All Party Parliamentary Small Business Group

An Inquiry into Productivity and Small Firms

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Acknowledgements

We would like to thank all the witnesses who gave oral evidence and the organisations who submitted written evidence. We would also like to extend our gratitude to the staff at the Federation of Small Businesses for their support.

Foreword

Despite increasing UK economic growth, productivity levels continue to lag behind our competitors with UK productivity nearly 20 per cent lower than the average for G7 countries. This is affecting competitiveness, earnings and our potential to generate higher economic growth.

The debate on productivity has mainly focused on the macroeconomic causes and solutions. Small businesses are the lifeblood of the UK economy. If we are to improve our productivity levels there needs to be a small business focused solution.

During the course of this inquiry we have had the pleasure to hear from a wide variety of different organisations from business groups, the education sector, to Local Enterprise Partnerships (LEPs) and academics. We would like to take this opportunity to thank everyone who submitted evidence to the inquiry, and to the Federation of Small Businesses (FSB) for providing the secretariat.

There was one thing we heard across all the evidence we received: we are not sufficiently capitalising on our resources and the Government needs to act to boost productivity levels.

We need to rebalance the economy to maximise our output across the country. There is a marked difference in the productivity levels of London and the South East compared to the rest of the country. It needs to be easier for firms to both physically and virtually access customers. We need more investment in productive capital and for infrastructure to be delivered - not just announced by the Government.

Broadband has become a vital service for small businesses to compete and grow. The disparity in coverage across the country and particularly in rural areas can be seen as evidence of a digital infrastructure policy that is no more than a work in progress. To enable more of our businesses to compete in global markets, the Government must be far more ambitious than the current targets.

It is not just regional differences that are holding back our productivity potential. Across the country the education and skills systems are not delivering the skilled workforce businesses need. It is a travesty that so many young people are leaving schools and universities unprepared for the workplace. We need to address the skills gaps preventing small businesses from growing, aligning businesses and education, embedding employability skills into every school curriculum and encouraging more firms to invest in workforce training.

The ability of small businesses to access finance to invest and innovate remains a considerable barrier to growth. Small and start-up businesses also require support and advice to scale up and secure new commercial opportunities, both domestically and in export markets. The current plethora of support schemes makes it difficult for small businesses to navigate and although the Government has made steps to streamline support centrally, it could go further.

The present Government has taken a number of positive steps to support small businesses. However, if the UK economy is to remain competitive and deliver sustained and balanced growth in the future we must address the drivers behind our relatively low levels of productivity.

Our inquiry has found that there are many areas where a future Government could boost the performance and productivity of small businesses and in turn help more to become world-beating firms. This report sets out a blueprint for the next Government, whatever its colour, to finally address our historic productivity weakness and drive forward our economy in the years to come.

Brian Binley MP,
Chair of the Productivity Inquiry

Anne Marie Morris MP,
Chair of the All Party Parliamentary Small Business Group

Introduction

1. Following the financial crisis, productivity growth has weakened significantly. As the economy moves into recovery, it is essential that productivity levels improve. Even before the crash successive governments have attempted to boost productivity and on most measures it has remained consistently low relative to our key OECD competitors.
2. This suggests that despite a growing economy and evidence of a flourishing of entrepreneurial activity, there remains a structural productivity gap facing the UK. Much of the debate on the UK's poor productivity performance has explored macro economic causes and consequences. Relatively less attention has been paid to what has been happening at an individual business level, and even less within small businesses.
3. In May 2014, the All Party Parliamentary Small Business Group launched a wide-ranging inquiry into drivers of small business productivity. It took evidence from a variety of organisations, including academics, businesses, Government departments, non-governmental bodies and others with expertise in this area.
4. This report presents the main findings from the inquiry. It argues that the Government has a critical role to play in supporting the productivity growth of small businesses, by creating the right environment for businesses to grow and invest and by breaking down barriers to enterprise. This includes improving access to finance, ensuring the tax system encourages productive investment, fostering innovation and technology development, investing in critical infrastructure, creating skills and education systems that meet businesses requirements, and streamlining business support.
5. This inquiry has sought to identify practical solutions to UK's productivity gap and set a challenge for the next Government to finally address this long-standing weakness. Our goal must be to create a business environment that will nurture and support productive enterprise and, in so doing, help to boost the overall productivity performance of the UK economy.

Summary of the key recommendations:

- Policymakers should address information gaps for both finance providers and small businesses, which impedes the provision of finance and in turn prevents firms from investing. Business current account data should be more accessible, with an industry-wide solution needed to improve access to credit data for those seeking to provide finance to SMEs.
- The Government should continue to promote alternative forms of finance and provide long-term backing for the British Business Bank. This will give it the means to promote non-bank finance and ensure there are a variety of finance options to meet the needs of businesses at different stages of their life cycle.
- The business tax system needs to be simplified and structured in a way that consistently encourages business investment. The Annual Investment Allowance should be set at an attractive but stable level for the long term to facilitate investment.
- The Government should proactively identify regions and projects where capital investment in infrastructure can deliver increases in productivity and act swiftly to deliver these projects. Improving east to west connectivity in the North of England and other regional connections will help rebalance the economy, and increase productivity in areas outside of London.

- The Government must ensure that high quality broadband services are available at a reasonable price to small businesses throughout the UK. This will require far greater policy ambition to drive forward future investment in broadband infrastructure, alongside reforms to the telecoms market. Failing to embed this ambition within future infrastructure policy and delivery will result in Britain becoming increasingly uncompetitive within the global marketplace.
- Local Enterprise Partnerships (LEPs) should be strengthened and developed into effective agents of regional economic growth in England. The Government should improve transparency and accountability mechanisms and streamline LEP funding arrangements. LEPs should adequately consult their local small business community in the design of business support programmes, to ensure that public funds are being targeted effectively and nurturing high-performing local firms.
- The Government should proceed with its review into the system for applying for Research and Devlopment (R&D) tax credits; exploring options to simplify the application process and promote the scheme to thereby improve uptake among a greater number of small businesses.
- The Higher Education Innovation Fund should be increased to £250 million, as recommended by the Witty Review, while the option of introducing a dedicated translational funding stream to support greater collaboration between Universities and businesses should be given serious consideration.
- Schools and colleges should devote resources to careers education and the Ofsted inspection framework should place greater weighting on the delivery of a broad skills base across functional, workplace and interpersonal skills.
- The Government should target business support on boosting leadership and management capabilities in small firms. It should also support firms to undertake an annual skills audit to ascertain if they are making the best use of their workforce to meet the business's strategic aims, and identify cost-effective opportunities for training and up-skilling.
- The Government should establish a UK Small Business Administration (SBA) with a direct reporting line into 10 Downing Street or the Cabinet Office, to provide a strategic and coherent small business policy framework and help streamline the business support offer for small firms. To better target support, and to increase awareness of the Government schemes in place, the Government should also adopt a more commercial approach to the marketing and branding of business support.
- The Government should commit to an ambitious target for direct public procurement spend with small businesses in the next parliament. To complement this, the National Audit Office should publish annual performance data on spending with small, medium, and micro firms, covering all procurements over £500, for all UK public bodies. The Government should also review the impact of supply chain engagement processes on the performance and productivity of contract-winning businesses.
- The Government should redouble its efforts to get a greater number of small and start-up businesses exporting. UK Trade and Investment should be equipped with sufficient resource in the medium to long term to support small firms and first-time exporters. The British Business Bank should play a greater role in the provision of export finance to small and medium sized businesses, including export credit guarantees.

The UK's productivity performance: An overview

Overall productivity of the UK economy

1. The UK has a long-standing productivity gap with its international competitors. Productivity as measured on an output per hour basis was 17 per cent lower than the average for the rest of the G7 in 2013, according to provisional estimates[1]. This is the widest the gap has been since 1992. Similarly, output per worker was 19 per cent lower than the G7 average in 2013. Taken together, the UK has the lowest level of labour productivity in all of the G7, with the exception of Japan.

2. Output per hour in the UK fell slightly in 2013 compared to 2012, in contrast to the rest of the G7 where output per hour increased by one per cent on average. This continues a trend since 2007, where UK productivity gap with our competitors has progressively widened.

3. The UK's historic productivity lag in relation to our competitors can be explained by various factors depending on the growth accounting measure used[2]. For instance, the gap with our European counterparts, such as Germany and France, is explained by levels of tangible investment or specifically the amount of capital produced per worker. By contrast, the gap with the US is primarily accounted for by differences in Total Factor Productivity, namely levels of innovation, competition, ways of working and entrepreneurship. Average skills levels – both intermediate and higher - also help to explain part of the gap with Germany, France and the US.

4. The financial crisis and subsequent recession has had a severe impact on productivity growth in the UK. Although output per hour is at roughly the same level as it was prior to the recession in 2007, it is 15-16 percentage points below what it would have been had pre-recession trends in productivity growth continued[3]. Unlike previous recessions, the economy has not experienced a rebound in productivity growth as GDP growth began to recover, leading economists to refer to what is now commonly known as the UK's 'productivity puzzle'.

5. A number of factors have been put forward to explain the causes of the ongoing weakness in UK productivity growth. These include the collapse of the financial sector, labour hoarding by employers during the initial phase of the downturn, the composition of the UK labour market, misallocation of capital, low levels of investment and falling real wages exacerbated by strong employment growth. Data measurement issues may also partially explain the productivity shortfall, however analysts at the Bank of England have concluded that other factors listed above are likely to be a stronger determinant[4].

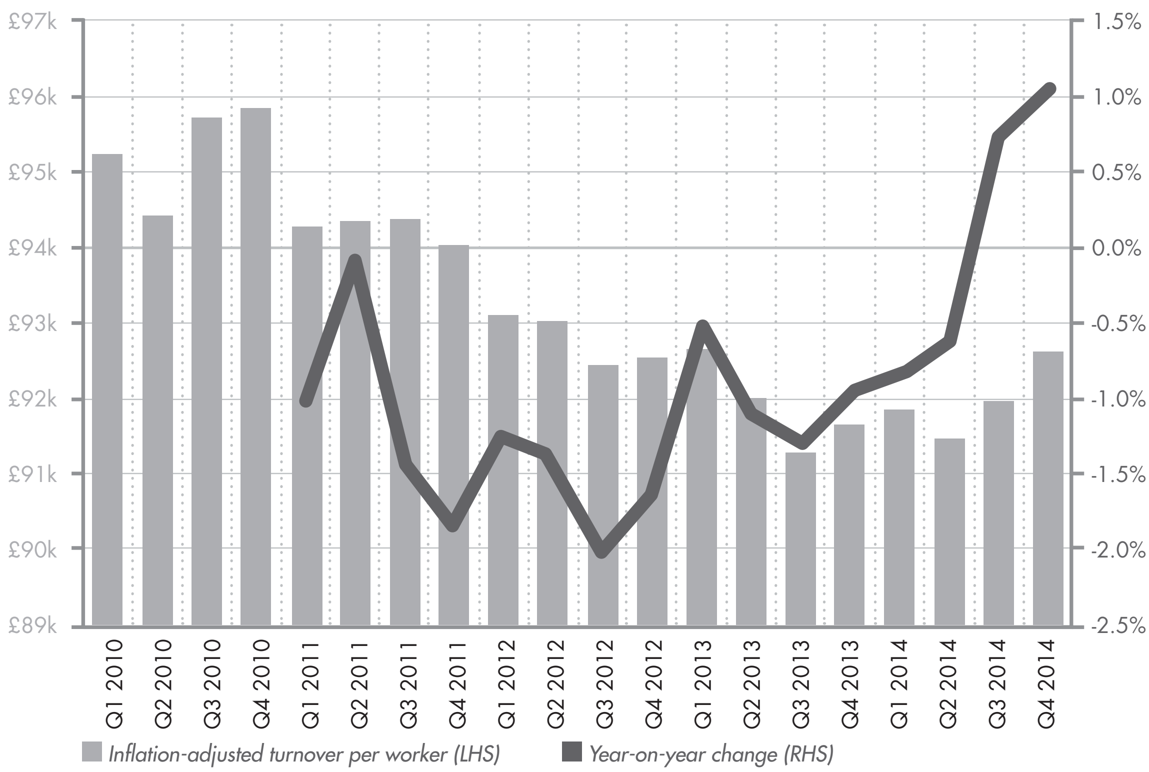
1 Office for National Statistics, International Comparisons of Productivity – First Estimates, 2013
2 HMG, Written evidence
3 http://www.ons.gov.uk/ons/rel/productivity/labour-productivity/q2-2014/index.html
4 http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2014/qb14q201.pdf

Small businesses and firm level productivity

6. Small and medium-sized enterprises today account for 99.9 per cent of all businesses in the UK, 47 per cent of private sector turnover and 60 per cent of private sector jobs[5]. Given their significant contribution to the economy, small businesses are by definition critical to boosting aggregate productivity levels in the UK. At the same time, dynamics within or affecting small firms may help to explain the current sluggish growth in productivity.
7. While these assumptions would appear indisputable, the literature on productivity and small businesses is relatively limited. This is in part due to a lack of detailed firm level data to allow for rigorous quantitative analysis on the productivity characteristics of small businesses. Most of the available data either involves large samples with limited information or on the other hand, detailed datasets with limited coverage among small firms[6].
8. In response to this, the FSB has developed a productivity indicator for the FSB quarterly 'Voice of Small Business' Index. According to latest figures, productivity measured on this basis (turnover per employee, inflation adjusted) grew year-on-year in the second half of 2014 for the first time since comparable data began in 2010, rising by 1.1 per cent in the year to Q4 2014. This is an encouraging sign for the both economy as a whole and workers in particular, as wage growth is typically linked to productivity increases. However, overall turnover per worker is still significantly lower than that seen in 2010, as the graph below demonstrates[7].

