

ENTERPRISE AND GROWTH

Discussion Paper

SEPTEMBER 2007 - URN 07/1723

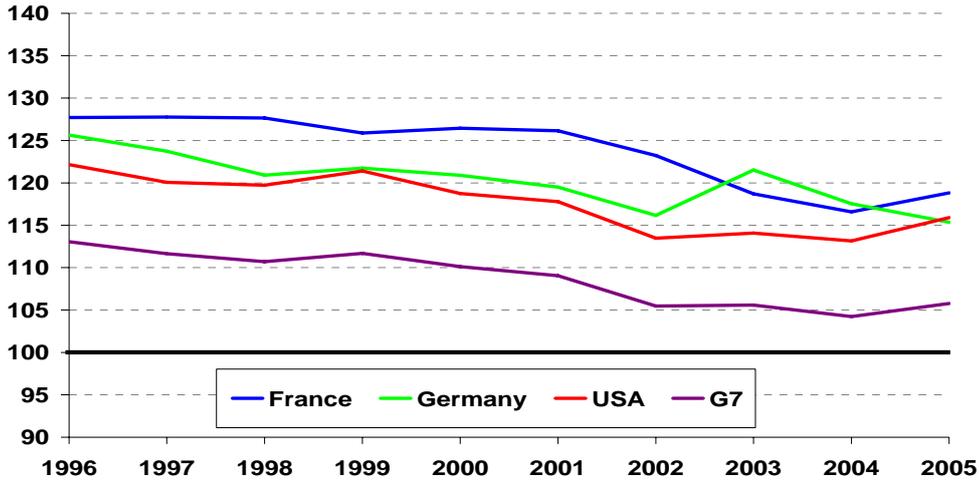
A Introduction

1. Entrepreneurship, whether expressed through start-up activity or the dynamism and growth of established businesses, has the capacity to play a central part in the UK's economic success. Recognising this, in 2000, the Government set a target of making the UK the best place in the world to start and grow a business. Significant progress has been made in a number of areas. There are clear signs that the small business sector is more dynamic than it was seven years ago as judged by both the increasing numbers of SMEs and their improving productivity performance. There are also signs that cultural attitudes to entrepreneurship are improving, with young people in particular, more attracted to starting their own business. All businesses, large and small, have benefited from the improvement in macroeconomic stability in the UK in recent years.
2. However, despite these positive developments, there are signs that more can be done to ensure that the role of SMEs is maximized as the UK responds to future opportunities and challenges stemming, in particular, from globalisation. For example, most measures of entrepreneurship, including key indicators of business growth and productivity, still show UK SMEs' performance some way behind that of the United States.
3. This paper aims to provide an overview of the evidence around entrepreneurship and growth issues in order to inform discussion about the most effective role Government can play in supporting entrepreneurship and what the priorities for action should be. It is vital that we hear the views of business people themselves - people with different backgrounds and experiences, representing different sizes of business and different sectors. In particular, where public policy is supportive or enabling, and where it is not.

B The context: UK macro performance and globalisation

4. The past 10 years have seen the UK perform well in terms of overall output, with the UK's annual GDP growth third highest in the G7 over the period 1996-2006. The UK has also made progress in closing its long-running productivity gap with leading industrial economies (Chart 1), which is particularly notable given the rise in employment during the same period.

Chart 1: GDP per hour worked (UK = 100)



