A BRIEFING PAPER BY THE PERFORMANCE AND INNOVATION UNIT (PIU) AND SMALL BUSINESS SERVICE (SBS)

This paper is produced to help develop thinking on small business policy within central government and to help strategic policy-making become more outward looking. It also aims to highlight the importance of SMEs to the UK economy and encourage policy makers to work together to take forward the principles of the 'Think Small First' initiative launched by the Government in January 2001.

The paper is written as background information for the **Strategic Opportunities for Small Business in the UK** Seminar on 11 September 2001. This is jointly co-hosted by the Performance and Innovation Unit (PIU) in the Cabinet Office, and the Small Business Service (SBS).

The paper contains:
- A **PIU synthesis of published work**
- **Appendix 1** outlining a **vision of 2010 by SBS**

Importance of Small Firms to the UK economy – present day

SMEs are defined by the Companies Act as meeting two of the following criteria:
- Employing 250 people or less;
- Having a turnover of less than £11.2m (EC use less than E40m);
- Having net assets of less than £5.6m (EC use less than E27m).

SMEs play a vital role in the economy, providing new ideas, products, services and jobs. The UK's 3.7 million SMEs account for approximately 40% of our GDP and have an annual turnover of one trillion pounds. Employing over 12 million people in the UK, they also account for 85% of the 2.3 million extra jobs created by new businesses in the private sector between 1995-99 and more than 50% of the 3.5 million jobs gained from expansion over the same period.

PIU Synthesis of published work

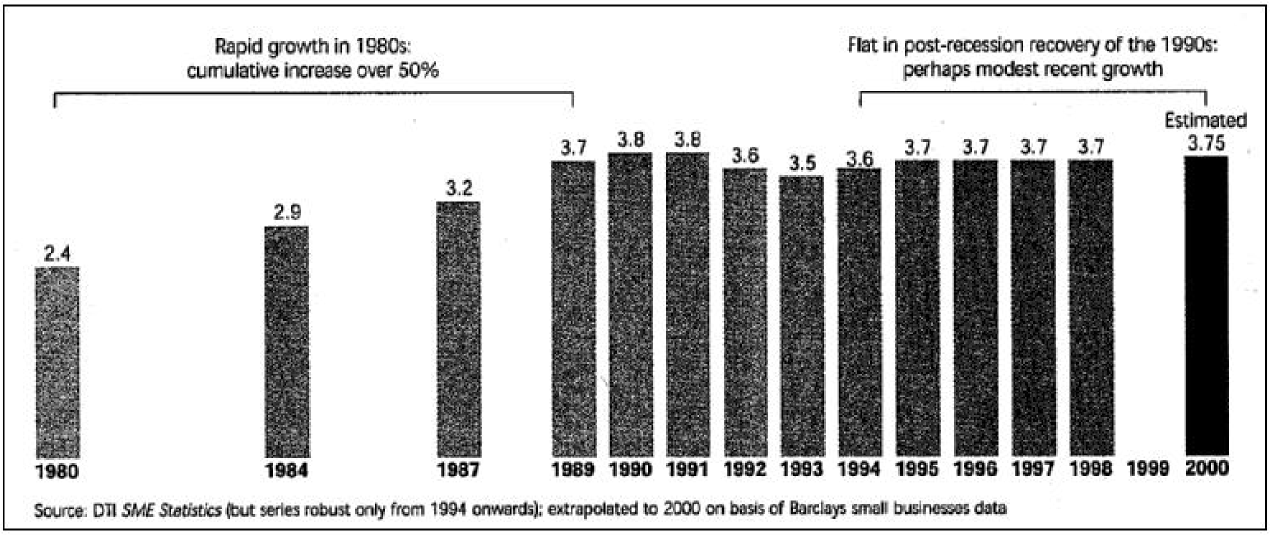
SMEs: Additional Facts and Figures

- The figure of 3.7 million SMEs in the UK has remained virtually unchanged over the last five years (see figure 1).[1] They have a combined annual turnover of around a trillion

[1] DTI SME Statistics

pounds and account for 40% of UK GDP. The number of SMEs grew relatively sharply in the 1980s, and dipped slightly in 1992-3 before recovering to its current level.

