

4

TACKLING MARKET FAILURES

INTRODUCTION

4.1 The previous chapter has outlined the steps that the Government is taking to create the right environment for enterprise to flourish throughout the country. While this is a vital component of the Government's approach to enterprise policy, it is not sufficient by itself, as free markets alone cannot always deliver the best outcomes.

4.2 Various market failures pose significant obstacles to enterprise within start-ups and smaller businesses, preventing them from competing with larger rivals on an equal basis. In particular, business formation and SME growth are constrained by market failures that affect access to external finance, by a lack of information about the availability and benefits of using external sources of advice, and by particular difficulties in appropriating the full economic benefits of their investments in training and research and development.

4.3 This chapter presents evidence of specific market failures in these areas, and outlines the Government's policies to tackle them. Many of these barriers are particularly severe within the UK's least prosperous communities, meriting more intensive policy action in the two thousand Enterprise Areas.

ACCESS TO FINANCE

4.4 Access to finance is important to all firms in achieving their business objectives, but is most critical for start-ups and for businesses that are seeking to invest and grow. While larger firms can often fund investment and growth from internally-retained profits, newer and smaller growth businesses are more likely to depend upon external sources of finance. These businesses have the potential to generate new employment and to stimulate productivity growth by subjecting rival firms to competitive pressure, so freely-functioning capital markets can help to achieve the Government's wider economic objectives.

4.5 Survey evidence suggests that established SMEs are generally satisfied with the availability of external finance: a survey by the Small Business Service (SBS) found that a clear majority (87 per cent) of established small businesses reported no difficulty in raising the finance that they needed.¹ Other survey evidence suggests that the availability and cost of finance has diminished as a constraint on small firms' ability to meet their business objectives over the past few years,² and significant increases in the value of deposits held in SME bank accounts tend to reinforce this view.³

4.6 Whilst the general financing situation for existing small businesses might be good, there remain particular problems for new businesses requiring start-up funding and for the small proportion of small businesses seeking to realise high growth potential.⁴ These problems exist in both debt and equity markets, and there is evidence that they are more severe in the UK's disadvantaged communities.

¹ Small Business Service (2001b).

² Cosh and Hughes (2000).

³ Bank of England (2002).

⁴ Cosh and Hughes (2000).

Debt finance

4.7 Market failures in debt markets stem from information problems, with the borrower typically possessing more information about their business proposition than the lender. To overcome this asymmetry, lenders attach significant importance to past relationships with the borrower, their track record in business, and their willingness to offer collateral or to take a significant equity stake in the business.⁵

4.8 While these mechanisms facilitate lending in many cases, individuals may lack the collateral or personal capital needed to overcome the information problems. Personal wealth remains a significant determinant of an individual's propensity to engage in enterprise,⁶ and entrepreneurs with limited personal or family wealth continue to face particular difficulties accessing debt finance on the same terms as other businesses.

4.9 Evidence shows that bank loans to businesses in disadvantaged communities are typically offered at higher interest rate margins, are smaller in value and shorter in duration than comparable loans made elsewhere.⁷ A recent study⁸ found that the self-employed in disadvantaged areas are:

- twice as likely to have **no personal bank account**, a key element of an individual's financial track record;
- less likely to be able to **produce business accounts**, an important source of information about the business' prospects; and
- less likely to **own their own home** or to **hold significant financial assets** that may be offered as collateral or invested in the business. Even for those who do, the property or financial assets are typically of lower value.

Bank finance for ethnic minority businesses

4.10 Similar difficulties may also affect some ethnic minority businesses. Afro-Caribbean and Asian-owned businesses have a higher propensity to report problems in accessing bank finance than white-owned firms, particularly at start-up.⁹ One study found that ethnic minority businesses pay higher interest rates and are more constrained by the availability of credit.¹⁰

4.11 However, much of the research indicates that the differences between businesses from different ethnic minorities are at least as great as those between ethnic minority businesses and white-owned ones. For instance, a recent study found that that Afro-Caribbean enterprises are significantly less likely to obtain external finance, and particularly bank finance, than other businesses.¹¹ In contrast, some groups of ethnic minority-owned businesses are significantly more likely than white-owned businesses to use external and bank finance (see Chart 4.1).

⁵ Bank of England (2002).

⁶ Blanchflower and Oswald (1998), Small Business Service (2002).

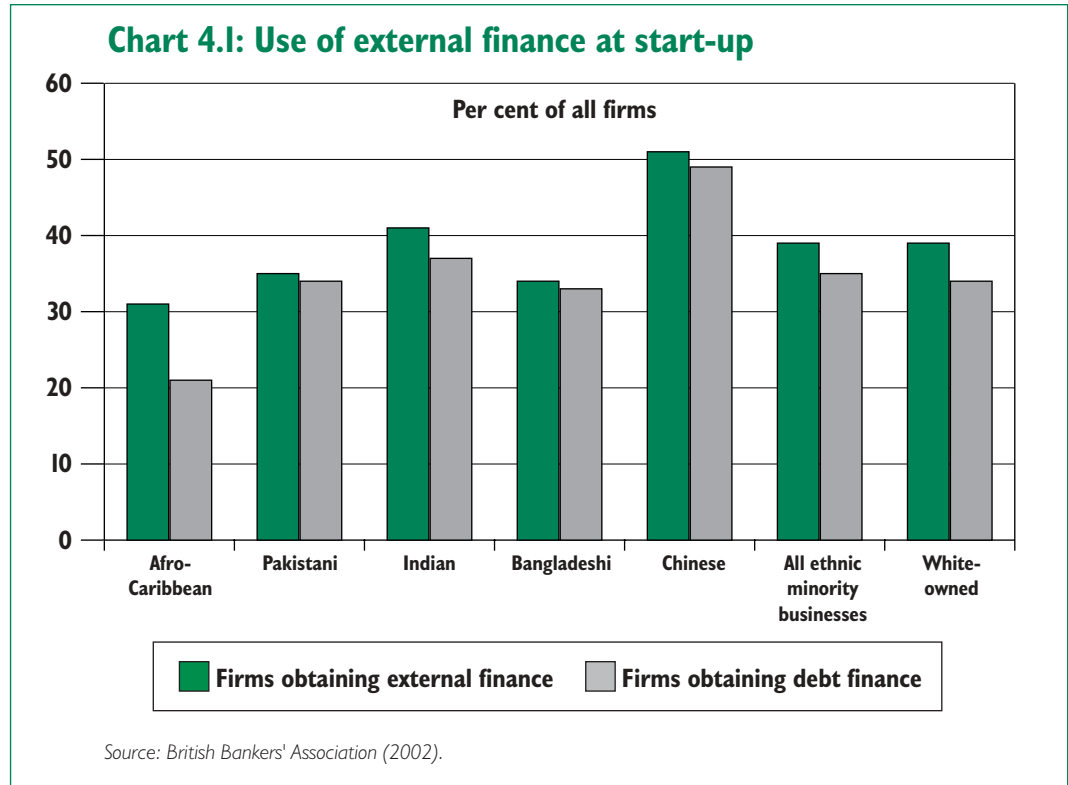
⁷ Bank of England (2000).