Chart 1 – small business productivity

Small business productivity and year-on-year change (inflation adjusted turnover per employee)



5 BIS Population estimates, 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/377934/bpe_2014_statistical_release.pdf
6 Mark Hart, Written evidence
7 FSB, Voice of Small Business Index – Q4 2014, December 2014

9. Notwithstanding the lack of quantitative data on small firms and productivity, a number of important insights can be gleaned from existing academic research. Firstly, start-ups can be an important source of competition, which in turn can drive productivity improvements across the economy. Through the process of 'creative destruction', a term coined by the economist Joseph Schumpeter, new market entrants place pressure incumbents to improve their productivity and in some cases can displace less productive firms. Schumpeter's theory proposes that over time higher rates of business 'churn', where less productive firms are replaced by more productive ones, lead to higher aggregate productivity levels[8]. This suggests that businesses that are not subject to the same degree of competitive pressure – either owing to the market or region in which they operate – are likely to experience slower productivity growth or become less productive over time.

10. At the individual firm level, productivity is a good indicator of business performance and survival. It determines a firm's profitability and influences their ability to invest, innovate and compete in markets both at home and oversees. The productivity of a firm also has an impact on its growth potential.

11. Evidence from NESTA[9] suggests that firms that exhibit high total factor productivity are more likely to experience high growth in sales. So called 'high growth firms' account for less than one per cent of the business population, yet they created 36 per cent of new net jobs between 2008 and 2013[10]. Many of these firms are small or medium sized businesses, or at least started off as small firms. According to Mark Hart at Aston Business School, high growth is 'a self-reinforcing process… where more productive firms are more likely to achieve high growth status and in turn high growth firms are more likely to achieve higher productivity growth'[11].

12. Not all businesses will achieve high sales or productivity growth. In the short term, start-ups are unlikely to be operating at their full potential productive capacity. Evidence from the US suggests that productivity levels converge between different age cohorts of business after five to ten years' time, but productivity in the early stages of business formation is weak compared to established firms[12].

13. Furthermore, the rate of start-ups in the UK does not appear to have a tangible impact on productivity levels. The rate of start-ups has remained steady since the downturn averaging just over 400,000 per year[13] at a time when productivity growth has fallen. At the same time we have seen a surge in self-employment – which now accounts for 15 per cent of the labour force, up from 13 per cent since the start of the recession. While much of the recent growth in self-employment may signal a burgeoning of new entrepreneurial activity, it may not necessarily translate into higher levels of productivity. Indeed, the Monetary Policy Committee of the Bank of England has suggested that it is inclined to believe that a least some of the self-employed are underemployed and not using their full productive potential, which may have a bearing on aggregate productivity levels[14].

8 See also HMG, Written evidence
9 http://www.nesta.org.uk/publications/high-growth-firms-and-productivity-evidence-united-kingdom
10 ERC, Written evidence
11 Ibid
12 Jensen, J., McGuckin, R. and Stiroh,K., 'The impact of vinatge and survival on productivity: Evidence from cohorts of US manufactoring plants, May 2001
13 Banksearch / HMG, Written evidence
14 April 2014 minutes http://www.bankofengland.co.uk/publications/minutes/Documents/mpc/pdf/2014/mpc1404.pdf

14. Productivity also varies significantly by sector in the UK. Output per worker is higher in sectors such as telecommunications compared with food services and accommodation. This may be explained by comparative skill levels of workers, with the former typically associated with higher skilled work than the latter. However, the evidence suggests that the UK's productivity gap with other countries owes more to poor productivity performance within sectors, rather than the sectoral mix of the economy[15].

15. According to Government estimates[16], the top 10 per cent of manufacturing businesses are more than five times as productive as the bottom 10 per cent – a trend that is similar, although less prominent, in other countries such as the US. It has been suggested that this is a result of a misallocation of resources to lower productive businesses and possibly a slower pace of reallocation to higher productive business through levels of competition and other external influences.

16. Lastly, Government policy and regulations impact upon a firm's ability to grow, invest and improve its productive capacity. The Government's joint submission to this inquiry points out that high levels of productivity in the US may be linked to the size of the economy and the ability of US firms to access a very large single market relatively unhindered[17]. Similarly labour or product market regulations can effect business growth and therefore productivity, for instance regulatory thresholds or exemptions according to business size can artificially restrict business growth[18].

17. Government policy is also critical in shaping the business environment, in areas such as the availability of finance, the effectiveness of business support, skills provision and access to infrastructure. All can affect on a firm's ability to do business and ultimately boost their performance. These areas form the focus of the remainder of this inquiry.

15 HMG, Written evidence
16 ibid
17 While there are differences in regulatory regimes between US states, they do not appear to pose significant barriers to market access across the US. HMG, Written evidence.
18 See for instance, Garicano, L., LeLarge, C. and Van Reenen, J. (2012), "Firm Size Distortions and the Productivity Distribution: Evidence from France", Centre for Economic Performance discussion paper No. 1128.

Drivers of small firm productivity: Access to finance and business investment

1. There is widespread evidence showing that business investment is an important driver of productivity. It was one the 'five drivers' of productivity set out by the Labour Government in 1997, with much analysis and policy action undertaken to raise the UK's performance on investment.
2. Efforts to raise investment have remained a central policy objective of successive governments, though the focus has not always been on smaller companies. Despite those efforts, on a business investment to GDP ratio (measured by gross capital formation), the UK continues to perform poorly compared to other OECD countries. In the context of this inquiry, it is worth noting Eurostat figures which show UK SMEs only contributed 38 per cent of total tangible business investment in 2012, a lower share than other EU countries[19].
3. While UK firms tend to perform better on measures of intangible investment, such as in software and organisational change[20], our historical weakness on tangible investment which has continued since the recession remains a cause for concern.
4. The underlying causes behind this relative underperformance of UK firms are widely documented and will not be repeated here. This chapter instead focuses on the link specifically between access to finance and investment, where further measures could be taken to raise performance. It also notes the tax environment as important though this did not feature prominently in the evidence put to the inquiry. It is nonetheless widely considered to be an important aspect to incentivising both investment by firms, and to attracting investment from outside investors into firms with promising growth prospects.

Access to finance

5. The ability to obtain finance, and of the right type for their stage in the lifecycle, often determines whether or not a firm will grow. Since capital is needed to fund investment, it is also a pre-condition for business investment, and therefore for individual firms' ability to expand and raise their productivity. By the same token, a lack of access to external finance can constrain cash flow and ultimately hamper businesses' investment and survival prospects.
6. In this context, the FSB among others has noted the important role of payment practices and the growing issue of late payments, particularly by large companies towards their suppliers. This can have a significant impact on affected firms in terms of their profitability, as well as their ability to plan and invest.

19 European Commission (2014) 'Annual Report on European SMEs' (Database for the Annual report) http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/supporting-documents/2014/annual_report_database.zip
20 See for instance Goodridge, Wallis and Haskell 2014, http://www.nesta.org.uk/sites/default/files/1402_working_paper_-_uk_investment_in_intangible_assets_report_for_nesta.pdf

7. Late payment harms cash flow, which in turn inhibits investment in capital and resources. Research from Bacs confirms that the debt of overdue invoices for SMEs now stands at approximately £32.4 billion[21]. Furthermore, it is estimated that the average business with less than 250 employees is currently owed around £32,000 in unpaid bills. Action to address this issue must be a priority for the Government[22]. Essentially, late payment amounts to de facto capital held by larger firms to invest in their own activities to the detriment of their suppliers. It can also delay payments through the supply chain to the detriment of other firms. The inquiry committee recognises the measures in the Small Business, Enterprise and Employment Bill to address late payments, but more needs to be done. The current imbalance of power that exists in the relationship between creditors and debtors needs to be addressed, with small firms being given a clear legal justification if they decided to seek redress or reject unfair payment terms.

8. Looking at finance from external sources, evidence shows that only 15 per cent of small businesses are currently seeking or have used external finance in the past year. Around 60 per cent of smaller businesses do not use formal sources of external finance, instead relying on trade credit from their suppliers or retained earnings[23].

9. Of those that do seek external finance, debt finance continues to dominate. Equity finance is far less common with only around one per cent of SMEs using this type of funding. Similarly, the proportion of SMEs obtaining finance from peer to peer lending platforms and crowdsourcing is currently very low at less than one per cent each. This is in part due to the recent arrival of these providers into the market and therefore low awareness among firms of their services.

10. Lack of awareness of alternative funding options when compared with bank finance has been identified by a number of studies, including Government commissioned research[24]. As a result of this, some SME customers make alternative arrangements such as reappraising cash-flow requirements, using other credit lines (including personal loans and credit cards) or placing greater reliance on credit from suppliers.

11. Evidence provided to the inquiry from ICAEW, HSBC, Lloyds, and Funding Circle made regular reference to improving the ability of firms to identify a diverse range of external sources of finance other than the bank that provides their business current accounts. While alternative finance providers and platforms have grown in size and significance in the UK, facilitating £939 million in funding to individuals and businesses in 2013, this represents a very small proportion of the overall market[25].

12. A number of solutions have been put forward to increase the range of providers used by businesses, including making switching between providers easier, and putting in place a referral mechanism to guide firms to other providers should their initial finance application be declined. Funding Circle data shows that 50 per cent of businesses exploring finance with their bank do not reach the formal application stage, 61 per cent do not get to the formal rejection stage, and only 12 per cent receive a rejection letter from the bank[26]. Small businesses therefore need to be

21 Bacs news release, February 2015. Available at: http://www.bacs.co.uk/Bacs/DocumentLibrary/PR_Late_payments_are_forcing_businesses_to_make_tough_decisions.pdf
22 Ibid
23 BDRC Continental (2014) 'SME Finance Monitor Q2 2014' http://www.bdrc-continental.com/EasySiteWeb/GatewayLink.aspx?alId=8049
24 `See for instance BIS, 'SME journey towards raising external finance', Oct 2013. http://british-business-bank.co.uk/wp-content/uploads/2013/10/SME-Journey-Towards-Raising-Finance.pdf
25 Nesta, 'The rise of future finance', Dec 2013. www.nesta.org.uk/publications/rise-future-finance
26 Funding Circle, Written evidence

signposted to alternative lenders before the point of rejection. This would help to increase SME access to alternative finance options and enhance lending volumes.

13. In addition, HSBC suggested the lack of access to the VAT register makes assessing the risk of funding applications more difficult for finance providers. The consequence of that lack of information is that creditworthy businesses often struggle to access finance, while firms with poor credit records access funding.

14. Efforts are now being made by the Government and the industry to address these issues. These should continue, starting with granting access with appropriate safeguards to the VAT register by the credit rating agencies (CRAs) as well as measures to improve the transparency of the credit scoring process. Furthermore, the current seven day switching service for firms moving banks could be improved further, alongside a referrals mechanism which would also help to match businesses to alternative lenders and promote competition in the market. In a further effort to improve information and to match investors to firms with growth potential, Sherry Coutu[27] has suggested national data sets should be made available so that local public and private sector organisations can identify, target and evaluate their support to scale-up companies.

15. Improving information flows and helping lenders identify companies who might make use of finance more effectively will have two particularly important benefits for investment and ultimately productivity:

    - First, it should improve allocative efficiency – namely that resources are better allocated across the economy to more productive ends thereby increasing growth. Firms who are creditworthy and who have better survival and growth prospects should therefore have access to appropriate sources of finance. In that regard, recent modelling by HMRC[28] has shown the potential benefits of access to the VAT register by the CRAs.

    - Firms are more likely to be directed to providers who best match their needs. As set out below, this may go beyond purely financing requirements. Different external providers, and particularly equity investors, can bring significant expertise and knowledge that can produce significant growth dividends for the firm. However, as well as identifying providers, measures are required to address 'funding gaps' for ambitious businesses that may explain part of the relatively weak investment performance by UK firms.

27 The scale-up report on UK economic growth (November 2014) www.scaleupreportup.org
28 Report on use of non-financial VAT registration data in trade credit scoring (HMRC 2014) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/323121/Non-financial_VAT_registration_data_research_project_report.pdf

Incentivising business investment through the tax system

16. Tax plays an important role in encouraging investment by firms. Concerns have been raised, especially from larger companies, on the link between investment in plant and machinery and business rates. Firms have reported that the benefits of investing in upgrading their plant and machinery are eroded by the consequential increase in business rates. As many have argued, the business rates system needs reform and the Government has now committed to reviewing the system, and will be reporting back in 2016.

17. The Annual Investment Allowance (AIA) was temporarily increased to £500,000 at Budget 2014, a welcome 20-fold increase from 2011 when it stood at £25,000. This welcome step should incentivise greater levels of business investment. However the increase is temporary and due to end on 31st December 2015. Rather than regularly altering the rate, a high and, importantly, stable rate is needed to give firms certainty and allow them to plan their investments over a longer period.

18. Evidence from the Government to this inquiry highlighted the importance of investing in R&D. As chapter 5 outlines, R&D investment in the UK, both in the public and private sectors, has historically compared poorly with the UK's international competitors. Incentives have been provided to smaller firms to invest in R&D through tax credits, and were recently raised to 230 per cent of investment in the Autumn Statement 2014. However, firms have concerns about accessing the R&D tax credit, both in terms of its complexity and the exclusions from making a claim. In a recent survey, the FSB found that just one in fifty of its members had claimed the credit, with a tenth saying they had not claimed due to the complexity of the process[29]. A review into the application process that started in January 2015 was announced at Autumn Statement 2014. It will be important to see progress made in simplifying the system if a resulting uptake of tax credits is to occur.

19. On a broader note, the overall complexity of the business tax system can often deter productive investment by businesses. The Association of Independent Professionals and the Self Employed (IPSE) argued in its submission that one of the biggest drags on freelancer productivity is the tax system[30]. Similarly, the FSB has reported that the average small business spends over £3,600 a year complying with their tax obligations through accountants[31], payroll and tax software. As has been recognised by others, the current tax system needs to be simplified and structured in a way that consistently encourages rather than deters business investment.

29 FSB, Voice of Small Business Survey – Q1 2014, May 2014
30 IPSE, Written evidence
31 FSB, Voice of Small Business Survey – Q3 2013, September 2013

Alternative sources of finance

20. As noted earlier, evidence shows that most firms do not seek external finance. Of those that do, equity finance is rarely used with debt finance more appropriate. But as the Breedon review[32] indentified, equity, along with alternative channels for debt capital, can potentially benefit these businesses in the early stages of their development. While not the focus of his review, Breedon highlighted the importance of getting the right framework to stimulate investor appetite for equity and to lower the cost of raising such capital.

