

An Enterprising Nation

The final report of the Small Business Taskforce

This is the final report of the Small Business Taskforce, an independent study commissioned by Rt Hon. Ed Miliband MP, Leader of the Labour Party and Chuka Umunna MP, Shadow Secretary of State for Business, Innovation and Skills. The views expressed in this report are those of the members of the Taskforce and will be considered as submissions to Labour's policy review.

The report sets out a menu of proposals to address the problems facing small businesses. It recommends strategies to improve access to finance and to raise skills, to support innovation and to create easier routes to market. It outlines necessary reforms for how government operates to support these changes to increase growth and prosperity. There is a single objective behind all the proposals: to make Britain the best place it can be to start, run and grow a small business.

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Dedication to Nigel Doughty



Nigel Doughty, 1957-2012

This report is dedicated to the memory of Nigel Doughty.

Nigel was a founding partner of Doughty Hanson, a past owner and Chairman of Nottingham Forest Football Club, founder of the Doughty Centre for Corporate Social Responsibility at Cranfield School of Management and President of the Cranfield Trust. Through the Doughty Family Foundation and the Doughty Hanson Charitable Foundation, he was one of the country's leading philanthropists.

He was a life-long supporter of the Labour Party and Chaired the Party's Small Business Taskforce until his untimely death last year. His emerging vision for small business in Britain is captured in the Taskforce's interim report published in December 2011.

In this final report we have sought to build on his vision and to honour his legacy.

Foreword from Ed Miliband and Chuka Umunna

Economic success is made by the many. That means that Britain's small businesses are vital to the future success of our country.

Small businesses are inventing, investing and working as hard as they ever have right now. But they are facing enormous obstacles, from banks that do not lend to a training system that doesn't deliver the skilled workforce they need.

All small businesses know that they can't overcome these obstacles on their own. They need a country that works with them and a government with new ideas for the future. We are determined that One Nation Labour will become that government.

That is why we commissioned an independent review into how Britain can support small businesses in the challenges ahead, to remove barriers and help foster innovation. And why we warmly welcome this report.

We are extremely grateful to Bill Thomas, a former Senior Vice President of Hewlett Packard Europe and Chair of the Advisory board at Cranfield School of Management, for chairing the taskforce with great commitment and imagination.

The report Bill and his team produced is fizzing with ideas to challenge and inform Labour's policy review, to make a huge difference and to put small business at the heart of future growth and the economy we need.

We also pay tribute to Nigel Doughty, who originally chaired the taskforce.

Nigel was an outstanding businessman, who was deeply passionate about his country and its future. Nigel brought great experience, insight, energy and verve to this project at the outset. He sadly passed away in February 2012. The impact of the interim report Nigel and his team published in December 2011, is a testament to his memory.

Labour has already taken forward many of the ideas in the interim report, including the case for a British Investment Bank, proposals for revamping the role of the Business Department and putting in place a more effective procurement policy. We look forward now to considering the recommendations in this final report as we develop our programme for the future of British business.

The great spirit of Britain's 4.8 million businesses has never been in doubt. This report, written by business people for business people, asks us to build on that spirit. The debate will rightly continue on the individual recommendations it makes. But what it shows us beyond doubt is that Britain's businesses can only thrive if we work together as a country, with businesses and government each playing their part in overcoming the challenges we currently face.

That is how we lay the foundations for our country's future success. That is how we create an economy made to last.

Rt. Hon. Ed Miliband MP and Chuka Umunna MP

Foreword from Bill Thomas, Taskforce Chair

Enabling a vibrant economy is a major priority for any government. It creates the funding for all public services; it creates opportunities for the next generation and ultimately enables a country to pay its way in the world. Small businesses represent 99% of UK businesses and within their ranks lie the seven per cent of high growth firms that create more than half of our new jobs. As such, small business lies at the very heart of economic growth.

For this reason I was more than willing to take on the role of Chair of the Small Business Taskforce. Our remit was to consider a broad range of policies and interventions, and make recommendations to Labour's policy review process, aimed at making Britain the best place it can be to launch and grow a small business.

Our process has involved widespread consultation up and down the country and we have received great support from many organisations and individuals. In particular, we have been assisted by – and are grateful for extensive input from – the British Chamber of Commerce, the Institute of Directors, the Federation of Small Businesses, the Forum for Private Business, the Engineering Employers Federation, the Trades Union Congress and the Confederation of British Industries. International best practise has been considered with visits to Singapore, Germany and the United States.

I have been extremely fortunate to have chaired a diverse team of hardworking, highly experienced, creative individuals. The Taskforce includes entrepreneurs, academics, private equity/venture capital specialists, local government officials and business people drawn from a broad cross-section of sectors. I am very grateful for their hard work, the team spirit they created and their commitment to the overall goal. In particular I would like to thank Jeff Masters and Matt Kelcher for their support in running the Taskforce secretariat and George Bevis for his dedicated marshalling and production of the final report.

There is no magic bullet for enabling small business and consequently the scope of our investigations is broad. Progress is required on a number of fronts and this is reflected in the wide range of recommendations made. In each case, we have sought to identify the problems constraining small business, and the potential solutions.

The ideas in this document are a starting point for further work. They present a menu of strategies, not a manifesto. We hope that the options set out will provide a basis for a wide-ranging consultation with stakeholders and small firms about the support they need to launch, survive and thrive. In doing so, I look forward to continuing to work with Toby Perkins MP, the Shadow Minister for Small Business, whose insightful input and constant support have been invaluable in completing the study.

Making it easier to launch and grow a business in the UK has the potential to make maximum use of the innovative, entrepreneurial spirit that has always underpinned the best of British business. Much of the growth, new jobs and future strengths of the UK economy will originate from small businesses. When we focus on the future of small businesses we are focusing on the future of our nation's prosperity.

Bill Thomas
Chair, Small Business Taskforce

Executive Summary

This is the final report of the Small Business Taskforce, an independent study commissioned by Rt Hon. Ed Miliband MP, Leader of the Labour Party and Chuka Umunna MP, Shadow Secretary of State for Business, Innovation and Skills. The views expressed in this report are those of the members of the Taskforce and will be considered as submissions to Labour's policy review.

The report sets out a menu of proposals to address the problems facing small businesses. It recommends strategies to improve access to finance and to raise skills, to support innovation and to create easier routes to market. It outlines necessary reforms for how government operates to support these changes to increase growth and prosperity. There is a single objective behind all the proposals: to make Britain the best place it can be to start, run and grow a small business.

To set up and run a small business takes courage, skill and determination. Those who do so take their destiny into their own hands, and create employment opportunities for others. Too often the contribution they make to our economy and society is insufficiently appreciated.

Small businesses are at the heart of our communities and the backbone of our economy. Together, they make up 99% of all businesses in the UK. They employ 14.1 million people, almost 60% of private sector employment, and account for almost half of private sector turnover. Smaller businesses are much more likely to recruit people directly from unemployment. Since the economic downturn almost nine in ten of unemployed people who found work in the private sector either started up or worked for a small business.

The context

These are challenging times for small businesses, with many struggling even to survive. The economy is bumping along the bottom, demand is weak and many excellent, profitable firms are unable to get the finance they need to continue and to prosper. Now, more than ever, we need our small businesses to succeed.

This starts with providing the right conditions for small businesses today. But the focus of British business – and of those who want it to succeed – must also be on the global economy of the future. This report includes many ideas to support business growth in 2015, but it also looks ahead to the next decade and beyond.

With anticipated changes in the domestic and global economy over that period, the importance of small businesses to our national prosperity can only grow. Most small businesses will remain small – often much to the satisfaction of those who created and run them. But among the group of five million will be a small proportion of firms – around 1 in 15 – that, at any one time, are experiencing rapid growth and generating a vastly disproportionate share of new jobs. If these firms can be helped to grow faster or for longer – or if more firms could experience similar levels of growth – our economy would be much stronger, dynamic and resilient.

The need for a robust, active industrial strategy

For the last three decades, the intellectual and political consensus in the UK has been to put our faith in the efficacy and efficiency of markets. The best thing that government could do was to get out of the way. The unsustainable and unbalanced nature of our economy's growth – by sector as well as by region – has exposed the limits of this approach.

Today there is a big divide in British politics is between those who believe that the best way to support balanced and sustainable growth in our economy is for government to step up, and those who cling to the notion that the government that does best is the government that does least. Such a position is outside the international consensus and is at odds with what Britain needs.

An active government approach must go beyond economy wide policies to improve the conditions for growth, as important as they are. We need the strategic development of our national capabilities, building on our strengths, correcting our weaknesses and offering clear direction to actors in individual sectors and across our economy. It must shift from being passive and reactive, to proactive and strategic – and must be wholly supportive of small firms.

The active, modern industrial strategy we need must support businesses during start up and growth, not forestall the demise of dying firms and industries as was tried in the 1970s. Because of the failure rate of individual firms, overall policy success requires the generation of many businesses with high potential. Supportive government policy can help to increase the success rate of more firms. The goal should be to create an environment where successful firms can flourish, not to pick individual firms. This will generate a diversified portfolio of good options for a prosperous future.