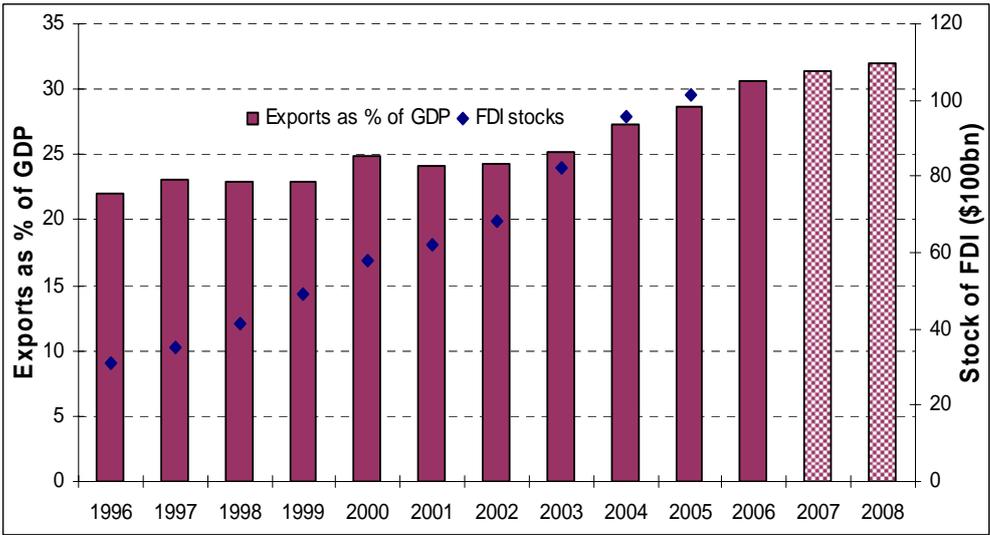
Source: ONS

- 5. Nevertheless, a significant productivity gap still remains with respect to our international competitors - with the gaps with respect to Germany, France and the US standing at 19 per cent, 15 per cent, and 16 per cent, respectively, in 2005.

Globalisation

- 6. The UK’s macroeconomic performance has been set against a context of increasing globalisation of the world economy. Globalisation can be seen most clearly in the rapid expansion of international trade and investment flows (Chart 2).

Chart 2 Global exports of goods and services as % of global GDP and World Stock of Foreign Direct Investment



Source: IMF World Economic Outlook (and latest forecasts), UNCTAD Handbook of Statistics

7. The recent wave of globalisation has also been characterised by the increasing importance in the world economy of China and India. Emerging markets and developing countries have increased their share of world output from one-fifth of total global output in 1996 to one-quarter in 2006, with growth expected to continue in the years ahead as China overtakes Germany in 2008 to become the world's third-largest economy.
8. Increasing international flows of goods, services and investment and the rapid growth of emerging economies provide substantial opportunities for the UK in terms of opening up new markets for exports as well as providing customers here with a greater choice of goods and services.
9. But globalisation also creates challenges for the UK economy. Globalisation puts UK firms and workers in competition with those from across the globe. In order to compete effectively in world markets and retain a competitive advantage, particularly against lower-wage competitors, the UK needs to offer innovative and high quality goods and services.
10. Smaller firms may not always benefit from the international networks and partnerships which can allow some firms to make productivity gains through out-sourcing the lower-value added parts of the production process and to take advantage of global economies of scale. However, they are particularly well placed to respond to low-wage international competition by producing the higher-quality, lower volume, niche products that often require working closely with consumers in order to meet their specialised needs.

Population ageing

11. The need to raise productivity and make the best use of the UK's labour force is reinforced by the fact that the UK population will become older over the coming years, reducing the ratio of people of working age to those outside working age. Increasing life expectancy and the ageing of the baby-boomer generation means that the number of people in the UK aged over 50 will increase from 34 per cent of the population to 44 per cent in 40 years time. We know too that older entrepreneurs are much less likely to want to grow their businesses.
12. Changing demographics mean that the economy as a whole will need to place a greater emphasis on fully utilising capacity throughout the labour market. But there may be particular issues we need to consider from an SME perspective such as the efficient transfer of ownership as older people wish to retire, pension provisions and SMEs or encouraging the older generation to continue to engage in entrepreneurship.

Climate change

13. Whilst climate change potentially threatens the stability of the world's climate and economy, it is also likely that the demand for environmental goods and services (EGS) will rise in the coming years due to:
 - Increased demand for environmental standards arising from growing real incomes; and
 - A growing international consensus regarding the economic case for action to reduce carbon emissions in response to global warming.
14. Government research suggests that the value of the UK EGS market will increase from £25bn in 2005 to £46bn by 2015, driven by particularly strong growth in the energy management, renewable energy and waste management sub-sectors. The same government research suggests that the value of the global ESG market will increase from \$600bn in 2005 to just under \$800bn by 2015.
15. Globally, opportunities in basic environmental infrastructures - such as water supply and waste management - may exist in many of the new EU Member States and in emerging markets more generally, as these countries either continue to industrialise or need to clean up the legacy of previous industrialisation. The greatest potential opportunities are likely to be found in China and India, where the rapid pace of development points to opportunities in cleaner technologies, renewable energy and more sophisticated approaches to environmental management.