21. Some progress has been made to stimulate investor demand in equity. In their evidence, Lloyds highlighted the equity investments made by the Business Growth Fund (BGF), a fund worth around £2 billion established by the large banks at the time of the crash to invest in UK companies. BGF takes equity stakes typically valued at between £2-£10 million in companies it sees as having credible growth plans. A particular feature is that these investments are usually for at least five years – the 'patient' capital many commentators view as lacking in the UK.

22. The Government can also encourage external investors to invest in start-ups and small firms. The recent introduction of the Seed Enterprise Investment Scheme (SEIS), which dovetails with the Enterprise Investment Scheme established in 1994, provides both income tax and capital gains tax relief to investors who subscribe for shares in qualifying companies. The scheme is aimed primarily at early-stage start-ups, reflecting the particular challenges these firms face in raising capital. Indications are that the scheme is having some success, with the levels of equity investments and activity at seed scale rising from previous years. As such the scheme should be continued to provide certainty for investors and for the market to develop.

23. On the supply-side, the creation of the British Business Bank has added a further source of liquidity to the market, and has begun to address well-recognised market failures that have resulted in persistent gaps in the funding 'escalator', from seed funding through to more sophisticated venture capital funds. Assessing the investment risk in younger businesses, especially those operating in new markets or developing new technologies, is difficult. Investor appetite is therefore either limited or investment is offered on terms that the firm cannot meet. The effect is this lack of access to finance impacts on longer-term growth. The Government, through the BBB, can address these market failures by accepting low rates of return and higher risk, and thereby increase the supply of this risk capital to firms who offer significant growth upsides.

24. In the private sector, arguments have been put forward to encourage investments in 'peer-to-peer' platforms to further increase the supply of capital and diversify the market. In that respect, the consultation on ISA wrappers for peer-to-peer lenders is to be welcomed as is changing the treatment of bad debt for investments in peer-to-peer lenders announced in the Autumn Statement 2014. This was an aspect of the tax system that Funding Circle argued needed reform in their submission to the inquiry.

32 Boosting finance options for business March, 2012

25. In addition to providing capital, equity investors can also bring significant external expertise to a firm which in turn can boost their growth prospects and performance. This contrasts with debt finance, where lenders tend to take a more passive approach. Access to such expertise is important given the widespread evidence[33] of relatively poor leadership and management capabilities within firms, which has been identified as a key factor lying behind the UK's weak productivity performance, as well as profitability and survival rates. Lord Heseltine[34] highlighted this point in his 2012 report 'No stone unturned: in pursuit of growth', noting that limited leadership and management capacity among UK firms was a feature of the Competitiveness Reviews carried out by the Government in the 1990s and yet continued to persist well over a decade later.

26. Addressing this management capacity weakness among smaller firms, where individuals can have a bigger impact on firm performance compared to larger firms where impact can be diluted, remains an under-recognised issue. Improved managerial capabilities should also mean firms are more likely to attract the confidence of external investors. Unless it is believed that as a rule entrepreneurs are 'born and not made', and born with the management talents to grow businesses, ongoing efforts to develop these skills in the UK workforce will be needed.

27. This issue is explored in more detail in chapters 6 and 7, where the role and effectiveness of Government business support in raising capabilities in these and other areas is considered. The conclusion here however is that if equity finance can introduce greater management capabilities into firms, there should be benefits to promoting equity finance for reasons beyond boosting access to capital and diversifying sources of finance available to small businesses.

33 See for instance, Bloom, Nick and Van Reenen, John (2010) Human resource management and productivity In: Ashenfelter, Orley and Card, David, (eds.) Handbook of Labor Economics

34 Lord Heseltine, No stone unturned: in pursuit of growth (2012)

Recommendations

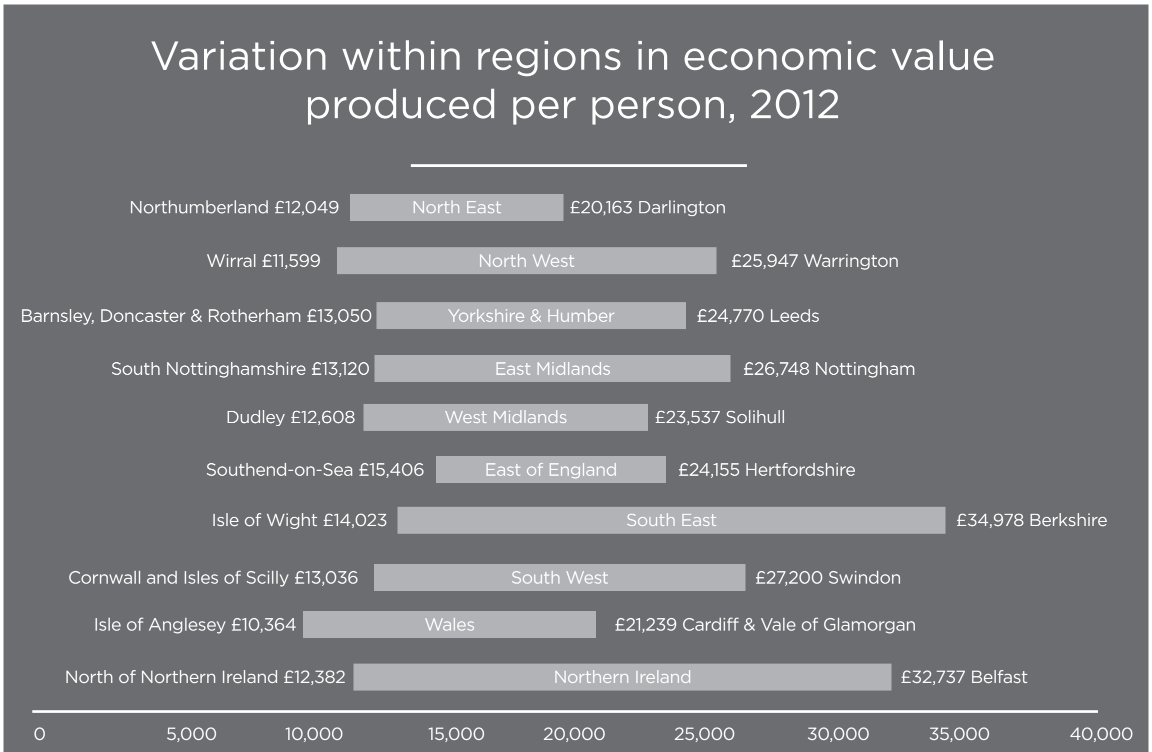
- Policymakers should address information gaps for both finance providers and businesses, which impedes the provision of finance and prevents firms from investing. Business current account data held by closed user groups within credit reference agencies should be opened up and support given to HM Treasury's proposals on the sharing of credit data to find an industry-wide solution to improved access to credit data for those seeking to provide finance to SMEs.
- The Government should develop a more comprehensive SME lending dataset that builds on the Bank of England's existing data sets, to get a more accurate picture of the SME financing landscape by firm size. This should seek to understand the reasons why 78 per cent of SMEs are classified as 'happy non-seekers of finance' and 85 per cent of SMEs are not approaching a bank to apply for credit. In addition, awareness of the lending appeals process should be raised among SMEs.
- The Government should continue to promote alternative forms of finance and provide long-term backing for the British Business Bank so it has the means to promote alternative sources of finance and ensure there are a variety of finance options to better meet the needs of businesses at different stages of their life cycle.
- Equity finance is a crucial enabler of high-growth businesses and should be promoted. There could be an educational role for the British Business Bank to assist more businesses to become 'investment ready' and attract equity investors. Policymakers should continue to develop and refine the EIS and SEIS schemes, and look at means to raise the overall level of equity investments in start-ups and firms in the early stages of their growth plans. Equity investors can bring management and other expertise into firms, and these opportunities should be maximised.
- To continue to increase competition and diversity of choice, policymakers should reduce barriers to entry by ensuring alternative finance providers are not at a competitive disadvantage relative to high street banks. This includes mandating signposting to alternative finance providers before the formal rejection stage and ensuring that supervisory and regulatory measures are proportionate.
- The business tax system needs to be simplified and structured in a way that consistently encourages business investment. The aim should be for the AIA to be set at an attractive but stable level for the long term to facilitate investment and provide certainty for businesses planning their growth strategies.
- The Government should tackle late payment practices by larger companies by enforcing a prompt payment limit of 60 days and strive for 30 days as good practice.

Connecting markets: Infrastructure and regional development

1. Businesses require modern infrastructure to connect with customers and suppliers, and secure new business opportunities. As the joint Government submission to this inquiry states, "infrastructure is vital to any modern economy. It drives growth, creates jobs and generates the networks which allow businesses and organisations to grow"[35]. It is therefore a pre-condition for business performance, growth and in some cases survival.
2. An absence of modern infrastructure capabilities, including high-quality transport networks and telecommunication services, makes it harder for firms to innovate and improve their productivity. The need for well-functioning infrastructure is well evidenced in existing research, including from the World Bank, which finds that infrastructure is a key ingredient for productivity and growth.
3. Economic geography can also have a significant impact on productivity. London and the South East benefit from economic and productivity benefits owing to the concentrated density of the region. In contrast, areas like Cornwall view the geographic feature of their region as a key fact of economic life[36].
4. The link between economic geography and infrastructure investment is well evidenced. Previous studies have identified significant disparities in the level of investment in infrastructure across the UK, with London and the South East receiving disproportionately large per capita investment compared to the rest of the UK. An IPPR North report found that per capita spending in London on transport projects was almost £2,600 per annum. By contrast, the figure was just £5.01 per annum for the North East. Outside the South East, the highest level of per capita spending was in the East Midlands at £218.94 per capita. However, this figure still amounts to less than 10 per cent of per capita spending on infrastructure in London[37].
5. Disparities in infrastructure investment have unsurprisingly meant different levels of infrastructure capacity across the country. This is likely to have had an impact on the realisable productivity within a given region. In its evidence to this inquiry, the university think-tank Million+ highlighted evidence that the UK had the widest disparity in productivity between its regions than any other country in the European Union[38].
6. Similarly, a recent report from the RSA's City Growth Commission found significant variation in the level of per capita gross value added both across the UK and within regions (see chart 2). This is backed up by evidence submitted to this inquiry by the York, North Yorkshire and East Riding LEP, which demonstrated the significant variation in productivity levels within the region they represent[39]. The RSA estimated that improving regional connectivity and broadband access, along with devolving political power to cities, could yield a five per cent growth in productivity[40].

35 HMG, Written evidence
36 Cornwall and Isles of Scilly LEP, Written evidence
37 IPPR North, 'Still on the wrong track: An updated analysis of transport infrastructure spending'. http://www.ippr.org/assets/media/images/media/files/publication/2013/06/still-on-the-wrong-track_June2013_10933.pdf
38 Eurostat data. Available at: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/1-21032013-AP/EN/1-21032013-AP-EN.PDF
39 York, North Yorkshire and East Riding LEP, Written evidence
40 RSA City Growth Commission: Unleashing Metro Growth. http://www.thersa.org/__data/assets/pdf_file/0009/1548090/Final-Report-Unleashing-Metro-Growth.pdf

7. Of note, and not reflected in this chart, is the extent of the difference in per capita GVA in London and the rest of the UK. Inner London (West) produced an average per capita GVA of £127,127, which is far in excess of any other region[41].



Note: Within Greater London, GVA ranges from £13,928 in Outer London (E&NE) to £127,127 in Inner London (West)
Source: RSA City Growth Commission

8. Evidence provided by Million + backs up the finding of the RSA report, and shows that there has been an increase in this regional gap in GVA over the period 1997-2012. It also demonstrated the extent to which London continues to dominate in share of national GVA[42].

9. Rebalancing investment in infrastructure – and thereby allowing businesses to connect to larger markets and suppliers beyond their immediate locale - can help to unlock the productivity and growth potential of businesses across the UK, and boost GVA both within and between regions. In contrast, constraints on infrastructure provision can deter inward investment and job creation. If areas outside of London and the South East are to begin to match the productivity of those regions, a significant rebalancing of infrastructure spending across all transport modes is required.

10. The Government has taken steps to address this through its latest National Infrastructure Plan. However, funding for infrastructure is still weighted towards London and the South East. Future regional infrastructure projects must be planned well in advance to ensure that sufficient skilled labour is available and that local firms can benefit from regional infrastructure spending – for instance, in being able to access procurement opportunities throughout the supply chain[43].

41 RSA City Growth Commission: Unleashing Metro Growth http://www.thersa.org/__data/assets/pdf_file/0009/1548090/Final-Report-Unleashing-Metro-Growth.pdf
42 Million +, Written submission
43 National Infrastructure Plan 2014. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/293688/PU1656_Infrastructure_Finance_Update.pdf

11. Projects such as HS2 and the Northern Hub have the potential to boost connectivity in the North and help rebalance the economy. However it is notable that HS2 will also provide better connectivity to London and may not yield the same rebalancing as the Northern Hub development could do. Both the Prime Minister and Chancellor have embraced the recent report by David Higgins, which called for significant investment in northern transit options[44]. Further, and as underlined in discussions around LEPs below, it is clear that improved transport connectivity is a necessary but not sufficient condition to rebalance growth away from London and the South East. A concerted co-ordinated effort is also required by key economic stakeholders in these regions for example local authorities, universities and LEPs, to encourage the relocation of economic activity to these areas.

Roads, Airports and Rail

12. As we have established, business growth and productivity relies on seamless connectivity amongst markets, customers, employees and suppliers. Transport connectivity is particularly important for areas where there is no central hub and where markets and consumers are geographically dispersed.

13. Investment in the road network is critical to facilitating business productivity. Research from the FSB has identified that for most small businesses, the road network is the most important means of transport[45]. The rail network and air capacity are also increasingly important to many small firms.