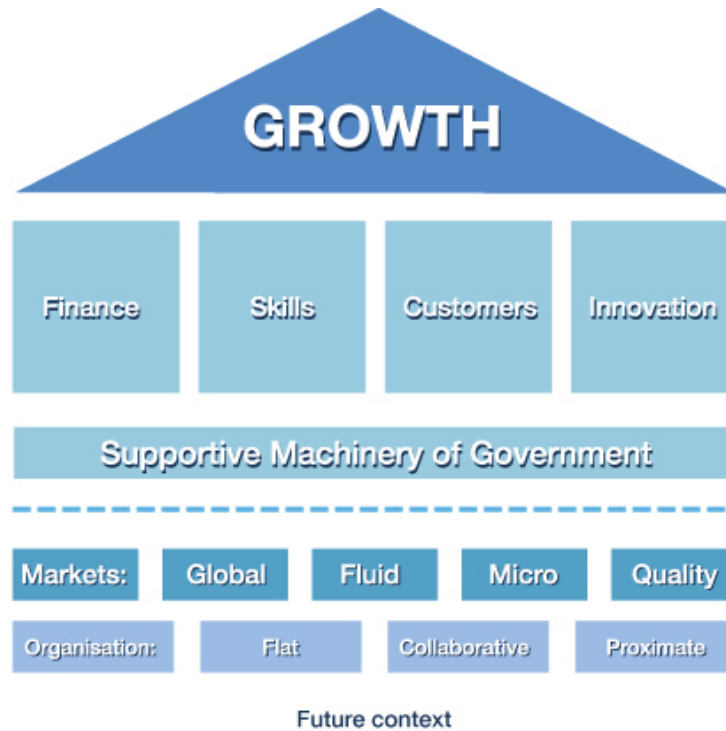
The approach of the Taskforce

The Taskforce Interim Report made recommendations to improve access to finance and government procurement, with reforms to government enabling it to better understand and respond to the needs of small businesses. Here we build on those recommendations.

Our approach is straightforward. To achieve **growth** a business needs the capacity to market, develop, manufacture and sell products and services. It needs **customers** to serve, domestic and international. Recognising that UK firms will not prevail by competing on low cost of labour in commodity markets, the pragmatic, widespread application of **innovation** lies at the heart of our work. Growth must be private sector led, but government can make a huge difference. Through **government procurement**, it can be an exemplar client for UK business and acts as a spur to innovation. It can support world class **exporting** or it can be passive, leaving UK business disadvantaged in global markets.

Bringing excellent, innovative products and services to market relies on two fundamental prerequisites: access to appropriate, timely **finance** and most important of all: access to the right **skills** in our people. It is possible that this can happen without government support, but how much more likely is this to occur if government steps forward to create the right climate for success. Our final area for consideration is therefore **machinery of government** and how it must change to be as supportive as possible.

The approach of the Taskforce



No two firms are the same, and the particular set of challenges faced by any business will be unique to that business. But there are problems that will be familiar to many firms at similar stages of the business lifecycle. The uncertainties and challenges of taking on a first employee are very different from the second, tenth, fiftieth or hundredth. The financing needs of a start-up anticipating high growth are very different from the self employed decorator or the mature business growing organically. We have tried to be sensitive to these differences, making recommendations that would create a supportive environment for all small businesses.

Running through our recommendations is the idea of everyday entrepreneurship - supporting an **Enterprising Nation**. It means shifting the perception away from entrepreneurship as a niche activity: not about a group of 50 or 500 or even 5,000, but encompassing the nearly 5 million business leaders running small businesses today. In our schools, colleges and universities we need to normalise entrepreneurship as a career option, with a deliberate focus on the developing the skills needed for success. And when people feel ready and able to strike out on their own, we must de-risk it as an activity, as far as is humanly possible.

Summary of major recommendations

This report contains a broad range of policy interventions as progress is required on a broad range of fronts. There are one hundred specific proposals which should be thought of as a menu of options. They are not an exhaustive list, but each would make a contribution to small business growth. The following paragraphs are a distillation of their broad direction. The full list of recommendations is set out in Appendix 2.

Finance: *Business lending has fallen in every quarter of the last two years. Underlying acute short term problems are longer term structural issues.*

- There is a great need for a major transformation in finance for small business. Overhauling, improving and diversifying the small business lending sector should be the highest small business priority.
- Introduce local lending institutions, based on the principles underpinning the local German savings banks, the Sparkassen. We are not suggesting the wholesale transplant of an identical Sparkassen structure. The challenge is to bring the key principles to life in a British context. The prize is worth the challenge: no other measure will provide a better solution to one of the biggest issues facing small business.
- Encourage and spread the availability of patient capital with a wholesale expansion and promotion of policies like the Enterprise Investment Schemes and Enterprise Capital Funds.
- Partner with the London Stock Exchange or others to create a real competitor to the US tech market Nasdaq, increasing the availability of equity finance for businesses with rapid growth potential. Floating such firms in London is insufficiently attractive and should be seen as a strategic goal for government, rather than a source of immediate tax revenues.

People and skills: *The UK ranks 14th worldwide in entrepreneurial attitude*

- Entrepreneurial leadership and management skills can be taught and should be taught at school and to all age groups who would benefit. Our BTEC is a good place to start.
- Self employment is a challenging but empowering path out of unemployment. The government should recognise the major increase in self-employment currently occurring and provide appropriate support.
- We cannot assume that our young people will simply acquire workplace skills by growing up: we need a formal NVQ in general employability skills.
- Our apprentice schemes need revitalising and supporting to rival the best in Europe.

Customers: *US Federal laws and targets ensures – de facto – that of the Federal procurement budget spend is with small businesses. The UK Government has an intention – but no statutory requirement – to use small businesses. UKTI supports 1% of exporters.*

- Whitehall and local government must rediscover the value of working with small businesses, acting as lead customers and opening up government procurement to the innovation which small businesses are recognised for.
- Update Treasury rules to encourage the consideration of wider economic benefit to a community when evaluating tenders.

- UKTI provide a valuable service but it touches a tiny minority of firms. We must invest – as competing nations do – in export support if our fall in share of global exports is to be halted and reversed.

Innovation: *Our R&D spend has fallen whilst that of our competitors has risen. HM Treasury controls 80% of UK government R&D via tax credits.*

- Establish a unified strategy for government funded R&D and exploitation. The SBRI programme is valuable but must be expanded to compete with other nations on a meaningful scale.
- Appoint an e-commerce ombudsman to ensure that powerful market positions of market leading firms are not allowed to unduly limit the growth prospects of small businesses engaged in e-commerce.
- Ubiquitous, free wi-fi supported by responsive suppliers is a key building block for continued success in digitally enabled business.

Machinery of Government: *The head of the US Small Business Administration reports to the President. Small business is one of the ten responsibilities of one of the six junior ministers within BIS. No one reporting to the Permanent Secretary in BIS is solely responsible for small business.*

- Like our major competitors we need a dedicated small business agency
- The Prime Minister needs to bring urgency and cross-government focus to the support of small business by creating a “Business COBRA”.
- A Director of Economic Development should be appointed in every government department to drive the execution of innovation policy throughout Whitehall.
- The government should work with business organisations like the FSB, the British Chambers of Commerce and others to increase membership and to create united and representative local voices for business.
- The taxation system and its administration must be simplified to reduce the 36 days small businesses spend each year on compliance.
- Reform insolvency laws to protect small business from rogue directors and protect honest entrepreneurs from needless liquidation.

As a concept, small business is cherished in Britain. But its strategic importance is not always fully recognised. We may understand that all big businesses were once small, and that among small businesses of today are some of the giants of tomorrow. But fewer people recognise the absolutely central role of small business in extending opportunity, enriching our communities and driving economic growth.

The focus on small business in this report is not to denigrate the importance of big business. Britain's economy is profoundly reliant on BP, Rolls-Royce, Vodafone and the rest of the FTSE. These firms create wealth and offer wonderful career opportunities. But by themselves they will not create the jobs we need for our almost one million unemployed young people, those going through our education system, and those displaced by the ongoing economic malaise.

It is our small businesses that are giving the first opportunities to nine out of ten people moving out of unemployment. It is through small business that people are taking control of their own lives as well as creating opportunities for others. And it is from small business that so many of the new ideas will come which will improve our lives and enable us to pay our way in the world.

That is why there is a single objective behind all the proposals in this report: to make Britain the best place it can be to start, run and grow a business.

Financial Impact

UK small businesses are at the bottom of the pack in productivity growth, compared with European rivals. If the UK could halve the gap in performance versus the EU average our calculations show that this would be worth the equivalent of £140bn of growth in the economy and 380,000 new jobs over the next 10 years. If we could close the gap with Germany this would more than treble (See Appendix 5).

1. Introduction

Nearly 5m UK small businesses, up from less than 1m in 1973¹
9 out of 10 unemployed who find work join or set up a small business²
7% of firms are small businesses that create more than half the new jobs³

To set up and run a small business takes courage, skill and determination. Those who do so take their destiny into their own hands, they create jobs and career opportunities for others, and they generate taxes that fund public services. Too often the contribution they make to our economy and our society is insufficiently appreciated.

These are challenging times for many small businesses, struggling even to survive. With our economy bumping along the bottom, demand is weak and many excellent, profitable firms are struggling to get the finance they need to continue and to prosper.

