TRADE & INDUSTRIAL POLICY STRATEGIES

POLICY BRIEF: 10/2022

Strengthening access to inclusive finance for local green entrepreneurs in South Africa

OVERVIEW

Local Green Entrepreneurs (LGEs) are increasingly responding to climate change and conscious consumer demands for green products, technologies and services across all economic sectors. Small Medium and Micro Enterprises (SMMEs) in South Africa are actively contributing to lowering carbon emissions by reducing their water usage, becoming more energy efficient, adopting renewable energy inputs, and managing their waste more responsibly. Policy support, however, is limited in its ability to deal with a range of barriers that LGEs face, such as market barriers, financial barriers, burdensome or inadequate regulations, absence of law, and lack of governmental support.

This Policy Brief looks at barriers that LGEs face and highlights areas that policymakers are best placed to address. One of the most critical barriers that this brief will examine is access to inclusive finance, including recommendations and examples of innovative finance mechanisms.

TIPS supports policy development through research and dialogue. Its areas of focus are industrial policy, trade and regional integration, sustainable growth, and a just transition to a sustainable inclusive economy.

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INTRODUCTION

Climate change is raising red flags that should not be ignored. The need for the world to move rapidly towards more sustainable, low carbon and inclusive economies is urgent. South Africa aims to transition to an inclusive green economy; however, both society and the economy remain highly unsustainable (Montmasson-Clair and Chigumira, 2020).

Policy documents calling for a transition to a green economy include the National Development Plan, the Innovation Plan, the Green Economy Accord, and the National Strategy for Sustainable Development and Action Plan (GEC, 2022). South Africa's Nationally Determined Contribution (NDC) sets the goal to reach net zero emissions by 2050 through a Low-Emission Development Strategy. This proposes a significant reduction in greenhouse gas (GHG) emissions target ranges up to 2030, with the 2025 target range allowing time to implement fully the national mitigation system, including those elements contained in the Climate Change Bill (DFFE, 2021). Progressive policy commitments are also made by national departments, such as the Department of Trade Industry and Competition (the dtic), developing climate compatibility industrial strategies for the country's key value chains (TIPS, 2022). There is also an opportunity to ensure greater alignment of industrial development master plans to meet Sustainability Development Goals (Montmasson-Clair and Chigumira, 2020).

A foundation of relevant policies and investments for building the green economy has been created. In addition to these commitments, a supportive ecosystem needs to be built around this policy-based foundation to ensure that there is an enabling environment for small businesses that are at the heart of the green economy (Marks and Hidden, 2017). The Department of Small Business Development (DSBD) could be instrumental in recognising the role that small businesses can play in the net zero transition. The National Integrated Small Enterprise Development (NISED) Masterplan acknowledges that small businesses are a core part of the economy and presents the next 10-year strategic approach to facilitating entrepreneurship, growth and support of small, medium and micro enterprises (SMMEs) in line with National Development Plan targets to assist small business (South African Government, 2022; DSBD, 2022b).

Small businesses are particularly important in the local green economy. There should be increased attention to the considerable potential value that LGEs hold in unlocking climate-related solutions and in engaging the private sector (Montmasson-Clair and Mudombi, 2019).

Many small, medium and micro enterprises across South Africa offer valuable climate mitigation and adaptation solutions and have developed viable business models to implement those solutions.

Many SMMEs across South Africa offer valuable climate mitigation and adaptation solutions and have developed viable business models to implement those solutions (Hattingh, 2022a). Supporting SMMEs would play a vital role in the global collective commitment to moving towards a more sustainable future (Montmasson-Clair et al., 2019; Sage, 2022). In this context, it is vital to understand the role of LGEs in sustainable development. Based on Montmasson-Clair et al., (2019), Table 1 outlines the role that small business plays in the economy. In addition, it highlights that small business have an even more important role in the green economy.

LGEs are, in many respects, responding to green economy demands (Montmasson-Clair et al.,2019; Hattingh, 2022a), but they are not receiving adequate support to expand (Finance Watch, 2022).

