

**Guest lecturer – UFS MBA PROGRAMME**

# **Government procurement policy and SMME development - successes and challenges**

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## 1. INTRODUCTION

### **A brief historical view of the legislative interventions and rationale behind it**

Since 1994, the South African government introduced and implemented a range of policy initiatives and programmes aimed at economic reform and in particular, those that give effect to the vision and objectives of addressing the economic imbalances and uneven development within and between South Africa's regions.

The past apartheid regime was characterised by segregated and unequal access to resources. The white minority in South Africa then, which was male-dominant used its exclusive access to both political and economic power to promote own sectional interests at the expense of other population and gender groups. This led to not only economic disparities between the different groups of South Africans, but also inequalities in terms of regional economic growth within South Africa.

As tools to address the imbalances in economic inequalities, the government passed certain policies and promulgated a number of pieces of legislation. Among these pieces of legislation and policy frameworks are: - the Preferential Procurement Policy Act, Act 5 of 2000 (PPPFA), the Broad-based Black Economic Empowerment Act, Act No. 53 of 2003 (BBBEE Act), and the National Small Business Act, Act 102 of 1996 (NSBA). All these are based against the background and vision that the achievement of a democratic system which cannot address the socio-economic problems within an expanding and growing economy will have little content and will be short-lived. All these Acts and other related policies, underpin in some way both the bill of rights and the obligation of the government to redress and address the socio-economic imbalances

as enshrined in the Constitution of the Republic of South Africa, Act 108 of 1996 (Constitution).

## **2. GOVERNMENT PROCUREMENT POLICY IN SOUTH AFRICA**

Section 217 of the Constitution provides that when an organ of state in the national, provincial or local sphere of government, or any other institution identified in national legislation, contract for goods or services, it must do so in accordance with a system which is fair, equitable, transparent, competitive, and cost-effective.

The objects of these Constitutional principles are to ensure maximum participation and competition that will result in value for money in the supply of goods and services to the government, whilst also ensuring equal treatment of all through the use of mechanisms that are open and transparent.

However, the Constitution also recognizes problems and socio-economic imbalance brought about by the past regime, and thus creates a platform for addressing them. Section 217(2) provides for the organs of state to implement a procurement policy providing for categories of preference in the allocation of contracts. This however must be provided within a National framework.

There have been debates in business, legal and other circles about government procurement being used for any other purpose than 'doing business'. This debate has been intensified further by the debates around section 9 of the Constitution on equal treatment of all. As stated, the Constitution, through the provisions of sections 9(5) and 217(2) does oblige the government to undo and rectify the imbalances and injustices

due to previous unfair treatment and discrimination. It has also been universally accepted that government procurement can be used as an instrument of government policy to facilitate social and economic empowerment. Citing Watermeyer, Rogerson (2004) states that “procurement provides business and employment opportunities, and, depending on how it is structured can be used as an instrument of government policy to facilitate social and economic development. Morris (as cited by Bolton 2006, 195-196) states that "public procurement is an important item of public expenditure with far reaching social, economic and political implications. To argue that public procurement is a sacred cow which should be ‘outside the political arena’ is restrictive and unwarranted. Purchasing policies pursued by public authorities should be open to modification in the light of pressing social and economic problems - even if this requires procurement decisions not to be guided exclusively by commercial criteria”. Bolton (2006, 195-196) further cites Craig stating that “the very power to grant contracts should be able to be utilised to advance socially desirable objectives, precisely because organs of state cannot be and should not be politically neutral towards such socially desirable objectives”.

To effect the provisions of section 217 of the Constitution, the PPPFA was promulgated in 2000. This Act provided the framework for the preferential procurement policy. The Act prescribes that, amongst others:-

- a preference point system should be followed when awarding contracts;
- bases on prescribed amounts, maximum 20 or 10 points may be allocated for specific goals provided the lowest price scores 80 or 90 points respectively;
- the contract is awarded to the bidder scoring highest points.

The intention of the Act with allocation of 20 or 10 points for specific goals is to address socio-economic issues through giving bidders qualifying for such a competitive advantage over others. These specific objectives may include SMME, local economic development and HDI. The Regulations under this Act defines HDI as including all blacks, people with disability and white women. The latter is the bone of contention as there is much skepticism around white women having been disenfranchised prior 1994, and also due to misuse of the status.

