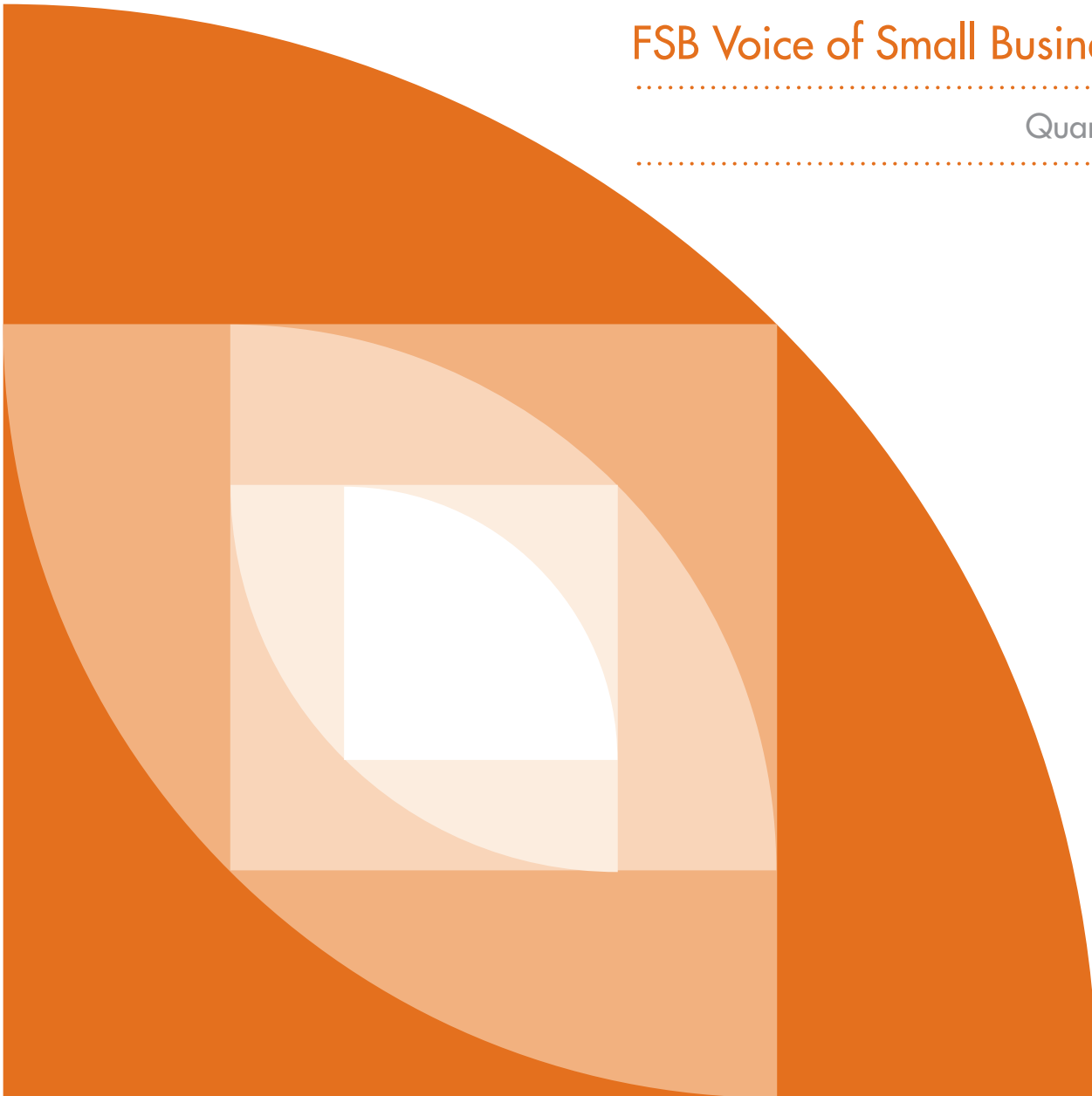




Federation of Small Businesses
The UK's Leading Business Organisation

FSB Voice of Small Business Index

Quarter 3, 2010



The Federation of Small Businesses is the UK's largest campaigning pressure group promoting and protecting the interests of the self-employed and owners of small firms. Formed in 1974, it now has 213,000 members across 33 regions and 194 branches.