Now, more than ever, we need our small businesses to succeed. And now, more than ever, our small businesses need a government that understands the challenges they face, that shares their ambition, and is willing to act to help them to succeed. This attitude is vital today, but it will be even more critical in the years to come.

With our economy still in a fragile state, British politics is understandably focused on securing a return to sustained and robust growth. This is an important and necessary goal, but it is insufficient. The concern for growth today must not distract us from the need to prepare for the demands of the future. The focus of British business – and of those who want it to succeed – must be on the global economy of the future. The report takes as its starting point what we need to do support business growth in 2015 but also looks ahead to the next decade and beyond.

¹ Bolton, J. E., *Report of the Committee of Inquiry on Small Firms*, Cmnd 4811, HMSO, London, 1971

² Unwin, P., and Buscha, F., *Back to work: the role of small businesses in employment and enterprise*, London: Federation of Small Businesses, 2012

³ *The vital 6 per cent: How high-growth innovative businesses generate prosperity and jobs*, NESTA Research Summary, London: NESTA, London, 2009, p2. The 6% figure in the report referred to the share of all surviving UK firms employing ten or more people in 2002 that accounted for 54 per cent of all jobs created between 2002 and 2005 by established firms employing ten or more people in 2002. This excluded: jobs created by surviving businesses with fewer than ten employees; jobs created by new firms; jobs created by the public sector; self-employment. The analysis included all jobs gained by surviving firms, whether by organic growth or acquisitions of existing firms. NESTA now use 7% instead of 6%, based on reanalysis of the data following ONS reclassification.

Strategic context

As the march of technology continues and the global centre of economic gravity shifts south and east, we are living in a world of short term constraints but longer term opportunities. Nations which pursue the right policy mix to inspire growth in the short term and position themselves for the next decade will enjoy a disproportionate purchase on prosperity.

We suggest seven trends are likely to shape the environment for UK enterprise in the future:

- We envisage a world where markets have become more **global**, although more **fluid** and **micro**, with a premium on **quality** goods and services.
- These changing market opportunities are likely to give advantages to firms with **flat** structures, **collaborative** approaches, and the advantages of **proximity** – the ability to draw on all the ingredients necessary for success within their own locality.

Paradoxically, the orientation towards the global will intensify the importance of vibrant local economies, with competition to satisfy the wants of demanding local consumers driving quality, and an enterprise culture supplying the capabilities to innovate with speed, to access global and local market opportunities.

Seven trends shaping the business environment in the future

1. **A global future:** The painful challenges which many western economies have faced in the past five years should not blind us to the fact that for much of the planet this same period has been one of feast, not famine. The rise of China and India, the economic emergence of the likes of Indonesia and Vietnam, the astonishing economic growth enjoyed by Brazil which may soon be echoed by Mexico and the transformation of many parts of Africa are events of fundamental historical significance. Between 2010 and 2025 some 75 per cent of global growth will be in these "emerging" economies who by 2025 will account for more than half of global output. By then the nature of the international customer base for enterprise will have been altered completely with an additional \$30 trillion of demand from a new global middle class. This will be the largest economic shift in history, bigger than the Industrial Revolution and on a much compressed timescale.⁴ We will have moved from an era we have called "globalisation" to something that might be better described as "economic democratisation", with huge opportunities for countries prepared to succeed in export markets.

2. **A micro future:** Combined with technological change, this far larger pool of customers will lead to a much larger number of small businesses, not a smaller number of large businesses. This development was covered in *The Long Tail* by Chris Anderson and illustrates how and why mass markets serving undifferentiated demand will fragment into a proliferation of esoteric but profitable niche markets. For much of British business, small will be the next big thing.

3. **A fluid future:** Different customers must mean different sorts of producers, as markets become more restless, more disruptive and more unpredictable. What was once static will rapidly become fluid. Firms who thrive in this environment will be those who can adapt swiftly to these constant shifts. This will create challenges not

⁴ *Winning the \$30 Trillion Decathlon: Going for Gold in Emerging Markets*, McKinsey & Company, 2012
http://www.mckinsey.com/features/30_trillion_decathlon

just for business, but also for ministers, officials and regulators who will need to acquire the institutional elasticity needed to keep pace with the commerce of tomorrow.

4. **A quality future:** There will be few if any areas in 2025 where British business will dominate markets by the provision of low-cost and low-quality products. Even in very local, purely domestic provision, quality will be essential to survive and succeed. Quality will depend on the skills of those involved in marketing, developing, manufacturing and servicing that which others wish to own, whether goods or services. A 50 per cent society which expects half of the population to acquire only lower level skills will get what it deserves: 50 per cent results. Only a 100 per cent society will get a 100 per cent outcome.

5. **A flat future:** Companies will not render themselves fluid by adopting rigid managerial hierarchies but by empowering all who work within them to make meaningful suggestions and take fundamental decisions. Sharp distinctions between “management” and “workers” will be hopelessly outdated.

6. **A collaborative future:** Creating goods and services of consistently high quality and at the pace demanded by fluid markets requires strength in numbers – utilising so-called “agglomeration benefits” that arise from clusters of similar businesses. While the classic image of the entrepreneur may be the pioneering individual, the experience of successful entrepreneurs will be increasingly cooperative with fresh ideas coming from thick, collaborative networks and often at the boundaries between organisations and disciplines.

7. **A proximate future:** Strong local economies are a prerequisite to global success, not an alternative. The capabilities for a firm’s success will be drawn from strong local communities– from the networks of skilled workers to the supply chains to the finance needed to thrive and grow. Firms will develop the disciplines needed to succeed in whichever market they choose by exploiting strong local economies with competitive markets and demanding consumers. Whether firms aspire simply to serve their local communities or to play in global markets, success will begin at home.

The critical importance of small businesses

If we are only right about some of these trends shaping the outlook for UK business over the next decade, the importance of small businesses to our national prosperity can only grow. When Britain joined the EEC in 1973, it had less than a million small businesses.⁵ The consensus then was of a future world dominated by a small number of very large corporations exploiting massive economies of scale. Today, the number of small and medium sized businesses is closer to five million. They make up 99% of all businesses in the UK, and employ 14.1 million people, almost 60% of private sector employment, and almost half of private sector turnover.⁶

⁵ Bolton, J. E., *Report of the Committee of Inquiry on Small Firms*, Cmnd 4811, HMSO, London, 1971

⁶ <http://www.bis.gov.uk/assets/biscore/statistics/docs/b/12-92-bpe-2012-stats-release.pdf> table. There are 4.8 million private sector businesses in the UK. Almost all (99.2%) of these are small businesses (less than 50 employees). Around 0.6% are medium sized (51 to 250 employees) and just 0.1% employ more than 250 people.

Most small businesses will remain small – often much to the satisfaction of those who created and run them. They will remain at the heart of our communities and the backbone of our economy. But even firms destined to remain small will face challenges of adapting to the changes in the business environment over the next decade – from the newsagent to the boutique digital content agency. Indeed, small firms already face a dynamic environment where entry and exit rates typically amount to 10% of businesses each year. President Clinton said recently that he worked on the basis that around a tenth of jobs will become obsolete each decade. To succeed in this future we will need not only to generate new businesses, but also new technologies, new markets and whole new industries.

Small businesses also play a critical role in extending opportunity. Enterprise is a route by which people can get on, taking greater control of their own lives. This desire to “be your own boss” is the most frequent reason those running small businesses give for doing so. But small businesses are also a critical first rung on the ladder of opportunity for many others. Where larger businesses recruit more frequently from the ranks of those already in work, smaller businesses are much more likely to recruit people directly from unemployment. Indeed, since the economic downturn almost nine in ten of unemployment people who found work in the private sector either startup or work for a small business.⁷

Every big business was once a small business. Among the group of five million will be a small proportion of firms that, at any one time, are experiencing rapid growth. The impact of these so-called ‘gazelles’ on the economy overall has been well documented. Nesta’s influential summary of the research reported that, “just 6 [now revised to 7%] per cent of UK businesses with the highest growth rates generated half of the new jobs created by existing businesses between 2002 and 2008”.⁸ If these firms can be helped to grow faster or for longer – or if more firms could experience similar levels of growth – our economy would be much stronger, dynamic and resilient.

The need for a robust active industrial strategy

With the importance of small businesses to our economy and society set to rise, what can be done to support this growth? As Nigel Doughty put it, what must be done to “Fulfil the promise of British Enterprise”? For the last three decades, the intellectual and political consensus in the UK has been to put our faith in the efficacy and efficiency of markets. The best thing that government could do was to get out of the way. The unsustainable and unbalanced nature of our growth – by sector as well as by region – has exposed the limits of this approach.

Now, from *Investing for Prosperity* – the report of the LSE’s Commission on Growth – to Lord Heseltine’s *No Stone Unturned*, this consensus is being challenged. It is challenged by the approach taken by President Obama’s Jobs Act, and by the reality – if not the rhetoric – of US policy over a much longer period. It is challenged by the approach taken in countries around the world at all stages of development. The Taskforce observed this directly during visits to Singapore, Germany and the USA.

⁷ Unwin, P., and Buscha, F., (2102) *Back to work: the role of small businesses in employment and enterprise*, London: Federation of Small Businesses

⁸ *The vital 6 per cent: How high-growth innovative businesses generate prosperity and jobs*, NESTA Research Summary, London: NESTA, London, 2009, p2. See footnote 3 for more information.