Fig. 1 **: Trend in total population of UK SMEs (millions, at start of year)**



- Around 12 million persons are employed by SMEs, representing 56% of the employed workforce. Of these, 80% are employed in firms of less than 50 persons, and 23% are sole traders. In terms of SME numbers, only 1% employ more than 50 persons, and sole traders make up 64% of the total.
- There are substantial variations between nations in the relative size of the SME sector. The majority of OECD nations have larger SME sectors than the UK in terms of percentage of workforce employed, including our EU competitors such as Germany (60%), France (63%), Spain (67%), Ireland (68%) and Denmark (69%). In contrast, the USA and Canada have somewhat smaller SME sectors.[2]
- SMEs engaged in manufacturing tend to be larger, whereas those engaged in business and financial services or the construction industry tend to be smaller.
- 30-40 % of UK SMEs trade in the EU.
- Women now run around a quarter of UK businesses, slightly up on 10 years ago. Women tend to own smaller SMEs and gravitate to the service sector.
- The average business start-up rate is 3.4 per 100,000 in the UK. This is around half of the North American rate (6.9), but is around double that of our EU competitors (1.8).[3]

The successful firm

---

[2] OECD Small and Medium Enterprise Outlook (2000). See annex table A2, p.211. Note that the USA and Canada employ a break at 100 and 500 persons, meaning that an exactly comparable figure cannot be calculated.

[3] Reynolds et al, Global entrepreneurship monitor, London (1999).

- Longitudinal data indicate that 'firms that innovate more consistently and rapidly employ more workers, demand higher skills, pay higher wages and offer more stable prospects for their workforce.'[4]
- Cross-nationally, between 30 and 60 per cent of all SMEs can be characterised as 'innovative', of which only a small share is technology-based. Regardless of sector, innovators grow faster.
- Dynamic entrepreneurs at the heart of innovative SMEs have historically typically been male, aged 40-50, generally have a university degree, consider themselves to be 'trained professionals' and rate themselves most highly on skills associated with general management.[5]
- SMEs generally appear to play a larger role in job creation than large firms. In a review of studies from ten countries, 13 out of the 16 studies found that net job creation rates fell with firm size. Larger firms, in contrast, tend to expand through take-overs.[6]
- In general, high growth SMEs:
    - Are more R&D intensive;
    - Are twice as likely to innovate;
    - Place greater emphasis on hiring skilled employees and motivating staff;
    - Tend to be younger;
    - Are more often involved in alliances;
    - Are more likely to be partly or wholly owned by others.
- Productivity (turnover per employee) is higher in large firms than SMEs. Larger firms tend to engage in more R&D.
- All nations show substantial variations in growth and innovation across sectors and regions. More accessible regions tend to perform better, but the sectors within which high growth is concentrated vary between nations indicating clusters of comparative advantage.
- In the UK, SMEs in the South East perform better on a range of performance indicators including retained profits and exporting than SMEs in other regions. At the aggregate level, SMEs in remote rural areas are less innovative, but this reflects the under representation of the more innovative sectors in such areas (such as electronic engineering and business and computer services). Comparing like with like, SMEs in remote rural areas are more innovative in some respects, such as market development, but less innovative in others, such as the use of the internet. These differentials partly reflect a lack of awareness and partly a preference for more labour-intensive development based on lower labour costs in remote rural areas.[7]

The life cycle of firms

[4] OECD, Technology, productivity and job creation (1996).
[5] Europe's 500.
[6] OECD. Small businesses, job creation and growth: facts, obstacles and best practices. See also OECD, Technology, productivity and job creation (1996).
[7] Cosg and Hughes, 1996; North and Smallbone (2000).