C Responding to future challenges?

16. The Government has a long standing target to raise the long term rate of productivity growth and make progress on closing the productivity gaps with leading industrial economies. The importance of the UK raising productivity in order to improve standards of living is reinforced by globalisation and the challenge of population ageing.
17. In meeting this challenge, the government has developed an analytical framework of 5 inter-related drivers of productivity; enterprise, investment, skills, innovation and competition. If the UK is to meet this challenge, we need to ensure that policies lead to all drivers playing their full role.
18. Within the 5 drivers framework it is the entrepreneur who weighs up the balance of opportunity and risk as a business looks to start, innovate, grow or sell to new markets. Entrepreneurship takes place in businesses of all ages and sizes and will evolve as a business changes and grows. While in smaller businesses it is generally the owner who may be easily identifiable as an

entrepreneur, larger businesses are also dependent upon harnessing the entrepreneurial abilities of their workforce in order to succeed.

19. Similarly, larger businesses can compete by taking advantage of economies of scale and are more likely to invest in, and reap the benefits of R&D, as well as playing a role in generating and fostering spin-offs from universities and research institutes. But alongside new established companies, entrepreneurs starting up new businesses often play an important role in ensuring the overall economy adapts quickly to new market opportunities and capture niche markets. They also drive innovation through their willingness to experiment with radical new ideas, implement innovative processes and operate new business models.
20. More generally, entrepreneurship at all levels contributes to the beneficial process of “productive churn” within the economy, with more efficient businesses forcing out less efficient ones and providing a competitive spur to other businesses. Such dynamism is vital to bring about overall improvements in the competitiveness of UK business.

D Recent developments in the UK economy and the contribution of new and small businesses.

21. In analysing the strength of the UK’s entrepreneurship, and hence the extent to which entrepreneurship plays its full role in helping the UK respond, the starting point is to look at the numbers of successful, high growth businesses.
22. Performance in terms of the key international indicators of the percentage of all businesses achieving 60 per cent turnover growth over three years is mixed; while the UK compares well with other European countries, the percentage of high growing firm is significantly below the US (Table 1).

Table 1: High Growth Businesses

Country	Percentage of all businesses achieving 60% turnover growth over three years
France	2.09
Germany	1.23
Italy	2.43
Japan	2.24
UK	5.80
US	8.14

Source: OECD 2006

23. This finding on growth is reflected in data on the size distribution of firms where, of firms with employees, the UK has 10 per cent more of its firms in the smallest category, but a smaller proportion in every other category.

Table 2: Size distribution of businesses

Firm size (employees)	UK % of firms	US % of firms
1-4	65	55
5-9	18	20
10-19	10	12
20-49	5	8
50-99	1.5	2.5
100-499	1.1	1.7
500+	0.3	0.4

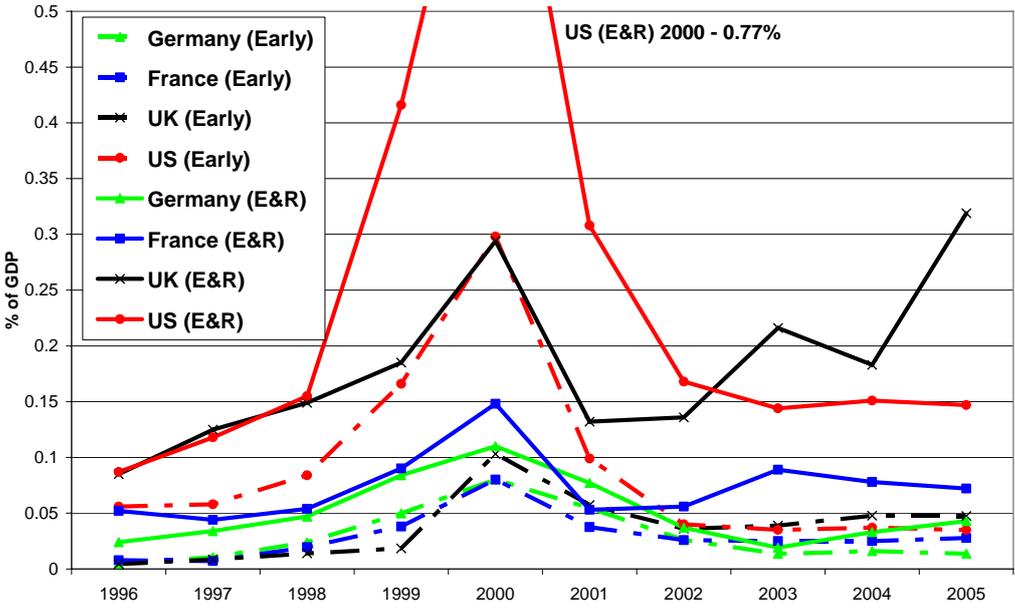
Source: UK 2002 source: SBS SME Statistics. USA 2002 source: "Final Estimates of Business Ownership for All U.S. Firms (Released September 14, 2006) Company Summary: 2002"