The biggest criticism of the system is that it emphasizes price as an overriding criterion and this is perceived as not adequate for empowerment by proponents of social and economic reforms.

### **3. SMME DEVELOPMENT**

#### **SMME development in South Africa**

The SMME sector is globally regarded as the driving force in economic growth and job creation. The South African Department of Trade and Industry (DTI) estimates that small businesses employ almost half of formally employed persons, and contribute to 42% of the country's gross domestic product (Levin, 1998:79; Sunter, 2000:3).

The role of government in South Africa is of critical importance in shaping the present and future of the SMME sector. A watershed shift has taken place since 1994 in the national policy environment surrounding small enterprises in South Africa. Post-apartheid South Africa has seen the emergence of a changed institutional and policy context, which governs the operations of the SMME economy.

This sector has thus received considerable attention in recent years. The South African government has acknowledged the economic potential of a strong SMME sector, and is committed to its promotion and growth. It aims not only to increase the number of new ventures, but also to create an enabling environment to ensure the survival and growth of small businesses.

The current legislation sets forth the national objectives for the SMME economy in South Africa. The goals proposed for the SMME economy, target the spectrum of SMME activities (RSA, 1995A). The primary objective is to create an enabling environment for national, regional and local frameworks to stimulate economic growth through removing obstacles and constraints that prevent SMME from contributing to overall growth, to strengthen the cohesion between SMME, to overcome their isolation by promoting the networking of SMME to build collective efficiency, to address development obstacles, and to take opportunities. The other objective is to level the playing field between large enterprise and the SMME and between rural and urban businesses. Lastly, the national strategy targets the goal of enhancing the capacity of small business to comply with the challenges of an internationally competitive economy (NSBA).

Small Enterprise Development Agency (SEDA) was established in terms of the NSBA to provide non-financial business development services to SMME. This includes amongst others:-

- the provision of business development services;
- facilitation of business registration;
- facilitation of financial assistance; and
- business advices and referrals.

Free State Provincial Government passed the Free State Development Corporation Act (Act 6 of 1995) to establish the Free State Development Corporation (FDC). The object of FDC is to promote and develop SMME in the Free State, emphasizing on financial support and services.

#### **4. SMME CHALLENGES AND SUCCESSES**

##### **4.1 SMME challenges and successes in relation to development**

It is estimated that the failure rate of the SMMEs in South Africa is between 70% and 80% (South Africa Yearbook, 2000:256).

Rogerson (2006, 71) in the study conducted in the Free State Province on SMMEs, identified the following challenges as attributes to the failure rate in the Province:

- Access to finance
- Inadequate premises
- Lack of equipment and tools
- Inadequate markets or marketing
- Theft
- Formally registering
- Transport

Other challenges and impediments to SMME development observed by Brand et al (2007:190) have been identified as the following:

- High rate of unemployment

High rate of unemployment in South Africa affects the number of informal SMMEs as many people are forced to make a living. This statement is

supported by Tustin (2003:36) by observing that SMME seem to function as independent units and operate mainly to cater for basic monthly household needs. This provides little scope for investment in existing businesses or for exploiting export opportunities that could support growth and competitiveness.

- General services

It is reasonable to argue that being able to run a formal business assumes the presence of important infrastructural elements. Many of these SMMEs do not have access to general services such as business premises, electricity, telephone, water, or sanitation citing (Lehohla [11], [12]). Without a permanent address or telephone it is extremely difficult for these businesses to communicate efficiently. The lack of access to communication technologies hampers the exchange of ideas, the integration of services, and the ability to tender or to conclude contracts. This leads to many SMME being excluded from business opportunities.

- Business location of SMME

The location of the small businesses can have an impact on costs. The quality of the local transportation system is vital, as the SMME must be able to deliver the products or services as required by the contract or agreement. The transport costs would therefore increase the supplier's final price which makes it extremely difficult for SMME to get business contracts.

- Government procurement dependency

Government procurement makes some SMME dependent on the government contracts rather than independent.