- Around 400,000 UK SMEs cease to trade per year - over 10 per cent of all SMEs - with a similar number being created. A typical SME has a 'half-life' of around three and a half years.[8]
- At earlier stages, management capabilities are crucial to survival. As the firm matures, human resource and innovation strategies increase in importance. By the time the firm is fully established, management and human resource capabilities are well developed, and differences in growth are more closely associated with innovation.

The current business environment

- CBI small business confidence indicators showed an increase over the early 90's, followed by a fall from the mid-90s, reaching a trough around 1998-9. Over the last two years, these indicators have generally moved up, with most recent figures being the most positive since early 1998 - despite something of a wobble in mid- to late-2000. This general pattern holds for optimism for the business situation, numbers employed, and volume of new orders, output and export deliveries.[9]
- The NatWest/SBRT Quarterly surveys show a similar pattern of a very recent upturn in sales, employment and investment. They also show a similar pattern of increases over the early 90s and a modest trough in 98-9. Expectations for sales in 2001 were lower in the first quarter of 2001, but expectations for investments were up.[10] This can be seen below in figures 2 and 3.

Chart 7
Optimism re-business situation

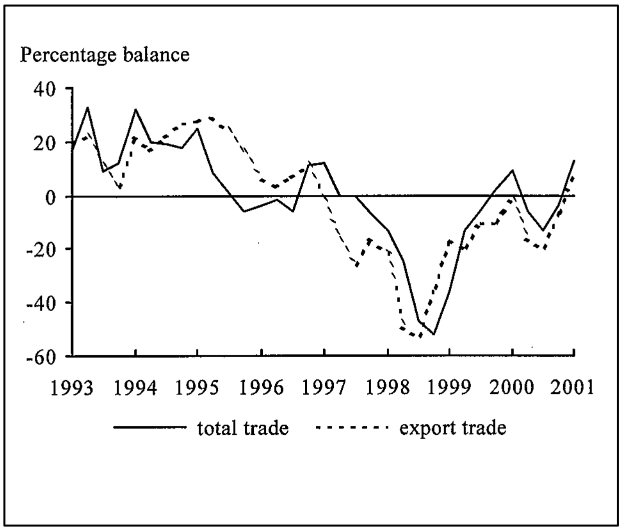


Fig. 2

Chart 1
Percentage balance for the actual change in sales, employment and investment

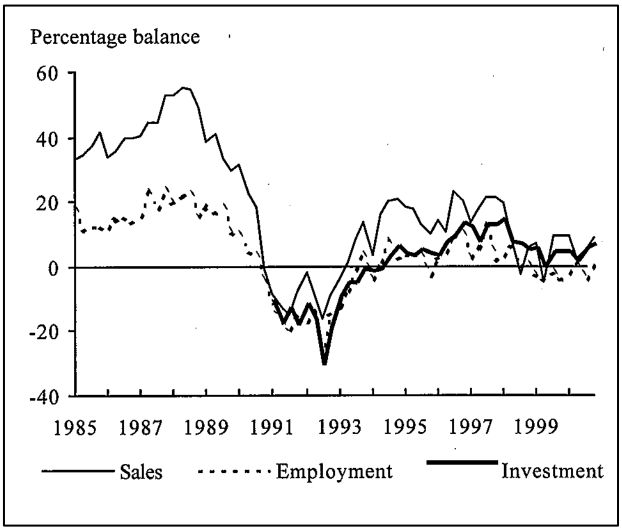


Fig. 3

8 Bank of England Quarterly Report on Small business (April 2001).
9 CBI Small and Medium Enterprise Trends (January, 2001).
10 NatWest / Small Business Research Trust Quarterly survey of Small Business in Britain (March 2001); see also Bank of England Quarterly Report (April 2001).

