, Norway, UK, Japan, Portugal, South Korea and France.

All countries included in the table offer more generous percentage allowances to SMEs for calculating tax credits as part of their R&D Tax Incentive Programmes. Thus these countries recognise that SMEs warrant special treatment based on their cash flow disadvantage when compared to larger companies, and their propensity to create innovation and jobs⁵²⁷. Following the table is an analysis of the approaches adopted in terms of the structure of tax credit, special treatment for SMEs, the depreciation on capital expenditure, sub-contracting of R&D and approval processes.

⁵²³ Ibid.

⁵²⁴ South Africa. National Treasury. 2014. National Budget Review. Annexure C. Table C.2 Tax expenditure estimates. National Treasury. www.treasury.gov.za

⁵²⁵ South Africa. Department Science and Technology. 2011. A Guide to Scientific and Technological Research and Development Tax Incentives (The Guide). Department of Science and Technology. www.dst.gov.za

⁵²⁶ Moses, C.; Sithole, M.; Blankley, W.; Labadarios, D.; Makelane, H.; Nkobole, N. 2012. The State of Innovation in South Africa: Findings from the South African National Innovation Survey. South African Journal of Science. <http://www.sajs.co.za>

⁵²⁷ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org



Table 12: Country Comparison of R&D Tax Incentive Programmes

	Overview of tax incentive	Special treatment of SMEs	Qualifying expenditure	Depreciation on capital expenditure	Subcontracting of R&D	Approval process
Australia	40% R&D non-refundable tax credit for eligible large companies, which may be carried forward indefinitely ⁵²⁸ . This recently replaced the tax deduction. The credit is deductible against tax and is calculated on qualifying R&D expenditure.	45% refundable tax credit for SMEs with an aggregated turnover of less than AUD 20 million per annum.	Qualifying expenditures include staff costs; direct costs; overheads; supplies; depreciation; certain capital expenditures on activities that are defined as core or supporting R&D; and goods and materials transformed or processed during R&D activities to produce marketable products.	Depreciation on plant and machinery is claimable.	Where the R&D activities are sub-contracted to another entity, the party who receives the major benefit from carrying out the R&D activities (for example, who owns the results of the activities) is eligible to claim the tax credit.	Taxpayer must register the R&D activities with AusIndustry within 10 months of the end of the year during which the R&D activities were conducted. The tax credit may only be claimed in the tax return after such registration ⁵²⁹ .
Canada	A 15% tax credit is refundable or deductible against tax. The tax credit is calculated on qualifying scientific research and experimental development (SR&ED) expenditure.	The credit rate is increased to 35% for small Canadian-controlled private corporations on the first C\$ 3 million of expenditures per year. It is 100% refundable for non-capital-related expenditures and 40% refundable for capital expenditures.	Qualifying SR&ED expenditures includes labour; consumed or transformed materials; subcontracts; leased equipment; other expenses directly related and in support of the SR&ED, namely, engineering, design, operations research, mathematical analysis, computer programming, data collection, testing or psychological research ⁵³⁰ .	Eligible capital expenditures for the provision of premises, facilities or equipment used for scientific research and experimental development in Canada may be fully deducted in the year they are incurred. However, this is being scrapped in 2014.	The R&D tax credit base includes 80% of arm's length contract payments. Where a claimant contracts another party to have SR&ED performed on their behalf, the party performing the work would be allowed to claim SR&ED expenditures in respect of the contract. The party would have to reduce its qualified SR&ED expenditures for tax purposes by payments received under the contract. In this way, there is no duplication of the tax claim.	There is no pre-approval process for qualified SR&ED expenditures. However, it is important to maintain supporting evidence to substantiate the claim on review by the tax authorities ⁵³¹ .

⁵²⁸ Ernst & Young. 2014. Worldwide R&D Incentives Reference Guide: 2013 – 2014. Ernst & Young.

⁵²⁹ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.OECD.org

⁵³⁰ Ernst & Young. 2014. Worldwide R&D Incentives Reference Guide: 2013 – 2014. Ernst & Young.

⁵³¹ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.OECD.org



Overview of tax incentive	Special treatment of SMEs	Qualifying expenditure	Depreciation on capital expenditure	Subcontracting of R&D	Approval process
An 18% R&D tax credit is claimable for eligible larger companies. If the credit amount exceeds the corporate tax liability, the excess credit amount is paid to the taxpayer.	The R&D tax credit (deduction against corporate tax) is calculated as 20% of qualifying and approved R&D expenditures for SMEs ⁵³² that have less than 100 employees and an annual turnover of less than NOK 80 million ⁵³³ .	Maximum R&D project expenditures as basis for calculating the tax credit using in-house R&D expenditure is NOK 5,5 million and 11 million NOK for projects based on R&D purchased from institutions approved by the Research Council. For combined projects all costs between 5,5 million NOK and 11 million NOK must be related to purchased R&D. Qualifying R&D expenditures include R&D personnel costs where the costs are calculated using a rate per man hour; contracted R&D services; purchase of R&D equipment; other current costs; patent and licensing costs associated with filing the first patent in a given country.	Cost of R&D equipment qualifies for 100% deduction.	There are no specific rules regarding cost contribution agreements. Instead, payments under such agreements are deductible according to the general deduction rules.	All projects have to be approved in advance by the Research Council, based on a detailed project description ⁵³⁴ .

⁵³² Ibid.

⁵³³ Cappelen, A.; Fjaerli, E.; Foyn, F.; Haegeland, T.; Moen, J.; Raknerud, A.; Rybalka, M. 2010. Evaluation of the Norwegian R&D tax credit scheme. Discussion Paper No. 640. Statistics Norway Research Department.

⁵³⁴ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org



Overview of tax incentive	Special treatment of SMEs	Qualifying expenditure	Depreciation on capital expenditure	Subcontracting of R&D	Approval process
Enhanced deduction of 130% available for qualifying expenditure in resolving technological and scientific uncertainties ⁵³⁵ . In addition, a 10% tax credit for large companies that cannot be converted into payable tax credits. (Large Company Relief).	Enhanced deduction of 225% ⁵³⁶ for SMEs which have less than 500 employees and an annual turnover not exceeding €100 million ⁵³⁷ . In addition, an SME may claim a payable R&D tax credit if it has a surrenderable loss (up to 125% of qualifying expenditure on R&D). However, on costs subsidised or related to activities that were contracted to them, they can under the less generous Large Company Relief, which cannot be converted into a payable tax credit.	Qualified R&D expenditures include employing staff directly and actively engaged in carrying out R&D; consumable or transformable materials, power, water, fuel, and computer software used directly in carrying out R&D; and the cost of relevant payments to subjects of clinical trials.	100% immediate capital allowance is provided for capital expenditure on R&D (including expenditure on machinery and buildings) qualifying for R&D allowances. The treatment depends on whether the R&D is performed for a company's own account, or for another company.	If the SME and subcontractor are not "connected", the SME can claim R&D tax relief on 65% of the payment it makes to the sub-contractor. Large Companies can only claim subcontract costs if they are paid to a university, health authority, charity, scientific research organization, individual, or a partnership of individuals.	No pre-approval is required to take advantage of the applicable tax benefit, which is claimed in the tax return ⁵³⁸ .