The data presented in this FSB-CEBR Q3 2010 report is weighted differently to the FSB-ICM reports and therefore the results may differ.

For more information please contact priyen.patel@fsb.org.uk

FSB Voice of Small Business Index

John Walker, FSB National Chairman



The Federation of Small Businesses (FSB) represents 213,000 small firms across the UK. The FSB Q3 'Voice of Small Business Index' comes out just days before the coalition Government's Comprehensive Spending Review (CSR) which will outline public spending from this year to 2014 – 2015.

The Government will continue its efficiency drive within Whitehall but also look to reduce public spending in departmental work; this will ultimately mean a shrinking of Government.

The FSB made the case in its CSR submission that the Government must set out a 'Programme for Growth' alongside the necessary cuts in services. We believe that the private sector, through more jobs and businesses being created, can help

increase the tax base of the UK. This approach would avoid potentially damaging effects of business tax increases and knee jerk cuts, and help reduce the deficit.

While the economy is slowly growing, the FSB is concerned that the 'Q3 2010' report shows a further decline in business confidence. Notably, confidence levels among businesses in Northern Ireland and Wales, and those operating in the leisure, hotel and construction sector are low.

These geographical areas with low confidence may be concerned about the reduction of the state which is why the Government needs to show that it is supporting existing small firms with a 'Programme for Growth'.

Looming over the horizon, along with the Government cuts is the VAT rise from 17.5% to 20%. Small businesses will not be able to absorb the 2.5% increase as easily as larger firms and prices for goods and services may increase. The impact on consumer and business demand may lead to an increase in business failures and job losses.

This is why we urge the Government to help small firms and find ways to increase the VAT threshold from the current level of £70,000.

Small businesses are cautious about taking on new staff. A net balance of businesses predicts a decline in employment levels over the next three months, running up to the Christmas period. With the recovery remaining slow, businesses will keep employment strategies under constant review. In March 2010 the same panel of businesses predicted an increase in employment levels, hoping that economic recovery would be stronger than it has been.

Small businesses are now at a tipping point and are looking to the Government for a growth strategy alongside the inevitable pain from the CSR.

Economist's View – Charles Davis, Managing Economist, cebr



The Q3 2010 FSB 'Voice of Small Business Index' report, based on a September survey of 1,304 small businesses, shows that firms continue to be concerned over the strength of the UK's economic recovery, and remain cautious in their future planning.

The net improvement in small business prospects – defined as the difference between those reporting an increase in prospects and those reporting a decrease – has been on a downward trend since March. This is likely to be, in part, a base effect. Given that the FSB survey asks small businesses whether they think prospects over the next three months will be better or worse than the previous three, the state of the economy over the last three months is important. The latest data from the Office for National Statistics showed strong quarter-on-quarter growth of 1.2% in Q2 2010, so September

participants in the survey were comparing future prospects with a period of relatively robust growth.

On the other hand, the most recent economic indicators suggest a slowing down in the pace of growth in the latter half of this year, while there are a number of concerns and uncertainties about the path the economy will take over the next few months and years. The VAT rise in January 2011, benefits reform and public sector spending cuts will all put downward pressure on domestic demand. Meanwhile, the export-led recovery has so far failed to materialise with any significance; indeed, the trade balance fell further into negative territory as export growth disappointed.

Reflecting these risks, businesses expect sales to weaken in the coming three months and employment to decline. In March, businesses expected to increase their headcount. This suggests the private sector remains cautious about 'putting their money where their mouth is', as overall economic growth is expected to slow.