Future trends

- Some forecasters have predicted increases in the number of SMEs over the next decade, bringing the total number up to around 4.5million. They argue that SMEs will expand as large corporations shrink, transferring over 2 million jobs.[11]
- It is argued that SME numbers will be driven up by:
    - E-economy favouring of fast-moving SMEs over large inflexible firms;
    - Outsourcing and disaggregation of large corporations;
    - Outsourcing of the public sector;
    - Growth in intellectual property-based 'new economy' start-ups;
    - More stable macro-economic environment encouraging risk-taking;
    - Cultural changes encouraging entrepreneurship;
    - A growing population of experienced over-50s wanting second careers.
- Disproportionate growth is expected in SMEs specialising in personal, social, business and financial services. Decline is expected in the number of SMEs engaged in manufacturing and agriculture.
- It is argued that the correlation between the size of SMEs and their turnover will weaken, as in future the main driver of value-added will be intangible assets, such as intellectual property.
- Women and ethnic minority owned businesses are generally expected to increase disproportionately in number.

Strategic opportunities / risks for UK

- The UK leads other EC nations in the application of ICT, though still trails behind the USA. The heavy investment in the USA is thought by many to help explain its high growth and improved productivity performance over recent years.
- OECD and Arthur Andersen benchmarks both rate the UK as the best current environment for entrepreneurial activity. This is shown below in figure 4:

Fig .4: **Formalities for establishing a business, late 1990s**

Country	Number of procedures	Time (weeks)	Estimated costs (ECU)
Australia	1	1	340
France	10	6	3 400
Germany	6	16	1 400
Italy	18	10	2 200
Japan	6	3	4 000
Netherlands	2	12	1 000
Spain	7	24	330
Sweden	3	3	1 130
United Kingdom	1	1	420
United States	1	1	[illegible]

Source: UNICE.

[11] Foresight, Financial Services Panel. Financing the enterprise society: financial services for small and mid-sized enterprises in 2010. A consultation document by the SME sub group (2000).

- However, the UK still lags behind its major competitors in terms of skills, infrastructure and, arguably, in terms of entrepreneurial culture.

Challenges for the government

The government's approach to SMEs relates closely to its view of a key weakness in the UK economy - the productivity gap. Though having low inflation and unemployment, the UK continues to lag behind its major competitors on productivity. Output per worker is 45 per cent higher in the USA, where the gap has widened, and 19 and 7 per cent higher in France and Germany respectively. There is also a large productivity gap in the UK. For example, GDP per capita in the North East is over 40 per cent below that in London.

The strategy to reduce the productivity gap rests on two pillars: '...delivering macroeconomic stability, to allow firms and individuals to invest in the future, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently'.[12]

Reforms in the last parliament included:

- Getting the basics right;
- Stabilising the macroeconomic environment through independence of the Bank of England;
- Fiscal policy;
- A drive to improve basic skills.

Specific measures affecting SMEs and their business environment include:

- Creation of the Small Business Service;
- R&D tax credits for small firms;
- 100 per cent first year allowances for SMEs investing in ICT;
- The creation of Regional Development Agencies;
- Implementation of the Social Investment Task Force to stimulate enterprise in disadvantaged communities;
- A new Competition Act;
- Increased real investment in UK science bases plus knowledge transfer funding;
- Myners review of institutional investment;
- Relaxing regulations over work permits; and
- Launching of joint CBI/TUC productivity campaign.

Government announcements to date indicate a further raft of specific policies directed at increasing productivity, many of which are aimed directly at SMEs and on which the views of SMEs are invited. These include:

[12] Enterprise and the productivity challenge. HM Treasury, June 2001, para.1.5

- Major reforms of the competition regime, including full independence and better financial and legal resources for competition authorities. These authorities will now be expected to act more proactively.
- Changes to the tax regime including:
  - a) Reductions in capital gains tax to 20 per cent after one year and 10 per cent after two years, implying a lower rate than even the USA;
  - b) Widening the 10 per cent Corporation Tax rate;
  - c) Support from Customs for firms experiencing problems with VAT instead of automatic fines;
  - d) Option of a flat rate of VAT for firms with taxable turnovers up to £100,000.
- Improvements to the financing environment of SMEs, including:
  - a) Enhanced funding and targets for the English Regional Venture Capital funds to help plug the 'financing gap' between small investors and commercial lenders, and lending up to £250,000;
  - b) Referral of the supply of banking services to SMEs to the Competition Commission.
- Reductions in 'red-tape' including:
  - a) A review intended to simplify the provision of payroll services for new and small business, led by Patrick Carter;
  - b) A modernisation of company law;
  - c) A review of DTI's support to business;
  - d) Streamlining EU patenting.
- Improving the skills base
- Changing the culture relating to entrepreneurship, both through legal changes, such as reducing the penalties for those that have genuinely gone bankrupt and through education.

Is this the right approach? Questions for discussion

Should we believe the futurologists?

A popular view is that there will be a significant increase in the number of SMEs over the coming decade. However, there has been no growth in numbers of SMEs over the last decade, despite the presence of many of the factors now claimed likely to drive future growth in numbers.

Downsizing of large firms is occurring in some, but not all countries. Similarly, while women have been starting businesses at a faster rate than men, in 13 out of 26 OECD nations, over the past decade, the reverse is true in a significant minority (at parity in 9 out of 26 nations, and relative growth in male owned firms in 5 out of 26). The UK also has the lowest rate of female unemployment compared with male in the OECD. This may help to explain why it is almost unique in not having any major programmes specifically aimed at increasing female entrepreneurship.[13] On both the proportion of large firms and the proportion of female owned firms, between-country differences are much larger than within country trends.

The likely overall impact of government policy on SME numbers is also uncertain. While current government proposals to encourage and support SME growth may assist many SMEs, parallel measures to increase competitiveness may offset any increase in survival rates. It is important that consideration is given to what individual departments and agencies are doing that is likely to affect or impact on small firms and whether an individual department's actions are right or wrong for small firms.

Will definitions have to change?

It is widely believed that the relationship between size and value will be eroded in the new economy. Tiny firms or a few people may own intellectual property rights worth billions of pounds. Such firms will have market valuations outstripping much larger firms that employ many more employees.

Such changes are likely to throw up significant problems for the definitions currently employed by statutory bodies, both within the UK and overseas (eg. the European Community).

Is red-tape (and tax) really the big issue?

Complaints about 'red-tape', according to one survey, are the No.2 complaint of UK SMEs.[14] Excessive regulation and the complexity of the tax regime are frequently cited as causes of decisions not to expand, and even decisions to cease trading. But is this really true or just a convenient rationalisation - does it really make much difference?

There is no doubt that equivalent regulations tend to be disproportionately expensive for small firms to comply with, due largely to economies of scale. Studies have found that the cost of regulatory and administrative burdens are typically around five-fold higher per employee for firms of less than 10 employee compared with firms of 500 plus.[15]

On the other hand, two recent surveys have already rated the UK as being the best place to start up and grow a new business. The issue of better regulation forms a significant part of the Government's Think Small First initiative. Against this, a DTI peer review of over 100

[13] OECD (2000). This may also reflect measurement differences.
[14] NatWest/SBRT Quarterly surveys of small business in Britain.
[15] Eg: costs of admin burdens in the Netherlands rise from 600 ecu per employee for firms of 100 or more to 3,500 ecu per employee for firms of less than 10. Cited in the European Observatory for SMEs, Third Annual report, p.287 (1995). Similarly, tax operating costs in the UK in the late 1980s were estimated at £58 per employee for firms of 5 or less, and £11 per employee for firms with over 500 employees. (Sandford, 1989). One US study found that the clerical costs due to regulatory requirements rose from $120 per employee in firms over 500 persons to $2,080 in firms of less than 5 – a 17-fold difference (Hopkins, 1995).

competition experts from around the world rated the UK competition regime as being in the top half of its peer group, but behind those of Germany and the USA.[16]

Perhaps other factors, less flattering to UK businessmen and women are in reality more important, such as the lack of training and skills among managers, or the relative weakness of a risk-taking entrepreneurial culture in the UK.[17] These factors may contribute as much to perceptions of excessive red tape as do actual levels of regulation. If this interpretation was accepted, it would indicate that the education and training of managers should attract as much attention as the cutting of the regulatory burden itself. In reality, both should receive equal consideration.