⁵³⁵ Ernst & Young. 2014. Worldwide R&D Incentives Reference Guide: 2013 – 2014. Ernst & Young.

⁵³⁶ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org

⁵³⁷ Ernst & Young. 2014. Worldwide R&D Incentives Reference Guide: 2013 – 2014. Ernst & Young.

⁵³⁸ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org



	Overview of tax incentive	Special treatment of SMEs	Qualifying expenditure	Depreciation on capital expenditure	Subcontracting of R&D	Approval process
Japan	A 10% R&D non-refundable tax credit for eligible large companies claimable against tax. The tax credit is limited to 20% of the corporate tax amount. In addition, a 5% R&D non-refundable tax credit is claimable where the current year's R&D expenses exceed annual average R&D expenses over the previous 3 years. Tax credits can be carried forward for 3 years⁵³⁹.	A 12% R&D non-refundable tax credit is claimable by SMEs whose capital does not exceed JPY 100 million⁵⁴⁰.	Qualifying R&D expenditures include raw materials; employing staff engaged in R&D; and overheads in conducting R&D, namely, manufacturing of products and/or improve, design, formulate or invent techniques.	Depreciation on plant, machinery and buildings is claimable⁵⁴¹.	The company that pays the contract fees can include them as R&D expenditure. Contract fees received do not qualify as R&D expenditure⁵⁴².	No pre-approval is required and the tax credit is claimable in the tax return⁵⁴³.
Portugal	A 32.5% R&D non-refundable tax credit for large companies, which may be carried forward for 6 years. In addition, a 50% non-refundable tax credit is claimable for R&D expenditure which exceeds the average R&D spend of the company in the previous 2 years, capped at €1.8 million.	A 42.5% R&D non-refundable tax credit is claimable by SMEs⁵⁴⁴ with less than 250 employees and turnover of €50 million or less⁵⁴⁵. For SMEs, there is a more generous inclusion of what constitutes qualifying R&D expenditure.	Qualifying R&D expenditures include up to 90% of wages of personnel directly involved in R&D activities (100% for SMEs); contract fees paid to entities to conduct R&D and operating costs; contributions to funds aimed to finance R&D; costs of registration and maintenance of patents (only for SMEs); patent acquisition costs related to R&D activities (only for SMEs); and costs of R&D audits.	Costs of new fixed asset connected with R&D activities are claimable. Land and buildings are excluded.	The company that pays the contract fees for R&D activities may include them in the R&D tax credit base, i.e. as part of eligible R&D expenditure.	Pre-approval is not required and the tax credit may be claimed in the tax return⁵⁴⁶.

⁵³⁹ Ibid.

⁵⁴⁰ Deloitte. 2013. 2013 Global Survey of R&D Tax Incentives: Analysis of National R&D Incentives. Deloitte.

⁵⁴¹ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org

⁵⁴² Ernst & Young. 2014. Worldwide R&D Incentives Reference Guide: 2013 – 2014. Ernst & Young.

⁵⁴³ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org

⁵⁴⁴ Deloitte. 2013. 2013 Global Survey of R&D Tax Incentives: Analysis of National R&D Incentives. Deloitte.

⁵⁴⁵ Mapeer SME. 2014, 24 June. Tax Incentives System in Research and Business development. Mapeer. www.Mapeer.sme.eu

⁵⁴⁶ Deloitte. 2013. 2013 Global Survey of R&D Tax Incentives: Analysis of National R&D Incentives. Deloitte.



	Overview of tax incentive	Special treatment of SMEs	Qualifying expenditure	Depreciation on capital expenditure	Subcontracting of R&D	Approval process
Korea	A tax credit equal to the greater of 8% (calculated according to a formula) of current R&D expenditure or 40% of R&D expenditure which exceeds the average R&D spend of the company for the previous 3 years. Tax credits may be carried forward for 5 years. No refund is available for tax credits.	A tax credit equal to the greatest of 25% of current R&D expenditure or 50% of R&D expenditure which exceeds the average R&D spend of the company for the previous 3 years. If an SME purchases certain intellectual property from a third-party Korean resident, the SME is entitled to claim a tax credit of 7% of the purchase price.	Qualifying R&D expenses include labour costs (salaries, wages, bonuses etc.); materials including samples, parts, and raw materials used in the conduct of R&D; rent for R&D equipment; commissions paid to the qualifying body; training costs; and other costs, including trademark development costs, design development costs, consulting fees, and quality guarantee costs.	A tax credit of 10% is claimable of the total investment amount for certain R&D equipment, including the costs of machinery, facilities, tools, office machines, telecommunications instruments, testing machines, optical instruments, etc. used in the conduct of R&D activities.	Contract fees paid to academic institutions may be included in the R&D tax credit base, i.e. as part of eligible R&D expenditure.	Claimed in the tax return and no pre-approval required. Companies may file an amended return to claim the credit up to 3 years from the date the original tax return was due⁵⁴⁷.
France	A 30% R&D tax credit, which may be carried forward for 3 years. If it is not claimed within the 3 years, it is refundable.	A 30% R&D tax credit is claimable by SMEs. SMEs with less than 250 employees and sales less than €50 million can claim a tax credit of 20% on expenses on prototypes or pilot assets. Tax credits are refundable to SMEs and they are not subject to the rule that tax credits be carried forward for 3 years before entitlement to a refund.	Qualifying R&D expenditures include R&D staff expenses, general and administrative expenses, patent costs, contract costs⁵⁴⁸.	Depreciation allowances are claimable at standard depreciation rates on buildings used in R&D. Accelerated depreciation allowances are claimable on machinery and equipment used in scientific and technical research⁵⁴⁹.	The company that pays the contract fees for R&D activities may include them in the R&D tax credit base, i.e. as part of eligible R&D expenditure.	No pre-approval is required to claim the tax credit. The credit is claimed in the tax return⁵⁵⁰.