14. The Government recently published statistics showing the impact of congestion on households and businesses. It estimates that by 2040, traffic will have increased by 46 per cent, equating to 100 million working days lost annually. This will have a significant impact on productivity - meaning new approaches will be needed if businesses are to benefit from an adequate road network[46]. Furthermore, relatively small variations in total journey time can potentially have a significant economic impact. Evidence published by the University of Bath suggests that for every 100 additional minutes of travel time to London, productivity falls by around six per cent[47].

15. Bottlenecks and poor maintenance of the road network are two key issues that affect business productivity. The National Enterprise Network (NEN) argued in its evidence that "poorly maintained and inadequate roads with unreliable journey times has a negative impact on the productivity of small firms"[48]. This was viewed as being especially true for rural areas where public transport options are generally less developed than in urban settings, a point reinforced in evidence submitted by the Cornwall and Isle of Scilly LEP. NEN also argued that funding for the road network has often focused on frequent short term repairs rather than longer term investment – an approach which is inefficient and detrimental to road users[49].

16. The Government's Road Investment Strategy, announced in December 2014, will see £15 billion of investment in the road network in England by 2020 with earmarked projects taking place around the country. It is important that these projects progress on schedule so that businesses can reap the benefits.

44 Rebalancing Britain: From HS2 towards a national transport strategy, October 2014
45 FSB Infrastructure Survey, April 2013
46 Department for Transport, 2014: Roads Reform, transforming our strategic road network. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/367435/transport-roads-summary.pdf
47 Boddy, M. (2007) Meeting the productivity challenge in SW England
48 National Enterprise Network, Written evidence
49 Ibid

17. The Cornwall and Isle of Scilly LEP argued in its submission that better rail links are vital if that region is to benefit from high profile national projects such as HS2. In the view of the LEP, HS2 will connect cities which already perform relatively well compared to the rest of the country – as a result, other regions need to be able to access this network in order to benefit from the upgrade[50]. Aside from the road and rail network, air connectivity was also viewed as important to productivity, with several submissions to the inquiry arguing that regional airports need to be included within any future infrastructure strategies.

Broadband and Super-Connected Cities

18. The internet has fundamentally changed the world of business. Secure and reliable internet access, high upload and download speeds and increasingly, mobile connectivity, are integral to how business operates, regardless of sector or location.

19. Many of the organisations who responded to our call for evidence identified the positive impact that fixed and mobile broadband connectivity have on business productivity. In 2011, McKinsey estimated that SMEs would see a 10 per cent increase in their productivity just through using the internet. It also found that SMEs that were able to establish a strong online presence grew more than twice as quickly as SMEs which had little or no web presence[51].

20. In an earlier report, McKinsey argued that firms which embrace, what they term as 'Web 2.0 technologies' derive measurable benefits. Web 2.0 technologies are services which move away from static internet pages, and include tools like social media which enable interactivity and better collaboration. 69 percent of respondents to the McKinsey survey reported that their companies had gained measurable business benefits from using these technologies. These include more innovative products and services, more effective marketing, better access to knowledge and a lower cost of doing business, all of which contributed to the delivery of higher revenues[52].

21. Across a range of sectors, businesses that are online can also access - and compete in - markets unconstrained by their physical location. Furthermore, small businesses that are able to access the internet can benefit from a range of services and products which can help to improve productivity by enabling innovation within the business. Indeed, high quality broadband can drive productivity gains through supporting the development of newer, more efficient, business models. It can also enable the re-design of business processes to improve performance, such as facilitating outsourcing and greater use of digital marketing and advertising.

22. The importance of broadband services to small businesses was highlighted in a recent report by the FSB. It found that 94 per cent of their members viewed a reliable internet connection as critical to the success of their business. Small firms told the FSB that they also needed better upload speeds. The focus on download speeds is a function of the disproportionate attention paid by Government and regulator to the needs of the residential market where downloading data is viewed as more important. If the needs of small firms are to be met, the report argued that Government and Ofcom need to ensure that upload speeds are part of service level requirements in future[53].

50 Cornwall and Isle of Scilly LEP, Written evidence
51 McKinsey, Global Institute, Internet Matters: The Net's sweeping impact on growth, jobs and prosperity, May 2011
52 McKinsey, How companies are benefiting from Web 2.0, September 2009
53 FSB, The Fourth Utility, July 2014

23. In Cornwall, there has been a significant amount of European funding made available to support the roll out of Next Generation Access (NGA) services. A recent evaluation of this project suggested that 79 per cent of businesses saved both time and money as a result of having access to superfast services. Over half of the small businesses surveyed believed that internet access had allowed them to experiment with new ways of carrying out their business[54].

24. Furthermore, a recent report commissioned by DCMS suggested that greater availability of broadband would deliver significant gains in productivity. These include a two per cent reduction in the total UK commuting distance and a nine per cent reduction in the total UK business travel distance, delivered through an increase in teleworking. This report suggests that a doubling in broadband speed would lead to an average national productivity gain of 0.3 per cent, and a net GVA impact of £14 billion by 2024[55].

25. The productivity increases enabled through increased teleworking was viewed as particularly important by the IPSE, who stated in their evidence that insufficient broadband speeds are a key impediment to doing business for freelancers[56]. Research highlighted by The Work Foundation in its submission showed that in the US, SMEs which are 'born global' are more productive than other SMEs and large multinationals. Access to broadband was deemed crucial in allowing businesses to immediately interact with international markets[57].

26. There are several Government backed schemes, which are designed to improve the availability of super-fast broadband in the UK. While progress has been made, many organisations have expressed concerned that businesses are not able to access 'fit for purpose' broadband services and that the UK will fall behind international competitors as a result. There are significant disparities in the quality of the broadband services available in different regions of the UK – with poorer broadband access often found, although not exclusively, in rural or semi-rural areas. Businesses which are able to access high quality broadband services will be able to access the benefits which digital access offers, while firms which are unable to do so are likely to fall further behind in productivity and competitiveness.

27. A more ambitious strategy and commitment is required from Government to avoid this scenario. The FSB has called for a minimum service level floor to be introduced, starting at 10Mbps in 2018 and rising to 100Mpbs by 2030. In its view, the introduction of an ambitious service level floor would give investors the certainty they need to invest in the UK's broadband infrastructure that would be required to deliver this level of service.

28. In order to ensure that all businesses can access the productivity gains which high-quality broadband access promises, the Government must be more proactive in making fit for purpose broadband services available to all small businesses. This includes focusing new and existing support on connecting small businesses to super-fast broadband, including through the Super-Connected Cities voucher scheme which despite recent improvements remains heavily under-subscribed. The FSB also suggested that the needs of business parks should be given priority, as this will be the most cost effective way of increasing economic activity and productivity in the UK regions.

54 Superfast Cornwall evaluation report. http://www.superfastcornwall.org/about-sfc/research-innovation/superfastimpact
55 DCMS: UK Broadband Impact Study 2013
56 IPSE, Written evidence
57 The Work Foundation, Written evidence

Driving regional growth: the role of LEPs

29. In England, LEPs have a critical role to play in facilitating regional economic growth and boosting business productivity. LEPs were originally conceived as strategic bodies and their development since then has been organic. To a large extent, they have been left to decide what role they should play in relation to local businesses, and how they might foster a dynamic and productive small business community in their local areas.

30. Initially, some LEPs seem to have taken little interest in small businesses, whereas others went to considerable lengths to provide assistance to them. For example, the Humber LEP took advantage of the Regional Growth Fund to create a £30 million Business Improvement Grant scheme, and consulted small businesses to ensure it would be effective. Over 40 local small businesses have accessed the grant, with the average cost per job created for this funding significantly lower than the national average detailed in the National Audit Office's 2014 report on the progress of the RGF[58]. Similarly, the Northamptonshire LEP has developed a number of dedicated grants to support SMEs at different stages of their business cycle from start-up grants, rent-free periods and growth and innovation grants.

31. Lord Heseltine's report "No stone unturned: in pursuit of growth", combined with the decision to give LEPs responsibility for European Structural and Investment Funds, have placed SMEs at the heart of LEP thinking. A recent report by the Centre for Local Economic Strategies (CLES)[59] suggests that all 39 LEPs intend to deliver support activities to enhance the competitiveness of local SMEs. However, CLES also unveiled evidence of a mismatch in the demands of small business and the activities being delivered by many LEPs.

32. Commentary on LEPs to date has identified a number of factors inhibiting their performance. These include concerns regarding arrangements for ensuring appropriate standards of transparency and accountability, as well as level of resource and disjointed funding arrangements. The Forum of Private Business also suggested in its evidence that awareness of the LEP network among small businesses remains low in many areas.

33. Important insights were provided to this inquiry by many LEPs themselves. Cornwall and Isle of Scilly (CIS) LEP called for further localisation and rationalisation of the business support offering, and has recently established three Innovation Centres, focused on supporting growth, knowledge and innovation-led businesses in specific sectors. Support is offered to businesses at all stages of their journey from incubation through to mature enterprises looking to innovate and grow. Similarly, the South East Midlands LEP has also created a number of innovation centres to support innovative companies.

34. York, North Yorkshire and East Riding LEP has sought to address the "confusing mess" of business support schemes through its Growth Hub proposal. This uses local accountants, bank managers and professional advisers to deliver 'employment creating improvements' in businesses, and claims to have reduced the cost per job created from £10,000 to an estimated £1,000.

58 DCLG and BIS, Progress Report on the Regional Growth Fund, February 2014
59 CLES and FSB, The future of Local Enterprise Partnerships', September 2014

35. CIS LEP also emphasise the importance of the strategic role that LEPs can play in boosting small business productivity, for instance in areas such as transport provision. CIS LEP is seeking to address a range of transport issues as part of its Strategic Economic Plan, and has asked for greater devolution and integration of transport infrastructure through its Growth Deal proposals. However, while arguing that LEPs could have a valuable function in identifying areas to improve regional infrastructure, the York, North Yorkshire and East Riding LEP suggested that the differing capabilities of LEPs meant they cannot all be relied upon to provide strategic support for future infrastructure developments.

36. LEPs will have a significant influence over how more than £17 billion of public funds will be spent over the next six years, and as such they have an important role to play in regional economic development. Given the importance of small firms to regional growth, it is clear that all LEPs will need to have a clear focus on helping small firms to grow and improve their productivity. To this end, the Government should consider how to ensure that all LEPs are transparent and accountable, and how they can provide LEPs with greater clarity over their role and resources. They will also need to ensure that small businesses are embedded in LEP decision making to ensure that the support schemes aimed at them are fit for purpose and are help raise productivity in the SME sector[60].

Planning, business spaces and co-location

37. The planning system is often characterised as slow, complex and a significant impediment to boosting growth and productivity. HM Treasury's 2011 'Plan for Growth' cites the planning regime as a significant factor hampering the ability of UK firms to invest[61]. It also references evidence showing that, on average, it takes more than twice as long to build a warehouse in the UK as the USA, and that the gross costs of regulation associated with building office property are estimated to be 12 times higher in the City of London than in Brussels. Recent research by Reading University suggests that the costs to the economy associated with delays in processing applications are up to £3 billion a year[62], while Cheshire et al (2011) claim that planning policies have reduced productivity in the retail sector by approximately 20 per cent[63].

38. The planning system directly impacts on small businesses. Businesses are users of the system from which they may need a range of consents before they can commence certain forms of economic activity – namely, altering and expanding existing premises, and the construction of new developments. Here the complexity and unpredictability of the system causes delays and can generate substantial additional costs. In some cases these additional costs can lead to projects being abandoned. As such, the system can inhibit small firm productivity by frustrating their plans to invest and to grow.

60 See CLES and FSB, The future of Local Enterprise Partnerships', September 2014
61 HM Treasury, Plan for Growth, March 2011
62 Ball Michael, Housing Supply and Planning Control, January 2010
63 Cheshire et al, Evaluating the Effects of Planning Policy on the Retail Sector, January 2011

39. The planning system also impacts on small businesses indirectly through its wider impact on their business environment. This is manifested through the failure of the system to meet housing and transport needs, and by acting as a deterrent to those looking to invest in the country. This makes it more difficult to attract skilled workers and move goods and people effectively, while also dampening demand.

40. Planning reform was a clear priority in the Coalition Agreement and the Government has taken a vigorous approach to its attempts to address the problems through a range of measures including the introduction of the National Planning Policy Framework (NPPF), a review of the nationally important infrastructure regime, and a wide range of technical and administrative reforms all aimed at making it it simpler, clearer and easier for people to use. The intention to address the impact of planning on growth is clearly set out in the NPPF which requires local planning authorities to "set out a clear economic vision and strategy for their area which positively and proactively encourages sustainable economic growth" when drawing up their Local Plans.

41. This requirement is taken further by obligations on local planning authorities to work closely with LEPs and other authorities to maintain a robust evidence base on businesses' needs and to work closely with business to understand what these are and how they may change. It is only through working with businesses that local planning authorities can make plans that will facilitate rather than impede the adequate provision of employment, land and premises.

42. Through dialogue with the local business community it should be possible to identify opportunities for the planning system to facilitate the bringing together of businesses too, including through practices such as co-location and the sharing of premises. As digital technology and evolving forms of business have reduced the need for firms to keep large premises, more and more firms are turning towards co-location as a means of lowering overheads and boosting productivity.

43. While it is arguably too early to appraise the success or otherwise of the NPPF based system, other planning reforms do show some encouraging signs. CIS LEP notes in its evidence that it has secured two Local Development Orders at the airport to simplify the planning process to make it easier for businesses to relocate. However, not all reforms have met with such a positive response. London Councils state in their submission that the availability of affordable, flexible and appropriate premises is coming under pressure in London, particularly with changes to planning policy which allows the conversion of office space to residential use without planning permission[64].

44. Although there have been legitimate concerns over the potential impact of some of the planning relaxations, the overall response on planning reform to date has been cautiously positive. Small firms need clarity, predictability and efficiency from the planning system in order to be able to make investment decisions.