Supporting existing SMEs versus start-ups?

There may be some strategic choices to be made, within limited resources, between supporting existing SMEs versus supporting start-ups. An excessive support of existing SMEs may make it harder for new entrants into markets. On the other hand, excessive support of start-ups may cause unproductive churning and make it more difficult for existing SMEs to grow into successful larger firms.

It can be argued that the government has focused more attention on supporting existing SMEs than on supporting start-ups. What more can be done?

Should we 'think small first'? Balance between big and small...

There are strong grounds for believing that SMEs play a key role in innovation and growth.

The Government would like to make the UK the best place in the world to start and grow a business. There is evidence to suggest that this is already the case and there is no doubt that successful businesses are set up, and run, by enterprising individuals – but it is the Government that shapes the environment within which they do business. Those in government have the responsibility to support business success. That is the principle behind Think Small First.

Think Small First asks every part of government to think about their role in supporting and promoting small businesses and an entrepreneurial society. It advocates that policy makers should work closely together to provide the most appropriate support required and minimise the burdens imposed, for example through better regulation.

However, there is some evidence that suggests the picture is more complex.

---

[16] See http://www.dti.gov.uk/CACP/cp/cppeer/index.htm.
[17] For example, only 10 per cent of British respondents though that competition policy was important to the UK public, compared with 83 per cent in the USA.

Size can bestow power. Information and communication technologies (ICTs) may help facilitate SMEs to co-operate with one another for collective advantage, improve procurement and save costs through access to more competitive markets. But larger firms will still have the advantage in many common business situations. For example, even when governments award SMEs the formal right to claim interest on late payments, it is difficult to imagine that many will risk loosing business with large firms by insisting on this right. Size still brings some competitive advantages.
On this last point, international comparisons are salutary. The USA is widely recognised as the richest, most productive and entrepreneurial of nations. This last point is evidenced by its high rate of per capita start-ups. Less widely recognised is the fact that the USA has the highest proportion of employment in large firms in the OECD.[18] This statistic suggests that it is an error to assume that having a large SME sector is the key, or even an indicator of, a dynamic and successful economy.

What conclusions should we draw from this? And what is the right approach to the balance between big and small?

Why have firms anyway? The Case of Rachel.

Behind many of the issues previously raised, and the current debates about SMEs, lies a more fundamental question – why have firms anyway? This question was first raised over 50 years ago by the economist Coase. But recent trends in ICTs, and to some extent in social attitudes, raises the question with new urgency.

Coase's answer would today be characterised in terms of reduced transaction costs. The firm connects and binds together a group of individuals, such that they know that they can trust each other to be available to perform particular and complementary functions in a manner that makes the workers more productive as a whole than they would be individually. The close and continued proximity of co-workers helps information and expertise to flow easily, to accumulate and yet remain relatively secure. For the individual, the firm brings higher earnings and security.

But ICT and changing social attitudes appear to have radically altered the balance of this argument. Suddenly, information is able to flow easily and flexibly between distant individuals. Coalitions and exchanges can occur instantly and safely between trading partners, and these myriad relationships can flow and change like shifting sand. The pattern is reinforced and made possible by the emergence of regulatory and legal frameworks that enable relative strangers to trade with confidence with one another, safe in the knowledge that they can always get redress if things go wrong. At the same time, social attitudes appear to have shifted strongly in the direction of increased individuality, self-efficacy and self-expression. Tomorrow's workers want to be their own bosses, and no longer wish to spend a lifetime as a cog inside a giant corporation.