⁵⁴⁷ Ibid.

⁵⁴⁸ Ibid

⁵⁴⁹ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org

⁵⁵⁰ Deloitte. 2013. 2013 Global Survey of R&D Tax Incentives: Analysis of National R&D Incentives. Deloitte.



6.7.2.1 Analysis of elements of R&D Tax Incentive Programmes in above 8 OECD countries

6.7.2.1.1 Tax credit

All the countries included in Table 12 above offer a tax credit calculated as a percentage of qualifying R&D expenditure. The tax credit is set off against taxes payable and can either be:

- o Refunded to the taxpayer (refundable tax credit), even if only to the extent that it exceeds tax, or;
- o Carried forward indefinitely to be set off against tax in future years (tax credit carry over).

Broadly speaking, non-refundable tax credits and/or tax allowances are perceived to be of no immediate value or use to businesses in a “tax loss” position. This is because they are carried forward indefinitely, only gaining utility value when the business is in a tax paying position. The result is that businesses investing in R&D that are not yet profitable are at a significant competitive disadvantage in relation to larger, profitable businesses who are able to take advantage of the tax credit.

In contrast, a refundable tax credit boosts cash flow and alleviates constraints, which, in turn, encourage committed investment in R&D for the long term⁵⁵¹. This is of particular value to SMEs and start-ups that are often in a tax loss position or have very limited tax liability in the early stages of their development, when cash flow is most important to them.

The majority of the OECD countries offer taxpayers the tax credit, whether refundable or not. Countries that offer the taxpayer a refundable tax credit include, but are not limited to, Austria, Denmark, Canada, Norway and Ireland⁵⁵². The 2014 New Zealand Budget has also announced that a refundable tax credit is to be introduced in that country⁵⁵³.

6.7.2.1.2 Tax credits and SMEs

All of the countries in Table 12 above offer special treatment to SMEs investing in R&D. Australia, France and the UK recognise the limited cash flows and tax liabilities of SMEs, and thus particularly allow them a refundable tax credit, while only offering Large Companies a non-refundable or carry over tax credit.

In addition, all countries in Table 12 provide more generous R&D Tax Incentives for SMEs in that the percentage applied to qualifying R&D expenditure to calculate the tax credit is higher for SMEs. The rationale for exceptional tax treatment of SMEs by offering greater tax credits and in some cases, refundable tax credits, is as follows:

- o As SMEs are often in a loss position, they are at a competitive disadvantage in relation to profitable companies when the tax credit is not refundable, must be carried forward and used only when the business is in a position to pay tax.
- o Refundable tax credits boost cash flow and liquidity of SMEs.
- o SMEs account for a significant portion of employment, and therefore governments aim to ensure that policies encourage the growth of SMEs.

⁵⁵¹ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org

⁵⁵² OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.OECD

⁵⁵³ Spencer, L. 2014, 16 May. Budget 2014: NZ Govt supports tech start-ups in new budget. Zdnet. <http://www.zdnet.com/>



- o SMEs are seen to generate innovation, which positively affects economic growth. Tax incentives intend to encourage this innovation⁵⁵⁴.

6.7.2.1.3 Depreciation on capital expenditure

All the featured countries provide for depreciation on capital expenditure undertaken for purposes of R&D. There appears to be no special treatment for SMEs here.

6.7.2.1.4 Subcontracting of R&D

All eight featured countries have rules clarifying who is eligible to claim the R&D Tax Incentive in circumstances where the R&D activities have been sub-contracted to a third party. There is no discernible trend regarding the claiming of sub-contracting fees paid to a third party for R&D.

The UK does, however, have more favourable rules for SMEs in this regard. Large companies can only claim sub-contracting fees paid to a third party for R&D if the third party is a university, health authority, charity or a scientific research organization, individual, or a partnership of individuals. SMEs, in contrast, are free to claim sub-contracting fees paid to a third party as qualifying R&D expenditure, regardless of the nature of the third party. However, the amount qualifying as R&D expenditure is limited to 65% of the contract fee and the third party must not be connected to the SME⁵⁵⁵.

6.7.2.1.5 Approval process

Of the eight-featured countries, only Norway, like South Africa, has a pre-approval process for determining whether the taxpayer's R&D is eligible for the tax incentive. In Australia, the tax incentive can be claimed in the tax return only after the R&D activities have been registered with AusIndustry, the government agency dealing with trade and industry. In all the other featured countries, approval is granted or denied on claiming of the tax incentive in an annual tax return.

The approval process, whether it is pre-approval or approval on registration (as in the case of Australia), may be a significant determinant of the extent to which the incentive is utilised. Specifically, the duration of the process, and particularly delays in the process, may significantly undermine the value of the incentive to small business. Where refundable tax credits are available, taxpayers are incentivised to conduct R&D because the credit is paid "upfront" and is of immediate use to them. Time consuming and cumbersome pre-approval processes negate the incentive of "upfront" payment. It is therefore imperative that approval processes are expedient, consistent and transparent, and that they provide clarity on the eligibility for, and requirements of claiming, the tax incentive. All evidence suggests that where tax policy is identified as a major issue in investment decisions, transparency and administrative certainty are often prioritised ahead of special tax relief by investors. Uncertainty of tax consequences of special tax incentives increases the perception of risk and may discourage investment⁵⁵⁶.

⁵⁵⁴ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org

⁵⁵⁵ OECD. 2014. Summary Description of R&D Tax Incentive Schemes for OECD Countries and Selected Economies. OECD. www.oecd.org

⁵⁵⁶ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org

6.7.3 Relevance of the R&D Tax Incentive for the Start-up/SME Sector in South Africa

The DST indicates in its 2010 report to Parliament on the R&D Tax Incentive that participation by SMEs in the R&D Tax Incentive Programme is low⁵⁵⁷. In fact, the report confirms that in South Africa, for the period 2009 to 2010, approximately 80% of the R&D expenditure reported in lodged R&D approval applications came from just 38.6% of companies with an annual turnover of R100 million and above⁵⁵⁸. This seems to be corroborated by the World Bank study, which reports that, other than the significantly large firms, very few firms are accessing the R&D Tax Incentive Programme in South Africa⁵⁵⁹. Within those firms claiming the South African tax incentive, most are in the manufacturing industry. Indeed, over 50% of businesses using the South African R&D Tax Incentive Programme are from the manufacturing sector⁵⁶⁰.