⁸ Kempson and Mackinnon (2002). While self-employment is not synonymous with all small business activity, the two are sufficiently closely related to give the findings a broader significance.

⁹ Small Business Service (2001a).

¹⁰ Forum of Private Business (1998).

¹¹ British Bankers' Association (2002).



4.12 To an extent, lower usage of external finance may reflect the sectoral distribution of ethnic minority businesses, though this appears not to be a complete explanation,¹² and informational failure may play an important role. A Bank of England study found that conclusive evidence of widespread discrimination is hard to pin down, but that certain ethnic groups may be disadvantaged by less easy access to capital or collateral, and by their lack of a track record.¹³

Small Firms' Loan Guarantee Scheme

4.13 To overcome market and informational failures in the mainstream debt finance market, the Government continues to offer the **Small Firms' Loan Guarantee Scheme**. This scheme helps small businesses access debt finance even if they lack collateral, and currently supports around 4,200 new loans to small businesses each year, with a total value of over £250 million. The latest evaluation found that a clear majority of the loans granted under the scheme could not have been obtained from other sources, and that these loans enabled businesses to develop new products, services and markets, and to introduce leading-edge technologies.¹⁴

4.14 From April 2003, eligibility for the scheme will be extended to include firms in the retail and catering sectors. While this will provide benefits across the UK, it will especially broaden enterprise opportunity within the two thousand Enterprise Areas and amongst ethnic minority groups, where these business sectors are strongly represented. Removal of these sector exclusions will also reduce unnecessary bureaucracy that inhibits take-up of the scheme.

¹² Smallbone et al. (2001). British Bankers' Association (2002) found that sectoral distribution was a factor in the lower use of external finance by Afro-Caribbean firms, but that it alone does not explain the gap when compared with white-owned firms.

¹³ Bank of England (1999).

¹⁴ KPMG (1999).

Community Investment Tax Credit **4.15** To improve access to finance in the two thousand Enterprise Areas, the Government has introduced a **Community Investment Tax Credit**, which has now received state aid approval. This will open up new markets for commercial lending through Community Development Finance Institutions (CDFIs), which provide finance to businesses excluded from mainstream finance, operating mainly in disadvantaged areas. The credit provides tax relief worth 25 per cent of capital to individuals and corporations who invest in or lend to a qualifying CDFI. This incentive will help CDFIs to access mainstream commercial lending budgets, rather than the quasi-philanthropic capital on which they mainly rely today. The first allocation of tax credits will be made before the end of the financial year.

Box 4.1: Community Development Finance in the UK

The community development finance sector supplies private finance to enterprise and community projects in order to generate benefits in terms of community development and regeneration, as well as financial returns.

A wide variety of intermediaries exist in the UK to provide community development finance. These Community Development Finance Institutions (CDFIs) include credit unions, loan funds, micro finance funds, social banks and venture capital institutions. It is estimated that CDFIs control capital of between £250 and £500 million within the UK. As well as supplying finance, CDFIs also assist the firms and individuals in which they invest by providing business advice and support to help them develop and grow. There is a great deal of variety amongst CDFIs – some focus their attention on particular geographical areas, some only lend to projects that cannot access bank finance, whereas others help to develop packages of finance, which may well include some bank finance alongside loans from the CDFI.

Examples of CDFIs include:

- **Aston Reinvestment Trust (ART).** ART invests across different sectors within disadvantaged areas of Birmingham, financing projects across a range of regeneration policy fields in housing, small business, community enterprise, social business and energy efficiency, with the aims of helping residents to become more empowered through local economic development and retaining and recycling investment returns in the inner city. It lends money at commercial rates to those who are unable to get bank loans because of a lack of credit history or collateral;
- **Aspire Micro Loans for Business Limited, Belfast.** Aspire, launched in February 2000, provides access to finance for the self-employed and micro-businesses in Belfast. Since its inception, Aspire has made 200 loans totalling £800,000. First loan sizes range from £100 to £5,000 and repeat loans can be up to £15,000. The cumulative write-off rate is only 3.25 per cent, and 85 per cent of businesses are still in operation one year after they received their loan; and
- **Local Investment Fund (LIF).** LIF was established in 1995. It provides loan finance to not-for-profit community organisations, and has made loans worth £3.8 million since its establishment. In partnership with a number of the Regional Development Agencies, it is also involved in setting up community loan funds in a number of the English regions.