24. In part this may reflect inherent advantages of the US economy in terms of size and geography. But a range of other factors may play a role, including:
- Access to finance
 - Skills
 - Innovation
 - Regulation
 - Entrepreneurial climate

Access to finance

25. Barriers to enterprise, such as access to finance, can inhibit the creation and growth of new businesses, in particular of smaller businesses.
26. Comparisons of access to finance between countries are inevitably problematic given the diverse range of sources of finance and the lack of comparable data. On one important type of finance for growth - venture capital – the UK appears to perform well and the position has improved. While the data series is dominated by the ICT boom in 2000, the overall trend suggests that UK venture capital investment (both early stages and expansion and replacement (E&R)) has grown relatively strongly over recent years, particularly for investment in expansion and replacement, rising from less than 0.1 per cent of GDP in 1996 to over 0.3 per cent of GDP in 2005 (Chart 3 below).

Chart 3: Venture Capital Investment – Early stage and Expansion and Replacement



Source: Eurostat, based on data from EVCA & PriceWaterhouseCoopers

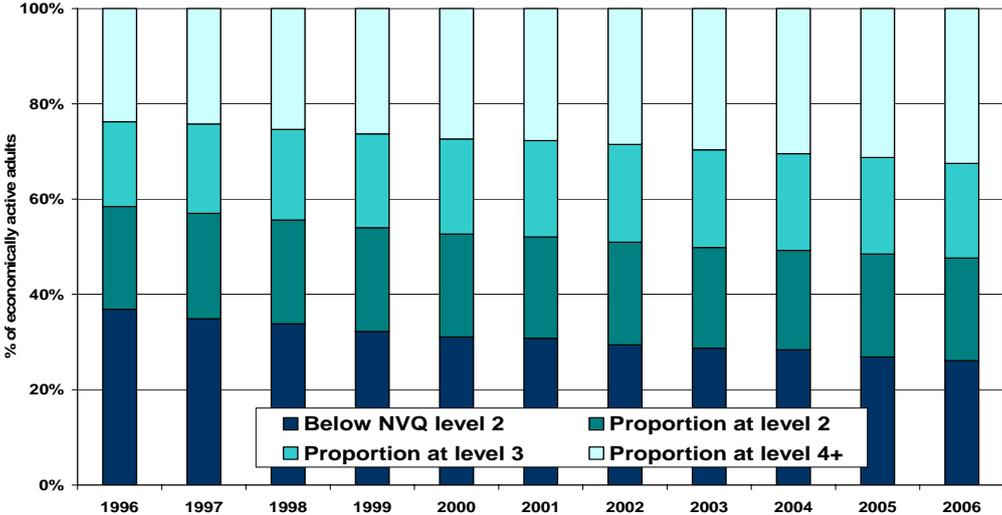
27. However, anecdotal evidence would suggest that the UK still lags behind the US on informal venture capital (business angel finance). Although the trend may be positive, there are areas where access to finance remains a problem. Government analysis suggests that amongst firms who facing financing difficulties, the biggest proportion of businesses facing difficulties is for those seeking between £50k and £1 million. For those specifically seeking equity finance, the balance of evidence indicates that businesses seeking between £250,000 and £2 million have particular problems (HMT (2003) Bridging the Finance Gap: next steps in improving access to growth capital for small businesses). The introduction of Enterprise Capital Funds is designed to address this problem.