The design of the R&D Tax Incentive Programme was intended to be simple in order to appeal to South African taxpayers and enterprises of all sizes and in all sectors of the economy⁵⁶¹. However, the current design and implementation of the tax incentive does not speak to the stage, capacity or interests of start-ups and SMEs, resulting in limited relevance and low uptake of the incentive within this sector.

The nature of SMEs is that their innovation tends to be undertaken at the early stages, when they are developing their unique products and services but are typically in a loss position, with limited cash flow. Indeed, 40% of SMEs surveyed in 2013 reported cash flow problems⁵⁶². Consequently SMEs are more likely to seek secure, upfront capital investment to conduct R&D as the cash flow benefit of the tax incentive is only enjoyed by the SME when it is in a tax paying position. This is relatively unappealing, especially when considering the hurdles involved in the application process and the uncertainty of its outcome. Additional reasons for low uptake in South Africa, reported by the World Bank study, include detailed forms and evidence being required to substantiate activities claimed, as well as the effort and resources required to validate their claims to the satisfaction of the DST⁵⁶³.

Reports from start-ups and SME stakeholders highlight four principles that an R&D Tax Incentive should embody in order to enhance attractiveness and uptake by start-ups and SMEs. These are outlined as follows:

- 1) The Tax Incentive mechanism must result in an immediate and upfront cash flow benefit for the start-up or SME
- 2) A simple and cost-effective application form and process should be implemented so that start-ups and SMEs can apply without the need for costly advice from third party advisors
- 3) A rapid turn-around time on pre-approvals (within weeks)

⁵⁵⁷ South Africa. Department of Science & Technology. 2012. Department of Science and Technology Ministerial Review Committee on the Science, Technology and Innovation Landscape in South Africa. Final Report. Department of Science and Technology.

⁵⁵⁸ Ibid.

⁵⁵⁹ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

⁵⁶⁰ South Africa. Department of Science & Technology. 2010. Report on Research and Development Tax Incentive Programme 2009/10: Annual Report to Parliament. Department of Science & Technology. www.catalystsolutions.co.za

⁵⁶¹ South Africa. Department Science and Technology. 2011. A Guide to Scientific and Technological Research and Development Tax Incentives (The Guide). Department of Science and Technology. www.dst.gov.za

⁵⁶² SBP Business Environment Specialists. 2014. Headline Report of SBP's SME Growth Index: Growth and Competitiveness for Small Business in South Africa. SBP Business Environment Specialists.

⁵⁶³ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.



- 4) Clear and simple eligibility criteria to empower start-ups and SMEs to test eligibility, without the need for expensive third party advisors.

6.7.4 Industry feedback to encourage the development of R&D Tax Incentive that meets the specific dynamics of Start-ups and SMEs

The following feedback and recommendations represent an industry view, collated by the stakeholders and the Impact Trust research team. It outlines critical barriers that need to be addressed for a relevant and attractive R&D Tax Incentive to be developed that is applicable to and beneficial for start-ups and SMEs. These are broadly categorised according to the four principles detailed above:

6.7.4.1 Cash flow benefit

- Many early-stage start-ups and SMEs are in a tax loss position. Accordingly there is little cash flow benefit to be achieved through the deduction of the tax incentive until they are in a profit-making position and have taxable income against which to claim the deduction. This may be a number of years after start-up, so any cash flow benefit for early-stage start-ups and SMEs is significantly deferred, leaving very little incentive to fulfil the process and/or claim the deduction. Equally this fact may have inhibitive features for entrepreneurs, reducing the number of potential innovations being explored due to a lack of real incentive to invest in early stage R&D.
- Due to the cash flow reasons outlined above, a refundable tax credit equal to a percentage of R&D expenditure is preferred. It is recommended that this tax credit be claimable even if the SME is in a tax loss position (vis. Australia, Canada, Norway, UK, New Zealand and France)⁵⁶⁴. However, the process to achieve this needs to be simple. In South Africa, the backlog (since Oct 2012) within the current pre-approval system means that this process would likely take too long to meet the needs of, and/or be of benefit to start-ups or SMEs in their early stages. Indeed, even if SMEs were to receive an immediate benefit of an upfront tax credit, delays in the pre-approval process are likely to cancel out the positive effects of such a benefit.
- If the refundable tax credit is to be limited to those in a tax paying position, a tradable tax credit (convertible to cash on pay-out from SARS) could potentially be most beneficial for the SME sector. In this scenario, those that are in a loss position are incentivised to sell their credits to businesses in a profit position that are able to then claim them from SARS. Consequently, the seller is theoretically able to realise an immediate cash flow benefit⁵⁶⁵. However, once again, the backlog and delayed pre-approval process would need to be addressed.

6.7.4.2 Simple and cost effective application form and process

- Due to the complexity of the application form, process and evidence to be provided, applicants who are unable or unwilling to bear the costs associated with procuring the services of a consultant to assist with the pre-approval process to claim the R&D Tax Incentive, will struggle to secure a successful outcome. This again results in cash-strapped start-ups and SMEs being unlikely to pursue the tax incentive.

⁵⁶⁴ These Governments have structured their R&D Tax Incentives so that they refund the tax credit, even when the SME is in a loss position and not paying tax.

⁵⁶⁵ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org



6.7.4.3 Timing in relation to pre-approval process

- A pre-approval process means that an upfront plan is required for all R&D in respect of which a tax incentive is sought. The current backlog in South Africa results in innovation being 'held up' while applicants wait for pre-approval. In the eight countries considered above, only Norway requires the tax incentive to be claimed based on pre-approval.
- Potential applicants may be reluctant to share their ideas upfront and would rather do so once a product is fully developed and they are able to protect it accordingly.
- The South African application process is supposed to take 90 days. However, lengthy delays in the process have resulted in some taxpayers waiting almost a year for advice as to whether their R&D is eligible. In addition, some taxpayers who submitted their application shortly after the pre-approval process was introduced in October 2012 have still not received any response to date. This leads to uncertainties for taxpayers regarding claiming of the tax incentive.⁵⁶⁶ This is concerning as OECD studies have clearly shown that investors rank transparency and administrative certainty ahead of tax relief when making investment decisions. Uncertainty of tax consequences increases the perception of risk and may discourage investment, hence the need for speedy and efficient approval processes⁵⁶⁷.