Today there is a big divide in British politics between those who believe that the best way to support balanced and sustainable growth in our economy is for government to step up, and those who cling to the notion that the government that does best is the government that does least. Such a position is outside the international consensus and is at odds with what Britain needs. Without time to develop and patient finance too many small companies go under, fail to grow or are sold. Elegantly operating in an orthodoxy that is out of date will fail to meet the challenges ahead.

An active government approach must go beyond economy wide policies to improve the conditions for growth, as important as they are. We need the strategic development of our national capabilities, building on our strengths, correcting our weaknesses and offering clear direction to actors in individual sectors and across our economy. It must shift from being passive and reactive, to proactive and strategic – and wholly supportive of small firms.

An unbalanced economy

The reliance on market forces over the last three decades had many positive consequences, including new investment into the UK from abroad and some welcome improvements in productivity. But it also created large imbalances within our economy. Retail, financial services and professional services thrived in the new environment, along with media, telecoms and pharmaceuticals. But manufacturing was decimated, from commodity products and raw materials through even to hi-tech products. The scale of change is important. Manufacturing's share of UK GDP fell by more than 10 percentage points between the mid 1980s and 2010.

If the productive base of the economy is to be broadened and re-balanced then the scale of the change needs to be of a similar order. There will be a number of elements to this transformation. But, investment in a large number of small and medium sized innovative concerns represents the best bet for the UK. They will form the basis for creating the large UK companies of the future. Also, they are the most reliable way of creating new jobs in a sustainable and affordable manner.

In the 1960s and 1970s, government intervention in the economy involved attempts to support larger firms struggling to survive because of competition from abroad. This was often intervention when a significant business or industry was in trouble and about preventing collapse or decline. This has been dubbed 'losers picking government'. Today, an active approach must focus on supporting businesses to start and grow, not to forestall the demise of dying firms and industries. It must stimulating the growth of large numbers of smaller firms, producing high value goods and services, and able to compete with the best in the world. This will take creativity and patience, as well as an acceptance that along with the successes there will be failures too. There will always be risks in business, and supporting business growth will involve risk too. But not doing so carries greater risk. The goal is absolutely not to 'pick winners' but to develop strategic support for sectors and a plentiful portfolio that secures options for future growth.

In the last century, in corporations and in governments, decision making tended to come from the centre, relying on the talents of the few and the compliance of the many. Today, successful firms are often nimble and flat. They harness the talents of the many, and empower those who are intimate with the markets they serve. Smart governments must recognise the critical importance of proximity – of regions having appropriate control of the ingredients for economic success. Silicon Valley entrepreneurs have all the ingredients for

success at their fingertips. The financiers are right there in Palo Alto, California. Government officials from the SBA are nearby. Citizens, too, are more likely to accept responsibility for their economic future if they have in their hands the means to determine it.

Small business at the centre of 21st Century industrial strategy

An active, modern industrial strategy must support businesses during start up and growth, not forestall the demise of dying firms and industries. Large companies can excel at applying and developing innovative ideas. But it is small firms they rely on for their supply chains and it is often in small firms where ground-breaking new products and services are created. With these innovations can come periods of rapid growth, new jobs and export success, and creates the vibrant supply chains that larger firms need.

This kind of success takes creativity, patience and a tolerance for failure. The technology start-up companies can take 12-15 years to move from the initial concept to when it can generate investment funds on its own. Because of the failure rate of individual firms, overall policy success requires the generation of many businesses with high potential. Supportive government policy can help to increase the success rate of more firms. The goal should be to create an environment where successful firms can flourish, not to pick individual firms. This will generate a diversified portfolio of good options for a prosperous future.

The approach of the Taskforce

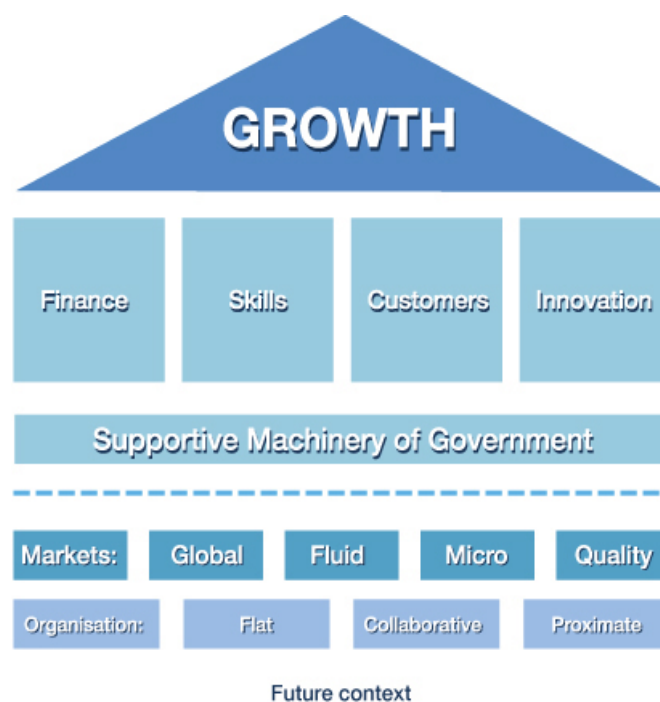
The Taskforce Interim Report made recommendations to improve access to finance and government procurement, with reforms to government enabling it to better understand and respond to the needs of small businesses.⁹ Here we build on these recommendations.

Our approach is straightforward. To achieve **growth** a business needs the capacity to market, develop, manufacture and sell products and services. It needs **customers** to serve, domestic and international. Recognising that UK firms will not prevail by competing on low cost of labour in commodity markets, the pragmatic, widespread application of **innovation** lies at the heart of our work. Growth must be private sector led, but government can make a huge difference. Through **government procurement**, it can be an exemplar client for UK business and act as a spur to innovation. It can support world class **exporting** or it can be passive, leaving UK business disadvantaged in global markets.

Bringing excellent, innovative products and services to market relies on having access to appropriate, timely **finance** and – most important of all – access to people with the right **skills**. It is possible that this can happen without government support, but how much more likely is this to occur if government steps forward to create the right climate for success? Our final area for consideration is therefore **machinery of government** and how it must change to be as supportive as possible.

⁹ *Fulfilling the Promise of British Enterprise*, Interim Report by Nigel Doughty, Chair of Labour's Small Business Taskforce, 2011, <http://www.labour.org.uk/uploads/5c176b69-38c4-19b4-05d0-ff3eae06b37d.pdf>

Chart 1: The approach of the Taskforce



No two firms are the same, and the particular set of challenges faced by any business will be unique to that business. But there are problems that will be familiar to many firms at similar stages of the business lifecycle. The uncertainties and challenges of taking on a first employee are very different from the second, tenth, fiftieth or hundredth. The financing needs of a start-up anticipating high growth are very different from the self employed decorator or the mature business growing organically.

We have tried to be sensitive to these differences, making recommendations that would improve the supportive environment for all small businesses. To take the critical issue of finance as an example, we have looked at where there are broken links in the chain of finance for business growth, but also on increasing the diversity of financing options for business at every link in that chain.

Running through our recommendations is the idea of everyday entrepreneurship - supporting an Enterprising Nation. A lot of the discussion about entrepreneurship tends to focus on the unique characteristics of extraordinary people with unlimited appetites for risk. Such heroic people do exist and they have the potential to make a huge difference to our economy and society. But the key to an Enterprising Nation lies not in encouraging excessive risk taking, but in reducing the risks entrepreneurs must take to start and grow a business. It is inevitable that small businesses must take risks, but the factor that distinguishes high performance ventures is their ability to manage that risk.¹⁰

It means shifting the perception away from entrepreneurship as a niche activity: not about a group of 50 or 500 or even 5,000, but encompassing the nearly five million business leaders running small businesses today. In our schools, colleges and universities we need to

¹⁰ Burke, A. E. (2009), Strategies for Entrepreneurial Success, *Journal of Strategic Management Education*, 5(1), 33-44; Reis, E. (2011), *The Lean Startup*, New York: Crown Business

normalise entrepreneurship as a career option, with a deliberate focus on the developing the skills needed for success. And when people feel ready and able to strike out on their own, we must de-risk it as an activity, as far as is humanly possible.

This report contains a broad range of policy interventions as progress is required on a broad range of fronts. There are one hundred specific proposals which should be thought of as a menu of options. They are not an exhaustive list, but each would make a contribution to small business growth.

Chapter 2 makes recommendations on the critical issue of improving access to finance – aiming to increase the range of options open to small businesses whatever their size or ambitions for growth, as well as the variety of providers within each option. **Chapter 3** focuses on how to enhance the skills of entrepreneurs and the people they employ. **Chapter 4** is concerned with improving routes to market at home and abroad, as well as the role of government as a customer. **Chapter 5** makes recommendations on how to improve support for innovation. **Chapter 6** looks at the changes needed to government itself, so that it can perform its role in supporting small business as effectively as possible. Finally, the **Concluding remarks** emphasise the choice facing governments: to allow small business to rise and fall with the markets or to intervene to provide active support to make a real difference.