The UK CDFI sector is relatively small in comparison with that of the United States, where it is estimated that assets held and invested locally by CDFIs totalled \$5.4 billion in 1999 – following 35 per cent growth over the preceding two years. Even after adjusting for a lower population, the UK has a community development finance sector no more than around forty per cent of its counterpart in the USA, although in the USA a considerable proportion of CDFI activity is related to housing, rather than enterprise.

Equity finance

4.16 Although banks supply the majority of external finance obtained by SMEs, debt-based finance may be poorly suited to projects with a higher risk-return profile, or where positive returns are expected to accrue only after a number of years. These characteristics are typical of businesses at start-up stage and of enterprises with the potential to generate rapid growth.

4.17 However, information problems present obstacles to supplying equity finance in relatively small amounts. The costs involved in appraising potential projects, and in monitoring their subsequent progress, do not vary proportionately with the size of the investment under consideration. For smaller investments, these costs may be prohibitively large relative to the anticipated returns.

Business angels **4.18** Despite these constraints, informal investors or ‘business angels’ have gained importance as a source of start-up and early-stage funding in recent years. Overall, around four fifths of equity finance for new and nascent firms comes from informal sources.¹⁵ Business angels typically make relatively modest individual investments:¹⁶ a survey of business angels in 1999 found that around three quarters of all investments were of less than £100,000.¹⁷ Business angels may also provide an important boost to productivity in investee firms, for example through their previous business experience or by playing a mentoring role.

4.19 Broad estimates suggest that their collective annual investments may lie in the range £½ billion to £1 billion,¹⁸ and the development of the business angel sector in recent years is likely to have helped to broaden access to equity finance for the smallest businesses. Nevertheless, the sector remains younger and less developed than in the US: there are proportionately fewer angels in Europe, and they typically make less frequent investments.¹⁹

4.20 Recognising the importance of business angels and other sources of informal capital, including family and friends, in boosting the availability of finance to SMEs, the Government has taken a number of steps to stimulate further growth in this sector. In particular:

- reforms to **capital gains tax** (outlined in Chapter 3) have enhanced incentives for all investors, including business angels;
- the **Enterprise Investment Scheme** provides tax incentives for individuals investing in smaller, higher-risk trading companies;
- the **Early Growth Funding** programme will provide £50 million of early-stage risk capital finance to small businesses, in many cases co-investing with business angels and other informal investors, in amounts averaging about £50,000; and
- modified **financial promotion rules** will make it easier for start-ups and other small firms to promote their shares to business angels without having to be subject to regulation under the Financial Services and Markets Act. The main changes were to exempt promotions to so-called high net worth individuals and to sophisticated investors.

¹⁵ Reynolds *et al.* (2001).

¹⁶ Mason and Harrison (2000).

¹⁷ British Venture Capital Association (2000).

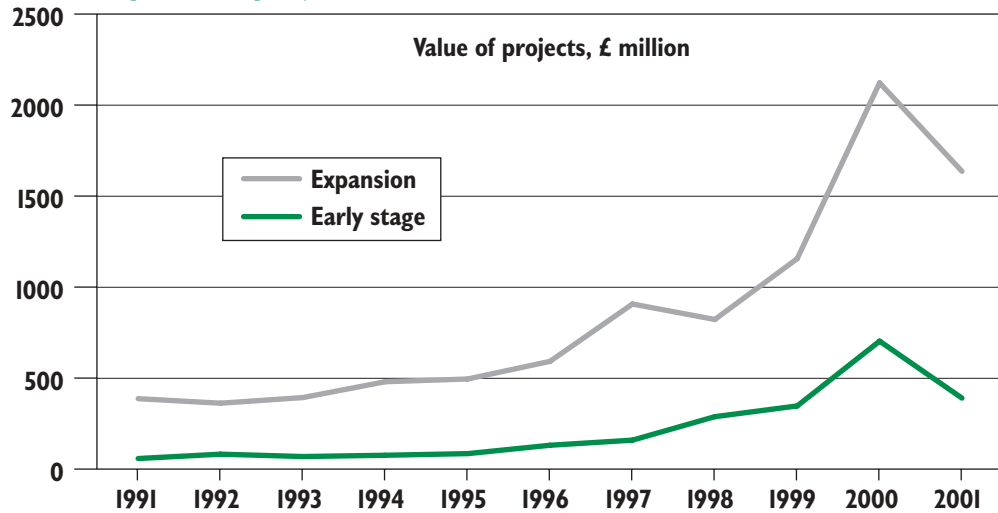
¹⁸ Bank of England (2002).

¹⁹ Mason and Harrison (1999).

Venture capital 4.21 The formal venture capital sector is an important provider of larger tranches of risk capital. In value terms, the supply of venture capital has grown rapidly through the 1990s, accelerating towards the end of the 1990s, and the UK has the largest private equity industry in Europe – accounting for 28 per cent of the total market.