Skills

- 28. If firms are to compete successfully, they need to be able to recruit and retain employees with appropriate skills, and then ensure those employees are able to continue to upgrade their skills and knowledge.
- 29. However, international comparisons suggest that the UK underperforms compared to the US and Germany in terms of higher level skills, with OECD analysis of levels of educational attainment showing that a relatively high proportion of the UK population have only low-level skills (35 per cent in 2004, in comparison to 17 per cent and 13 per cent in Germany and the US respectively).

30. Chart 4 below points to some improvement of the overall skills profile over the last decade, through continuing reductions in the proportion of workers with skills levels lower than National Vocational Qualification (NVQ) Level 2 (equivalent to achieving 4-5 GCSEs at grade A-C) and higher proportions of workers at Level 4 plus (equivalent to undergraduate and postgraduate degrees). Nevertheless, according to the Leitch review of skills, 7 million UK adults lack functional numeracy and 5 million lack functional literacy.

Chart 4: Highest qualification, UK

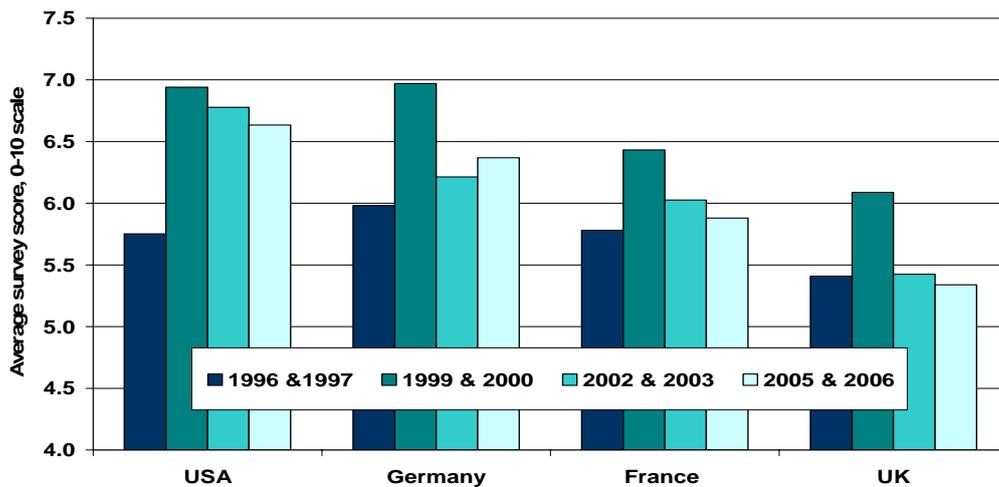


Source: UK Labour Force Survey

31. The UK is also perceived to have a relatively poor stock of management skills. For example, half of CBI employers cite improving management and leadership skills as the most significant factor contributing to competitiveness and a large number of research studies confirm a strong relationship between the systematic implementation of leadership development and organisational performance.

32. Although difficult to measure, one set of assessments over the last ten years from the Institute for Management Development shows the UK to be consistently behind France, Germany and the US.

Chart 5: Business Executive perceptions of Quality of Management



Source: IMD

33. In part problems of skill shortages relate to a lack of investment by firms. Just under two-thirds of business establishments had provided any staff training in the previous 12 months, less than half have a training plan or provide off the job training for their employees and only one in three have a training budget. Finally, less than one third of managers receive any off the job training.
34. The recent Leitch Review of Skills addressed issues that affected both large and small firms in the UK. Recommendations targeted at helping SMEs included the suggestion that access to Train to Gain brokers providing advice on training needs and public support should be extended to smaller businesses, and that the Learning and Skills Council's Leadership and Management programme for SMEs be extended to firms with between 10 and 20 employees.

