



November 2012

## Jobs growth from informal producers that supply the formal sector? The case for intermediaries

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*Government's vision for the development of informal business is that, with the right support, these enterprises will achieve formal status, contribute to economic growth and create jobs. However, few informal businesses produce goods for which the formal economy has any a demand. Moreover, informal producers are structurally prevented from accessing the formal economy without the facilitation of intermediaries. This implies the need for an enabling institutional and legal environment which (a) supports intermediaries that assist informal producers to access formal markets and (b) provides incentives for formal-sector retailers to enter into contracts with intermediaries on more equitable terms.*

### Introduction

Government's vision for the development of informal businesses<sup>1</sup> is that, with the right supply-side inputs (such as micro-credit, business and skills training), they will flourish, formalise, contribute to economic growth and create jobs (DTI 2005). This article interrogates the perspective of this policy. It argues that most small business are structurally excluded from forging forward linkages (selling their goods and services to formal markets) without the facilitation of intermediaries, although they do participate in the formal economy through backward linkages (as consumers for personal and business consumption). This article draws on the author's empirical study of intermediaries which was undertaken for the Second Economy Strategy project.<sup>2</sup>

Almost 65% of informal business in South Africa is in the retail and service sectors. Typically, they sell groceries ('spazas'), alcohol ('shebeens'), fresh or grilled meat, second-hand furniture, or trade as hair salons, own car/radio/television repair shops or catering/function hire businesses. The demand for their products and services in the formal economy is low

and they are thus relegated to operating in their local markets (Development Bank 2005). These local markets are over-traded, highly competitive, and the profit margins are low. Training or credit may grow the beneficiary business, but at the cost of other informal businesses. Rogerson (1997) coined the term 'involutionary growth' to describe the churning that accompanies growth in the informal economy. An estimated 12% of informal manufacturing businesses are active in 'soft' sectors such as paper-making, tailoring and craft.

Theoretically, with the right support, these manufacturing businesses could access formal markets. Specifically, the agri-business and craft sectors are characterised by low barriers to entry. Government's policy position is that crafters and producers should access formal markets without the intervention of middlemen or intermediaries (Philip 2008). However, empirical studies<sup>3</sup> attest to the fact that producers neither have the design expertise nor the skills necessary to manage the negotiation process or the logistical challenges of bulk orders. As Elk (2010) attests, "understanding the market and ensuring that the product has a market is one aspect of a business. Getting the product to the market on time and at the right price is another".

The majority of informal crafters are marginalised from the English-speaking mainstream economy: "[They] don't have the confidence to carry out complex discussions in English and don't have literacy skills to communicate in writing. Much negotiation takes place using e-mail. Producers don't have technology, and even if they did, they do not have the literacy skills or command of English to do so" (Hay, McKenzie and Thompson 2010: 21).

Retailers who have direct contracts with producers have experienced a 'gulf of understanding' between what producers thought they wanted and what retailers felt they had contracted for. "Many believed they had gone the extra mile to find ways to support local and rural producers, but often at too high a cost and risk, as the constraints faced on the supply side translate into a litany of tales of late delivery, poor quality, wrong quantities and more" (Philip 2008: 213).

While government has offered incentives, through BEE legislation and the Preferential Procurement Act, to corporations to procure preferentially from black-owned businesses, corporations' procurement requirements are beyond the remit of informal businesses. Intermediaries understand the sophisticated design demands of modern markets and can manage the administrative burden and capital outlay associated with large orders. Thus, intermediaries are critical to facilitate the participation of informal producers in value chains.

South Africa is engaged in a fierce debate about labour brokers who facilitate outsourcing, subcontracting and/or the replacement of permanently employed people with casual labour (the 'casualisation' of labour). This has the effect of eroding existing employees' rights, benefits and protection. It is critical to differentiate between these brokers and the intermediaries for whom I make a case: brokers provide labour (for which the employers would otherwise have had somebody in their employ themselves), thereby freeing the employers from the responsibilities of entering into employment contracts. By contrast, intermediaries provide design input, negotiate contracts for bulk orders, teach between 30 and 100 producers these designs, co-ordinate bulk orders from individual producers, and carry the financial risk. Without these intermediary functions, individual informal producers are unable to participate in these formal markets.