Overall, this data from the engine room of the UK economy – the thousands of small businesses across

the land – adds to concerns over weakening growth in the second half of 2010 and into 2011. We have always taken the view that the recovery would be something of 'non-recovery' – a long hard slog as private and public sector debt is gradually lowered to more sustainable levels. The evidence on the ground points to a loss of momentum in the recovery, and as such, we expect the Monetary Policy Committee to commit to a further programme of asset purchases (or quantitative easing as it is affectionately known) in the final quarter of 2010. We expect an additional £50 billion to be injected into the economy to aid the ailing recovery. Inflation may have been above target in 2010, but the Bank of England must focus on inflation two years down the line. If the private sector continues on the trajectory implied by the FSB's 'Voice of Small Business Index', anaemic economic growth will be the overriding concern as public sector cuts bite and growth in the private sector struggles to compensate for this.

Key findings this Quarter:

- Business confidence has been declining steadily since March.
- The latest data shows small business prospects over the next three months at their worst since the FSB's 'Voice of Small Business Index' began in March 2010.
- Businesses in England are more confident than those in Northern Ireland, Scotland and Wales – where public spending as a share of GDP is higher.
- Businesses are increasingly cautious over prospects for growth in revenue, with the net balance of revenue expectations declining from May.
- Firms are cautious about taking on new staff as the recovery has weakened; a net balance of businesses expects employment to decline over the next three months. Contrastingly, in March a net balance expected employment to rise over the coming three months.

Business confidence continuing to waver

The Q3 FSB 'Voice of Small Business Index' suggests that business confidence has weakened since the June survey. The net improvement in small business prospects has weakened in each successive survey since March, suggesting an ongoing trend. Part of this is a base effect as the more recent surveys will have been comparing with a period in which the economy grew at a robust pace as the inventory cycle turned.

However, the trend decline is also likely to be indicative of a slowing in the pace of economic recovery.

Indeed, the worsening in small business prospects corroborates a number of short-term indicators. Purchasing managers' indices¹ for manufacturing, construction and services have all softened in the third quarter of 2010, while official data on industrial production and retail sales have weakened.

Figure 1 shows the clear downward trend in business confidence. The net balance of businesses expecting an improvement in business prospects over the next three months has declined from 16.2% at the end of

Q1 2010 to 4.2% at the end of Q2 2010 and now just 0.5%. There has been a notable rise in the share of businesses reporting much worse business prospects over the next three months compared to the previous three months in September compared with June. Similarly, reflective of the deterioration in small businesses' mood has been the steady decline in the share of businesses expecting business prospects to be much improved. This has declined from above 8% in March to just 5% in September.