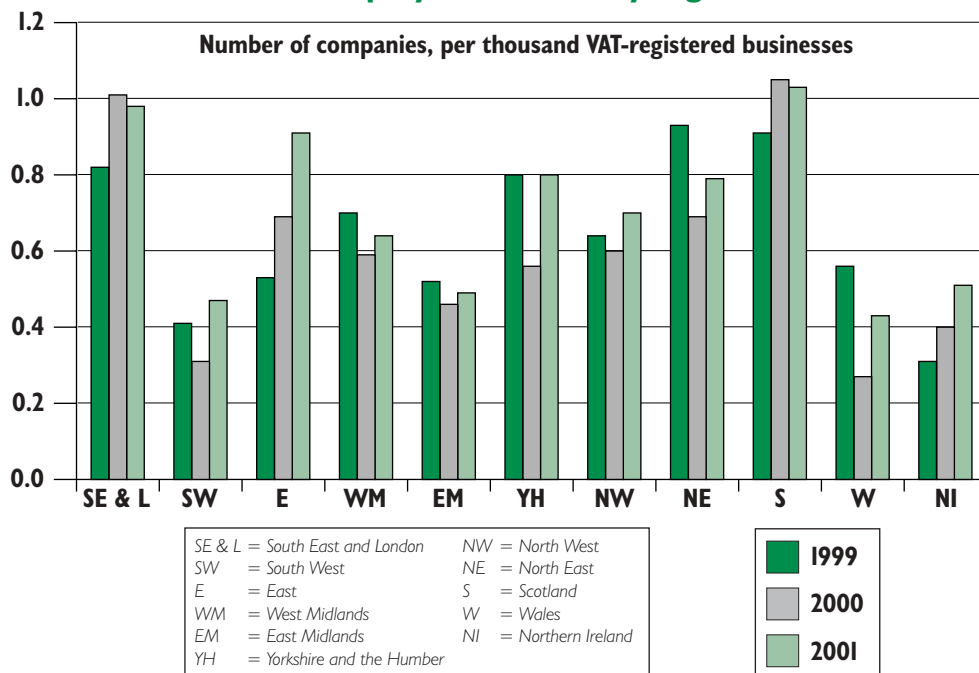
4.22 The growth in private equity investment has been accompanied, however, by a marked increase in the average value of individual investments. This has made it increasingly difficult for smaller firms to obtain private equity finance below £1 million. Moreover, the geographical distribution of venture capital investments is highly uneven.

Chart 4.2: Private equity investment for early-stage and expansion projects



Source: British Venture Capital Association (2002).

Chart 4.3: Private equity investment by region¹



¹Number of companies receiving private equity investment, per thousand VAT-registered businesses. Source: British Venture Capital Association (2002).

4.23 To address the under-provision of venture capital, and to ensure an adequate supply of early-stage equity finance across the country:

- **Regional Venture Capital Funds** are being set up in each of the nine English regions. A total of £270 million, including a government contribution of up to £80 million, will be available for investment in small businesses with growth potential. Seven of these funds are now operational, and three have already made investments (see Box 4.2);
- the Government has reformed the **Venture Capital Trust (VCT)** scheme, which offers a range of tax reliefs for individuals investing up to £100,000 per tax year in VCTs. These trusts deliver growth capital funding to companies that are generally too small to attract larger commercial venture capital finance. VCTs have already raised well over £1 billion from investors; and
- the Government is taking forward all the recommendations of the **Myners review**.²⁰ This review made a series of recommendations to promote more sophisticated approaches in institutional investment, including stronger emphasis on asset allocation and a broader range of asset classes, including private equity. In particular, as recommended by the review, the Government consulted on and promulgated a set of principles for institutional investment last year.

Investment readiness 4.24 On the demand side, small businesses in the UK appear to be less aware of the possibilities of different forms of risk finance than their US counterparts, and are often unable to present a convincing business case to access it.²¹ To assist the flow of information, and thereby improve the efficiency of the risk capital market, especially in the provision of equity finance, the Government has launched pilot ‘investment readiness’ projects to provide tailored educational programmes for SMEs and intermediaries seeking to understand and access different finance options. The pilots will be evaluated and, if successful, the programme will be rolled out across the country.

Box 4.2: Regional Venture Capital Funds – a case study

Scientia Solutions Ltd, based in Gateshead’s MetroCentre with a highly experienced team of 22 staff, specialises in designing and implementing Internet and Intranet portals. Its clients include national blue chip companies and public sector organisations. It worked with One NorthEast, its local Regional Development Agency, to establish the first regional knowledge portal, providing 100,000 businesses and a population of 2.6 million with access to government information and business services. It also provided a solution for Childline, when the charity was unable to cope with its high volume of telephone calls.

Scientia operates in a rapidly growing market, and is set to move forward to its next stage of development with the help of a £250,000 investment from the new North Eastern Regional Venture Capital Fund, managed by Northern Enterprise Limited (NEL).

Scientia’s Managing Director explained: “We were finding it difficult to attract funding from the traditional venture capital market and NEL’s support has been ideal for us. They deal with the size of investment we were looking for, their deal costs are significantly smaller, they have the knowledge and contacts we needed and are well informed about the needs of smaller companies. Speed was crucial for us and the deal was organised in weeks rather than months.”

²⁰ Myners (2001).

²¹ Mason & Harrison (2001).

Equity finance in disadvantaged communities **4.25** As with bank finance, it is likely that problems in accessing risk capital are more intense for businesses in disadvantaged communities. There is less direct evidence on risk capital than on bank finance, but internal research by HM Treasury, based on a small sample of venture capital deals, suggests that deprived areas attract only half as much venture capital per head of population as the rest of the country.

4.26 Research also indicates that entrepreneurs in disadvantaged communities are to some extent cut off from business angel investment. As there are lower levels of wealth and fewer established businesses in disadvantaged communities, business angel networks are likely to be relatively under-developed there. Moreover, as around 80 per cent of angel investment is supplied to individuals already known to the investor,²² businesses in disadvantaged communities will have more limited access to this form of funding.

Bridges Fund **4.27** In order to address the shortage of equity finance in disadvantaged areas, the Government has invested £20 million in the **Bridges Community Development Venture Fund**, alongside £20 million from the private sector. The fund aims to stimulate enterprise in deprived areas and to demonstrate the investment potential of these areas to other venture capital providers. The fund may invest in businesses only in the most deprived 25 per cent of wards in England, including all Enterprise Areas in England, and only in firms that can demonstrate a meaningful level of interaction with the local economy.