6.7.4.4 Eligibility criteria

- Over the years, the R&D Tax Incentive has been amended many times. As a result, there is confusion as to the most recent specifics of the policy. Consequently, applicants need to set aside a substantial amount of time and hire consultants, who can assist in understanding the policy, their eligibility and the application requirements.
- An additional grey area in the legislation was created when eligibility to claim the R&D Tax Incentive was changed from the funder to the party able to 'determine or alter the methodology of the research. This lack of clarity is seen in the outsourcing of R&D (often a key business strategy amongst start-ups and SMEs, and in particular, the technology sector), where both parties have some degree of control over or potential to alter the methodology. As a result, eligibility is no longer clear.

Internationally, a three-part test is typically applied to confirm eligibility. Essentially, the taxpayer who receives the major benefit of the R&D activities can claim the incentive. The party that receives major benefit is determined by considering who effectively owns the intellectual property or other similar results arising from the R&D activities; has appropriate control over the way the R&D activities are conducted; and bears the financial burden of carrying out the R&D activities⁵⁶⁸.

- International criteria for distinguishing R&D from related activities include the presence of an appreciable element of novelty and the resolution of scientific or technological uncertainty⁵⁶⁹.

⁵⁶⁶ South African Institute of Tax Professionals. 2014. Call for Comment on the Fiscal Framework and Revenue Proposals: 2014 Budget. South Africa Institute of Tax Professionals.

⁵⁶⁷ OECD. 2009. OECD Tax Policy Studies Taxation of SMEs: Key Issues and Policy Considerations. OECD. www.oecd.org

⁵⁶⁸ Australia. Australian Tax Office. 2014, 24 June. Research and Development Tax Incentive. Australian Tax Office. www.ato.gov.au

⁵⁶⁹ OECD. 2002. Frascati Manual: Proposed Standard Practice for Surveys on Research and Experimental Development, 6th Edition. OECD.

In South Africa, however, a narrower approach is reportedly applied in the case of Experimental Development activities, i.e. improvements to products. This is the case despite the applicable requirements in the South African legislation being similar to these international requirements⁵⁷⁰. The reality is that, in South Africa, much R&D takes place in order to adapt products to the South African market due to localisation criteria and often-inferior materials and inputs in South Africa. Hence there is much R&D conducted in order to improve quality and competitiveness in the local context. This is a trend seen in most developing countries⁵⁷¹.

Standard international practice is that such improvements typically do constitute 'appreciable level(s) of novelty' and are thus eligible as R&D. However, R&D applications that include such innovations are reportedly not typically approved. Despite scope in the wording of the R&D definition in South Africa to accommodate these improvements, the application of the definition, specifically the interpretation of the phrase "significant ... improvement", is narrow in practice. Furthermore, this narrow approach is seen generally with regard to applications related to improvements and not only related to the aforementioned example.

This is unfortunate as much of the innovation that yields short-run socio-economic gains is of this variety. By contrast, innovation requiring "new" basic research often takes two to four decades to yield real socio-economic gains⁵⁷². Furthermore, it is reported that in South Africa, most of the R&D activities undertaken by the business sector are in fact Experimental Development activity⁵⁷³.

6.7.5 Conclusion

The current uptake of the R&D Tax Incentive is limited to a few large firms, which indicates that the current design of the R&D Tax Incentive does not meet the interests of start-ups and SMEs. The lack of uptake is primarily due to the prohibitive eligibility, in addition to the evidence and extensive application paperwork required for most small firms. Furthermore, since many start-ups and SMEs are generally in a tax loss position, they are less able to experience the cash flow benefit from the incentive and rely more on direct incentives, such as grants and loans.

A refundable tax credit, payable even if the beneficiary is in a tax loss position, would be a more suitable and beneficial way to structure an R&D Tax Incentive for the start-up and SME market. As is the case in many countries, this can be introduced as special tax incentive provisions for start-ups and SMEs, with the current tax deduction remaining for other businesses. It is imperative that the current delays in the pre-approval process and level of complexity involved in the application are addressed. This is especially important, beyond basic structuring, if the government wishes to realize its objectives for uptake of the R&D Tax Incentive.

⁵⁷⁰ Section 11D(1)(c) of the Income Tax Act No 58 of 1962 includes as R&D "making a significant improvement to any invention, functional design, computer program or knowledge....for the purposes of new or improved function; improvement of performance; improvement of reliability; or improvement of quality...". The Organisation for Economic Co-operation and Development (OECD) generally defines (in the Frascati Manual "Proposed Standard Practice for Surveys on Research and Experimental Development", Paris (2002)) R&D as being the sum of three exhaustive and mutually exclusive activities, one of which is Experimental Development. Experimental Development takes into account drawing from "existing knowledge" to improve substantially products that are already produced or installed.

⁵⁷¹ World Bank. 2010. Fostering Technology Absorption in Enterprises in Southern Africa: Finance and private sector development: Africa Region. World Bank.

⁵⁷² Peter F Drucker. 2006. Innovation and Entrepreneurship. Revised Edition. Elsevier Ltd.

⁵⁷³ South Africa. National Advisory Council on Innovation. 2013. South African Science and Technology Indicators. Department of Science & Technology.

Additionally, gaining clarity around who can claim for the R&D Tax Incentive in situations where the funder and person who conducts the R&D are not one in the same will benefit SMEs, as well as larger businesses. Currently, the person who controls the methodology is entitled to claim the deduction. However, there are instances, particularly in the high technology sector, where it is not clear who controls the methodology, and thus who is entitled to claim for the incentive.

In summary, we believe that the R&D Tax Incentive mechanism will only overcome the obstacles to SME uptake and relevance should the following principles be applied: provide an immediate and upfront cash flow benefit for the start-up or SME; offer a simple and cost-effective application form and process without the need for costly advisors; have a rapid turn-around time on pre-approvals (within weeks); and stipulate clear and simple eligibility criteria to empower start-ups and SMEs to test eligibility without needing costly advice.

Given South Africa's urgent need for growth, innovation and greater global market competitiveness, serious consideration should be given to these requirements for SMEs as the typical growth drivers in the economy.



7 Conclusion

It is well established that modern economies increasingly focus on enhancing productivity through innovation, with innovation and entrepreneurship acting as key contributors to growth and competitiveness.

Entrepreneurship and its by-products, Small and Medium Enterprises (SMEs) and High-Growth SMEs (HG-SMEs), are typically hailed as the main sources of job creation and significant contributors toward economic growth. As such, these key areas are increasingly demanding the focus of policy makers, both internationally and in South Africa.