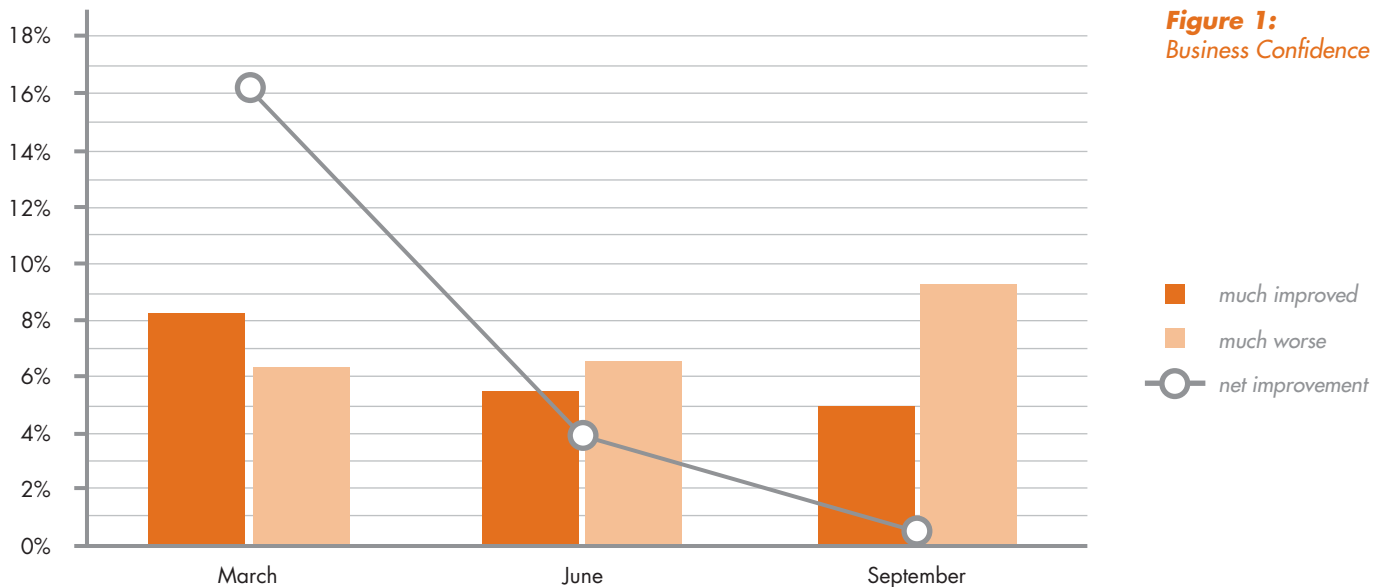


Figure 1:
Business Confidence

Source: FSB 'Voice of Small Business' Panel Survey (March - September 2010)²

¹ Source: Chartered Institute of Purchasing and Supply / Markit Economics

² Net improvement is defined as the percentage point difference between the number of businesses who feel that prospects over the next three months will improve, and those who feel that prospects will be worse.

Businesses in England more upbeat than rest of the UK

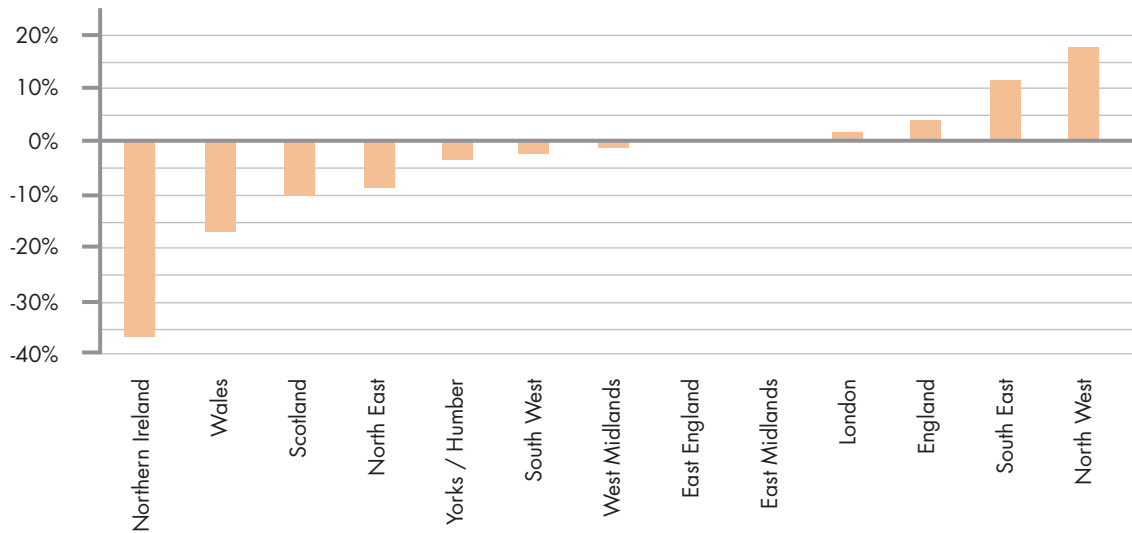
The FSB's 'Voice of Small Business Index' continues to show large disparities in small business views on economic prospects across regions and countries within the UK, as illustrated in Figure 2 below. In particular, while small businesses in England are expecting a net improvement in business prospects in three months time compared to the previous three months, businesses in Northern Ireland, Wales and Scotland are all expecting net deterioration. Business prospects

are particularly weak in Northern Ireland, with a net 37% of businesses expecting a worsening in prospects over the next quarter.