BUSINESS ADVICE

4.28 Starting up a new business is a daunting proposition for many entrepreneurs, particularly those who are doing so for the first time or who have had little prior exposure to enterprise, as is often the case in less prosperous communities. Equally, established business owners encounter new challenges as their enterprises grow and evolve.

4.29 Breadth of internal expertise is a particular difficulty for smaller firms, which cannot typically employ individual specialists on a full-time or permanent basis. The availability of external business advice is therefore an important determinant of the performance of small businesses. In turn, more successful small businesses offer greater economic benefits, by providing a stronger competitive spur to innovation and efficiency gains amongst rival firms and by contributing to prosperity in local communities.

4.30 Small firms can obtain advice from a variety of external sources, and those who use such advice typically report positive levels of satisfaction, stating that the advice has contributed to the success of their business.²³ Research suggests that people who take external advice when creating a business build turnover faster and are more likely to survive than those that do not.²⁴

4.31 Nevertheless, survey data show that almost half of SMEs did not seek any external advice over a twelve-month period.²⁵ Given that external advice generally provides tangible positive benefits, it appears that these firms lack awareness of the range of advice that is available, and therefore cannot assess its potential value. Survey evidence shows that information-related barriers are more frequently cited as an obstacle by smaller companies.²⁶

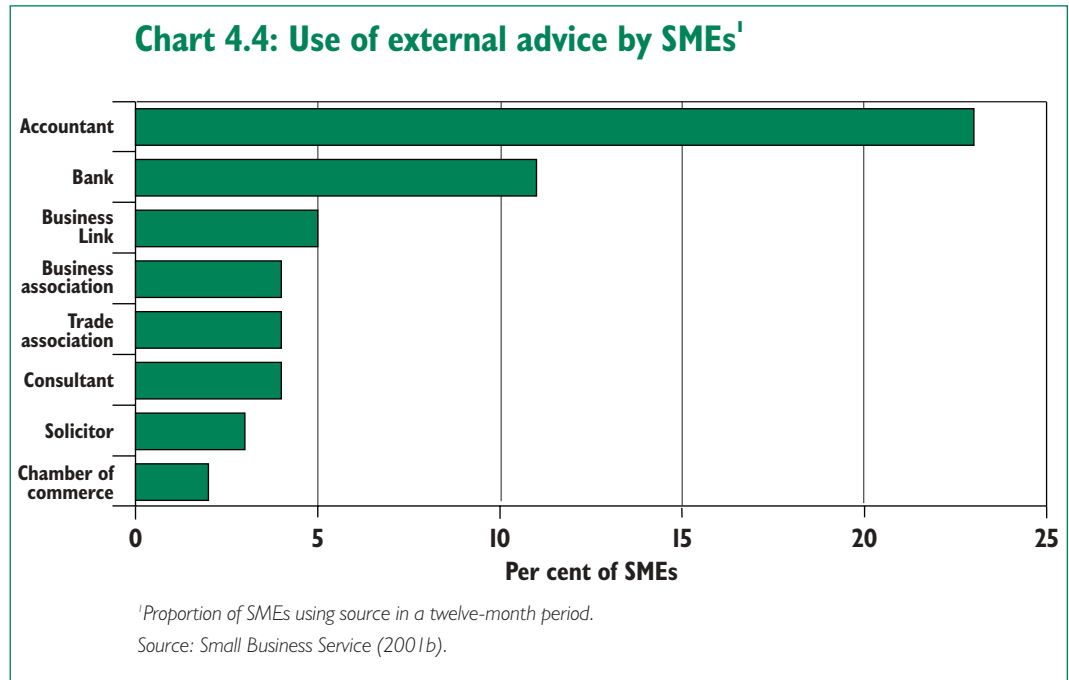
²² Reynolds et al. (2000).

²³ Cosh and Hughes (2000).

²⁴ Barclays/ National Federation of Enterprise Agencies (2001).

²⁵ Small Business Service (2001b).

²⁶ European Observatory for SMEs (1997).



4.32 There is little direct evidence about the perception and usage of business support services amongst people living in deprived areas, but research has indicated that some ethnic minority groups have a low propensity to use mainstream business support agencies.²⁷ One study found that only 7 per cent of ethnic minority businesses accessed support from public or quasi-public sector agencies at start-up, compared with 11 per cent of white-owned businesses.²⁸ Consistent with one of the key themes of the SBS strategy to improve SMEs' experience of government services, the *Start-Up Guide* described in Chapter 3 will improve access to government information for new businesses, and will outline the additional support available in the two thousand Enterprise Areas.

Business Links 4.33 Services provided through the Business Link network are designed to raise small firms' awareness and understanding of potential sources of advice, and to overcome their tendency to under-estimate the value of that advice. Business Links offer basic guidance and act as 'honest brokers' to a range of other specialist public and private-sector providers. This helps businesses to start up and grow with greater confidence, to raise their productivity²⁹ and to increase their chances of success.

4.34 To widen access to business support, the Government has restructured and relaunched the national network of Business Link operators. To integrate their services more effectively with Regional Economic Strategies, pilots of Regional Development Agency-led management and coordination of Business Links are being developed in the North West, West Midlands and East Midlands. Enterprise Agencies and the Prince's Trust also continue to play a valuable role in providing business support services, particularly in less prosperous communities.

British Trade International 4.35 To assist firms seeking to expand into overseas markets, the Government has established British Trade International, which delivers advice and support services through local Business Links and other partner organisations. These strengthened regional and local networks in England provide the best way to reach small businesses and help them become more competitive. For example, most participants in the £2.3 million *Your Passport to Export Success* programme reported that they were more successful in winning business as a result.

²⁷ Small Business Service (2001a).

²⁸ British Bankers' Association (2002).

²⁹ Roper *et al.* (2001).