- Lack of business skills and experience

Exposure to management experience impacts on the management skills of entrepreneurs. Years of restrictions and control of access to entrepreneurial opportunities created a mindset focused on wage and salaried work rather than the establishment of small business and entrepreneur. This process has led to an increasing number of people who become economically active but cannot find employment and do not have capacity to embark on self – employment or other income generating activities citing (Lehohla [11], [12]).

#### **4.2 FS Provincial Government intervention to SMME development and market access**

In addressing the SMME development challenges in the Free State, the Free State government directly focuses on the provision of financing and market access through government procurement.

##### **Financial support by Free State Provincial Government through FDC**

Table 1 below depicts the financial support provided over the past 3 financial years by the FDC to enterprises in the Province:

**Table 1:** Loans approved by FDC

| <b>Sector</b>         | <b>2004/05</b>    | <b>2005/06</b>    | <b>2006/07</b>     |
|-----------------------|-------------------|-------------------|--------------------|
| Petro-chemical        |                   | 505,000           | 4,500,000          |
| Mineral beneficiation |                   | 150,000           |                    |
| Tourism               | 4,217,685         | 3,675,500         | 2,005,746          |
| Manufacturing         | 5,845,400         | 1,105,000         | 36,164,441         |
| Retail & service      | 8,850,859         | 5,793,073         | 75,062,130         |
| Construction          | 33,557,669        | 28,885,352        |                    |
| Franchise             |                   |                   | 1,100,000          |
| Agro-processing       |                   |                   | 40,000             |
| <b>Total</b>          | <b>52,471,613</b> | <b>40,113,925</b> | <b>118,872,317</b> |

*Source: Author's calculations from FDC Annual Report*

From the table above, it is clear that the Provincial Government focused more attention on the development of SMME through providing financial support. Though the funding decreased in 2005/06 by 31% (as compared to 2004/05), it increased by 66% in 2006/07.

#### Creation of market access through government procurement

The size and volume of government contracts facilitates the government's decisions regarding when and whom it contracts with, and these decisions affect a number of issues. Aside from government procurement being "business" i.e., the acquisition of goods and services on the best possible terms, it also has broader social, economic and political implications (Morris, 1998). Government procurement is and has, for example, often, been used to promote aims which are arguably, secondary to the primary aim of procurement. Examples include using procurement to promote social, industrial or environmental policies (Cane, 2004).

*It is in this regard that government procurement is of particular significance to South Africa. Due to the discriminatory and unfair practice of the past, a number of groups in South Africa were prevented from accessing government contracts. Prior to 1994, the government procurement system was geared towards large and established contractors. Thus new contractors found it difficult to participate in government procurement procedures (Manuel, 1997).*

In South Africa, public sector procurement is estimated to amount to approximately 14% of gross domestic product (GDP). In the United States, the monetary value of public sector contracts given to the private sector is estimated to be about 15% of GDP (Amos, 2005). In Western Europe, it is estimated that public purchasing by government bodies adds up to between 12 and 25% of GDP (Rogerson, 2004). The Provincial budget for 2008/09 financial year for goods and services constituted 18% and this amount excluded capital payments. With capital payments and goods and services together, the amount is R3,8 billion or 30% of the total budget.

In order to provide market opportunities for the SMME and those that are based in the Free State in particular, the Provincial Government identified 15 most procured commodities to enable targeted procurement. This strategy was complemented by the establishment of a Centralised Suppliers Database (FSCSD) which (1) enables government procurement to be distributed throughout the Province and (2) promotes participation by local enterprises.

Responding further to the creation of market opportunities for SMME and addressing the dilemma of balancing value for money and cost premium emanating from empowerment objectives, the Provincial Government

introduced a procurement policy that further seeks to achieve empowerment through (1) standardizing the preference point allocation to HDI to 80% of total specific objectives points allocated and (2) introducing mandatory point allocation split between price and functionality as a means towards promoting local economic development and Free State-based enterprises and competition.

An analysis of the enterprises registered in the Free State Centralised Database shows that of the total 3611, 95% are SMME. However, Free State-based enterprises represent only 32% (i.e. 1145 suppliers). It is also noted that almost 50% of those enterprises are not focusing in any specific core competency.