The region most bullish about economic prospects over the next three months is the North West of England. Businesses in London and the South East also expect a net improvement in business performance over the next three months compared with the previous

three months; all other English regions expect business prospects to remain the same or worsen.

Figure 2: Net improvement in small business prospects in three months' time – regional variation



Source: FSB 'Voice of Small Business' Panel Survey (September 2010)³

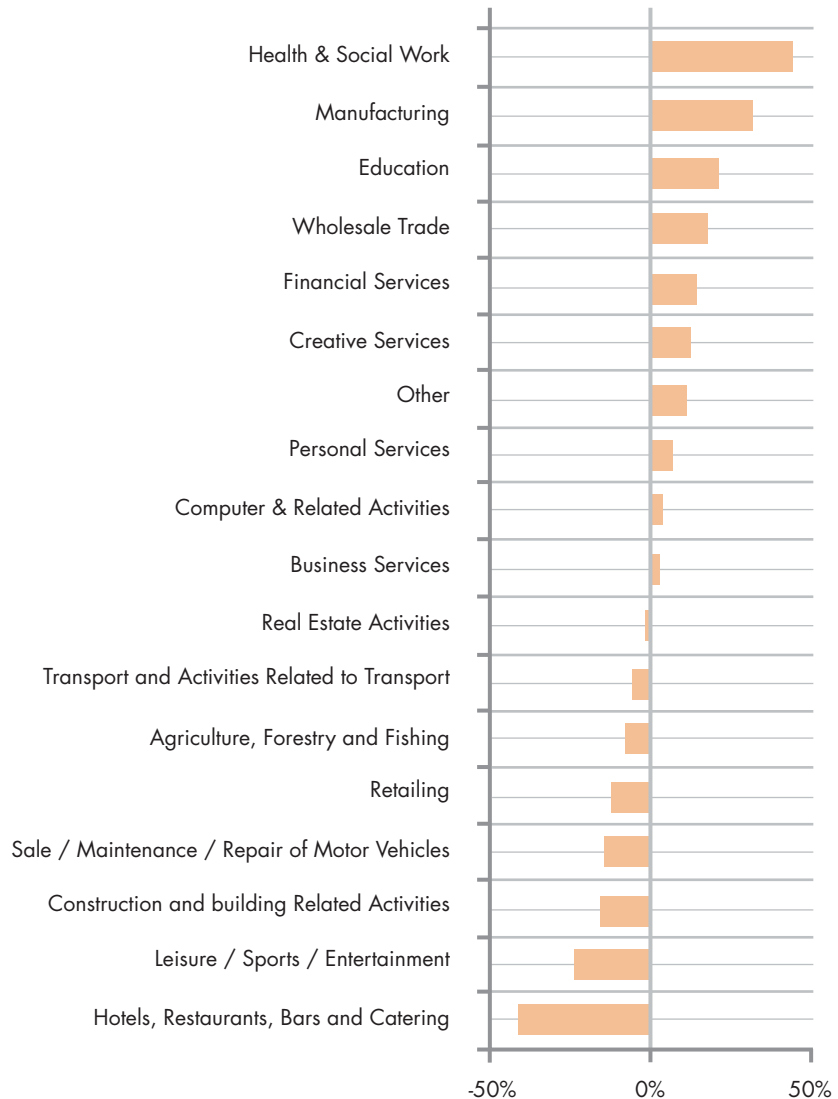
³ Net improvement is defined as the percentage point difference between the number of businesses who feel that prospects over the next three months will improve, and those who feel that prospects will be worse.

Sector differences reflect tough outlook for the consumer

The FSB's 'Voice of Small Business Index' illustrates divergences in the outlook for businesses across different sectors of the economy. Particularly noteworthy are the continued negative expectations for business prospects for the hotels, restaurants, bars and catering sectors, and for leisure, sports and entertainment, as illustrated in Figure 3.