64 London Councils, Written evidence

Recommendations

- The Government should proactively identify regions and projects where capital investment in infrastructure can deliver increases in productivity, and act swiftly to deliver these projects. Improving east to west connectivity in the North of England and other regional connections can help rebalance the economy and increase productivity in areas outside of London.
- While public transport is important to many small firms, the road network remains the primary mode of transport and must receive investment at a level commensurate to this. The needs of rural areas must also be taken into account to ensure that benefits from regional infrastructure spending are felt outside of cities.
- The Government must ensure that high-quality broadband services are available at a reasonable price to small businesses throughout the UK, regardless of their location. This will require greater policy ambition for the rollout of digital communications infrastructure, as well as reforms to the telecoms market to deliver high quality broadband services to small firms. Failing to embed this ambition within future infrastructure delivery will result in Britain becoming increasingly uncompetitive within the global marketplace.
- Business parks should be prioritised in the roll out of super-fast broadband to ensure that these key drivers of the local economy nurture high-performing firms that are able to grow and compete internationally.
- LEPs should be strengthened to enable them collectively to develop into effective agents of regional economic growth in England. The Government should review its LEP policy with the intention of improving arrangements for transparency and accountability, and streamline funding arrangements for LEP capacity building and programme budgets. For their part, LEPs should consult small businesses in the design of business support programmes – to ensure that public funds are being effectively targeted at nurturing high-performance among local firms.
- The Government should continue to drive improvements in the planning system by incentivising uptake of powers to introduce Local Development Orders and monitoring the effectiveness of its changes to permitted development rights to ensure that they are operating as intended. Further consideration needs to be given to how the planning regime can facilitate evolving business practices, such as co-location and running businesses from home.

Innovation, technology and clusters

Innovation and R&D

1. Innovation is often associated with high-performing firms and productivity growth. Businesses that innovate are more likely to gain market share as a result of introducing new products or processes, or improve their own performance and productivity by reducing costs or other overheads. Academic evidence finds significant positive effects accrued as a result of innovation, particularly product-based innovation, on the revenue productivity of individual firms[65].

2. Several respondents to the inquiry highlighted the UK's poor performance on indicators of innovation, noting in particular that R&D spending, both public and private, compares poorly with many of our competitors and fell to 1.72 per cent of GDP in 2012[66]. While this does not tell the full story in terms of innovation-led economies, the relative and persistent lack of investment in research and development remains problematic. In fact, there is a strong case for the Government to commit to increasing long-term expenditure, and continue to use the tax system to incentivise private investment, as discussed in Chapter 3.

3. Innovation should not however be seen as synonymous with the technology industry or R&D. As CIPD point out in their submission to this inquiry, considerable innovation takes place in the form of workplace and organisational innovation and improvement processes for the delivery of traditional products and services[67]. Process-based innovation can yield tangible benefits to a business's bottom line and, as Jonathan Haskel has argued, goes beyond mere R&D activities to include investments in intangible assets[68].

4. The Intellectual Property Office (IPO) has highlighted the growing importance of intangible assets in helping firms access finance. It suggests that the UK finance sector needs to make greater progress in this area compared to other countries and recommends the development of a resource toolkit to help SMEs and lenders better value intangible assets[69]. There remain a number of challenges around the valuation of intellectual property by small firms, and how the finance sector can develop approaches to this, but there does need to be urgency on following these recommendations through. Intangible assets are the most likely form of security for new knowledge-intensive businesses, against which they can borrow to fund future investment providing suitable frameworks are put in place.

5. Reforms to the UK's Intellectual Property (IP) regime introduced as a result of the Hargreaves Review are welcome modernisations, particularly given the importance of IP in modern digital economies, with intellectual property rights intensive industries contributing 26 per cent of employment and 39 per cent of GDP in the EU[70]. However, some concern still exists around the difficulties faced by small firms in securing rights and enforcing them, with fees for advice often significantly higher than the basic cost of the application.

65 Hall B (2011) 'Innovation and productivity', National Bureau of Economic research working paper, http://www.nber.org/papers/w17178.pdf
66 ONS, UK Gross Domestic Expenditure on Research and Development, 2012
67 CIPD, Written evidence
68 http://www.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/contributions/lseGC_haskel_investment.pdf
69 Intellectual Property Office, Banking On IP? 2013
70 Intellectual property rights intensive industries: contribution to economic performance and employment in the European Union, European Patent Office and the Office for Harmonization in the Internal Market, 2013

6. Universities have an important role to play in enabling knowledge transfer to small businesses who can then benefit through innovation and increased productivity. Part of the expected benefit of research funding will be the knock-on impact on partners who collaborate with universities. However, in its evidence, Million+ identify a particular gap in support for translational research, developing practical applications from research, and have proposed the creation of a separate fund for translational research[71].

7. Several respondents to this inquiry also highlighted the Higher Education Innovation Fund (HEIF) as an important tool in supporting knowledge transfer. HEIF supports a broad range of knowledge-based interactions between higher and further education institutions and the wider world, and is designed to assist in both economic and social benefits. Professor Lynn Martin[72] suggested targeting the fund specifically at small businesses, and rewarding institutions who were successful in doing so, and Million+ called for increased funding to better take advantage of the fund's successes[73].

8. The current level of core funding for HEIF is £150 million, with an additional £10 million being provided to top performing institutions until 2015 The Witty Review recommended, among a number of recommendations which were largely adopted, that HEIF should be increased to £250 million[74]. While the Government have not been able to implement this increase due to the current financial settlement, it did in its response highlight independent analysis suggesting that each £1 spent on HEIF returned £6.30[75]. Given the broad support for an increase in the level of HEIF, and the overwhelming economic evidence of its effectiveness, there is a strong case for the Government to increase the overall level of the fund in line with the Witty Review.

9. Smart use of procurement opportunities is an important way to assist in the commercialisation of innovation. The Small Business Research Initiative (SBRI), based on the successful US Small Business Innovation Research Program, issues a number of challenges based on delivering innovative solutions to problems encountered by departments or non-departmental bodies. The winners of those challenges gain a lead customer, and receive funding for testing feasibility as well as retaining intellectual property rights, helping them to develop their innovations and make them commercially viable.

10. The Government has recognised the potential of SBRI, setting a target for total spend of £100 million in 2013-14 and £200 million in 2014-15[76], but is so far falling short of the promised level of expenditure. In part, this reflects a culture where the default is to choose larger suppliers. Changing such ingrained attitudes will take ongoing efforts. As this expenditure is departmentally-led, the onus is on the Government to ensure that targeted departments (MoD, Health including the NHS, Transport, Home Office, DECC, DEFRA) are delivering the promised investment. In particular, there is a need to ensure that where individual departments are failing to meet targets, this is made transparent and that immediate action is taken to address the reasons for the shortfall.

71 Million+, Written evidence
72 Professor Lynn Martin, Written evidence
73 Million+, Written evidence
74 Encouraging a British Invention Revolution: Sir Andrew Witty's Review of Universities and Growth, 2013
75 Government response to the Witty Review, 2013
76 HM Treasury, Budget 2013

Science and Technology

11. The Government has made important efforts to promote the research, development and commercialisation of new technologies through initiatives such as the Technology Strategy Board (now renamed Innovate UK) and by creating a series of Catapult Centres to focus on innovation and the deployment of new technologies.

12. As well as supporting innovative companies that develop new technology, there is a need to improve firm level productivity through ensuring mainstream businesses have access to productivity-boosting technology and possesses the skills to use it. This includes harnessing digital skills, building on the Digital Inclusion Strategy[77] set out by the Government to explicitly focus on the needs of businesses and enhancing productivity through use of digital technologies, with the Autumn Statement allocating an additional £61 million to High Value Manufacturing Catapult and £28 million for a Formulation Centre.

13. The Government has allocated £5.9 billion of capital investment into the UK's research infrastructure from 2016-21, setting out more detail on how this funding would be allocated at Autumn Statement 2014, including a £2.9 billion Grand Challenges fund to develop research facilities that are of national significance. This includes £235 million funding for the Sir Henry Royce Institute, specialising in advanced materials, £113 million in big data at Hartree, Daresbury, and £95 million towards the next European mission to Mars.

14. This investment is aimed at ensuring that the UK develops the capacity to commercialise ideas in areas where we have established expertise, and can make a significant contribution. Developing successful businesses from our world-class research base is crucial to our future economic success, so this investment is welcome, but it will have to be supported by a long-term strategy which ensures stable funding over a number of years.

15. A further area of importance for productivity is cloud computing, which has the potential to provide significant efficiency benefits through storage and working processes. However, cloud computing and its value to business is currently not well understood, while security challenges have limited the scope of this technology to date.

Clusters

16. Universities are important drivers for local and regional economic growth, and it is crucial that it is as straightforward as possible for willing businesses to forge links with universities. In many areas this is already the case, but examples of best practice should be replicated. In its submission to this inquiry, CIPD draw attention to the labour market impact on clusters, with firms in certain sectors gathering in certain areas with large numbers of workers with particular skills[78].

17. Clusters should be supported wherever possible, and support should be focused on areas where particular industries and research showcase tangible signs of development and commercial potential for UK Plc. IPSE gives the example of a cluster of tech freelancers in Brighton benefiting from initial government support to encourage networking and knowledge transfer, before

77 https://www.gov.uk/government/publications/government-digital-inclusion-strategy/government-digital-inclusion-strategy
78 CIPD, Written evidence

developing and transferring this capability to the private sector[79]. This shows the impact that support of clusters at the right time can provide. Equally, it reinforces the point that clusters do not have to involve major national initiatives, and can be effective as small locally-driven projects.

18. The work of Michael Porter has been influential in establishing how competition and collaboration within clusters is central to productivity, with advantages in areas such as the sourcing of inputs; accessing information, technology and institutions; co-ordinating with related companies; and measuring improvements[80]. He argues that in modern economies, competitive advantage, or how productively firms use inputs, has become more important than comparative advantage through established locational factors (for example low labour costs)[81].

19. This work has led to the development of mapping approaches such as the US Cluster Mapping Project and the European Cluster Observatory, which seek to map and analyse the various clusters that exist. There is a need to look much more systematically at where clusters are, and how their growth and success is influenced by policies. Cluster mapping is an important tool for policymakers in learning where their efforts to support clusters can be effective, and crucially to make sure that small businesses are at the heart of this strategy.

20. The Government has sought to support clustering through the creation of Enterprise Zones to drive regional economic growth. Firms located within Enterprise Zones can access several benefits, including business rates relief, simplified local authority planning rules and superfast broadband. However, only those within Assisted Status Areas are eligible for enhanced capital allowances. Given that these areas have been identified as potential drivers of regional economic development, enhanced capital allowances should be extended to all enterprise zones.

21. Catapult centres, which are themselves modelled on local research expertise, should help drive nascent industries located in clusters. Modelled on overseas examples, such as the German Fraunhofer network, catapults have as yet had limited time to demonstrate their effectiveness, but could help address barriers that inhibit the commercialisation of innovation.

22. However, catapults are necessarily niche and limited in scope, and will only be part of the solution of turning innovative ideas into commercial products and services. They can have a wider community role however through impacting the local economy and labour market, and in particular should seek to involve local small businesses in their engagement activities and through supply chains, as recommended by Hermann Hauser in his recent review of catapults for the Government[82].

79 IPSE, Written evidence
80 Porter, (1998), Clusters and the New Economics of Competition, Harvard Business Review
81 Ibid
82 https://www.gov.uk/government/publications/catapult-centres-hauser-review-recommendations

Recommendations

- The Government should proceed with its review into the system for applying for R&D tax credits, to explore options to simplify the application process, and promote the scheme. Both steps should help to improve uptake among a greater number of small businesses.
- Policymakers should focus on ways to support firms to undertake informal process-based innovation, and help them measure the value of intangible assets within their workforce. Support to undertake formal product innovation, such as patents and trademarks should also be prioritised, including through making the process of securing and enforcing intellectual property rights more cost-effective for the smallest businesses.
- Firms should be encouraged to harness the benefits of new technologies to maximise the scope for product and process innovation. This can be supported by Government-backed initiatives to foster digital skills, and extend the focus of this support to small firms across all industries and sectors.
- The Higher Education Innovation Fund should be increased to £250 million, as recommended by the Witty Review, while the option of introducing a dedicated translational funding stream to support greater collaboration between Universities and businesses should be given serious consideration
- Policymakers should make full use of public procurement to encourage and facilitate firm level innovation, and make sure that targets such as for the increased use of the SBRI are met. Where individual Government departments are failing to meet targets, this needs to be made transparent and immediate action taken to address the reasons for the shortfall.
- A far more systematised approach to developing regional economic clusters is needed, with small businesses at their heart. Policymakers should make more use of cluster mapping to inform their efforts to support clusters and ensure they are effective.

Skills and the labour market

1. Skills are key to boosting workplace productivity. Firms that have access to the right skills for their business are more likely to generate higher economic returns, innovate and grow.
2. There has been a desire from successive governments to promote and enhance the UK skills base. Research from City & Guilds found that over the past thirty years there have been 61 Secretaries of State responsible for skills and 13 major Acts of Parliament relating to this area. However, the instability of skills policy is exemplified by the fact that this policy area has changed hands between ten government departments over the past three decades[83].
3. This has led to a large and complicated skills landscape with a plethora of qualifications across all levels, delivered within a marketplace of awarding bodies. It could be assumed that increasing choice would lead to an increase in employer take-up. However, businesses across a range of sectors continue to report difficulties recruiting employees with the appropriate skills. Indeed, UK business leaders are more concerned about the availability of key skills than any of their western counterparts[84].
4. Despite the growth in the number of people undertaking further and higher education, the number of skills-related vacancies is rising[85]. According to the UK Commission on Education and Skills (UKCES), the shortage is more acute for small businesses, with a third of all vacancies in businesses with fewer than five staff described as hard-to-fill due to a lack of skills, qualifications or experience[86]. Similarly, recent research from the FSB finds that small businesses view skills shortages to be the third most significant barrier to growth, only behind wider economic conditions and access to finance[87].
5. Firms that experience persistent skills shortages will not be operating at their full productive potential. As well as being a drag on firm performance, there is evidence that this may in part account for the weakness in wage growth that we have seen in the UK[88] - although skills shortages in some sectors may inflate wages, most firms operating below their productive potential are unlikely to have the headroom to deliver sizeable wage increases without improvements in productivity. The disconnect between the skills being produced and the skills businesses require, as well as the ability of firms to up-skill their existing workforce, is therefore a significant problem with wider implications for the economy and as such merits significant policy attention.