Business incubators **4.36** As well as providing premises, business incubators provide business start-ups and early-stage SMEs with hands-on support. They have been shown to enhance the chances of survival and growth,³⁰ and also form effective partnerships reaching out into local communities. To promote these facilities, in particular so that their supportive environment is accessible to those starting up in the UK's most deprived areas, the Government is widening the Business Incubation Fund to offer grants for feasibility studies to encourage the development of quality incubation projects.

4.37 For incubation projects planned in 20 per cent of the most deprived wards in England, including Enterprise Areas, grants of up to £30,000 covering 70 per cent of the cost of a feasibility study will now be available. In other areas, up to £20,000 will be offered to cover 50 per cent of the cost of the study. This funding should act as a catalyst for new incubation projects, boosting enterprise in many local communities.

Phoenix Fund **4.38** The Government recognises that mainstream provision of business advice may be insufficient to tackle information failures, particularly for members of disadvantaged communities. The problem is not restricted to public agencies: other providers can be perceived as discriminatory by minority groups, restricting demand for their services.³¹

4.39 To address this problem, the Government has established the Phoenix Fund, which has supported 150 independent organisations specialising in the delivery of business support services to members of disadvantaged communities. A third of these organisations are also community development finance providers. The Fund has been instrumental in helping local organisations to develop business support projects, and in encouraging a greater degree of partnership amongst public, private and not-for-profit organisations. The fund was originally allocated £96 million in funding, to which a further £50 million was added in the 2002 Spending Review. Projects supported include:

- **Faith in Business**, which aims to encourage and nurture enterprise within Afro-Caribbean communities by working with churches that have mainly Afro-Caribbean membership. The project provides training and support for individuals to help them set up and run their businesses, and is also working to build the capacity of church-based community groups and business support organisations to provide long-term support for this client group;
- the **Development Fund for Rural Renewal**, which is targeted at businesses and communities hard hit by the outbreak of Foot and Mouth Disease. It is aimed at businesses working together or organisations seeking to support them. 19 projects were successful in their bids for funding and all projects are now up and running;
- the **Women's Employment Enterprise and Training Unit**, which is providing a Centre of Excellence to help women from disadvantaged urban and rural areas to start and develop their own businesses. Its provision includes training, access to finance, networking and childcare provision. A particular feature of the project is the use of Lending Circles, which are formally structured mutual support groups to help members access finance for their businesses; and

³⁰ Hannan and Chaplin (2000).

³¹ HM Treasury (1999).

- **Bolton Business Ventures**, which is an established Community Development Finance Institution. It provides a variety of loan funds for small and new businesses, but Phoenix Fund support is enabling it to operate a last resort loan fund targeted towards women entrepreneurs in the North Manchester region, and also to provide uniform access to micro-loans for enterprise across the five boroughs of the North Manchester regeneration area.

4.40 The Government's funding for voluntary, community and other not-for-profit organisations, discussed in Chapter 3, will further help to ensure that entrepreneurs within disadvantaged communities and other under-represented groups have access to the information, support and encouragement they need to start and grow a successful business.

TRAINING AND SKILLS

4.41 There is clear evidence of a positive relationship between skill levels and productivity. The talent and experience of a firm's manager will influence the firm's performance, while skilled workers may be more effective at implementing innovative working practices.³² They can increase the ability of firms to adapt to change, making the economy more flexible and productive in the longer run. Skill levels may also affect productivity indirectly through capital investment: having highly skilled workers may increase the returns to new investment, and hence the likelihood that firms will invest.³³

4.42 At an aggregate level, research suggests that a significant proportion of the UK's productivity gap with other major economies may be explained by skill levels.³⁴ Within UK manufacturing plants, there is a clear relationship between productivity and the share of skilled workers in the total workforce. For individual workers, holding a tertiary degree is estimated to increase productivity by between 30 and 100 per cent relative to a worker with no qualifications.³⁵

Recruiting and retaining high-quality staff

4.43 Small firms may face particular difficulties in recruiting and retaining skilled staff, as a result of social perceptions or attitudes to small business. For example, graduates tend to regard self-employment or employment within a small firm as less prestigious than working in a larger firm,³⁶ and highly innovative enterprises may face particular difficulties as a result of the perceived uncertainty and risk associated with employment in such firms. Moreover, the Council for Excellence in Management and Leadership (CEML) has concluded that the UK is facing a pervasive management problem, with inadequacies on both the demand and supply sides.³⁷

4.44 To help small companies recruit and retain high-quality staff, the Government has introduced the Enterprise Management Incentive scheme, which allows firms to incentivise workers through the use of tax-advantaged share option schemes. In addition, recognising the important contribution of strong management to enterprise success and to productivity growth, the Government is taking forward the CEML's recommendations.

Investment in training

4.45 There are various reasons why firms may under-invest in training their staff. These apply to all businesses, but present a particular constraint on training in smaller enterprises. Evidence shows that small firms are much less likely than larger firms to provide 'off-the-job' training, and that employees in smaller firms are, on average, less well qualified than those in large firms.

³² Cassen and Mavrotas (1997), Laplagne and Bensted (1999).

³³ Confederation of British Industry/Trades Union Congress (2001).

³⁴ HM Treasury/Department for Education and Skills (2002).

³⁵ Jenkins (1995).

³⁶ Westhead (1997).

³⁷ Council for Excellence in Management and Leadership (2002).