Financial Impact

UK small businesses are at the bottom of the pack in productivity growth, compared with European rivals. If the UK could halve the gap in performance versus the EU average our calculations show that this would be worth the equivalent of £140bn of growth in the economy and 380,000 new jobs over the next ten years. If we could close the gap with Germany this would more than treble. The methodology is set out in Appendix 5.

2. Finance: Proximity, Diversity, Equity

In the decade before the crisis, 84 per cent of the money lent to British residents by British banks went into property and financial services¹¹
More small business loan applications are unsuccessful in the UK than in our main competitor countries¹²

Community banks in the USA, the local Sparkassen in Germany were relatively unaffected and continued to serve their communities after the crisis hit¹³.

There is widespread dissatisfaction with the ability of the big banks to meet the financing needs of small businesses. This problem is particularly acute in the short term. According to the Bank of England, net lending to business only been positive in 6 over the last 24 months, falling by more than £28bn over the same period. This is despite attempts at a succession of ideas and schemes by the Government - from Project Merlin, to the National Loan Guarantee Scheme or credit easing, and now Funding for Lending - to increase the flow of finance to business.

These 'fixes' have not worked, in part because this is a problem with deep roots. As long ago as the 1930s with the identification of the Macmillan Gap, policy makers have been concerned with the failure of the banking and finance industries to serve the needs of real economy businesses in the UK.

The Taskforce has considered improvements that could be made across has made across all dimensions of finance for small firms, covering:

- Bank lending
- Equity (from private sector investment funds)
- Personal investments (from founders and business angels)
- Listing on public markets
- Alternative finance

There are well known - but still unresolved - problems in the chain of finance for growing businesses which our recommendations address. The major gaps are higher risk lending, venture debt and early stage venture capital. But we have also looked at how the options at every link in this chain can be improved. In finance for small businesses, as in life, variety is a valuable end in itself. It is better suited to the variety among the small business population it serves. But it is also likely to be more effective. In contrast to the centralised and homogeneous business models across our big banks, it can draw on much richer seams of expert or local knowledge.

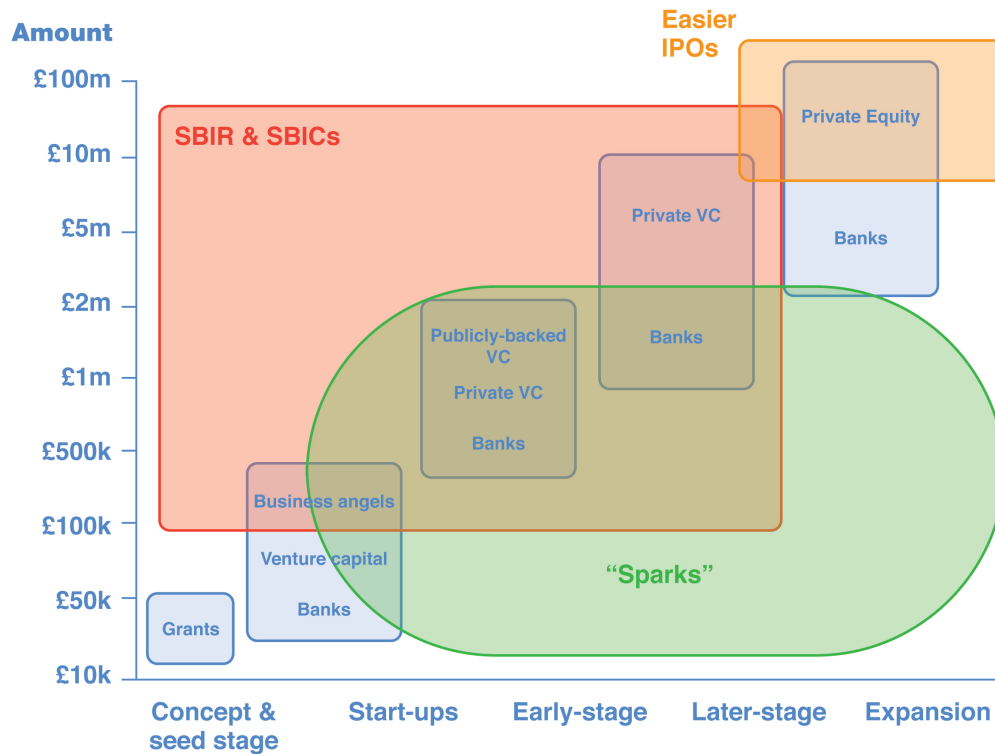
Together, the proposed package of reforms we recommend would enable the revolution in finance for small firms that is long overdue.

Calculations based on Bank of England data, from Weldon, D., 'A Diverse Banking System' in Harrop A (ed.) *The Great Rebalancing*, London: The Fabian Society, 2013

¹² http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/4-03102011-AP/EN/4-03102011-AP-EN.PDF

¹³ See, for example, *Germany: Technical Note on Banking Sector Structure*, IMF, Washington DC, 2011; Michie, J. and Llewellyn, D. T., *Converting failed financial institutions into mutual organizations*, Journal of Social Entrepreneurship, 1 (1), 2010.

Chart 2. Taskforce recommendations would improve financing options for all small firms



Bank lending

Net business lending has fallen every year since 2008¹⁴
 UK bank debt rejection rates rose from 5.6% to 20.8% between 2007 and 2010¹⁵

Britain’s banking sector offers limited choice to small businesses. Most of the market concentrated among a small number of large banks, each with a similar business model. This concentration and homogeneity does not serve the diversity of small business needs well enough, while making it difficult for new entrants to enter the market. We need a far more diverse small business banking services sector to give our small businesses the best access to financial services in the world.

Problems with banks are numerous and well documented. **Debt finance is difficult to obtain.** Project Merlin – the Government’s deal with banks to encourage further lending - has been unsuccessful in driving a significant improvement in credit availability. Net UK business lending has fallen every year since 2008.¹⁶

¹⁴ <http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary13.pdf>

¹⁵ http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/4-03102011-AP/EN/4-03102011-AP-EN.PDF

¹⁶ <http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjanuary13.pdf>

Banks state, correctly, that they would lend more if additional lending were profitable. However the constraint on that profitability is often banks' own ability to price lending risk correctly. Having systematically diminished the role of **local bank managers** over decades, banks lack local staff competent to make sound discretionary lending decisions to small businesses – the empowered local bank managers of the past. As a result, British bank loan rejection rates are among the highest in Europe.¹⁷ Envious eyes have been cast towards Germany, and its network of local lending banks, the Sparkassen.

The German Sparkassen system is comprised of credit institutions established under public law. These essentially local banks are complemented by regional banks and the KfW (this is the government owned development bank, similar in concept to the British Investment bank, the rationale for which was argued in Nick Tott's recent report for Labour's policy review). There are 426 independent banks that make up the Sparkassen system, with over 15,000 branches in Germany.¹⁸ They have a 40 per cent market share of business/customer deposits and loans. Savings banks have a public service obligation, which includes universal banking and small business loans. This is established by law at the regional level. These banks have persisted in Germany because of the stability built in by municipal law. In most other European countries they would have been vulnerable to takeover by much larger institutions.

Banks are obliged to have a solid risk strategy supervised by the overall Savings Bank Finance Group. No bank required bailing out during the financial crisis. The network of savings banks has one IT structure and one joint liability scheme. They specialise in "relationship banking" – quick decisions taken at the local level by local managers. Most of these managers come up via apprenticeships rather than Higher Education.

Indeed, the success of the Sparkassen is built on three concepts of proximity:

- An individual bank must operate only within its designated geography;
- All loan decisions must be made by people located at that particular bank in that geography;
- The people making those decisions live in that geography giving them contextual knowledge.

While the particular Sparkassen model may be specific to Germany, the characteristics that make it successful – of genuine proximity, creating deep expertise within a geographically mandated area – is not. This can be part of the future for small business banking in the UK.

There are a number of examples of ideas that are emerging or being developed in localities. For example:

- **Nationwide** building society has expressed its intention to enter the market for small business lending from 2014.
- The development of the **Bank of Salford** is a good example of local authorities in the vanguard of new solutions as are local authorities working with Funding Circle to create local funding opportunities.
- Members of the Shadow Team Chris Leslie and Gareth Thomas have also published a policy review document supporting the development of **credit unions** as an

¹⁷ http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/4-03102011-AP/EN/4-03102011-AP-EN.PDF

¹⁸ http://www.dsgv.de/download_gallery/Englisch/E_DSGVO_Flyer11_120711_final.pdf

additional source of small business finance. The TUC also support a greater role for credit unions and mutuals within a more diverse banking sector.¹⁹

- Other alternatives might be to consider the potential to leverage **national savings** as a source of capital or for joint ventures between local authorities and commercial banks, perhaps with local authorities **borrowing against future revenues**.

There is no need to limit this future to the development of one particular model: the objective should be to create an enabling environment in which a diverse family of solutions could flourish.

Proximity can work for British banks too. Santander UK has expanded its small business banking rapidly (18% B2B lending growth in 2012 vs. 4% market decline) with an approach which champions local “credit partners” who make lending recommendations alongside local “relationship directors”. Santander UK believes that its localism enables better financing solutions, risk assessment and decision making.