BARRIERS TO DEVELOPMENT OF LGEs IN THE GLOBAL SOUTH

Access to inclusive finance is one of the critical challenges that SMMEs face. In addition, the negative impact of the COVID-19 pandemic increased finance-related barriers for SMMEs (UNDP South Africa, 2020). They were the least resilient, due to limited cash reserves, smaller client bases, and had less capacity to manage commercial pressures than larger companies (Kalidas et al., 2020). Micro and informal businesses were even more vulnerable and badly affected during COVID-19 lockdowns in South Africa. Funding and support programmes were primarily targeted at formal and more established businesses, leaving entrepreneurs in micro and informal businesses largely unaided.

Looking ahead, it is important to recognise and address access to finance barriers for SMMEs. The DSBD, Development Finance Institutions (DFIs) and other government and private sector financial institutions, including banks, have invested significant financial resources to support the development of a vibrant and sustainable SMME sector with measured impact on economic growth, reduction in inequality and employment creation. Yet, the SMME sector continues to face ongoing access to finance challenges, along with many others,[1] making growing green businesses successfully in South Africa even more challenging (Hattingh, 2022b). At the same time, if these barriers can be adequately addressed, LGEs can be a powerful answer to support a post-COVID19 recovery by driving economic prosperity and supporting climate and sustainability targets (Finance Watch, 2022).

Access to formal sources of finance varies among countries but is a significant issue for LGEs, particularly in the micro, small and medium enterprises (MSME) segments. The MSME financing gap, which is mostly accounted for by the SME segment, varies from 5% to 20% of gross domestic product (GDP) depending on the country (Finance Watch, 2022). On top of this existing financing gap, MSMEs need access to additional finance to transition to sustainable business models and to build resilience to natural disasters and slow-onset climate impacts (e.g. droughts or rising sea levels) – the so-called MSME "green funding gap" (Finance Watch, 2022). Global climate financing continues to fall far short of what is needed to meet the ever-increasing costs of climate impacts in the Global South and Africa in particular.

[1] LGE Barriers: Financial literacy, market barriers, financial barriers, burdensome or inadequate regulations, absence of law, a deficit of rule-of-law, lack of demands and lack of governmental support.

Table 1: Role of small (green) businesses in economic development

SMMEs	LGEs
Small businesses play a key role in the economy	Small business plays an even more important role in a green economy
• Small businesses are the primary employment creator. • Earnings from small businesses lift people out of poverty. • Small businesses contribute to inter-generational upliftment. • Small business drives innovation.	• Small businesses contribute to greater inclusion and reduce inequality. • Small businesses contribute to economic empowerment. • Small businesses foster community and rural development. • Small businesses drive the development of social and green businesses.

Source: Authors, based on Montmasson-Clair et al, 2019.

Funders do not fully grasp access to finance needs and have a limited risk appetite to offer finance solutions to local green entrepreneurs.

African countries have only received 10% of the adaptation funding needed to address infrastructure resilience in the various sectors (Richmond et al., 2021). Significantly more focus and finance are needed in this space to support LGEs with the potential to deliver climate adaptation and climate mitigation solutions.

LGEs face access to finance barriers across sectors, from the renewable energy and energy efficiency sector, to climate-smart agriculture, responsible water management and waste management (Hattingh, 2022b). Evidence shows that a wide array of female-, black- and youth-owned enterprises are actively providing solutions to address South Africa's triple challenge of poverty, inequality and unemployment. However, these LGEs are experiencing access to finance barriers that limit their growth and, in some cases, youth-owned enterprises in an early stage ideation phase are not able to take off. The access to finance challenges documented in South Africa mirror a set of internal and external barriers identified in other Global South countries, such as Peru, India, Mongolia and Uganda (Finance Watch, 2022). These barriers, spanning informality, financial access, information and capacity gaps, and regulatory mismatches due to a lack of supportive regulations, explain the persistence of financing gaps.[2]

In South Africa, as shown in Table 2, a number of barriers are captured in the Draft SMME and Cooperative Funding Policy (DSBD, 2022a). However, no reference is made in the draft policy document to Local Green Entrepreneurs. Considerations of SMMEs in green industries should be integrated and acknowledged; and relevant, innovative finance mechanisms should be designed to address not only access to finance challenges for SMMEs and cooperatives but also consider how the policy can address sectoral challenges.

South Africa offers insufficient support for LGEs to access inclusive finance and more can be done to lower barriers. The following signature issues emerged from the South African Contextual Financial Analysis study (Hattingh, 2022b) and findings from the global report by Finance Watch (2022):

Signature Issue 1: Funders do not fully grasp access to finance needs and have a limited risk appetite to offer finance solutions to LGEs.