83 City & Guilds, Sense and instability: Three decades of skills and employment policy, October 2014
84 PwC, A Talent Challenge: A time for extraordinary leadership, 2013
85 UKCES, Employer Skills Survey 2013, January 2014
86 UKCES, The Labour market story: An overview, July 2014. UKCES, Employer Skills Survey 2013, January 2014
87 FSB, Small Business Index – Q2 2014, June 2014
88 See the CIPD's 'Labour Market Outlook', Q2 2014

Responsiveness of the education system to employer needs

6. As the UK has strived to create a more skilled workforce, the education system has needed to evolve to keep pace with employer demand. Evidence received by the inquiry and previous studies have suggested that the education system too often falls short in preparing young people for the workplace. This is corroborated by survey evidence from employers, including a 2013 study conducted by UCKES which found that four in ten employers believe 16 year old school leavers lack basic job skills[89].

7. In addition to academic study, practical, workplace and interpersonal skills are increasingly important to employers. When recruiting, businesses increasingly look for skills such as team-working, communication and problem-solving[90]; skills that are formed and ought to be nurtured from an early age. This has prompted organisations such as Young Enterprise, through its '5 key skills' campaign, to highlight the importance of embedding these qualities within the education system[91]. However, neither the qualifications system nor the current inspection framework in England is currently designed to accommodate or explicitly promote employability skills, with funding dependent on the number of learners rather than sustainable employment outcomes. The long-term impact is a reduction in the quality of employability skills being gained.

8. Functional skills, such as English and maths, also remain important. According to the Institute of Chartered Accountants in England and Wales (ICAEW) poor numeracy is costing the UK economy up to £20 billion a year. Likewise, English and maths are regularly cited as vital basic skills needed by businesses[92].

9. Efforts to address UK productivity require a broad skills-based strategy that incorporates the development of functional, workplace and interpersonal skills. According to London Councils, it should also address structural problems with the skills system, including "insufficient labour market information, flawed incentives for skills providers, and over-centralisation of skills funding decisions"[93]. Beyond supply side considerations, there is growing recognition of the need to fully engage businesses in the education system, so that they can communicate their needs, help design qualifications, and support learners at all stages to gain skills that are recognised by and required by employers.

Building links between businesses and education providers

10. Business engagement in education establishments can lead to positive employment outcomes for young people and help employers identify and attract skilled young people when they leave education. In its joint submission, the Government stated that employer involvement in skills development is vital to "developing a workforce that is capable, agile and able to respond to the challenges presented by globalisation and new technologies"[94]. Despite this, more needs to

89 UKCES Employer Skills Survey 2013
90 CBI, Education and skills survey 2014, July 2014
91 Young Enterprise, 5 skills campaign - http://www.young-enterprise.org.uk/support-us/the-5-skills-campaign/what-is-the-five-skills-campaign/
92 ICAEW, Written evidence
93 London Councils, Written evidence
94 HMG, Written evidence

be done to incentivise and encourage businesses to develop links with education at all levels, particularly in schools.

11. Businesses traditionally get involved through direct engagement with schools, for instance by providing work experience. However, small businesses often find it difficult to engage. FSB research shows 20 per cent of small businesses cited restrictions from schools and colleges as a barrier to engagement. Worryingly more than 40 per cent of small businesses have no engagement with schools or colleges, citing time and cost as significant barriers[95]. Dawn Whiteley, Chief Executive of the NEN captured this mindset when she stated that "business owners had their heads down and were focused on the business and so it was very difficult for them to look at what might be around them"[96].

12. Despite restrictions on direct engagement, there is growing consensus around the benefits of businesses having more indirect engagement with the education system. School governance reforms are designed to attract more business leaders to become governors[97]. Moreover Ofqual has announced that it is requiring qualification bodies to consult businesses in the design and delivery of qualifications so that they meet the needs of business. Involving businesses in education can contextualise learning for students and increase the level of information, advice and guidance learners receive about employment pathways and skills requirements.

13. As stated in chapter 5, the higher education sector has considerable opportunities for small business engagement. However the small business footprint on UK campuses is not very big and large businesses tend to dominate[98]. This is likely to reinforce existing perceptions among students, with a recent NUS survey showing that 64 per cent of students said that it would look better to have a 'known' employer on their CVs, with only 16 per cent believing that their longer term career prospects would be better with SMEs[99]. Despite this, 77 per cent of students felt they would get more responsibility at a smaller employer and 61 per cent say they would learn more skills[100]. Through increased collaboration and direct engagement, students will be better informed about the opportunities available in small firms, while the latter will be harness graduate skills to support their growth aspirations and enhance their performance.

14. University education is not confined to young people. Over a quarter of all first year university students are part-time and nearly a third are aged over 21[101]. Life-long learning will be increasingly important to the economy and for productivity growth, against the backdrop of an ageing workforce. At the same time, CBI research suggests that higher level skills are growing in demand as the economy continues to recover[102]. Universities are well placed to offer flexible learning opportunities for employees of all ages, and businesses should be encouraged to facilitate learning and make use of university expertise.

15. Colleges have a long tradition of engaging with the local business community and are well placed to respond to local employer demand. As the 157 Group of colleges articulated, "the credibility of colleges with employers is tied up with what they offer and colleges must ensure

95 FSB, Voice of Small Business Survey – Q2 2013, June 2013
96 Dawn Whiteley, Chief executive NEN – Oral evidence
97 DfE, Constitution of governing bodies of maintained schools, May 2014
98 Ibid
99 National Union of Students, Smaller business – A positive career choice for graduates?, November 2013
100 Ibid
101 Higher Education Statistics Agency, 2012-13 statistics – www.hesa.ac.uk/stats
102 CBI, Education and skills survey 2014, July 2014

that the skills they deliver are the ones that the economy demands. This can be done only by close and systematic contact with employers"[103]. This approach can be applied to all levels of education, as closer collaboration will yield reciprocal benefits of employment and productivity gains.

Careers advice and enterprise education

16. The evidence received by the inquiry was unanimous in stating that high quality careers advice that explored vocational pathways, such as apprenticeships and traineeships, alongside academic routes is vital if the skills gap is to be addressed. The ICAEW told the inquiry that although the UK was making a marked change in the availability of vocational education routes, "more resources are needed to communicate the benefits of all career options to young people and businesses. This will provide businesses with the skilled labour-pool they need to expand and pull the UK out of low levels of productivity"[104].

17. Most careers guidance takes place with 15-16 year olds[105], with over 85 percent of pupils in this year group receiving some form of careers support in 2012-13[106]. However, subject choice decisions are made early on before a child has reached the age of 13. Engagement with careers education must therefore take place from an early age and include vocational options. This is important as 14 year olds can study vocational courses at further education colleges and university technical colleges. Evidence suggests that learners who study through vocational routes, such as BTECs (80 per cent), were more likely to be in employment than those that had studied A-levels (74 per cent)[107]. However, funding and reputational factors lead schools to focus on A-level provision over promoting vocational options to students. More needs to be done to educate teachers on the benefits of vocational education, so that we can begin to address the reputational imbalance between academic and vocational education.

18. Businesses have a vital role to play in the delivery of careers education. Research from the Education and Employers Taskforce found that a young person was five times less likely to be Not in Education, Employment or Training (NEET) if they had four or more employer contacts throughout their school life than those without contacts[108]. This is not being realised as schools often fail to engage with their local business community and do not invest sufficient resources in careers support, while the inspection framework in England does not weight employability sufficiently enough to incentivise education institutions to focus on it. This has led to a drop in the provision of effective careers guidance since schools were given responsibility for it and the abolition of compulsory work experience at key stage 4[109 110].

19. City & Guilds told the inquiry that pupils must receive better quality face-to-face careers guidance that explains the full range of career options available to them[111]. Currently many young people are not receiving the information they need to take the opportunities that best suit their needs and aspirations. Likewise it is important for teachers to have the support and training they need

103 157 Group, Written evidence
104 ICAEW, Written evidence
105 National Careers Service, Taking action: Achieving a culture change in careers provision, September 2014
106 The Pearsons Think Tank, A cloudy horizon: Career services in England: Careers 2020 phase two, September 2013
107 London Economics, The outcome associated with the BTEC route of degree level acquisition, May 2013
108 Education and Employers Taskforce, Employer contact at schools reduces likelihood of young people becoming NEET, February 2012
109 Education Select Committee, Careers guidance for young people: The impact of the new duty on schools, January 2013
110 Ofsted, Going in the right direction? Careers guidance in schools from September 2012, September 2013
111 City & Guilds, Written evidence

to promote the diversity of options for young people and connect with businesses. Failure to do so will hamper efforts to lower the skills gap.

20. As identified in Chapter 1, the supply of entrepreneurship to the economy can have an important impact on aggregate productivity levels. In order to reap the benefits of a growing entrepreneurial base, it is important that enterprise learning starts from an early age. According to the CIPD 18-24 year olds are most likely to consider setting up their own business but least likely to have done so[112]. There are many reasons for this, however reports published by Lord Young[113] and the APPG for Micro Businesses[114] both suggest that support and guidance for young people is often disjointed and devoid from the education system. Both reports call for the Government to have an overall vision for enterprise education and that it is embedded in teaching and learning. This is emphasised by the RSA, who have stated that "enterprise education can have a powerful impact in developing both the soft and hard skill sets of young people. Yet sometimes it is left on the margins of the curriculum, meaning it only reaches the most proactive students"[115].

21. Several organisations are undertaking positive efforts to promote enterprise learning in schools, which are yielding additional benefits for young people. One such example is Young Enterprise's 'Company Programme'. In 2013-14 over 21,000 pupils took part in the programme, with over 90 per cent reporting that they improved at least one employability competency. Communication, problem solving and resilience saw the greatest average point increase[116]. As the prospect of setting up a business is an increasingly popular pathway, it is critical that the benefits of enterprise learning are promoted throughout the education sector to equip young people with the business skills and acumen to succeed either as future employees or business owners.

Apprenticeships

22. Apprenticeships are an important means of addressing skills shortages and evidence has shown that taking on an apprentice can increase company performance. The Government's Apprenticeships Unit found that 70 per cent of employers report higher productivity and improved quality of product or service as a result of taking on an apprentice[117]. According to the Centre for Economics and Business Research (Cebr), an apprentice can increase productivity for a business by up to £200 per week[118].

23. The Government has endorsed the need for an employer-led approach to apprenticeship provision following the publication of the Richard Review of Apprenticeships[119] and is also giving employers greater ownership of apprenticeship standards through its Trailblazers programme. This marks an important step-change from the training provider-led model and should mean that apprenticeships are designed and tailored in a way that more adequately meets employer needs and, in turn, encourage more businesses to take on apprentices.

112 CIPD, Entrepreneurs: What can we learn from them?, May 2014
113 Lord Young, Enterprise for All: The relevance of enterprise in education, June 2014
114 APPG for Micro Businesses, An education system fit for an entrepreneur, February 2014
115 RSA, A manifesto for youth enterprise, October 2013
116 Young Enterprise, Young Enterprise Company Programme 2013-14: Impact report
117 BIS and DfE Apprenticeship Unit Presentation, November 2013
118 Cebr, Productivity matters: The impact of apprenticeships on the UK economy, March 2013
119 Department for Business, Innovation and Skills and the Department for Education, Future of apprenticeships in England: Richard Review next steps, March 2013

24. As the need for higher-level skills increases, so has investment in higher-level apprenticeships.[120] This has increased the pool of potential apprentices for business to capitalise on, alongside an increase in apprenticeship standards in non-traditional sectors; such as financial services, accountancy and cyber security. However, if the benefits of an employer-led apprenticeship framework are to be realised, it is crucial that employers have confidence in the value of the apprenticeship framework. The Government's vision for apprenticeships must be clear and understood by employers. Furthermore, the reforms must not create significant additional costs and burdens on small businesses that recruit apprentices. Responses to the inquiry urged caution in this regard and sought to remind Government that the changes must not disengage employers. Concerns were raised by the Electrical Contractors Association in their submission, who suggested that many of its members were inclined to reduce the number of apprentices because of concerns regarding the changes[121].

25. The FSB has argued that "any increase in the administrative burden on small businesses, any problems with the implementation of the reforms and any increase in the overall cost of apprenticeships for small businesses… will risk reducing the volume of apprenticeships in the short term"[122]. This was reiterated by City & Guilds who noted that the "risk of disengagement is greater among SMEs, among those firms that traditionally recruit small numbers of apprentices, and those in sectors where employers have traditionally been 'recruited' to the programme by providers. Hence it is likely to affect the level of apprenticeship uptake and by implication, productivity levels"[123]. Addressing these concerns will therefore be a priority for the Government as it rolls out the reforms.

Workplace training and up-skilling

26. When considering steps to boost business productivity through skills provision, the supply of skills is not the only factor to consider. Employers also have a key role to play in identifying and utilising existing skills effectively, and taking appropriate steps to up-skill their staff where skills gaps are identified.

27. The UKCES Employer Skills Survey 2013 found that 16 per cent of the workforce, or 4.3 million workers, had skills and qualifications above those required by their current role[124]. This widespread under-use of skills suggests that not all employers are taking advantage of and maximising the productive capacity of their workforce, and in many cases are also likely to be missing out on important growth opportunities.

28. Respondents to this inquiry argued that businesses should evaluate their own workforce regularly and identify employee training needs that have the potential to raise productivity levels. This is becoming increasingly important as technological advancements are changing working practices. Employees are also working longer and investment in training has to recognise the ageing of the workforce. Older workers can bring unique and valuable skills, experience and perspective to the business. At the same time, they may also require re-skilling and conversion training, in areas such as digital skills.