Banks’ reliance on centralised, pattern-based credit decision making is compromised by poor data availability: **small business credit scoring** is typically far less sophisticated than consumer credit scoring. The **bank account data** necessary for assessing companies more effectively is kept relatively inaccessible by banks who only permit unwieldy manual downloads of recent (typically 4-8 weeks) transactions. This makes it hard for competitors to decide to lend to the same businesses in the way that, for example, On Deck Capital enables in USA.

On Deck Capital is a US small business lending company started in 2007. They offer loans from third parties of up to \$150,000 approved in as little as one business day. Lending is based on the “On Deck Score” which is a business credit score developed with Equifax.

On Deck’s platform allows businesses to create profiles, which link to electronic data sources, including online banking, accounting and merchant processing (and aggregates social, tax, and industry data), so third party banks and lenders can more easily access a potential borrower’s complete financial profile. This saves lenders from the hassle of collecting the data themselves, or relying on personal credit scores to evaluate credit.

The company already has four regional offices in addition to its headquarters, more than 140 employees and has issued more than \$350 million²⁰ in loans. On Deck uses technology to identify credit-worthy businesses that may struggle to get capital from banks.

To help extend bank lending to businesses perceived to be higher risk, the **Enterprise Finance Guarantee Scheme** was introduced in 2009 to replace the previous Small Firm Loan Guarantee scheme.

The EFGS offers loans of between £1000 and £1m with repayment terms from 3 months to ten years. Interest rates are a commercial matter for individual banks and

¹⁹ <http://www.tuc.org.uk/economy/tuc-21384-f0.cfm>

²⁰ <http://www.ondeckcapital.com/in-the-news/34-articles/371-record-growth>

reflect their assessment of the risk. Borrowers are also charged an annual guarantee fee of 2% by the Government.

The EFGS accounts for just 1-2% of total small business lending in the UK: a total of £294m was lent under the scheme during the 12 months to June 2012, compared with £680m over the 12 months to June 2010. The average loan size is around £100,000. Only around 8% of EFGS loans are for more than £250,000.²¹

UK government involvement in small business bank compares poorly with international best practice, in particular the US Small Business Administration.

The US Small Business Administration operates a family of government backed finance programmes including several *loan guarantee* programmes and the *Small Business Investment Corporation* (SBIC) programme. In the case of the SBA Loans programme, the SBA operates by licensing private sector companies which make the lending decisions, and all of the funding comes from the private sector. SBA guarantees mitigate investor risks, and like the UK Enterprise Finance Guarantee Scheme, this is paid for though what is effectively an insurance premium. The SBA then spreads the risk it takes on over a nationwide portfolio, the objective being that the costs of defaults are at least covered over the long term.

The SBA loan family includes 15 different products,²² ranging from “SBA Express” loans of up to \$350k with a turnaround time of 36 hours, to 7(a) loans of up to \$5m and available for a wide range of uses, from equipment purchase to working capital and debt refinancing. Maximum repayment periods vary, but can be as long as 25 years. The SBA sets some basic ground rules for each of the different loan instruments, including the percentage of the loan guaranteed and the maximum interest that can be charged. This depends on the category of risk at which the instrument is aimed.

Between January 2009 and April 2011, the SBA supported an average of \$23.8 billion in loans per annum,²³ with an average loan per business of around \$0.5m. Three quarters of these benefited from the reduced fees and higher guarantees made available through the American Recovery and Reinvestment Act and the Small Business Jobs Act. This figure represents roughly eight times the lending rate of the UK Enterprise Finance Guarantee scheme after taking into account the relative sizes of the two economies.

SBA loans are available from many more lending organisations than in the UK. There are 186 just within Massachusetts alone.²⁴ Around a third of all SBA loans are made by institutions with less than \$1 billion in assets and 50% by institutions with less than \$10 billion.

²¹

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/49464/Enterprise_Finance_Guarantee_Statistics.pdf p1

²²

<http://www.sba.gov/sites/default/files/Quick%20Reference%20Guide%20to%20SBA%20Loan%20Guaranty%20Programs.pdf>

²³ http://www.sba.gov/sites/default/files/MaineNews_November_%202011%20Newsletter.pdf

²⁴ <http://www.sba.gov/sites/default/files/Massachusetts%20Lenders%20List.pdf>

Between its inception in 1953 and 2008, the SBA's overall loss rate on its largest loan programme was just 5.83% (though loss rates during more recent years have been higher). It will adjust fee rates to make the programme self-sustaining over time.

SBICs operate further along the risk spectrum than SBA loans. Although structured as partnerships like venture capital funds, 45% of their financings are in the form of straight debt, for which the maximum rate of interest allowed is typically 19%. A further 23% of financing is in the form of debt with a small additional equity element (venture debt). US companies that benefited from SBIC funding in their early years included Apple Computers, Amgen Inc., Intel, Federal Express, and Staples. In 2011 SBICs provided a total of \$2.8 billion to US businesses.

SBICs operate by leveraging each \$1000 of private sector investment into the fund with \$2000 of unsecured loans (debentures) from the SBA. The money for these is in turn raised by the SBA through regular pooled SBA-backed Trust Certificates on the public markets.

The US SBA financing approach creates a symbiotic relationship with private sector banks and fund managers. Programmes are designed to help banks expand the range of financing products they offer businesses, encouraging competition and new entrants. In contrast, the UK Treasury placed such strict constraints on how the EFGS (and other) programmes are used that they have limited utility to private financial institutions.

Britain is alone among G8 countries in not having a dedicated institution dealing with small business financing issues and initiatives.²⁵ It is unclear whether the Business Bank announced by the Coalition will have sufficient means or ambition to make a significant difference to UK small business finance.

UK small business banking is an oligopoly dominated a **handful of goliath banks**. Customer service is – unsurprisingly – poor. In 2010 the OFT reported that only 30% of small businesses were “satisfied” or “very satisfied” with their banking services.²⁶ Firms may wait weeks to have a card payment acceptance facility opened, and then find that their card revenue is held for weeks before release. Bank loan decisions can also take weeks. These delays always constrain business growth, and sometimes lead to avoidable business failure. We believe that competitive pressures can lead to a transformation in banking customer service – but that pressure requires some new competitors.

It is **too hard for new competitors to enter the banking services market in the UK**. Don Cruickshank, author of an independent review into UK banking for Gordon Brown, put it well when said in 2005 “if you want to become a bank you’ve got to be a bank”.²⁷ As a result, there have been few new entrants into UK banking in recent decades. The primary constraints are capital (new banks are expensive to finance, and that capital is difficult to raise in Europe) and the cost of regulatory compliance (both lawyers and trusted technology platforms) because the FSA is perceived as unwelcoming of potentially risky new banks.

Regulatory capital requirements are a particular constraint on new banks. They exist for the right reasons: it is important that depositors know that they will be able to realise their

²⁵ <http://www.labourmatters.com/british-investment-bank.pdf>

²⁶ http://www.of.gov.uk/shared_of/personal-current-accounts/oft1282 p. 218

²⁷ <http://www.guardian.co.uk/money/2005/feb/18/business.accounts>

deposits at will. Nationwide have expressed their intention to enter the market for small business lending from 2014. To encourage such moves, we should be careful that banking reforms do not have unintended consequences. For example, enhanced capital requirements could have a disproportionate and unintended impact on organisations whose risk profiles are lower than typical high street banks.

Banking services do not need to be delivered by banks – alternative providers, sometimes called “near banks” are emerging with the ability to disrupt the culture of poor customer service.

Simple.com is a New York-based consumer banking startup. It is not a regulated bank itself, but rather provides a customer experience on top of a third party regulated bank (who stay invisible to the user). Simple.com has won plaudits from reviewers for its exceptional online self-serve customer experience.

FundingCircle is a UK business debt funding marketplace. Individuals can identify businesses to lend to, whose risk characteristics have already been analysed and priced. Since 2010, £73m has been loaned to over 1000 UK businesses.²⁸

MarketInvoice is a UK business invoice financing marketplace. Businesses raise capital against the invoices they have issued to customers. Capital is supplied by third party funders. £39m has been loaned since February 2011.²⁹

Alternative B2B finance companies are beginning to demonstrate real traction, but their growth is hamstrung by limited awareness among potential customers. Because alternative finance companies take only a small share of the public benefit they create they may not receive the level of financial support which would be optimal for government. Specifically, a company which facilitates finance for £100m of additional economic activity also stimulates millions of pounds of tax revenue on that activity (perhaps tens of millions). Hence it may be efficient for Government to directly fund marketing budgets for the alternative business finance industry to help them grow faster.

RECOMMENDATIONS

GOAL: Make the options for debt finance for UK business as varied and attractive as those anywhere else in the world.

Reforming the banking system

- 1 **Signal a clear commitment to the development of new local solutions for small business finance, inspired by the Sparkassen.** There is a wide range of solutions currently emerging, or in development, including mutual solutions. There is no need to choose one at this or any stage – in fact choosing one is how we have ended up with our current banking oligopoly. What is needed is a clear commitment to the development of a diverse family of solutions.