**Table 2** FS – based enterprises registered in Centralised Suppliers Database

| Sector   | No. of FS Enterprise |               |
|--|----------------------|---------------|
| Agriculture  | 31                   | 2.7%          |
| Catering, accommodation & other Trade                | 7                    | 0.6%          |
| Community, Social & Personal Services                | 37                   | 3.2%          |
| Construction   | 37                   | 3.2%          |
| Electricity, Gas and Water                           | 186                  | 16.2%         |
| Manufacturing  | 25                   | 2.2%          |
| Mining and Quarrying                                 | 9                    | 0.8%          |
| Not Specified  | 551                  | 48.1%         |
| Retail, Motor Trade and Repair Services              | 24                   | 2.1%          |
| Wholesale Trade, Commercial Agents & Allied Services | 238                  | 20.8%         |
| <b>TOTAL</b>   | <b>1145</b>          | <b>100.0%</b> |

Source: Author's calculation from FSCSD

Information provided by the National Treasury on contracts awarded to HDIs during the 2007/08 financial year shows that the FSPG contracted with HDI to the total amount of R1,4 billion. The value of the contracts awarded to enterprises owned by blacks was R1,1 billion. This constitutes 29% of the total goods and services plus capital payments budget.

Whilst the government is creating a host of market opportunities, there are other supply-side constraints which impact on the performance of the SMMEs. Rogerson (2001) identified complex of relationships between supply-side constraints and the working of targeted procurement. These constraints include:-

- skills development;
- access to tender information;
- legislative framework;
- access to finance; and
- availability of labour-based technology.

Despite policy interventions made by the Provincial Government, the observations made during monitoring process of departments by provincial Treasury indicates that there are still existing and perceived to be impacting on its effectiveness:

- Government departments not nurturing and building capacity of officials to design and develop specifications that will be unambiguous and clear to the users and suppliers so that it enables fair evaluation of bids and responsiveness by suppliers, in particular from black-owned enterprises.
- Officials and in particular supply chain management practitioners have problems with uniform understanding and application of government procurement objectives and related policies.
- There is lack or omission of proper demand management that leads to poor supply chain management planning and budgeting.

- There exists a general lack to exert leadership in instilling paradigm shift and change management in the direction of new government procurement regime.
- There is inadequate supplier relationship management (SRM) and supply chain performance management by government institutions and SCM Units.
- Generally, targeted suppliers/enterprises that are doing business with the government do not have core competencies in any specific industry or sector, that is, many are in the 'business of tendering' as shown in table 2 above.
- Small black-owned and large businesses/enterprises do not collaborate and cooperate, thus miss on market opportunities created through black economic empowerment.

#### **4.3 SMME development and black economic empowerment**

The BBBEE Act was promulgated in furtherance of section 9(2) of the Constitution which provides that in order “to promote the achievement of equality, legislative and other measures designed to protect or advance persons or categories of persons disadvantaged by unfair discrimination may be taken”.

The DTI's strategy document classified elements of BBBEE as follows:

##### **Direct empowerment**

The process of BEE must result in an increase in ownership and control of the economy by black persons. Black persons must participate in decision making at board, executive management and operations levels.

### **Human resource development and employment equity**

The focus should be on the development of the employees of an enterprise or sector as well as employment equity. Of critical importance to the BEE is involvement of black persons in operational, professional, and executive decision making portfolios.

### **Indirect empowerment**

Preferential procurement by both the government and private sector is effective in the development and promotion of new enterprises as it provides SMME with opportunities to expand their businesses. Enterprise development is another element of BBEE which may be achieved through investment in black owned and black empowered enterprises; joint ventures with black owned and black empowered enterprises that result in skills transfer.

Though government has recognized the significance of procurement in promoting black empowerment, there is a delay in the application of the promulgated codes with regard to government procurement. This delay is mainly caused by the divergence in the application of the two relevant Acts, namely, PPPFA and BBEE Act. There is an argument that the BEE codes are complex and add to the cost of doing business in South Africa and are deterring investments (Financial Mail, 2008).