Innovation

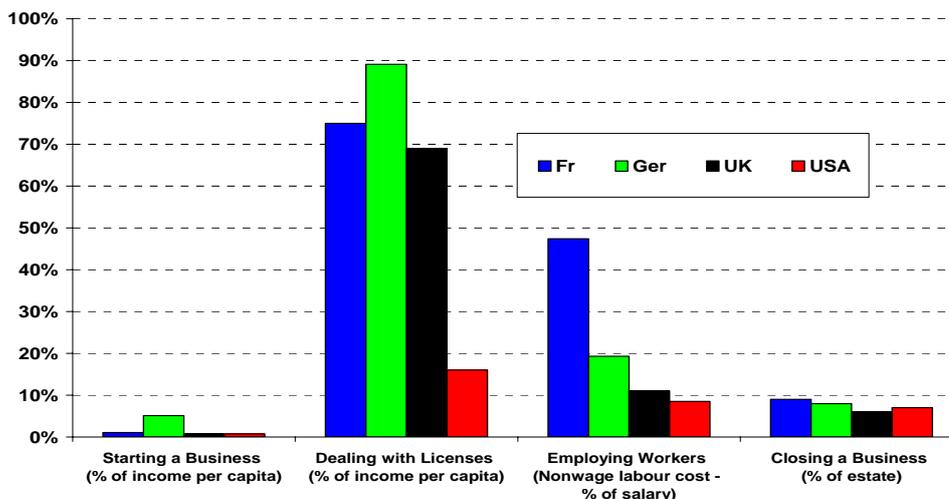
35. A key driver of growth is the capacity to innovate successfully either through improved products or more effective processes. Evidence shows that large businesses are much more likely to innovate than small businesses and small businesses are more likely to introduce radical innovations. However, the UK's innovation performance is only around the average of other advanced EU member states. Only just over a quarter of all SMEs introduced some kind of new or improved product or service in 2005 and only seven per cent introduced an entirely new product or service.
36. A key input into the innovation process is investment in R&D. UK expenditure on R & D as a proportion of GDP is just under 2 per cent. This lags behind that in a number of other countries including the US (2.6 per cent), Germany (2.5 per cent) and France (just over 2 per cent). The majority of small UK businesses work in isolation rather than entering into collaborative R&D relationships with others; less than 5 per cent have arrangements with

universities and about 20 per cent with other businesses.

Regulation

37. An economy's regulatory framework is undoubtedly fundamental to the economy's global success, and is a particular issue for SMEs. If firms are to compete successfully internationally, they need both the legal certainty that good regulation underpins, and to be able to operate and innovate without unnecessary time and cost pressures being placed upon them.
38. Again, gaining robust international comparisons of regulation is difficult given the difficulties of measuring and defining regulation and the danger of value judgments influencing assessments. The OECD's assessments on the restrictiveness of product and labour market regulation are the most respected international assessments and suggest that the UK has a relatively unrestrictive product market framework – significantly better than France and Germany, and only slightly more restrictive than the US.
39. In terms of labour market regulation, the OECD's Employment Protection Legislation (EPL) Index (based on the strictness of regulation for regular contracts, temporary contracts and collective dismissals) suggests that while the UK system became slightly stricter between 1998 and 2003, we remain less restrictive than our major European rivals, and only slightly more restrictive than the US.
40. An alternative way of considering the regulatory environment is to look at estimates of costs of doing business in different countries. Clearly such measures are difficult to assess, although the data in Chart 6 below, from the World Bank, suggests the UK position is relatively strong.