As these are discretionary services which depend heavily on domestic demand and sufficiently high consumer confidence, these findings may be a reflection of the fact that the next few months are likely to be difficult for the consumer. Households face the headwinds of sluggish income growth, tightening of benefit packages, and the effects of above-target inflation and the January 2011 VAT increase, on purchasing power. Indeed, inflation has consistently run above earnings growth in 2010 to date – so households are facing real terms declines in spending power. In addition, growth in new bank lending to consumers remains very weak at just a small fraction of pre-recession levels.

Figure 3: Net improvement in small business prospects in three months' time – by sector



Source: FSB 'Voice of Small Business' Panel Survey (September 2010)⁴

⁴ Net improvement is defined as the percentage point difference between the number of businesses who feel that prospects over the next three months will improve, and those who feel that prospects will be worse.

Small business revenue growth expectations continue to soften

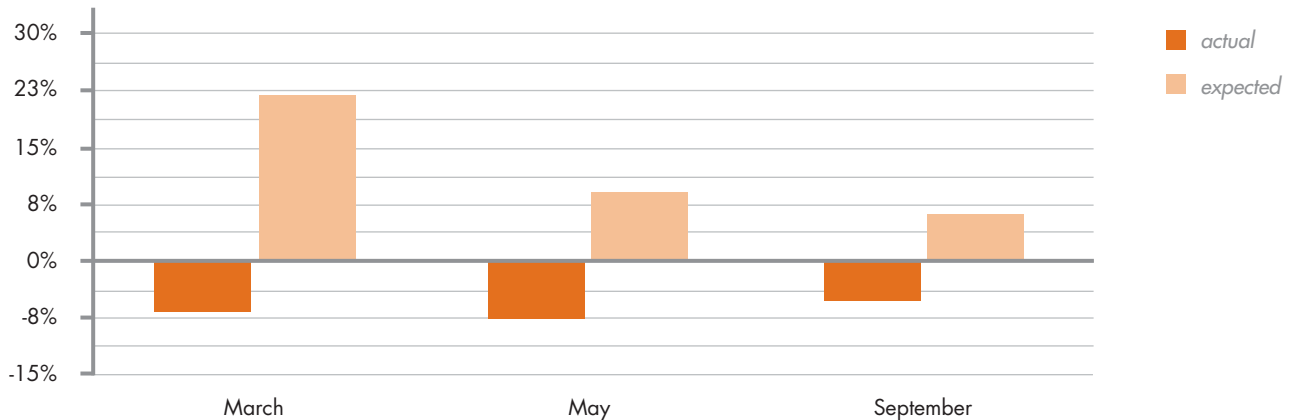
More small businesses reported a decline in revenues over the three months to September than reported an increase in revenues. While 33.2% of businesses reported an increase in revenues, this was offset by 38.1% of businesses reporting a decrease in revenues, implying a net improvement of -4.9%. The share of businesses reporting positive revenue growth has increased from May but is lower than in March. The proportion of businesses reporting a decline in revenues increased by two percentage points from May in

September, but remains below the level reported in March. Hence, there has been some improvement in revenue growth over the last six months, but the fact that a net balance of small businesses report a decline in revenue suggests that despite the strong 1.2% growth in economic output in Q2, the recovery is far from robust.

Furthermore, expectations for future revenue growth have continued to weaken in the latest dataset. There has been a trend decline in business

expectations of future revenue growth from March through to September as shown in Figure 4. Some 30% of small businesses expect revenues to decline over the coming months. This compares to 23% in March. Similarly, the share of businesses expecting an increase in revenues has steadily fallen. Some 45% of small businesses expected their revenue to grow in March but this has fallen to just 36% in September.

Figure 4: Small business revenue growth, net percentage balance increase or decrease



Source: FSB 'Voice of Small Business' Panel Survey (March, May and September 2010)⁵

⁵ Question asked: "Ignoring any normal seasonal variations at this time of the year, how much have the revenues/sales of your business changed over the last three months?"