What would an enabling institutional and legal environment for intermediaries look like? Below I make two suggestions: The first is for government to facilitate the collective organisation of intermediaries. The second is that the BEE Scorecard potentially provides a policy space to encourage retailers to procure from intermediaries on more equitable terms than they currently do.

### **Collective organisation of intermediaries** <sup>4</sup>

A sector-specific membership body for intermediaries would offer shared services (such as accounting and design), undertake policy research, advocate for and represent the interests of intermediaries (and their producers). It could address the need for bridging finance with institutional partners and insurance mechanisms to underwrite risks inherent in participating in a global value chain. A charter would include membership criteria, focus on the

progressive realisation of decent work for producers and include a grievance procedure that would enable producers to blow the whistle if members failed to comply with the terms of the charter. These broad suggestions would have to be worked out with key stakeholders in different sectors.

## **Using BEE for equitable procurement**

Retailers are extracting considerable value from producers – more than their labour or the value of the products. First, they leverage marketing value for sourcing the product ‘from the community’ (termed ‘cause branding’). Second, if producers are organised as a co-operative (even if managed by an intermediary) or if they own shares, retailers score BEE points for procuring from black-owned businesses.

BEE compliance is assessed by accredited agencies. Measuring compliance for preferential procurement (which counts 20 out of 100 BEE scorecard points) is complex but amounts to assessing the percentage ‘B-BBEE procurement spend’ of the ‘total measurable spend’ of the firm in question. In other words, points are calculated on the basis of the total monetary value of all the preferential procurement supply agreements. The codes prescribe auditing of sample transactions to satisfy particular criteria but fail to focus on the substance of the contract – whether the terms are equitable, or how the transaction costs and risks are distributed between the supplier and the retailer. This means that retailers are able to structure a supply agreement to extract maximum value, and to shift all the risks to the suppliers (which they do) and still earn BEE points (Von Broembsen 2011; 2012).

Where the supplier is an intermediary, the adverse terms of supply agreements have implications for how much producers earn and their conditions of work. Whereas one may argue that these are normal market activities, the point is that the terms on which black-owned or community-owned suppliers participate has public interest implications, specifically concerning the kinds of jobs generated. In order to score BEE points, corporations should have to comply not only with procedural but also substantive criteria. From a public policy point of view, if they benefit from BEE points, they should bear some of

the cost of realising decent work for the value that they extract from the producers via intermediaries<sup>5</sup>.

Given the embeddedness of national supply chains within the global economy (and the ability of retailers to shift procurement from local to global suppliers), dialogue among all stakeholders in supply chains is critical to minimise the unforeseen consequences of a unilateral policy and legislative changes (such to the B-BBEE Act or Codes of Conduct, employment laws or to the tax regime). Existing fora, such as the retail committee of the National Empowerment Fund, could provide a space for dialogue. However, the risk is that entrenched power relations might disempower nascent organisations of intermediaries and/or producers.

## Conclusion

Given the structural constraints for producers to forge forward linkages into formal markets, intermediaries represent one of the few ways in which informal producers in South Africa can participate in formal markets. As such, intermediaries potentially can make a significant contribution to the livelihoods of those who are excluded from labour markets.

Perhaps government should focus less on extending rights or creating new rights for labour (including informal producers) and more on identifying, creating and supporting institutional arrangements that will re-distribute bargaining power between capital and contemporary forms of labour. This article has focused on retailers and intermediaries in the craft and agri-foods sectors, but the arguments apply more broadly.

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<sup>1</sup> The definition of 'informal' is contested. Generally, an informal business is one that is unregistered, as a business or for tax purposes. SA Statistics has defined informal businesses as businesses not registered for VAT.

<sup>2</sup> The Second Economy Strategy Project was located in the Office of the President during Thabo Mbeki's presidency.

<sup>3</sup> See Elk (2010); Haywood et al (2010); Philip (2008); Von Broembsen (2012).

<sup>4</sup> See von Broembsen (2012) for a more detailed discussion.

<sup>5</sup> There is precedent for claiming recognition of the value of B-BBEE scorecard points in the form of monetary compensation in the commercial sector. For example, a South African company listed on the stock exchange ("A") had three large shareholders. One shareholder ("B") had recently completed a black economic empowerment transaction, in terms of which a percentage of its shares was acquired by a black-owned entity. At a board meeting of A, the directors representing B argued that B should be compensated because its newly acquired empowerment credentials simultaneously enhanced A's empowerment credentials, which would translate into quantifiable benefits for A.