Within this context, it is essential to foster an ecosystem that is conducive to innovation and entrepreneurship, taking cognisance of the complex systems, relationships and influences out of which innovative entrepreneurial ecosystems may emerge. Consequently, policy measures to stimulate and catalyse innovation and growth should be considered in the context of the ecosystem in which they operate, rather than in isolation. That is, each component contributes to the health of the ecosystem as well as to its counterparts. Consequently, consideration must be given to the full range of elements of the entrepreneurial ecosystem in South Africa. Specifically, it is imperative that we understand how these elements interact and how they might be enhanced through policy action to mutually reinforce each other in order to realise their potential.

In response, and indeed to overcome market failures and realise the potential within the entrepreneurial ecosystem in South Africa, this paper includes a series of policy recommendations. These recommendations are broadly intended to identify and make practical policy recommendations to overcome existing barriers, implement appropriate incentives and take advantage of existing opportunities and assets to realise a vibrant and growing entrepreneurial ecosystem in South Africa, in accordance with the country's strategic development agenda. More specifically, the recommendations are intended to facilitate the growth, competitiveness and international expansion of SMEs and start-ups; improve the relationships, understanding and interpretation surrounding the IPR-PFRD Act towards increased uptake of publicly-funded IP and R&D; introduce new approaches to funding to leverage government investment and crowd-in private sector skills and capital to the nascent VC and SME investing industries; refine the South African Business Visa to attract international entrepreneurs to contribute towards the local entrepreneurial ecosystem; facilitate better responsiveness of the labour market to the particular needs and requirements of start-ups and SMEs; and to refine existing tax incentives to increase the access of SMEs and start-ups to stage-appropriate capital.

8 Appendix 1: Stakeholders Engaged

Name	Surname
Abdul	Gabier
Adelheid	Reyneke
Ahmed	Seedat
Alan	Knot-Craig
Alan	Langman
Alan	Tikwart Alden
Alewyn	Burger
Alexandra	Fraser
Alicia	Harmse
Andile	Ngcaba
Andre	Holtshausen
Andre	Marais
Andrea	Bohmert
Andrew	Papadopoulos
Andy	Volk
Anita	Nel
Anthony	Galloway
Arthur	Goldstuck
Astrid	Ludin
Aubrey	Malabie
Aubrey	Rankin
Avril	Halstead
Ben	White
Berno	Niebuhr
Bill	Wolfe
Braam	Verster
Brandon	Doyle
Brendan	Hughes
Brett	Commaile
Brett	StClair
Brian	Mphahlele
Brian	Rainier
Brian	Richardson
Bridget	Fury
Buhle	Vilakazi
Name	Surname

Cas	Coovadia
Casper	de Villiers
Casper	de Villiers
Catherine	Townshend
Cecil	Morden
Cedza	Dlamini
Cezanne	Trosky
Charles	Atkins
Chris	Bull
Chris	Locke
Chris	Paul
Chris	Rolfe
Chris	Staines
Christelle	Rassou
Christiaan	Erasmus
Christo	Davel
Christo	Fourie
Claire	Buseti
Claudia	Tringale
Daniel	Jordaan
Daniel	Guasco
Darren	Margo
David	Esau
David	Fine
David	Frankel
David	Hislop
David	Kitley
Deon	De Villiers
Deon	van Heerden
Derek	Wilcocks
Derrick	Kotze
Devin	Drake
Dondo	Mogajane
Donovan	Neale-May
Douglas	Cherry
Duncan	Robertson
Name	Surname

Eero	Tarjanne
Ela	Romanowska
Elmar	de Wet
Elizabeth	Gould
Elize	de Villiers
Envir	Fraser
Eric	Osiakwan
Erika	Van der Merwe
Euvin	Naidoo
Faheem	Kajee
Funeka	Montjane
Gabrielle	Habberton
Garth	Crickmore-Thompson
Gary	Eisenberg
Geoff	Hainebach
Gina	Jorasch
Gis	Van Rooyen
Gladwyn	Leeuw
Grant	Greyling
Greg	Elk
Gregory	Baxter
Gysbert	Kappers
Halton	Cheadle
Hannes	van Rensburg
Hannes	Van Zyl
Haroon	Bhorat
Hayley	Reynolds
Heather	Lowe
Helmut	Engelbrecht
Herman	Engelbrecht
Herman	Heunis
Hlonela	Lupuwana
Inze	Neethling
Jack	Monedi
Jaco van	Eeden
Jacob	Malemo
Jacqui	Buchanan



James	Rait
Jamie	Clyde
Jan	Klopper
Janice	Stoddart
Janine	Chantson
Jason	Goldberg
Jay	Naidoo
Jean Pierre	Kloppers
Jean-Michel	Koenig
Jeff	Miller
Jenny	McKinnel
Jess	Green
Jetane	Weyers
Johan	Lamprecht
Johan de	Lange
Johanna	Kollar
John	Kotsaftis
John	Peters
Jonathan	Beare
Jonathan	Jacobs
Jonathan	Marks
Justin	Arnesen
Justin	Coetzee
Justin	Green
Justin	Stanford
Kamogelo	Manamela
Karel	Pienaar
Karien	Holtzkampf
Keet	Van Zyl
Kennedy	Bungane
Kerry	Faul
Kerryn	Krige
Kerryne	Nooifoltd Krause
Kim	Reid
Kirsten	Rhoda
Kosheek	Sewchurran
Kresten	Buch
Kuben	Naidoo
Kurt	Pakendorf

Kyle	Day
Landon	McMillan
Lawrence	Seeff
Len	Pienaar
Lianne	Du Toit
Lincoln	Mali
Linda	Mngomezulu
Linda	Van Zyl
Lisa	Clifford
Llew	Claasen
Ludwig	Marishane
Lungisa	Fuzile
Lynn	Maggott
Madelein	Kleyn
Malcolm	Segal
Malik	Fal
Marc	Balkin
Marc	Elias
Marc	van Olst
Maria	Pienaar
Marina	Vayanos
Mark	Kingon
Mark	Pretorius
Marlan	Mouton
Martie	Swanepoel
Max	Kaizen
Mayan	Mathen
McLean	Sibanda
Melanie	van Biljon
Mercy	Magadze
Mervyn	Goliath
Miana	Naude
Michael	Goldmanm
Michael	Jordaan
Michelle	Atagana
Michelle	Viljoen
Mike	Anderson
Mike	Murphy
Mike	Wright