²⁸ <https://www.fundingcircle.com>

²⁹ <http://marketinvoice.com>

- The Taskforce has itself developed its own model for a network of new lending institutions for small businesses called **Sparks**, designed to stimulate local development, which could provide a way forward. (See box below) This very specific approach builds out a capability after starting with 20 pilot Sparks

The power of proximity: establishing a network of ‘Sparks’

There is no exclusive model for setting up a British equivalent of the German Sparkassen. Here we propose one idea called **Sparks** – a specific model for a network of new lending institutions for small businesses to stimulate local development – which could contribute to the solution. This is only one of many approaches that could be developed to achieve Sparkassen-like objectives. At this stage, more important than the particular model is a clear commitment to this development process.

UK small business lending suffers from two structural problems:

- First, banks are too big to make lending decisions on a case by case basis, the loan officer who knows the small business in question is many levels of management away from the risk committee setting lending policies.
- Second, there is a lack of pluralistic competition. With the big banks dominating the market there is little pressure on any of them to improve availability, lower prices or improve service.

Setting up a network of local lending vehicles - Sparks - to channel private capital into small businesses would address both these issues.

Each individual Spark would be small and focused on a particular geographic area or industrial sector so as to build up expertise, with a mandate to promote employment and economic growth through profitable lending. Each Spark would be a separate trust, answerable to local stakeholders (would could include, for example, local government, LEAs, and local chambers of commerce) but largely left to run itself.

Each Spark would be initially capitalised with £10m of public equity and £90m of private debt. Sparks small enough to be effective lenders are unlikely to be large enough to access capital markets on their own. But the network of Sparks acting together would be. So a central Spark Umbrella would raise capital by selling long term bonds to private investors. It would loan the proceeds to individual Sparks (at a slightly higher rate), who in turn would loan the money out to individual small businesses, allowing the Sparks to leverage the initial government investment. These Spark Umbrella bonds would be collectively guaranteed by the individual Sparks. The Spark Umbrella would also, for a fee, provide back office support to individual Sparks. This fee, and the profit it made on lending to Sparks, would cover running costs. The Spark Umbrella would be collectively owned by individual Sparks. Sparks might also use National Savings as a source of finance, perhaps with some local hypothecation of funds.

The first round of Sparks would result in 20 local lenders, each capitalised through £10m of public equity and £90m of private debt, for total small business lending power of £2bn. The impact on central government finances would be the £200m cost of initial Spark capitalisation. The subsequent private debt would not be government liabilities and would not count towards PSNB. The first round of Sparks would be an opportunity to test the model and learn. Further rounds could then follow until there are several hundred Sparks around the country.

While the first round of Sparks might require central government investment, they would leverage this through borrowing. Over time other groups (local government, entrepreneurs or philanthropists) could set up their own Sparks, and would be allowed access to Spark Umbrella finance. This is loosely based on the German Sparkassen network, where 423 local banks chains account for around 40% of German corporate lending. Sparks could relate to the British Investment Bank as the Sparkassen relate to the KfW, which does not have a distributive structure.

- 2 Expand the range of loans offered under the Enterprise Finance Guarantee Scheme to be closer in utility to the US SBA lending programmes. Specifically, **remove the “catch 22” requirement for banks only to use the Enterprise Finance Guarantee Scheme for commercially viable loans** which they would not otherwise make (because such banks are likely to finance loans they judge viable anyway). Instead the programme should be recast to grow the range of borrowing requests deemed “viable”, using similar criteria to the successful US programmes.
- 3 **Develop an SBIC-like programme** for higher-risk business lending and venture debt (debt combined with a small equity element). This may be achieved through extension of the existing Enterprise Capital Fund model.
- 4 Deliver a **British Investment Bank**. We support the case made by Nick Tott in his report published last summer for a British Investment Bank to increase finance for small businesses.

Diverse sources of credit for business

- 5 **Support the creation of challenger banks**. It is good to see new entrants already like Metro Bank and the Co-op developing as a major high street presence but there needs to be deeper and wider competition across all areas of the UK. The Bank of England, Treasury and regulators should together develop new procedures and support measures to make it easier and quicker for new specialised banks to become established. These might include financial support for early accounting, compliance and technology costs offered in return for total transparency about bank operating processes and difficulties.
- 6 Promote **risk-based capital requirements** for banks and building societies with lower risk lending models. These would recognise that different types of activity are associated with different levels of risk, and hence reduce barriers to additional lending in less risky sectors.
- 7 Legislate for comprehensive **bank data portability** so that businesses can easily broaden the range of financial services providers they use. It is typically impossible for UK businesses to access data about their own bank accounts or share that information with third parties (for example when requesting loans or doing accountancy). Data is not made available for automated access (via API) but is instead restricted to manual downloads, often for very limited date ranges. This data is not difficult to release: Barclays have recently enabled a “Data Services” product with this function (although it can only be used with a handful of accountancy applications). Labour should require that banks enable read-only transaction data feeds (APIs) for all customers who request them.

- 8 Government should give active support and encouragement to **emerging alternative finance marketplaces** and their participants. This means understanding the particular business models adopted by new providers and the challenges they encounter. For example, the growth of marketplace lenders is being constrained because they must pay interest income tax calculated *before* lending losses. This makes it unprofitable to lend to riskier businesses. The government should permit marketplace lenders to calculate income tax obligations based on interest net of bad debts, rather than pre-bad-debts.

Equity (from private sector investment funds)

The average return investors in UK Venture Capital funds is 0% per annum

The limited availability of early stage venture capital in the UK reflects the very poor returns it has provided investors in the past. However the public returns can be much greater in terms of jobs, workforce skills growth building technological advantage. Poor returns to early stage investors are often coupled with large ones for later investors, and the failure of any one business often provides the seeds of more successful ones. There are examples – notably Israel – where direct investments by government have proved successful. But government can also play a role in boosting venture capital investment to the level which is right for economy as a whole, whilst leaving investment decisions to the private sector. In doing so, it must remain cognisant that other forms of finance are more appropriate for most growing businesses.

Average returns to investors in UK venture capital have been much lower than those available to investors in less risky asset classes for at least two decades. For early stage VC funds, the average long run rate of return is currently around zero per cent per annum. **Venture capital therefore attracts little interest from institutional investors** and few invest capital. Returns elsewhere in Europe are similar or worse: this is often ascribed to the smaller size of European “wins” in comparison with American venture-backed businesses, a reflection of its more homogenous market. Aside from the overall level of investment, there are a number of specific problems with early stage venture capital that need to be addressed:

Most **VC funds are too small** and cannot follow through on their investments; this also results in proportionately high management fees and difficulty in recruiting and retaining experienced investment managers. It also leads to complex investor syndicates which take time for portfolio company Chief Executives to manage

The standard **ten year life partnership model is too short** for many science and technology businesses.

VC timescales and pressures from their own investors mean that **exits are largely through trade sales**. Export-orientated businesses are usually sold to companies based overseas, with the resulting loss of UK employment opportunities. Better sources of complementary non-equity funding are required to offer entrepreneurs the option of growing their business for longer as well as to improve VC returns.

Yozma: Israel's venture capital adventure

Governments can succeed with direct investment funds. For example, the ten Yozma funds created between 1992 and 1997 raised over \$200 million with the help of initial government finance. Those funds were bought out within five years and the whole government stake effectively sold on by 2000. Today they manage nearly \$3 billion of capital and support hundreds of Israeli companies.

These companies are early stage and almost all in high technology sectors. Yozma also triggered further independent private investment. As a result, Israeli venture capital survived the tech-stock bubble burst of 2000 and the rapid deterioration of the Oslo peace process from 2001. Its legacy was that limited partner venture capital funds grew at an annualised average of 85 per cent per annum on average between 1993 and 2000.

In contrast to the Israeli experience, British Government direct investment funds – in particular regional funds – have had a poor record for backing successful businesses. It is worth noting that the government's office of the Chief Scientist in Israel (which – despite the name – is better understood as a government investor arm for startups) has a specific objective to back riskier business projects which might not otherwise get finance. It invests some \$500 million a year in 3,000 companies. The portfolio is not based on a 100% success rate as this would mean the risk ratio is too low. There is a political consensus that this is the right approach – and an acceptance that there will be failures as well as good successes. On a recent visit to Israel by Labour's Shadow Ministers the Chief Scientist said: "In the area of innovation, government has an inherent role to play. You can't optimise the role of innovation by leaving it to the market".

The more recent Enterprise Capital Funds (launched in 2006), have shown more promise, though fund sizes – typically £35m - are below the critical mass needed by a viable early stage fund and they suffer from a number of important restrictions. More important the structure of government support does not deal with the fundamental problem, the very low returns experienced by the sector. This problem also applies to Government backed "funds of funds", aimed at attracting institutional investors to invest alongside it, and on the same terms, in UK VC funds.

Like the US SBICs ECF's work by leveraging each £1 of private sector investment with £2 of government debt funding. The structure enables private sector investors to get a higher return once the fund hits a certain profit target, but does nothing to protect investors from the very low average returns that have in practice been experienced by the asset class for at least a decade. As a result there has been very little interest from institutional investors and few ECFs have got off the ground. Those that have tended to be angel-backed and are mainly focused on digital where products can be brought to market very quickly.

Nevertheless, adjustments to the ECF structure could be used to deliver the number and size of VC funds we need. This could be achieved by making the government debt element partially subordinated to the private sector investment return. This would reduce the risk of major loss to investors in the same way that the Enterprise Capital Scheme uses Government guarantees to reduce the risk of loss to bank lenders. In return repayment of the Government debt and interest could have a "catch up" feature, which would come in to play once a certain level of profitability had been achieved. This structure would make ECF's much more attractive to institutional investors, whilst enabling the Treasury to share in the profits of the most successful.