Signature Issue 2: Environmental, social and corporate governance (ESG) is compliance-driven, and not fully aligned with the intentions to truly back "green" investments.

[2] External barriers, on the one hand, are obstacles arising from contextual factors on which enterprises have no influence on an aggregate level. These may include the general business climate, interest rates, national and supranational regulations, and social and cultural norms and values. More specifically, factors such as a lack of green industry funding, along with other challenges SMMEs face, such as the regulatory environment and an underdeveloped green economy ecosystem. Internal barriers, on the other hand, refer to these obstacles that are dependent on factors linked to the firm's capabilities and choices. This includes entrepreneurial attitudes, level of skills and internal processes.

Table 2: SMME challenges identified in DSBD's Draft SMME and Cooperative Funding Policy

KEY CHALLENGES	DESCRIPTION
Demand for financing	Mismatch between supply and demand of SMMEs financing.
Government assistance	Limited effectiveness of government programmes designed to support the development of SMMEs and cooperatives due to poor coordination among various stakeholders.
Skills shortage	Shortage of skills relating to entrepreneurial and business acumen.
Collateral requirements	Lack of functional and accessible movable collateral registry.
Cost of compliance	The lack of easy, fast and cheap business registration processes.
Poor tax regime	Absence of a tax regime that compensates small businesses for the burden of tax compliance.
Poor literacy levels	Low levels of financial literacy.
Limited business support	Limited awareness of available business support.
Regulatory challenges	Lack of an easy, fast and cheap business registration process. Inefficient registration processes.

Source: Draft SMME and Cooperative Funding Policy DSBD, 2022a

Policy reforms are key in increasing financial flows towards creditworthy local green entrepreneurs, and in "greening"' existing micro, small and medium enterprises.

Signature Issue 3: Sectoral barriers further contribute to layers of complexity navigating certification processes. Unnecessary application delays add to extended implementation timeframes resulting in increased operational cost.

Signature Issue 4: There is insufficient targeted business development support for LGEs in South Africa to access finance and access new markets.

Signature Issue 5: There is a lack of coordination of green economy ecosystem programmes/initiatives that limits LGEs in accessing business development support services.

One of the main barriers to accessing inclusive finance is that LGEs are seen as high risk by financiers, as they are generally in an early growth stage, lack collateral requirements, and have limited credit records. Furthermore, financiers are in unfamiliar territory and do not have the knowledge to navigate many green industries. These factors lower the risk appetite of funders. The following section explores recommendations to address access to inclusive finance and provide examples of innovative finance mechanisms.

RECOMMENDATIONS

Innovative finance that will address the growing need of emerging LGEs is necessary. The green economy window of the Small Enterprise Finance Agency (sefa) Innovation Fund is one of the current funds aimed at fostering greater inclusion. It supports funders to be able to take more risk. This fund is structured as a Credit Guarantee Scheme for Fund Intermediaries with an established SMME pipeline to derisk capital. The Innovation Fund`s loan book for the Green Economy Window is geared towards extending lower interest loans from R200 000 for female-, youth- and/or black-owned SMMEs operating in green industries (EDSE, 2022).

Policy reforms are key in increasing financial flows towards creditworthy LGEs, and in "greening"' existing MSMEs. Finance Watch (2022) recommends a dedicated green MSMEs master plan to address the following reforms:

1) Bridging the trust gap

- Ensuring MSMEs can pledge movable assets as collateral.
- Improving and greening credit guarantee schemes.

2*) Bridging the information and capacity gaps*

- Creating a robust, but simplified chain of ESG information
- Making credit information sharing more granular and greener.
- Establishing MSMEs agency as a one-stop-shop.

3*) Bridging the finance ecosystem gap*

- Unleashing DFIs' potential.
- Improving consumer protection to reduce irresponsible lending.
- Improving the quality of public spending and reducing the cost of debt.