4.46 This may partly reflect a preference for ‘on-the-job’ training in smaller firms, and the Government recognises that effective skills development does not necessarily lead to formal qualifications. Nevertheless, there are various reasons why SMEs may choose not to invest in training, even when the firm itself could benefit. These include:

- the **poaching problem**. An increase in an employee’s skill level will benefit not just their current employer, but also their future employers, and the trainee may enjoy a higher wage in future jobs. Accordingly, if the firm providing the training does not expect to appropriate the full benefits, it is likely to under-invest in training. This is a particular problem for smaller firms, which experience higher staff turnover – partly because of the limited scope for internal career progression;
- **information problems**. Employers and their staff may be unable to judge the quality of training or evaluate its benefits in terms of improved firm performance. Smaller firms will experience particular difficulties: they are likely to have only limited experience of the benefits of training, and cannot spread the costs of obtaining information over a large number of employees. The Small Business Service has an important role to play in helping firms to access relevant information and to develop training strategies, for example through the Business Link network;
- **credit market imperfections**. Although training provides long-term benefits to firm performance, it is often costly. Firms may therefore lack the resources to invest in that training; as noted earlier in this chapter, smaller firms are particularly likely to experience credit constraints; and
- **frictional costs**. Smaller firms face higher costs when individuals take time off work for training. Individuals in smaller firms are more likely to be engaged in specific jobs that others are not able to undertake in their absence.

Government policies **4.47** The Government has introduced wide-ranging reforms to the education and training system, backed by substantial increases in funding, to ensure that young people enter the workforce with more of the skills they need to succeed and progress. For example, Modern Apprenticeships allow businesses to equip young people with the skills and experience they need, providing hands-on experience and on-the-job training, as well as formal qualifications. The Government has also introduced the Skills for Life programme, supporting adults in improving their basic skills through free training, information and support.

4.48 Various policies have been put in place to help employers to raise the skills levels of their staff. Some measures especially benefit smaller firms, recognising the particular difficulties they face, including:

- **Employer Training Pilots**, which are currently allowing firms in six areas to access free training, information and advice, and are providing subsidies to meet the costs of providing time off for staff without basic skills or Level 2 qualifications to train. These subsidies are paid at higher rates (of up to 150 per cent of wage costs) for SMEs;
- a **Small Firms Development Account** pilot, which offers an integrated package of business development with a specific focus on skills, and includes a financial incentive in support of workforce development;
- allocation of an additional £30 million to support more small firms working with the **Investors in People** standard, enabling them to identify skill needs more effectively and to act strategically to raise their skill levels; and

- the **University for Industry (UfI)**, which offers flexible and convenient learning opportunities to meet business training needs. UfI is already reaching over 40,000 SMEs a year through **learnirect**, and is aiming to reach 70,000 SMEs a year.

Workforce development **4.49** The Strategy Unit has recently published its second report on workforce development,³⁸ containing an action plan and a timetable for implementation, evaluation and review of the Government's strategy to improve workforce development. The Learning and Skills Council (LSC) published its strategy for workforce development³⁹ alongside the Strategy Unit report. This sets out how the LSC will deliver its statutory responsibility to raise skill levels and the demand for learning, and engage employers in improving skills for employability and national competitiveness.

4.50 In addition, new pilot schemes to be launched next year will involve RDA and LSC co-management of post-19 training. These pilots will bring together the different sources of funding for post-19 skills at the regional level, delivering a more effective match of skills demand from employers and supply from learning providers, and allowing a closer alignment of regional skills funding with Frameworks for Regional Employment and Skills Action.

Migration **4.51** Migration is a key source of skills and labour in the UK, helping to fill skills gaps and labour shortages. The Government has therefore reformed the work permits system so that permits last longer and are processed much more quickly. The Government will continue to enhance the service offered by Work Permits UK and by the Highly Skilled Migrants Programme. Steps are also being taken to ensure that employers and individuals have access to appropriate information on migration.

Jobcentre Plus **4.52** Jobcentre Plus plays an important role in helping to match firms' demand for staff with the available supply of workers. Its new strategy for employer engagement⁴⁰ aims to provide a high-quality and consistent service to employers and to position the agency as a valuable recruitment partner. This will increase the supply of vacancies Jobcentre Plus has access to, providing greater opportunities to place unemployed people into work.

4.53 To enhance its service to small and medium-sized employers, Jobcentre Plus intends to develop links with employer associations and other representative bodies to tailor their approach to specific sectors, thereby capturing the requirements of SMEs without placing an undue burden on them. At a local level, Jobcentre Plus is currently piloting a local account management function specifically servicing the needs of SMEs, in cooperation with the National Employment Panel.

INNOVATION

4.54 Chapter 2 outlined the important role of innovation as a driver of productivity growth. Novel products, processes and methods of working can yield efficiency gains and quality improvements not only within the innovating firm, but also within other firms that replicate or build on the innovation within their own organisations.

4.55 Although the UK has a very high level of academic research output from the science base, with universities producing more scientific papers per head than any other G7 economy, its record on turning this knowledge into commercial success is less good. Compared to other countries, the UK invests proportionately less in research and development (R&D), and its relative position has been in decline for many years.

³⁸ Strategy Unit: In demand – adult skills in the 21st century – part 2, November 2002, www.cabinet-office.gov.uk/innovation/2002/wfd/report.

³⁹ Learning and Skills Council: LSC workforce development strategy, November 2002, www.lsc.gov.uk/news_docs/WDS_NationalPolicy2005_Summary.pdf.

⁴⁰ Jobcentre Plus Employers' Charter, Jobcentre Plus, March 2001, www.jobcentreplus.gov.uk/pdfs/EmCharter02.pdf.