[18] There is some controversy over measurement, such as whether the USA figures properly capture sole traders.

In this new world, will the SME – indeed the sole trader – predominate? The latest Foresight panel on financial services describes a young professional women in the year 2010, called Rachel, who runs her own firm entirely from her wireless PC as she darts around the world. Her personalised portal seamlessly and actively enables her to run her business, to invest and to borrow. Banks, firms and co-workers are a distant memory to young Rachel, just as vinyl records and empty roads were to her grandparents.

Are firms redundant? Before we write the obituary, we should consider what the firm still offers in an ICT dominated new economy. Complex tasks, and particularly in manufacturing, still requires large numbers of people to work together in a tightly meshed and sustained manner, and with a degree of commercial confidentiality to maintain a competitive advantage with rivals. It may be that ICT will allow large corporations to disaggregate to some extent, yet behind this structure a 'virtual' firm may still have to exist. Even in the new economy, issues of trust, power, exposure to risk and the need for collective action will continue to be powerful forces, on both individuals and SMEs.

'This page is intentionally blank'

APPENDIX 1

A vision of 2010 by SBS

It is becoming clear that the business population will undergo dramatic change over the next 10 years. Of all the customer groups served by financial institutions, smaller businesses will probably change the most. The aim of this paper and the seminar is to:

- discuss the forces of change;
- outline the vision for how the business world might look in 2010;
- set out some of the threats and constraints which might prevent them becoming a reality as well as setting out the opportunities which might present themselves;
- consider how Government can ensure that British businesses are positioned to exploit those opportunities.

By 2010 it is expected that:

- There will be over 4.5 million small and medium sized businesses in the UK (most of which do not exist today);

- They will have created over 2 million new jobs;

- The sectoral mix of smaller businesses will have changed significantly; fewer in manufacturing, construction and transport, more in services particularly knowledge, care, creative and leisure industries;

- More businesses will be trading internationally – using the Euro as currency even if the UK is not a member;

- Many small businesses will be 'New Economy' companies which are not readily amenable to traditional valuation techniques;

- Almost all businesses will have internet access and will bank electronically by 2010.

The following are intended to stimulate debate:

Are we significantly over or underestimating the likely growth in the number of businesses and the level of employment in the small business sector?

Which of today's businesses are most under threat of not surviving to 2010? What can we do to support them through that changing environment?

What types of business are most likely to succeed in the coming decade?

Likely forces of Change – opportunities

The business environment is about to enter a period of dramatic change driven by influential technological, economic, social, and regulatory developments. The following is a list of some possible major forces driving change over the next ten years.

- **The new economy**: the core of the 'New Economy' is the combined advancements in computing and information and communications technologies, triggered by the spread of the internet.
- **The impact of e-commerce**: the e-commerce revolution will transform the business of most traditional businesses.
- **More stable macro-economic environment**: Business survival prospects are much enhanced.
- **Social trends favouring business formation**: through changes in the structure of the workforce, educational aspirations, greater tolerance to business failure, increase in second career opportunities, longer life expectancy and more businesses owned by a more diverse range of social groups.
- **Government policy and regulation**: positive and negative impact.
- **Changing patterns of private investment.**
- **Tensions in regional and rural development.**
- **Globalisation:** not new but will continue to have a powerful impact in the coming decade.

Threats and Constraints to prevent the vision becoming a reality

The vision of the business environment and the business population in 2010 is an optimistic view and not a definitive projection. There are many uncertainties. The following list highlights some of the likely threats and constraints.

- Skill shortages;
- Risk aversion to enterprise;
- Risk aversion to investment;
- Macro-economic or micro-economic shocks;
- Demographic pressures;
- Inadequate physical infrastructure;
- Legal and regulatory complexity;
- Knowledge 'warfare'.

PIU/SBS
September 2001