120 House of Commons Library, Apprenticeships Policy, March 2014
121 Electrical Contractors Association Apprenticeship funding reform technical consultation member survey results, 23rd April 2014
122 http://feweek.co.uk/2014/06/06/apprentice-chief-forces-home-cash-message-on-funding-reforms/
123 City & Guilds, Oral evidence
124 UKCES, Employer skills survey 2013, January 2014

29. There are well-rehearsed arguments why many firms do not undertake training, with a fear of 'poaching' by rival businesses often cited in the literature. However, increasingly firms realise that seeking opportunities to up-skill staff is important to their performance. In many small firms, this can happen organically as staff are often exposed to different facets of the business and learn 'on the job'. However, formal training can also bring significant benefits to firms.

30. There are incentives for businesses to enhance the skills of their workforce including tax relief for training. Furthermore, initiatives such as the Employer Investment Fund and the Growth and Innovation Fund are supporting the skills needs of both employees and employers. However, the UK is still lagging behind other countries when comparing levels of investment in the workforce. The Government's 'employer ownership of skills' agenda seeks to address this through creating an infrastructure for employer-led skills development and training, however the number of small businesses involved in this scheme to date has been low. The announcement in June 2014 to create a new £30 million Employer Ownership Fund for the engineering sector, targeted specifically at small and medium sized businesses, is therefore welcome[125]. More small businesses across all industries need to be engaged in this agenda and the benefits of work-based training promoted, so that they can harness the benefits of investing in skills.

Leadership and management skills

31. Management skills are vital to improving firm performance and productivity. Yet as has been highlighted earlier in this report, the UK has a long-standing weakness in this regard. Studies by Nick Bloom and John Van Reenen[126] among others have pointed out the existence of a 'long tail' of British companies lacking adequate leadership and management capabilities, including shop floor management and basic monitoring of people and processes. The Government also recognises this problem and in a 2012 report found that UK management capability is weaker on average than countries such as US, Germany, Japan and Sweden[127].

32. Better management practices are strongly associated with higher levels of competitiveness, including trade openness[128]. Effective workforce planning can also help mitigate the effects of skills shortages. For those businesses that do not undertake effective workforce planning, there is a risk of creating a 'low skills equilibrium'[129] which can inhibit productivity gains. Furthermore, the importance of well-being at work has been linked to higher performance, creativity and productivity. Indeed, there is significant body of evidence showing poor management and leadership skills is associated with lower levels of well-being and higher risks of workplace stress[130].

33. In its evidence to the inquiry, ACAS argued that investment in management skills is often overlooked in favour of technological and financial training[131]. This is particularly concerning for small firms as they are disproportionately affected by manager-level skills gaps and more likely to have manager-level skills shortage vacancies. Moreover, research from the Chartered Institute of Personnel and Development (CIPD) found that three quarters of organisations in England reported a deficit of leadership and management skills[132].

125 https://www.gov.uk/government/news/30-million-fund-to-secure-supply-of-engineers-and-boost-number-of-women-in-sector
126 See for instance, http://cep.lse.ac.uk/pubs/download/dp0716.pdf
127 BIS, Leadership and management in the UK – The key to sustainable growth, July 2012.
128 Bloom and Van Reenen, op cit
129 UKCES, Written evidence
130 ACAS, Future of Workplace Relations, discussion paper, 2012
131 ACAS, Written evidence
132 CIPD, Annual Learning and Talent Development Survey Report, 2014.

34. UK Commission for Employment and Skills (UKCES) told the inquiry "that the UK's managers are, by comparison with many of our major competitors, poorly qualified, both in general education and in leadership and management. This lack has been seen as a critical component of the UK's productivity gap and a major constraint on economic growth"[133]. To put the value of management training into context, a single point improvement in management practices is associated with the same increase in output as a 25 per cent increase in the labour force or a 65 per cent increase in invested capital[134].

35. Policymakers can do more to address this problem and provide existing businesses and start-ups with access to leadership and management capabilities and training. Lord Young raised this in his report, Growing Your Business, which called on business schools to take a lead on supporting small business growth ambitions and skills needs. The Small Business Charter is one way that local structures can provide businesses with advice, guidance and additional support such as start-up loans and growth vouchers.

36. Existing schemes to promote leadership development and management, including Growth Accelerator, should also be targeted at - and awareness raised among - a wider range of start-ups and small firms. At present, these schemes are accessed by businesses which self-identify as 'high-growth firms', which limits their scope, and are not widely marketed. This points towards the need for an effective business support offer from Government, while other bodies such as LEPs and finance providers may also be well placed to provide management advice and expertise to firms.

133 UKCES, Written evidence
134 BIS, Leadership and management in the UK – The key to sustainable growth, July 2012.

Recommendations

- The Government should ensure that schools and colleges devote resources to careers education, and require the Ofsted inspection framework to place greater weighting on the delivery of a broad skills base across functional, workplace and interpersonal skills.
- More small businesses and start-ups should be involved in educational governance, making use of representative bodies to encourage members to become governors of education institutions.
- The Government should ensure its apprenticeship funding reforms do not inadvertently affect take-up among small firms, while at the same time striving to deliver more high-quality apprenticeships. This can be achieved by making the majority of apprenticeships level 3 and above and investing more in traineeships and pre-apprenticeship programmes for entry to level 2 qualifications. At the same time, the Government should put in place a framework for continuous employer engagement in apprenticeship standard evaluation that focuses on the needs of small businesses, in order to build their confidence in the system and produce the skills small firms need.
- The benefits of vocational education to the UK's skills base and employment outcomes should be promoted widely throughout the education sector. Schools should be encouraged to devote one INSET day per year for teachers to understand vocational education and to harness the opportunities of vocational education for young people.
- Enterprise and employability should be embedded in teaching and learning so that children are exposed to workplace skills and engage with businesses from an early age. This could be achieved through promoting work experience, and encouraging local businesses leaders to give talks to inspire students.
- More businesses should be encouraged to invest in work-based training and unlock latent skills within the workplace. Small firms should be supported to undertake annual skills audits to ascertain if they are making the best use of the workforce to meet the business's strategic aims, as well as identifying cost-effective opportunities for training and up-skilling. The Government's Employer Ownership Fund should be promoted more widely among small businesses so that they too can benefit from financial support to design and deliver workplace training.
- Business support should place more focus on developing leadership and management capabilities within small firms and start-up businesses. This includes championing the Small Business Charter to promote the support available from business schools; widening the reach of the Growth Accelerator scheme; providing additional support to companies with high growth potential but minimum cash capital; and supporting small business enterprise projects on education campuses
- The Government should promote awareness among small employers and their staff about the relationship between health and wellbeing at work, good management and business productivity and performance. This should include developing practical tools and resources to support healthy workplaces, to complement existing resources available through local health bodies and the new Fit for Work service.

Improving access to business support and new commercial opportunities

1. Until now this inquiry has focused largely on the indirect impact of public policy in a range of areas, in boosting the productivity levels of small businesses. However, Government can influence firm productivity and performance in more direct ways too. This includes through the provision of Government-backed business support schemes available to small firms and start-ups, and by using its significant clout as a procurer of goods and services to support the growth of SMEs across the UK.
2. Business support policy that is effectively targeted and easily accessible has the potential to drive productivity benefits for small firms. Small firms that can identify and take advantage of government support schemes – including financial support and advice streams – should in theory report performance improvements.
3. However, over a number of years, business support policy has been piecemeal and has lacked a coherent structure. In her evidence to the inquiry, Professor Lynn Martin described a confused landscape with over 600 different schemes for business[135]. Furthermore, concern was raised by other respondents that there has been too much focus on start-up creation at the expense of existing businesses and productivity growth. Professor Francis Greene of the University of Birmingham pointed out that the key was in creating what he called a "more porous pipeline" to enable small business growth[136] and to provide support at all relevant stages of a business' lifecycle.
4. A number of respondents to the inquiry suggested the introduction of a US-style SBA would provide the structure for a more coherent business support offer, with Professor Francis Greene suggesting it should be a priority[137] and Million+ arguing that it was needed to provide a "strong voice at the heart of Government" for the UK's small and micro businesses[138].
5. A UK equivalent of the SBA could help to provide both an overarching strategy for business support that is currently lacking, and much greater co-ordination and coherence to the day-to-day management of schemes. Organisations such of the FSB have suggested that an arms-length SBA could amplify small business interests at the heart of government, with a direct reporting line into Number 10 or the Cabinet Office and close links with BIS and HM Treasury. This would mirror the SBA in the US, whose head holds a Cabinet-level post within the US administration.

135 Professor Lynn Martin, Oral evidence
136 Professor Francis Greene, Oral evidence
137 Professor Francis Greene, Oral evidence
138 Million+, Written evidence

6. The Government has begun to address some of these concerns and has undertaken an exercise to streamline the existing support offer. In particular, the recently launched Business Growth Service will target businesses with growth potential, focusing on the three key areas of advice, finance and exporting, and delivered through a single contact. While this is a welcome step, more action is needed: in particular, there is a strong case for further streamlining of the number of schemes to avoid proliferation and duplication particularly at the local level, with the NEN describing local provision as "completely fragmented and disorganised"[139].
7. Three simplification pilots have been initiated in Enterprise M3, Northamptonshire and Sheffield LEPs to address this issue, with a view to expanding the process to the rest of the LEP network in 2015. This is an important step and should help to ensure a more effective business support landscape that meets the needs of local firms. Up until now, robust evaluation of business support programmes has been relatively limited, a point made by both Professor Mark Hart[140] and Professor Henry Overman[141] in their evidence to the inquiry. The process of reviewing local business support by LEPs provides a golden opportunity to rectify this situation, and LEPs should be encouraged to include evaluation mechanisms in their considerations. All schemes should be evaluated, ideally with the use of a Randomised Controlled Trial (RCT), both initially and periodically, to ensure that schemes are effective and are providing value for money.
8. The NEN raised concerns in its evidence about the lack of awareness of support among businesses, highlighting the non-commercial approach towards marketing that often characterises government support schemes. While NEN note the need for resources to be used effectively, it argues that providers are subject to disproportionate restrictions on marketing inhibiting awareness and uptake[142]. Others pointed to the need for marketing of business support to be more commercially-driven. While marketing spend may be seen by some as peripheral, business support should be considered as any other commercial product, and as such a more commercial approach to marketing and branding should be adopted.
9. To assist in the delivery of business support at the local level, the Government is establishing Growth Hubs in each LEP area. Growth Hubs will act as a 'one-stop-shop' for businesses seeking support and will be able to signpost businesses towards the appropriate private or public sector support. However, concerns have been raised by the FSB over whether Growth Hubs have adequate performance measures to be assessed against, and conflicts of interest where those who have been awarded the contract to run the Growth Hub are also providing brokerage.[143]

139 NEN, Written evidence
140 Professor Mark Hart, Oral evidence
141 Professor Henry Overman, Oral evidence
142 National Enterprise Network, Supplementary written evidence
143 FSB, A New Design: Making Local Support Work for Business, February 2015

Mentoring

10. Mentoring can be vital to the success of a business. According to BIS, over a quarter of businesses that used mentors grew over a 12 month period compared to 11 per cent of those that did not use them. In addition, one third of all SMEs felt that could have used a mentor, particularly at the start-up phase[144].

11. The value of mentoring to business growth is largely a result of the individuals providing their support, commitment and drive to other businesses. While the Government provides basic online guidance for new businesses through the Business is GREAT portal, there are a number of mentoring initiatives in the UK. Mentorsme, for instance, is an online portal, set up by five leading banks as part of the Business Finance Taskforce. It connects businesses to mentoring networks, giving them access to advice and support that meets their needs.

12. Private sector partnerships are also important for a successful mentor network. Lloyds has an aim of securing 1,700 mentors by 2017, and recommended in its evidence measures to partner business owners up with external enterprise stakeholders to manage projects, such as through 'meet a mentor' events. Partners could also guide new businesses and newly self-employed individuals through the support available, such as the new Enterprise Allowance, enterprise resources and training, as well as helping existing businesses to identify ways to increase their productivity.

13. It is important that new business owners have confidence in mentors and that they are accessible. Evidence from London Councils noted the value of mentors but highlighted concerns around the lack of diversity in terms of ethnicity, gender, disability, skills and sector experience. It has called for more targeted recruitment and placement of mentors.

14. Mentoring support does not just have to be separate to company activity and around a third of mentors are already known to the businesses; highlighting the opportunity for unknown mentors but also the strength of peer networks[145]. City and Guilds pointed out opportunities for small businesses to make use of the expertise and knowledge of the wider supply chain. Larger businesses and Tier 1 contractors may be able to offer access to mentors, advice and guidance, with the rewards adding value and benefit to firms throughout the supply chain[146].

15. Furthermore community networks, such as the local branches of representative bodies, sector bodies and, as they move into the delivery of schemes, LEPs also, can provide valuable advice and informal mentoring support to new and existing businesses[147]. However, mentors cannot be the only solution and as argued by the NEN must be part of a wider package of business support. Better communication is also needed to close the gap on mentoring awareness and take-up. Only four per cent of SMEs have heard of the mentorsme website[148] and only a fifth thought finding a mentor was straightforward. This needs to change if the value of monitoring is to be realised by a greater number of business, new and existing alike.

144 BIS, Demand for mentoring among SMEs, December 2013.
145 Department for Business, Innovation and Skills, Demand for mentoring among SMEs, December 2013.
146 City & Guilds, Written evidence
147 Forum of Private Business, Written evidence
148 www.mentorsme.co.uk

Exports

16. Government-backed business support schemes should not only strive to support business growth in domestic markets, but also enable a greater number of UK firms to break into export markets and obtain global market share. This will be critical to ensuring a sustainable and dynamic private sector, as well as a more balanced economy.