Chart 6: Selected costs of doing business



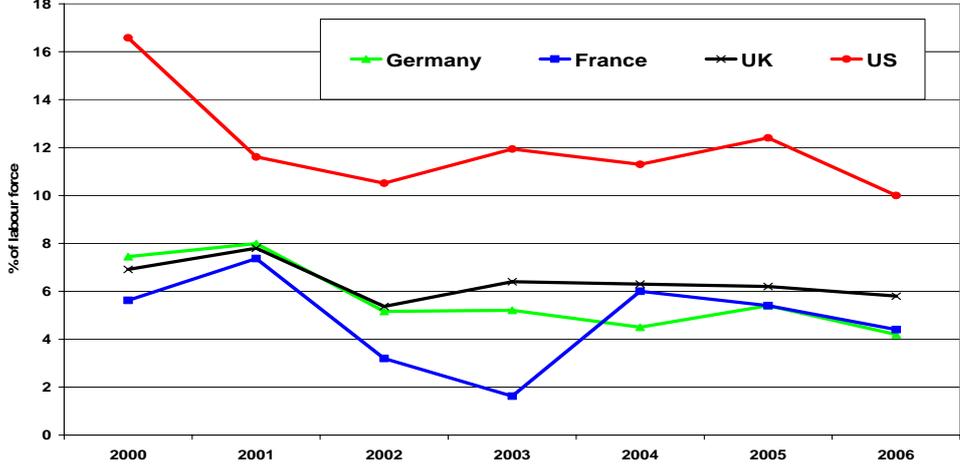
Source: World Bank Doing Business 2007

41. Despite the UK’s relatively strong showing in some international comparisons, the regulatory regime remains an ongoing concern for many businesses, and regulation is widely reported as an obstacle to growth in many business surveys. However, more in depth studies tend to show that concerns often focus on the frequency of regulatory change and the complexity rather than regulation *per se*. Employment and health and safety regulation are typically singled out as causing particular problems.

Entrepreneurial activity and aspirations

42. Encouraging a significant proportion of people to take part in entrepreneurial activity is key to our hopes of developing more successful high-growth firms. Chart 7 below shows that in terms of total entrepreneurial activity there is still a significant gap with the US. The US continues to be a clear leader in relation to entrepreneurial activity, although the UK has overtaken France in recent years.

Chart 7: Business Start-ups – Total Entrepreneurial Activity Index



Source: Global Entrepreneurship Monitor; Per cent of the labour force either (i) actively involved in starting a new business of (ii) owner or manager of a business that is less than 42 months old.

43. Considering entrepreneurial ambition, the number of people considering starting a business in the next three years also shows the UK lags well behind the US, and a number of other leading economies.

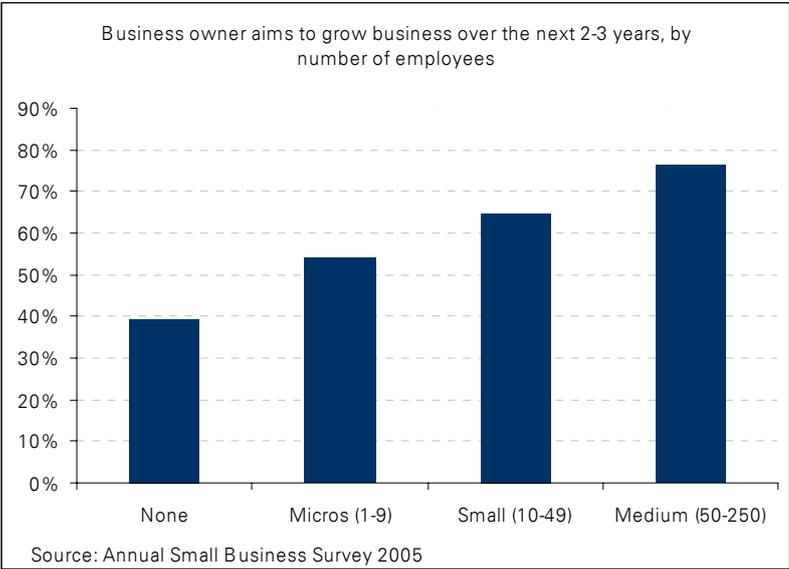
Table 3: Percentage of population expecting to start a business

Country	Expected start-ups
Canada	8.7
France	14.8
Germany	6.7
Italy	10.2
Japan	2.4
UK	7.8
US	13.0

Source: Global Entrepreneurship Monitor. Percentage of population expecting to start a business in the next three years

