

The Enterprise Investment Scheme: a consultation document

March 2008



HM TREASURY



HM Revenue
& Customs

**The Enterprise
Investment Scheme:
a consultation document**

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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

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1

INTRODUCTION

THE ENTERPRISE INVESTMENT SCHEME: A CONSULTATION DOCUMENT

1.1 The Enterprise Investment Scheme (EIS) aims to incentivise investment in smaller, higher-risk companies that have growth potential but sometimes struggle to raise finance. The EIS plays a significant role in the provision of venture capital for small businesses, having helped raise over £6.1 billion, invested in over 14,000 companies.

1.2 Building on the enhancements of recent years, Budget 2008 announces a further increase¹ in the annual investor limit to £500,000 (subject to State aid approval) to ensure that the scheme continues to stimulate investment. To complement this increase, the Government is keen to ensure that the scheme continues to be effective in promoting enterprise and in encouraging investment, and that it is imposing the least burden necessary on users. To achieve these objectives, the Government will continue to engage with stakeholders to ensure that full and best use is being made of the scheme.

1.3 This consultation examines the rules and processes governing the scheme, and aims to explore how it may be made more accessible, both to investors and to companies seeking finance. The main areas the Government would like input on are how users (and potential users) feel that the scheme could be simplified; how administrative or regulatory burdens could be reduced; and how awareness of the scheme could be raised among potential users. Specific areas for consideration are highlighted throughout the document but the Government would also welcome more general comments.

1.4 The Government welcomes responses by Friday 20th June 2008. The Government will report back on the results of this consultation document, with an accompanying Impact Assessment (if relevant), in the autumn.

THE GOVERNMENT'S OBJECTIVES

Productivity 1.5 The Government's central economic objectives are to achieve high, stable and sustainable rates of economic growth and employment. A key determinant of long-run growth is productivity growth that, together with employment growth, leads to greater prosperity.

1.6 Over the last decade the UK has made progress on raising the rate of productivity growth and narrowing the productivity gap with comparator countries. Since 1997 the UK has narrowed the gap with France (from 24 percentage points ahead to 17) and Germany (from 27 percentage points ahead to 17), and is the only G7 country to keep pace with the United States' impressive productivity performance (22 percentage points ahead to 19).²

1.7 While a number of factors are likely to have contributed to this, including the UK's policy of openness to trade and investment and maintenance of macroeconomic

¹ The limit was raised from £150,000 to £200,000 in 2004, and to £400,000 in 2006

² *International comparisons of productivity*, Office of National Statistics, 19 February 2008

stability, improved performance has coincided with significant reforms structured around the Government's five drivers of productivity: skills; competition; innovation; investment; and enterprise.

Enterprise 1.8 As one of the drivers of productivity, enterprise is at the heart of the Government's approach, bringing ideas, knowledge and skills, and providing incentives to innovate through raising competition. Enterprise can be considered both in terms of entrepreneurial entry (how many people become entrepreneurs) and how much entrepreneurial activity they undertake.

Access to finance 1.9 One of the Government's priorities in promoting enterprise is to ensure deserving companies have good access to both debt and equity finance. Securing external funding is vital to new start-up companies, as well as to expanding companies, in order to grow, develop and become viable, sustainable, profitable enterprises.

1.10 Although surveys have found an improvement in the overall financing environment for small and medium-sized enterprises (SMEs) over recent years, they mask a more complex underlying picture. For a minority of SMEs, especially young or potentially risky SMEs with high growth aspirations, debt finance alone (such as bank loans) is inappropriate and risk capital in the form of equity finance is more suitable. Evidence indicates that such firms may have difficulty accessing relatively modest amounts of equity or other forms of risk capital³.

1.11 Risk capital is demanded by high growth potential firms, and is offered by investors ready to take high risk in exchange for potentially high returns. As the European Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (SARC guidelines)⁴ acknowledge:

"...there is an 'equity gap' in the risk capital market, a persistent capital market imperfection preventing supply from meeting demand at a price acceptable to both sides, which negatively affects European small and medium-sized enterprises".

ADDRESSING THE EQUITY GAP IN THE UK

1.12 Many venture capitalists are reluctant to invest small amounts in companies for a variety of reasons: principally high fixed transaction costs, shortage of available exit options, and a perceived greater risk in investing in early-stage companies. This reluctance has translated into a funding gap where smaller, higher-risk companies struggle to obtain the finance they need in order to grow. This is known as the "equity gap".

1.13 Although the existence of a UK equity gap has been known about since 1931⁵, questions persist over how to identify and target the gap. It remains fundamentally difficult to pin down the size or shape of the gap, even through inexact proxy measures. There are a number of reasons for this.

1.14 The primary obstacle is the inherent difficulty of differentiating between those deals that are deserving of finance (and yet unable to secure it because of market

³ *Bridging the finance gap: a consultation on improving access to growth capital for small businesses*, HM Treasury and Small Business Service, April 2003

⁴ *Community Guidelines on State aid to promote risk capital investments in small and medium-sized enterprises (2006/C 194/02)*, Official Journal of the European Union, August 2006

⁵ *The report of the committee on finance and industry*, Macmillan, June 1931

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