Mind	Mabhunu
Mmateka	Chuene
Mojalefa	Mohoto
Mulalo	Madula
Mxolisi	Motau
Nadira	Bayat
Natalie	Labuschagne
Neil	Hinrichsen
Neven	Murugan
Nic	Baigrie
Nick	Utton
Nicole	Cheyne
Nicole	Viljoen
Nils	Flaatten
Nivue	Naidoo
Nkuli	Shinga
Nonkululeko	Shinga
Norman	Parkin
Okkie	Kellerman
Oliver	Anton
Oliver	Hagan
Osman	Mollagee
Owen	Dean
Page	Boikanyo
Patrick	Lawson
Patrycja	Kula
Paul	Plantinga
Paul	Salvage
Paul	Zille
Paul	Jackson
Pavlo	Phitidis
Peter	van der Zee
Philip	Kiracofe
Philip	Marais
Phillip	Boshielo
Phindile	Tshabangu
Pieter	de Villiers
Pieter	Venter
Polo	Radebe



Pontsho	Maruping
Prins	Mhlanga
Rapelang	Rabana
Raybin	Windvogel
Raymond	Ndlovu
Raymond	Paola
Rehelda	Williams
Relebogile	Moatshe
Richard	Flett
Rob	Le Blanc
Rodney	Kuhn
Roelof	Goosen
Roselle	Marais
Roy	Havemann
Rudi	Jansen
Russell	Dreisenstock
Ryan	Short
Saberi	Marais
Safroadu	Yeboah-Amankwah
Samantha	Pokroy
Sanaa	Rawji
Sarah-Anne	Arnold
Sean	Moolman
Segenthee	Solai
Selwyn	Goldberg
Senisha	Moonsamy
Setsomi	Molapo

Shameela	Ebrahim
Sharon	Smulders
Shiluba	Mawela
Shona	McDonald
Sim	Tshabalala
Simon	Barber
Simone	Cooper
Simphiwe	Duma
Sipho	Maseko
Siya	Xuza
Stephan	Lamprecht
Stuart	Gast
Stuart	Minnaar
Sylvia	Brune
Tamsin	Freemantle
Tamsin	Jones
Tamzin	Ratcliffe
Tapie	Marlie
Tarik	Alatovic
Tawanda	Sibanda
Tebogo	Skwambane
Thembela	Hillie
Thobile	Jiyane
Tinashe	Ruzane
Tinyiko	Valoyi
Tony	Rudman
Tony	Ruiters

Troopti	Naik
Twane	Gouws
Vanessa	January
Vasili	Sofiadelis
Vinny	Lingham
Vuyisa	Qabaka
Wally	Horak
Wayne	Field
Wayne	Sussman
Wendy	Luhabe
Wendy	Ngoma
Werner	Mansfeld
Wesley	Diphoko
Wesley	Gabriels
Wesley	Lynch
Willem	Gouws
Willem	Le Roux
William	Eastwood
Wilna	Barnard
Yolande	Van Wyk
Yusuf	Randera Rees
Zane	Gers
Zetu	Gayeni
Zeyr	Angania



9 Appendix 2: Overview of SiMODiSA Task Teams

9.1 Regulatory & Red Tape Task Team

9.1.1 Core Ecosystem Problem:

The regulatory burden and operating environment in South Africa is killing start-ups and removing the one advantage that SMEs have – being more ‘nimble’ than large corporate animals.

9.1.2 Core Taskforce Objective:

Remove unnecessary red tape and regulatory burdens currently limiting the competitive advantage and in turn viability and potential of SMEs and early-stage companies

9.2 Funding & Incentives Task Team

9.2.1 Core Ecosystem Problem:

Too few VC & SME Fund managers and far too little Angel investing in South Africa has resulted in a shortage of capital and the private sector skills necessary to invest effectively in start-ups and SMEs due to weak economics and high risk.

9.2.2 Core Taskforce Objective:

Find policies that are attractive for investors who are keen to finance start-ups and early SMEs through the business development life cycle. An appealing policy landscape will attract large-scale private-sector capital into SME investment, provide significant profit potential, and attract top business skills and SME Fund Managers.

9.3 Talent & Visa Task Team

9.3.1 Core Ecosystem Problem:

Businesses in South Africa struggle to attract or retain talent according to their requirements. This is partly due to (i) a low level of education in school-leavers and/or a lack of incentive to follow skills development in areas of critical importance to the growth of businesses and the South African economy; (ii) a mis-match between business skills gaps, education that is on offer and education being pursued; and (iii) an inability for SMEs, particularly high-growth-potential SMEs, to compete with corporate salaries provided for the skilled expertise they require.

9.3.2 Core Taskforce Objective:

Address the key issues to ensure that South Africa is able to develop, retain and attract appropriate local and international talent in accordance with the country’s current and future skills needs, particularly within the SME and start-up ecosystem.

9.4 IP & Technology Task Team

9.4.1 Core Ecosystem Problem:

Overly restrictive and cumbersome environment that lacks sufficient incentives and flexibility to attract and retain R&D and IP development and investment.

9.4.2 Core Taskforce Objective:

Applied Research that solves real world problems and can be commercialized. Transparency and certainty (clarity). Protected patents and IP that is exportable in accordance with business expansion and competitiveness requirements.



10 Appendix 3: Summary of Available Concept and R&D Incentives in South Africa

Below is a summary of incentives available to private sector enterprises that invest in the creation, design and improvement of new products and processes. Such businesses conduct investigative activities with the intention of making a discovery that can either lead to the development of such new products and processes or to the improvement of existing products.