It has been argued that the efficacy of black economic empowerment is critically dependent on whether the regulatory context within which it is

introduced allows the codes of good practice to be applied (Marais and Coetzee). In the Financial Mail, Empowerdex Chia-Chao Wu shares the same sentiments that given the importance of procurement in the scorecard it would not be feasible to have this factor defined by two separate and differing legal frameworks. There needs to be alignment to give companies legal clarity when they make procurement decision (Financial Mail, 2008).

## **5. CRITICAL ANALYSIS OF CHALLENGES AND SUCCESSES**

The South African government procurement policy system, the SMME and black empowerment policies are no doubt aimed at achieving justifiable cause. In spite of the noted good intention, the implementation of the strategies seems lacking behind. This requires a critical analysis of the policies and the challenges and the successes. This however, implies by no means that the intent of the policies is questionable.

Recognition that addressing imbalances of the past will bring stability in the country that is needed for business and investment

Political freedom, without economic power, has no content and will not last in the long run. The inconvenience to business that will be brought about by instability that is caused by poor and deprived people will affect business negatively. One of the considerations for Foreign Direct Investment decision is the stability of a country in which foreign investors intend to invest in.

However, the delay in the implementation of the BBBEEE Codes of Good Practice that have the potential to address further the SMME development

may threaten to derail the progress already made by other policies targeting SMME, particularly those owned by blacks.

Strong SMME sector is acknowledged for job creation and poverty alleviation. However, the failure rate of start-up SMME is also high due to a number of factors that includes amongst them, lack of finance and access to markets. This is in spite of the interventions targeting them in terms of financing and accessing government markets. Many of these SMME are also 'survivalist', that is, they operate to provide for basic monthly households requirements. Those doing business with government are solely reliant on government contracts. The critical issue is then whether the government support structures created for purposes of enterprise development are indeed effective in their mandate, or for that matter, whether the targeting strategy is only redistributing wealth instead of also creating much needed jobs.

Considering that in 2007/08, only 29% of government contracts in the Free State was awarded to SMME owned by blacks, are the procurement practitioners and other officials responsible for designing specifications exerting enough effort in realizing the socio-economic objective of the government when they procure for goods and services. Or is the procurement system inherently pro price consideration over other specific objectives.

Many SMME, particularly those owned by blacks, are beset by many constraints that affect their capacity to meet contracts. Many still, do not have core competencies in any specific industry or sector, thus are generalists. There seems to be no concerted effort from either the SMME or the large established enterprises to collaborate and cooperate in the distribution channel. This leads to missed market opportunities created for black economic empowerment by both SMME and large enterprises. The

issue is whether there exist an opportunity that white-owned enterprises may meaningfully cooperate with black-owned enterprises without 'fronting', in order to seize opportunities created by the Free State government?

## **6. SUMMARY**

South Africa is providing massive opportunities currently for enterprising individuals, be it white or black, male or female. The government has created a platform where all can participate in business and profit. It is also creating an environment conducive to Foreign Direct Investment through ensuring politically stable country where economic discontentment may not realise as a result of continuation of deprivation.

All of us have the role to play in ensuring the attainment of socio-economic objectives espoused in the various pieces of legislation aimed at addressing the imbalances created by the past unfair discrimination policies. We are also all faced with the challenge to facilitate the implementation of these policies in our own little arenas.

The University and the academia must design and provide appropriate courses for SMME to develop much needed business skills. The provision of these courses must take account of the situation of the entrepreneurs their targeting and must be adapted to their needs.

The MBA students are or will soon be captains of corporations. The challenge the new policies are bringing to you should be seen in the light of the changing business landscape, and be taken advantage of instead of being resisted. There is a lot business sense that can be achieved through cooperation than competition if only you could see and seek beneficiaries

of preferential procurement system and black economic empowerment as 'complementors'.

The public servants participating in this programme must go to their departments and be change agents and exert leadership and culture that will result in the achievement of the socio-economic objectives advocated by the empowerment legislations.

## **7. CONCLUSION**

All possible ways must be sought by all to ensure the achievement of the objectives and the spirit of the pieces of legislation addressing the past imbalances. The attainment of such is in the best interest of the whole country. Business will thrive in an environment where the majority of the people are economically content, and only stability reigns.

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