44. Nevertheless, more detailed analysis shows some positive results in terms wider attitudes to entrepreneurship, especially amongst young people:
- The proportion of 16-24 year olds considering or planning to become entrepreneurs increased by over 20 per cent from 2003 to 2005.
 - The proportion of the working age population expecting to start a business in next 3 years increased by 70 per cent between 2002 and 2006.
 - The proportion believing they have the skills to start a business increased by a quarter between 2001 and 2006.
45. While this relates to business start-ups, it seems to be indicative of a more entrepreneurial culture in the US. The paper has considered a number of barriers that may constrain growing businesses but it is also important to reflect upon factors that prevent many businesses from aspiring to grow at all.
46. BERR's Annual Small Business Survey (ASBS) data for 2005 shows that only 44 per cent of all UK businesses report that they intended to grow in the coming two to three years (see Chart 8). Over half of all businesses with less than 50 employees have no ambitions to grow. If only a modest proportion of those businesses currently lacking ambition were persuaded to adopt a more enterprising philosophy, the aggregate gain would be large. The question is not so much whether latent potential exists here, rather it is whether and how this potential can be realised.

Chart 8: Business owner aims to grow business over the next 2-3 years, by number of employees



- 47. However, any attempt to change aspirations could be difficult. A large proportion of those without ambition consciously opt to be 'lifestyle' businesses; about a half of those that do not aspire to grow are 'happy with the size they are' and a further 20 percent lack growth ambitions because they are planning to retire or close the business. Relatively few businesses lack ambition because they feel constrained by the market (12 per cent) or lack resources or the capacity to grow (8 per cent).
- 48. It is possible that a proportion of those who claim 'they are happy' with the size they are do not wish to adopt an active growth strategy because they fear failure or because they do not have confidence in their skills to manage the change process effectively. There is evidence that some business owners over-estimate the problems associated with growth.

E Issues for discussion

- 49. The above analysis suggests that while the UK overall performance has been relatively strong in recent years and has benefited in particular from a strong growth in the numbers of new start-ups, there remains a weakness in terms of our ability to grow companies.
- 50. Enterprise issues can be complex and multi-faceted. We need your expertise and experience in prioritising the key issues. Suggested issues for discussion are attached in the Annex. In considering the issues we are particularly keen to hear whether and where government policy should play a role in enabling or supporting progress.

ANNEX – ISSUES FOR DISCUSSION

Growth within UK business

In your experience, what drives or prevents growth within a business? Whether high or steady growth, what role should public policy play in supporting the process? Do these drivers, or barriers, vary across firm age, size or sector?

What should be the balance of priority between supporting high growth among a small minority of businesses and steady growth across the vast majority?

What skills are lacking across the workforce to support growth? Academic studies make much of leadership and management training and cultural attitudes being key to growth. Do businesses support this?

Challenges and opportunities

How are the opportunities and threats presented by globalisation and the expansion of the European Market viewed by business? How does the position change by sector and size of business?

What role do businesses see for government in them being able to access opportunities or respond to threats? How can the UK realise the benefits of global trade when many UK SMEs show relatively little appetite for it?

How can business exploit the market opportunities created by the demand for environmental goods and environment regulation?

Supporting environment for growth

We would welcome views from business around the incentives and barriers to growing businesses in the UK. In particular, where is public policy supportive or enabling and where is it not?

What do you consider to be the most useful policy tools/inputs the government has provided to support business growth in the last 10 years?

In terms of attracting and retaining companies in the UK – is the UK 'offer' sufficient?

Closing the Gaps

How can growth be encouraged in deprived areas and regions with their more limited access to skills and markets?

Under-capitalisation at start-up and high levels of part-time business ownership explain the lower levels of performance of women-owned businesses compared to male-owned. It seems harder for many women to commit more fully to enterprise activity. How might this be addressed?

Overall, ethnic minority business owners have similar growth aspirations to other business owners but overall their businesses tend to be smaller and more sectorally concentrated. How can we better respond to the needs of different ethnic minority groups when their backgrounds and experiences of enterprise differ so greatly?

Which new approaches to public policy in these areas should be considered?

Encouraging individuals to be more enterprising

Do businesses accept the assertion that growth is reliant on harnessing the entrepreneurial talents across the workforce in larger businesses?

Can (and how should) public policy realistically encourage more positive attitudes and less risk aversion around entrepreneurship? How can government support consideration of broader models of entrepreneurship, such as social enterprise? What role is there for education and skills?

How might public policy help in maintaining growth and competitiveness among UK SMEs when an ageing population means older entrepreneurs with more limited growth aspirations?