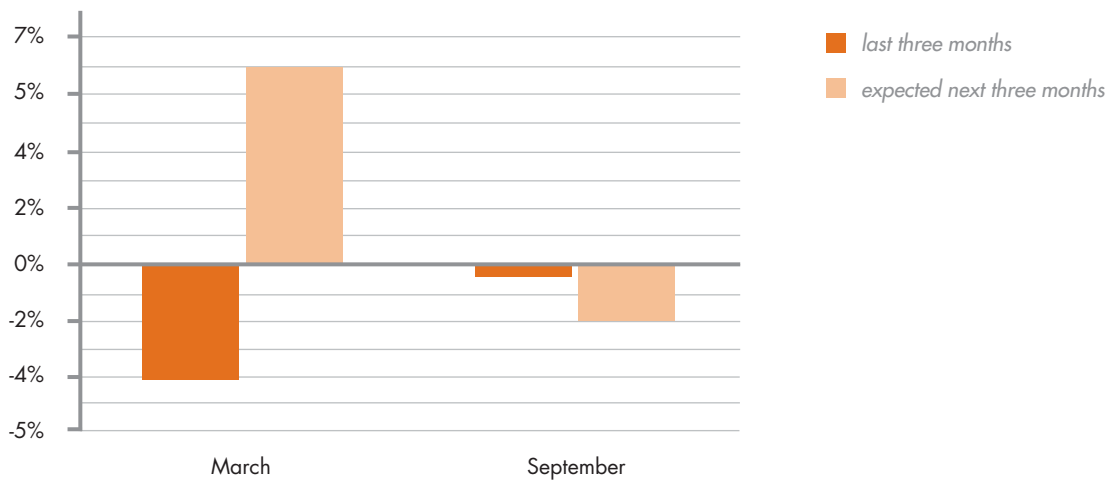
Employment intentions weaken in second half of 2010

With small business confidence in future prospects and revenue growth weakening over the latest quarter, it is no surprise that small firms recruitment plans have become increasingly cautious. Over the last three months, 11.4% per cent of businesses reported an increase in the number of people employed, while 11.8% reported a decrease. So, a net balance of 0.4% of businesses recorded a decline in employment, up from 3.7%, reporting a decline over the

three months to March (see Figure 5 below). This corroborates official data that showed improvement in the labour market through the first half of the year. However, more recent official data has pointed to a weakening in the labour market recovery. Claimant count unemployment rose for the first time in August since January, while job vacancies fell to their lowest level since the three months to December in the three months to August.

The FSB's 'Voice of Small Business Index' illustrates that private sector job creation remains muted as businesses are cautious about the strength of the recovery and concerned over a double-dip recession. In September, the weighted proportion of firms expecting to increase employment over the next three months was 8.7%, but 10.4% of firms expect to decrease employment. Hence, the net expected change in employment is 1.7%. This compares with a positive balance of 6.1% in the March

Figure 5: Net change in number of people employed – last three months, and expected over next three months



Source: FSB 'Voice of Small Business' Panel Survey (September 2010)⁶

⁶ Net improvement is defined as the percentage point difference between the number of businesses who feel that prospects over the next three months will improve, and those who feel that prospects will be worse.

survey, when 12.2% of businesses expected to increase employment over the coming months.

So, while the small business labour market improved in the three months to September, compared with the three months to March as the economy recorded robust growth in the second quarter of the year, businesses have become more cautious about increasing headcount. The evidence from

the FSB's *'Voice of Small Business Index'* means it looks likely that the labour market recovery will lose some momentum in the second half of 2010. As such, further increases in the rate of unemployment are possible despite the marginal decline in unemployment in August shown in the latest Office for National Statistics data. Furthermore, we expect the labour market to be weakened in the coming years as the effect of public sector spending cuts take effect.

Methodology

This report is based on the September 2010 FSB 'Voice of Small Business' Panel survey of FSB members. All panel members (4,483) were invited to take part in an online survey. Reminders were sent to all non-respondents. 1,304 responses were received, a response rate of 29%. The data is weighted to the profile of small businesses across the UK and accounts for the slight variation in results from the FSB's 'Voice of Small Business' survey panel.



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