Incentive	Objective	Beneficiaries	Benefits	Implementing Agency
Grants for small R&D projects: Support Programme for Industrial Innovation (SPII) ⁵⁷⁴	This incentive was designed to provide financial assistance for the development of commercially viable, innovative products and/or processes, and facilitate commercialization of such technologies.	South African private-sector enterprises. Specific provisions apply under the different schemes.	Product Process Development Scheme: Max R2 million grant Matching Scheme: Max R5 million grant	Department of Trade & Industry
Grants for large R&D projects: Partnership in Industrial Innovation (PII) ⁵⁷⁵	This incentive was designed to provide financial assistance for the development of commercially viable, innovative products and/or processes, and facilitate commercialization of such technologies. PII is suitable for large R&D projects.	South African private-sector enterprises. Specific provisions apply under the different schemes.	A minimum grant of R10 million. If the project is successful, the grant is repayable under pre-negotiated conditions.	Department of Trade & Industry
R&D Tax Incentive: Science & Technology Incentive - S11D of the Income Tax Act ⁵⁷⁶	This incentive was designed to encourage private-sector investment in scientific and technological research and development activities. It was introduced to help the country achieve a target for R&D expenditure of 1% of GDP.	Private-sector investors conducting R&D, the results of which the taxpayer intends to use in the production of income.	Operating Expenditure: Up to 150% of qualifying expenditure incurred. Depreciation Allowance: Accelerated depreciation: 50/30/20 basis.	Department of Science & Technology
Grants for feasibility studies: Capital Projects Feasibility Programme (CPFP) ⁵⁷⁷	The CPFP makes targeted grants that contribute to the cost of feasibility studies into projects outside South Africa. These projects are likely to increase local exports for South African capital goods and services.	South African-registered companies conducting feasibility studies on projects outside SA, whether new, expansions or rehabilitation of existing projects.	A grant of between R100,000 and R5 million.	The Department of Trade and Industry

⁵⁷⁴ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. Grants for Small R&D Projects.

<http://www.investmentincentives.co.za>

⁵⁷⁵ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. Grants for Large R&D Projects.

<http://www.investmentincentives.co.za>

⁵⁷⁶ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. R&D Tax Incentives.

<http://www.investmentincentives.co.za>

⁵⁷⁷ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. Grants for Feasibility Studies.

<http://www.investmentincentives.co.za>



Technology and Human Resources in Industry Programme (THRIP) ⁵⁷⁸	THRIP aims to boost SA industry by supporting research and technology development, and enhancing the numbers of appropriately skilled people. THRIP brings together the best of SA's researchers, academics and industry players.	All companies undertaking science, engineering and technology (SET) research, in collaboration with educational institutions, and with the aim of addressing the participating firms' technology needs. Registered, small South African companies.	50:50 cost-sharing grant, to a maximum of R8 million per annum, across any number of projects.	The Department of Trade and Industry
SEDA Technology Programme (STP) ⁵⁷⁹	The STP is part of an over-arching strategy to consolidate small business support activities, formerly spread across six projects: the Godisa Trust, the National Technology Transfer Centre, the three business incubators of the dti, the Technology Advisory Centre, the technology-transfer activities of the Technology for Women in Business (TWIB) programme, and the support programmes for small enterprises of the South African Quality Institute.		50% grant for the cost of approved tools, machinery and equipment to a maximum of R800,000; and 80% grant for approved training and business development services to a maximum of R200,000.	The Technology Transfer Division, Small Enterprise Development Agency (SEDA)
Technology Venture Capital Fund (TVC) ⁵⁸⁰	TVC is a fund established by the dti and managed by IDC that provides business support and seed capital for the commercialisation of innovative products, processes and technologies. TVC aims to increase the number of economically productive companies in SA, and thus contribute to economic growth and international competitiveness through innovation and technological advancement.	South African SMME companies.	Financial assistance to qualifying companies that wish to commercialise innovative products.	The Industrial Development Corporation
R&D in the automotive industry: Automotive Investment Scheme (AIS) ⁵⁸¹	The AIS makes targeted grants to support the growth and development of the automotive sector. It rewards investment in new and/or replacement models and components that	Light motor vehicle or component manufacturers that are investing in their productive capacity. Contributions to the	The AIS provides for a grant of twenty to thirty per cent (20-30%) of the value of qualifying investment	The Department of Trade and Industry

⁵⁷⁸ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. Technology and Human Resources in Industry Programme (THRIP). <http://www.investmentincentives.co.za>

⁵⁷⁹ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. SEDA Technology Programme. <http://www.investmentincentives.co.za>

⁵⁸⁰ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. Technology Venture Capital Fund. <http://www.investmentincentives.co.za>

⁵⁸¹ South Africa. Economic Development Department, Department: Trade and Industry, and the Industrial Development Corporation. No Date. Government Investment Incentives: Research and Development Incentives. R&D in the automotive industry. <http://www.investmentincentives.co.za>



	will increase plant production volumes, sustain employment and/or strengthen the automotive value chain.	tooling industry and to own R&D activity enhance the benefit.	in productive assets, as approved by the dti.	
Industry Innovation Partnership Fund ⁵⁸²	IIP funds research, development and innovation through co-investment and partnership between industry and government. The aim is to enhance competitiveness of various strategic sectors of the economy through these partnerships.	Applicants from key strategic industries, such as post-harvest innovation, aquaculture, citrus, red meat and grain.	Based on co-investment with industry.	Department of Science & Technology
Uyilo E-Mobility Programme ⁵⁸³	The programme funds and supports the development of commercially viable technologies in the electric-vehicle industry, and focuses on accelerating the development and commercialisation of these technologies in SA.	Research institutions, SMMEs, suppliers, manufacturers, innovators and entrepreneurs throughout the technology innovation chain.	Grant to a maximum of R500,000.	Technology Innovation Agency
Youth Technology Fund ⁵⁸⁴	The fund provides young South Africans with access to financial and business support to stimulate the culture of technology innovation and entrepreneurship among this group.	Young South Africans between the ages of 18 and 30 who are developing prototypes at the various TIA technology stations.	Vouchers issued to access services and/or resources (such as business plan creation, SABS testing, incubation etc.) that they could otherwise not afford.	Technology Innovation Agency
Innovation Fund ⁵⁸⁵	This fund provides funding to promote the development and commercialisation of technological innovations within research institutions and industry, and to encourage collaboration between these sectors. In addition, the fund provides the funding of patent registration and maintenance costs.	Small, medium or large companies, as well as research institutions. Regarding patenting costs, beneficiaries are entrepreneurs and small businesses.	Funds are provided on a matching basis between 30% and 50% and cover all relevant costs upfront of undertaking a technology innovation, including overheads and operating cost; patenting costs are funded up to R500,000.	Technology Innovation Agency

⁵⁸² Department of Science and Technology. 2013. Industry Innovation Partnerships: Call for Proposals: Establishment and Management of Sector-specific Innovation Funds. Mail&Guardian. www.mg.co.za

⁵⁸³ Uyilo E-mobility Programme. 2013. Uyilo E-Mobility Technology Innovation Programme. www.uyilo.org.za

⁵⁸⁴ Technology Innovation Agency. 2008 – 2014. Youth Technology Innovation Fund. TIA. www.tia.org.za

⁵⁸⁵ South Africa. Technology Innovation Agency. 2010. Funding Application General Guidelines. TIA