17. There is evidence to suggest that developing the export potential of firms can provide additional productivity benefits. Many academic studies have been carried out on the relationship between exporting and business productivity and clearly demonstrate that firms who export are likely to experience higher productivity. There remains debate as to how much of this effect is attributable to selection (i.e. more productive firms are more likely to export) versus how much is attributable to productivity gains associated with experience of exporting. Nevertheless, exporting firms are more likely than not to be productive. This is reinforced by evidence submitted by Professor Mark Hart, which notes the presence of 'born global' firms who export early in their lifecycle, and points out that many of the characteristics of such firms suggest that they are 'born productive'.[149]

18. The ability of an economy to realise productivity gains through export growth may also, and counter-intuitively, depend on the flow of imports into a country. A recent HSBC study found that 'intelligent importing' could boost firm productivity by allowing companies to successfully compete at the higher value-added end of the global supply chain, attributing between six and 12 per cent of the increase in manufacturing productivity between 1998 and 2008 to an increase in imports[150].

19. As mentioned above, the recently established Business Growth Service is designed in part to improve the provision of export support for firms with growth potential. Increasing UK export activity is a key goal in improving the UK's economic performance, so ensuring a more systematic link between potential exporters and the support on offer should help to drive up our trade performance.

20. Export finance continues to be an important issue for businesses looking to sell overseas, and despite attempts by UK Export Finance to make their range of products and support more appropriate for smaller firms, it is not clear that this has yet been successful in driving significant new finance for small businesses. Given the British Business Bank's role in supporting small business finance generally, we would like to see them play a greater role in delivering export finance and make it more accessible to small firms, including the provision of export credit guarantees building on a recent £100m paid scheme announced by the Government.

149 Professor Mark Hart, Written evidence
150 HSBC, Importing for Export Success, 2014

Public sector procurement

21. As mentioned above, the Government also has a role in driving small business growth, and by extension, firm profitability, by facilitating access to public procurement opportunities. In its response to this inquiry, the Government acknowledges the importance of maximising the benefit to the UK economy of every pound it spends, and has underlined this by making procurement one of the five strands of its Industrial Strategy.

22. Despite significant reductions in public sector budgets as part of the fiscal consolidation process, the public sector still spent a total of £230 billion on procurement of goods and services in 2012-13. As such, public sector procurement budgets can play a significant role in supporting local economic growth.

23. Research suggests that this is best accomplished by public sector procurers maximising their spending with small businesses as they tend to source and employ locally. As a result of these localised employment and purchase practices, a greater proportion of the money spent by the procurer in the local economy stays in the local economy. Research by CLES undertaken with local authorities in 2013 found that every £1 spent by a participating local authority with local SMEs generated an additional 63p of benefit for their local economy, compared to just 40p generated by large local firms. It also found that small local firms generated over 58 per cent more economic benefit for local economies in the participating areas over two rounds of re-spending than large local firms did.

24. The benefits of the public sector seeking to procure with small firms are not purely economic. As many local authorities have shown, an effective supply chain engagement process can be used to foster innovation, build capacity and boost productivity among participating firms. The capacity building issue is particularly important, as research suggests a dichotomy between those small firms with the capability required to win public sector contracts, and those without - the former are often able to access multiple contracts once the basic capacity to win a bid has been achieved. Capacity building and supply chain engagement programmes run by local authorities are therefore important, especially when the ability of firms to transfer this learning to private sector procurements is taken into account.

25. The Government has taken action in a number of areas with the intention of accessing the benefits of procuring with small and micro firms. This includes creating the Crown Representative for SMEs to build a more strategic dialogue between HM Government and smaller suppliers and setting a new target to award 25 per cent of spending with third party suppliers to SMEs by March 2015. It has also increased direct SME spend from £3 billion in 2009 to 2010 to £4.5 billion (10.5 per cent) in 2012 to 2013 which is a step in the right direction, although it is likely to fall short of the stated aspiration. The Government has also introduced a Mystery Shopper scheme to enable businesses to report poor public sector procurement practices.

26. Legislative reforms are also being brought forward under the Public Contracts Regulations 2015 and through secondary legislation and guidance to be provided for in the Small Business, Employment and Enterprise Bill, which among other things will strengthen the successful Mystery Shopper scheme.

27. The Government's legislative reform programme aims to address a number of well recognised problems that prevent small firms from successfully bidding for public sector contracts, namely around accessing commercial opportunities and the process itself. Opportunity related issues tend to be around insufficient advertising of contract opportunities, and insufficient contracts of a suitable size to bid for, with the former aggravated by pressures towards contract aggregation. Process issues tend to focus on the quantity, complexity and proportionality of tender process requirements.

28. Beyond the 2015 General Election, the continuation of fiscal consolidation will risk obscuring the gains expected from the procurement reform programme, as pressure on budgets may lead to greater contract aggregation in pursuit of apparent savings. The Government is replete with examples of where small suppliers have been able to deliver better value for less, and where aggregation has locked public sector buyers into long contracts for yesterday's solutions. The Government must provide guidance for the public sector on how to "right size" contracts, and should set an expectation that all procurement policies should be based on a "small by default" approach, which obliges procurers to sub lot contracts or explain why they have not.

29. A number of respondents to this inquiry suggested that the public sector should be looking to maximise its position as client to support local economic development though increased spend with small firms. Reforms set out in the Public Contracts Regulations 2015 and the Small, Enterprise and Employment Business Bill are welcome, and further steps can be taken to promote best practice procurement with all public sector bodies on the ground.

Recommendations

- The Government should establish a UK SBA with a direct reporting line into 10 Downing Street or the Cabinet Office to provide a strategic and coherent small business policy framework and help streamline the large number of business support schemes available to small firms.
- Policymakers should adopt a more commercial approach to the marketing and branding of business support, to better target and increase awareness of the various government schemes in place. All schemes should be evaluated regularly and piloted using RCT, to ensure that schemes are effective and are providing value for money
- Growth Hubs should have much more tightly defined performance measures, and that those awarded the contract to run a Growth Hub should not be able to provide the brokerage themselves to avoid conflicts of interest.
- Business leaders and business organisations should champion and raise awareness of mentoring and peer-to-peer support networks, such as mentorsme. Larger companies should be encouraged to provide advice, share expertise and offer other forms of support to smaller companies within their supply chain.
- The Government should redouble its efforts to get a greater number of small and start-up businesses exporting. UK Trade and Investment should be equipped with sufficient resource in the medium to long term to support small firms and first-time exporters. The British Business Bank should play a greater role in the provision of export finance to small and medium sized businesses, including export credit guarantees.
- The Government should commit to an ambitious yet deliverable target for direct spend with SMEs in the next parliament, alongside a plan on how it intends to achieve it. It should also make swift implementation of the procurement clauses in the Small Business Enterprise and Employment Bill a priority and should monitor the full range of its procurement reforms, to ascertain progress on opening up public procurement to small firms.
- The Government should review the impact of supply chain engagement processes, including those implemented by local authorities, on the performance and productivity of contract-winning businesses. Lessons should be drawn for the benefit of other procurers, both public and private, to ensure that the wider benefits of accessing procurement contracts can be reaped by small firms, while at the same time ensuring that procurement processes and requirements are proportionate.
- The Government should provide guidance for the public sector on how to “right size” contracts, and should set an expectation that all procurement policies should be based on a “small by default” approach, which obliges procurers to sub lot contracts or explain why they have not.
- The National Audit Office should publish annual performance data on spending with small, medium, and micro firms, covering all procurements over £500, for all UK public bodies.

Conclusion

1. The UK's comparatively low level of productivity is one of the biggest challenges facing the UK economy. The financial crisis and the recession had a severe impact on the UK's productivity levels. Although the economy is beginning to recover and entrepreneurial activity and business confidence is growing, the economy has not experienced the expected rebound of productivity levels that occurred following previous recessions Furthermore, the UK has experienced a persistent lag in productivity levels in comparison to competitor economies.
2. To date the majority of the debates surrounding the UK's 'productivity puzzle' have focused on macro-economic causes and, to a lesser extent, remedies. There has been far less focus on firm-level productivity and its drivers, and even less consideration of small business productivity. This is in spite of the fact that small businesses are essential to driving productivity growth, both through the supply of entrepreneurship and innovation to the economy, and in view of their overall contribution to economic output.
3. There has been much activity by the Government to create a stable and supportive environment to support entrepreneurship and businesses growth. Many recent initiatives, such as the creation of Enterprise Zones, Small Business Rate Relief and the introduction of the Employment Allowance have been beneficial to small firms. However, the specific issue of small business productivity and performance has again received less direct attention.
4. While there are good arguments that these weaknesses are a matter for the private sector to address, this inquiry has found there are number of areas where Government policy could effectively boost the productivity of small businesses. Above all, this means ensuring that the 'framework' conditions for business growth and relevant support are in place, without crowding out private sector activity. In specific areas, policymakers should play a more central role: for instance, in efforts to raise investment by smaller companies. The evidence provided to the inquiry highlighted the importance of finance to investment and found that small businesses need support to identify a diverse range of external sources of finance away from the banks that provide their business current accounts.
5. The UK economy remains unbalanced with a marked difference in the productivity levels of London and the South East compared to the rest of the economy. To boost productivity levels, business need to be able to easily and quickly connect to larger markets and suppliers beyond their local area. Investment in infrastructure across the UK is key to unlocking the growth potential of these businesses. Evidence to the inquiry demonstrated the need not just for investment in transport infrastructure, but the increasing requirement for businesses to access high speed broadband connections.
6. Innovation is often associated with high-performing firms and productivity growth. The UK's relatively poor performance on indicators of innovation, particularly in terms of public and private R&D investment, was mentioned by several respondents. Witnesses told the inquiry the Government should commit to greater long term expenditure on R&D, while encouraging and facilitating formal and informal product and process-based innovation among small firms.
7. Businesses that experience persistent skills shortages will not be operating at their full productive potential. Despite recent reforms in areas such as apprenticeships to match learning to employer needs, there remains a disconnect between the skills being produced and the skills businesses require. Submissions to the inquiry also argued that small businesses need support to up-skill their existing workforce and address leadership and management challenges.

8. Despite improvements to streamline business support, provision at local level remains particulary fragmented. Evidence submitted to the inquiry suggested the introduction of a US-style SBA would provide the structure for a more coherent business support offer, and would provide much greater co-ordination and coherence to the day-to-day management of schemes.
9. The inquiry took a significant volume of evidence and covers a broad range of Government policy areas. The report and the recommendations cover well-rehearsed ground, including the need to promote greater levels of business investment, improve access to finance and boost the quality of infrastructure across the UK. It also touches on areas of growing importance to small firms, such as the effectiveness of the business support offer, the importance of workplace training and upskilling, and the role of LEPs in England in supporting local business growth and performance.
10. The productivity and performance of the UK’s 5.2 million small businesses is up until now, relatively unexplored area of the productivity debate. In view of the share of small businesses for UK output and employment, improving aggregate levels of business productivity is certain to have a beneficial impact on overall productivity growth of the UK economy. For the long term success of the UK economy, this is an objective that merits further policy attention and ought to be a key priority for the Government in the years to come.

Appendix 1

Witnesses and Written Evidence

The following organisations provided written evidence to the inquiry

- ACAS
- City & Guilds
- Chartered Institute of Personnel and Development
- Cornwall and Isle of Scilly Local Enterprise Partnership
- Department for Business, Innovation and Skills
- Federation of Small Businesses
- Forum of Private Business
- Funding Circle
- HSBC
- Institute of Chartered Accountants in England and Wales
- Institute of Credit Management
- Jeremy Lefroy MP
- Lloyds Banking Group
- London Councils
- Million +
- National Enterprise Network
- PCG (now the Association of Independent Professionals and the Self-employed (IPSE))
- Professor Mark Hart
- UK Commission for Employment and Skills
- The Work Foundation
- York, North Yorkshire and East Riding LEP
- 157 Group

The following witnesses gave oral evidence to the inquiry

- Andrew Carter, Deputy Chief Executive, Centre for Cities
- Mike Cherry, National Policy Chairman, Federation of Small Businesses
- Heather Dean, Head of Skills and Business Support Buckinghamshire Thames Valley LEP
- David de Koning, Head of Communications, Funding Circle
- Professor Francis Greene, Professor of Small Business and Entrepreneurship, Birmingham Business School
- Professor Mark Hart, Professor of Small Business and Entrepreneurship, Aston Business School
- Stephen Ibbotson, Director of Business, ICAEW
- Alexander Jackman, Head of Policy, Forum of Private Business
- Cllr Peter John, Executive Member for Children, Skills and Employment, London Councils
- David Kerfoot, Vice Chair, York, North Yorkshire and East Riding LEP

- Professor Lynn Martin, Professor of Entrepreneurship and Director of the Centre for Enterprise, Manchester Metropolitan University
- Raechel Mattey, Vice President (Union Development), National Union for Students
- Professor Henry Overman, Professor of Economic Geography, LSE
- Pam Tatlow, Chief Executive, Million +
- Anthony Thomas, Head of External Relations, Lloyds Banking Group
- Dawn Whiteley, Chief Executive, National Enterprise Network

Appendix 2

Defining Productivity

Productivity is the relationship between inputs and outputs in the production process. For an advanced economy, improvements in productivity is the main source for improvement in living standards and economic growth.

Productivity is a general term and can be measured in a number of different ways. The two most common measures are Labour Productivity and Total-Factor Productivity.

Labour Productivity: is the amount of output produced per unit of labour input. There are a number of different ways of measuring labour producitivity - the most commonly used are output per worker or output per hours worked. Changes in labour productivity can occur through technological advancement, organisational change or increased efficiency. This is the most commomonly used measure of productivity.

Total-Factor Productivity: measures the increase in output over and above any increase in inputs. It is the output growth which cannot be explained by increasing volume of inputs and is assumed to reflect increases in efficiency. Two forms of total-factor productivity are most commonly used: Labour-capital value added productivity and KLEMS total output productivity.

- Labour-capital value added productivity is where the growth of value added is accounted for by the growth of labour and capital.
- The more detailed estimates employ the KLEMS approach, where the growth of real total output is accounted for by the growth of capital (K), labour (L), energy (E), materials (M) and business services (S).

ISBN 978-1-907474-32-3

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