The Department of Small Business Development and Parliament's Portfolio Committee on Small Business Development should develop a Green Economy Framework that can address the following areas:

- How is policy designed to finance the net-zero 2050 transition? This will affect all SMMEs, not only those in green industries. The implications of net-zero commitments are that all SMMEs in supply chains will need to be capacitated to understand new sustainability (reporting) requirements and be supported to decarbonise operations. The role of SMMEs in decarbonisation strategies is also a vital area that the National Integrated Small Enterprise Development (NISED) Masterplan should consider.
- How is policy supporting existing SMMEs to transition into green industries? Banks are not likely to provide finance for small businesses to transition. They require businesses to first transition on their own and deliver a proof of concept before they provide funding.
- How does public policy make provision for a COVID-19 recovery period? This is especially needed for LGEs that lost momentum during COVID-19 lockdown periods.
- How can the Draft SMME and Cooperative Funding Policy better support decarbonisation efforts? Existing SMMEs should also be included in sectoral decarbonisation efforts. Greening efforts for existing SMMEs can, for example, include greater energy efficiency measures, and energy security infra-structure (solar). These technologies require SMMEs to access finance. SMME greening initiatives can contribute to greater resilience against energy insecurity and in some cases water shortages.

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***Local green entrepreneurs can play a vital role in decarbonising the economy. Increased support to enterprises offering climate mitigation- and adaptation-relevant products and services is paramount in implementing effective climate strategies*.**

- How will black-, youth- and female-owned enterprises going to be supported to access inclusive finance, especially for entering new green industries

Looking ahead, a number of necessary policy interventions emerge to respond to the key challenges.

- Funders do not fully grasp finance needs and have a limited risk appetite to offer finance solutions to LGEs. More efforts need to be given by policymakers to remove barriers for LGEs to access finance. *Structured, continued dialogue processes between SMMEs (and LGEs in particular), financiers and policymakers are required, so that government and financial institutions can better understand how best to respond and design appropriate eligibility criteria that are aligned with the needs of LGEs. A series of dialogues can be structured around these topics with strategic stakeholders.*

- ESG is compliance-driven, and not fully aligned with the intentions to truly back green investments. *The Small Enterprise Development Agency (seda) and other business development ecosystem players should support SMMEs and particularly LGEs to strengthen their internal capabilities to report on environmental governance to ensure that they meet funding requirements. This can be done through adopting the Global Reporting GRI Standards.*

- Sectoral barriers further contribute to the layers of complexity in navigating certification processes. Unnecessary application delays add to extended implementation timeframes, resulting in increased operational costs. Greater transparency from government departments to communicate and speed up certification approvals requires attention to fast-track green business growth. This can reduce red tape and increase the ease of doing business in South Africa.. *The Portfolio Committee on Small Business Development is in a position to hold national government departments accountable to increase efforts to reduce red tape and increase the ease of doing business for SMMEs. For instance, DSBD can address the problematic area of late payments or overdue payments from government departments to SMMEs with which they are transacting. LGEs would benefit from increased transparency and timeous feedback from the Department of Forestry, Fisheries and the Environment on Environmental Impact Assessments and waste licence approval.*

CONCLUSION

LGEs can play a vital role in decarbonising the economy. Increased support to LGEs that are offering climate mitigation- and adaptation-relevant products and services is paramount in implementing effective climate strategies.

It is, therefore, essential to investigate efforts to increase inclusive participation for LGEs in strengthening and expanding green economy activities. Policies must recognise the role of SMMEs in contributing to sustainable development. These policies must also ensure greater inclusion of black-, youth- and female-owned enterprises, as well as those owned by people with disabilities. One such area is for the DSBD to include LGEs in the Draft SMME and Cooperative Funding Policy for South Africa. This policy mechanism, together with the 2022 NISED Strategic Framework, would need to include green industries and address barriers for LGEs and SMMEs to become "greener"' or enter new green industries. In addition to government's response, finance providers need to to be aware of barriers to inclusive finance that are hindering LGEs' growth and address concerns of financial risks associated with unfamiliar new green industries. Innovative finance solutions need to be developed based on LGE market demands.

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KEY POLICY MESSAGES

- Local Green Entrepreneurs must be recognised and acknowledged for their positive economic, social and environmental impacts to advance South Africa's economy.
- Greater visibility is needed to highlight the vital role that LGEs play in a green recovery and decarbonising the economy.
- LGEs should be prioritised to benefit from inclusive finance.
- LGEs should not be marginalised, and policymaking should provide for greater inclusion of black-owned, youth-owned and women-owned enterprises, and those owned by people with disabilities.

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