4.56 There are a number of reasons why the rate of innovation is likely to fall below socially optimal levels, and smaller innovating firms may face particularly severe barriers to innovation. The key constraints are:

- **limited access to risk capital.** The informational impediments to free-functioning markets for SME finance were discussed earlier in this chapter, but it is particularly difficult for potential lenders or investors to assess likely risk and returns accruing to future research or to the implementation of unproven innovations. Newly-established innovating firms often make a loss and face severe cash-flow constraints in their early years;
- **difficulties appropriating the full benefits of innovation.** Whilst a competitive environment will provide the best general incentive for firms to innovate, firms need to be confident that they can reap the rewards of their innovation. This is why the intellectual property regime allows firms to prevent, for a limited period, their competitors from copying their innovations. This is a necessary reward for the costs of R&D, and helps to encourage innovation. Nevertheless, the internal return to innovation may still be modest relative to the industry-wide benefits that arise once the innovation can be replicated by other firms;⁴¹ and
- **inability to diversify risk.** While larger companies may have a large portfolio of innovative activity, innovation in smaller firms may be concentrated on a single product or process, and the cost of undertaking the necessary R&D may be very large relative to the overall financial assets of the company. Accordingly, where SMEs are risk-averse, they will be discouraged from investing in innovative activities with uncertain returns.

4.57 Recognising these constraints on innovative activity, which are likely to be particularly acute amongst smaller firms, the Government has taken steps to address the UK's past under-performance in innovation and R&D. For example, it has:

- introduced a **tax credit for research and development** by SMEs. The credit provides support for all R&D carried out by smaller companies. Loss-making companies can obtain immediate benefit from the credit by converting it into a cash payment worth up to 24 per cent of their R&D spend;
- supported R&D and innovation, particularly in SMEs, through the **Smart** scheme, together with **SPUR** in Scotland and Wales. These schemes provide grants to support individuals and SMEs developing technologically innovative products and processes, or seeking to make more effective use of technology within their businesses. A recent evaluation showed that a large proportion of Smart grant recipients increased their investment in R&D, and that the scheme had significant effects on turnover, exports and employment.⁴² The number of small firms helped each year through Smart and SPUR has more than doubled over the past 5 years, to reach almost 1,000;

⁴¹ Griffith (2000).

⁴² PACEC (2001).

- allocated an **extra £1¼ billion by 2005-06 to the science budgets** of the Department of Trade and Industry and the Department for Education and Skills, compared with 2002-03. This represents the largest sustained increase in the science budget for more than a decade, and includes funding to support the implementation of the recommendations of the Roberts report on the supply of scientists and engineers;⁴³ and
- provided funding for **University Challenge**, which provides seed capital for research projects to enable them to be developed into prototypes, and the **Science Enterprise Challenge**, which promotes business and entrepreneurial skills in science, engineering and technology faculties. This is helping to ensure that extra science funding is converted into commercial success. These two schemes are being incorporated into the **Higher Education Innovation Fund**, whose annual funding will be increased to £90 million by 2005-06.

⁴³ Roberts (2002).

5.1 Having been in a long-term state of decline for much of the twentieth century, the small and medium-sized enterprise (SME) sector in the UK has experienced a resurgence since the 1970s. This resurgence can largely be explained by economic forces, but has also been supported by a turnaround in government policy towards smaller firms.

5.2 Nevertheless, the UK continues to face a significant enterprise challenge. Levels of entrepreneurial activity remain modest by international standards, and fall well below the rates seen in the US in recent years. There is also clear evidence of a substantial enterprise gap between the UK's most disadvantaged communities and the rest of the country. Unleashing the latent entrepreneurial potential within these groups is critical to meeting the Government's objectives of narrowing the UK's long-standing productivity gap with other major economies and of delivering greater prosperity and employment opportunity across all regions and communities.

5.3 A key element of the Government's approach is to build a more enterprise-friendly environment throughout the UK. This requires a fundamental change in public awareness of, and attitudes towards, enterprising behaviour, and also depends upon a business environment that allows firms of all sizes to flourish. The Government's approach recognises the power of market forces, but also acknowledges their limitations, and it is acting to correct various market failures that inhibit enterprising behaviour, which are frequently most acute in smaller businesses, particularly those in less prosperous communities.

5.4 The Small Business Service will make an important contribution to meeting the Government's objectives for enterprise. Its enhanced role, shortly to be set out in its new framework for government policy towards small business, will help to ensure that cultural change is achieved not just within society but also within government. Alongside central government, delivering a more enterprising society will also depend on successful initiatives at regional and local levels. Regional Development Agencies and Local Strategic Partnerships have a growing role to play as drivers of enterprise and economic development across the country.

5.5 Meeting the enterprise challenge will depend on the innovation and creativity of entrepreneurs themselves, but the Government must also provide the right conditions and the necessary support for successful enterprise. Building on measures already in place, the Government's focus on the two thousand Enterprise Areas will play a crucial role in ensuring that enterprise makes the fullest possible contribution to productivity growth and to rising prosperity that can be shared by all.

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LIST OF ABBREVIATIONS

ACAS	Advisory, Conciliation and Arbitration Service
BPZ	Business Planning Zone
CDFI	Community Development Finance Institution
CEML	Council for Excellence in Management and Leadership
CGT	Capital gains tax
DfES	Department for Education and Skills
DTI	Department of Trade and Industry
EIS	Enterprise Investment Scheme
EU	European Union
GCSE	General Certificate of Secondary Education
GDP	Gross Domestic Product
HMCE	HM Customs and Excise
HMSO	Her Majesty's Stationery Office
IiP	Investors in People
IR	Inland Revenue
LIF	Local Investment Fund
LSC	Learning and Skills Council
LSP	Local Strategic Partnership
NEL	Northern Enterprise Limited
OECD	Organisation for Economic Cooperation and Development
OFSTED	Office for Standards in Education
OGC	Office of Government Commerce
PACEC	Public and Corporate Economic Consultants
PSA	Public Service Agreement
R&D	Research and development
RDA	Regional Development Agency
SBS	Small Business Service
SME	Small and medium-sized enterprise
SPUR	Support Programme for University Research
Ufi	University for Industry
UK	United Kingdom
URC	Urban Regeneration Company
USA	United States of America
VAT	Value added tax
VCT	Venture Capital Trust

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