By setting targets for the number and size of ECFs to be raised each year, say four new £100m funds per annum, and adjusting the terms until this was achieved, it would be possible to deliver a much healthier UK VC sector, whilst placing investment decisions firmly in the hands of private sector fund managers.

There is now a wide range of government-supported funds managed by Capital for Enterprise. Typically they are managed by commercial investment teams on commercial terms, which is a sound discipline. However, such **investment managers are typically reluctant to invest in businesses with a high operational overhead**: i.e. those firms which generate most jobs-per-pound-revenue. They also prefer high tech, high risk-high return opportunities to safer but lower returns in traditional industries. Whereas this may be seen as the easiest way to grow investor IRR, it does not meet the national need for finance outside of the high tech community and jobs in a diverse range of industries.

RECOMMENDATIONS

GOAL: To maximise the chances of growth firms finding equity capital when they have a good chance of delivering a positive investment return.

- 9 **Set targets for the number (and value) of ECF funds to be raised each year** and provide more flexibility in their structure to ensure these targets are met. **In particular make it possible for the government debt element in ECF funds to be partially subordinated** to private sector investments.
- 10 **Encourage larger ECF funds to be formed with total investment capital of £100m** (the optimal size for early stage funds) and with **fund lifetimes longer than the current ten years standard**.
- 11 **Encourage the creation of an ECF-type fund specifically for highly employee-intensive business models**. Such a fund could use a mixture of equity, debt and venture debt instruments to invest in companies with lower rates of growth, but also lower risk.
- 12 **Introduce EIS-like tax relief for institutional funds (pension funds, hedge funds, family funds etc) on investments in early stage businesses**. Equity investment by individuals is encouraged by the Enterprise Investment Scheme which gives various tax advantages to investors, but there is no equivalent incentive for institutional investors. The recommendation would change this, applying to institutional investments in any of: venture capital funds, firms which engage in early and earlier stage business, classic start-ups and currently small but rapidly expanding companies which have the potential to become very sizable entities. Such a scheme should be designed to reward patient capital: commitments over a five, seven or ten year period (rather than being susceptible to tax avoidance planning or investor short-termism).

Personal investments (from founders & business angels)

USA has 250,000 angel investors. The UK has less than 10,000
Entrepreneurs are the only ones unable to receive tax incentives on cash investments in their
businesses

The experience in Israel is a notable example of the success governments can have in making direct investments. But it can also, and should, encourage more private investment with enhanced tax schemes. Furthermore, nascent equity marketplaces should be assisted through their early growth phase with proactive state support.

The **UK lacks a strong angel investment culture** and angel investing remains a rare, niche activity with which most affluent adults are unfamiliar. NESTA reports that the USA's business angel investment per capita is more than 3.5 times that in Britain.³⁰ Whereas USA has around 250,000 angel investors, the UK has less than 10,000.³¹

EIS has recently been enhanced by the more generous SEIS (Seed EIS) benefits on investments up to £150k. These programmes are widely used and highly regarded by - startups, but they suffer from some important limitations:

- **Founders are unable to invest their own money via SEIS and EIS.** There is a disincentive for Founders with personal capital to deploy it in their own businesses. For those founders without capital, "bootstrapping" a business using salary income from another job is extremely expensive as only post-tax income may be invested.
- **(S)EIS is only available for equity** investments, not debt. This has two major disadvantages. First, it makes finance much harder to obtain for those businesses unable or unwilling to issue equity. Second, it creates an additional cost for startups because the legal work surrounding equity issuance is typically more expensive than simple investor debt contracts.
- **Entrepreneurs' relief is applicable on the sale of a business**, but not on dividends it pays out during its lifetime. This may encourage entrepreneurs to dispose of businesses before they hit their optimum size, and to restrict their investments to businesses with a likely medium-term exit.
- **Entrepreneurs' relief is only available to holders of at least 5% of the business.** This disenfranchises other employees who hold less than 5% from benefiting from the growth in the business they are actively contributing to.

Seedrs.com is a British online marketplace for early stage business angel capital. It launched in 2012 and has raised £1m in venture capital funding.³² Businesses advertise their business plans and capital requirements, and individuals may agree online to invest. A number of businesses have already been funded via Seedrs, but it remains a nascent business.

³⁰

http://www.ukbusinessangelsassociation.org.uk/sites/default/files/media/files/bbaa_nesta_siding_with_the_angels.pdf page 11

³¹ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32218/11-p116-annual-report-business-angel-market-uk-2009-10.pdf

³² <http://techcrunch.com/2012/07/05/seedrs-goes-live-to-help-crowdfund-the-gap-in-idea-stage-investing/>

RECOMMENDATIONS

GOAL: To catalyse a transformation in the amount of capital available from angel investors to early stage businesses

- 13 **Extend (S)EIS tax advantages** to debt investors (as well as equity) and company founders (as well as third parties). Extended (S)EIS would help individuals to use their pre-tax earnings from a salaried job elsewhere to fund their startups. To avoid the cash flow burdens of PAYE being paid and reclaimed much later, a one 28-day “rapid rebate” process should be introduced to permit reclaim of PAYE taxes on income invested in (S)EIS eligible businesses.
- 14 **Extend Entrepreneurs Relief beyond capital gains to dividends**, in order to remove the incentive for entrepreneurs to dispose of their businesses rather than grow them.
- 15 **Reduce the 5% threshold for on Entrepreneurs Relief to 1% or below** to allow more employees to benefit from investing in the high growth companies they work for.
- 16 **Promote (S)EIS awareness and participation among affluent individuals with a dedicated advertising budget.** Doubling the number of British angel investors would release hundreds of millions in additional business finance, so the upfront promotional expense would be rapidly repaid in business growth.
- 17 **Support and promote nascent startup equity marketplaces.** Services like Seedrs require light-touch regulation and government should build direct relationships with nascent marketplaces to ensure that regulation is not proving excessively burdensome.

Listing on public markets

2011 US technology IPOs raised \$4.5 billion: just \$389 million was raised in Europe
20 of 20 European tech businesses considering IPO are targeting USA listings

Britain is well positioned to create a leading 21st century European listing market, but that task will require government engagement and support.

The ability of successful businesses to list on public markets is critical to maintaining a functioning small business ecosystem and encouraging employment growth in the UK. This is because the prospect of an IPO makes investment at earlier stages (startup, angel, venture capital, mezzanine and traditional private equity) worthwhile even in the absence of a likely acquirer. It is also more likely that management teams will have the opportunity to grow their business in the UK, rather than being forced to sell their business early to an overseas acquirer who might be less likely to expand (or even continue) UK operations. As Europe’s leading financial services hub, London is the right place for IPOs to happen in Europe.

However, the London marketplace designed for floats of smaller and mid-sized businesses, is widely considered to be struggling to service the needs of European technology businesses.

In 2011 US technology IPOs raised \$4.5 billion, compared with just \$389 million raised in Europe.³³ Bank of America Merrill Lynch recently reported that 20 of 20 large European technology businesses considering IPO intended to do so in the USA.³⁴

It is for these reasons that the London Stock Exchange is developing an alternative “high growth segment”, to complement AIM and provide an additional path towards entry to the main market.

Stamp duty significantly increases the cost of investment on growth markets such as AIM and ISDX-quoted. The LSE argue that the cost of capital for small businesses in London could be reduced by up to 13% by removing stamp duty on the purchase of shares in these markets. Stamp duty raises the cost of equity fundraising for UK business by an average of 7.5-9% and for technology companies by 10-13%. In the US there is no equivalent to stamp duty on equity.

RECOMMENDATIONS:

GOAL: To make the UK the best place to list a successful small business in Europe

- 18 **Ensure London has the right market offering for high growth businesses, in particular to compete with the US (Nasdaq).** Support the development of a new route to the UK IPO markets for high growth businesses in close collaboration with London Stock Exchange. In particular we support LSE’s establishment of a new High Growth Segment within its Main Market for high growth UK and European businesses as a step in this direction.

- 19 **Eliminate stamp duty for companies quoted on growth markets such as AIM and ISDX.** Removal of the tax would reduce the cost of capital for these companies directly impact their valuation and encourage additional investment in UK equities resulting in economic growth over the longer term. Removal of the tax will also have a significant signalling impact to the investor community and have only a modest impact on Government revenue, as it constitutes less than 3 per cent of the overall revenue from Stamp Duty on shares (approximately £72 million).

³³ <http://www.bloomberg.com/news/2012-04-05/europe-s-tech-startups-spurn-home-turf-for-facebook-fever.html>

³⁴ http://www.russellreynolds.com/sites/default/files/trends.and_moves_software.europe.2013.pdf

3. People and Skills

As local and global economies change, the capabilities required of their people change too. Serious intervention is required to ensure that UK small businesses have access to the leadership and staff skills they need to succeed.

Equipping entrepreneurs

UK ranks 14th among developed nations in entrepreneurial attitudes, activities and aspirations

Self-employment is on the increase, up 5% between 2011 and 2012
Under the last Labour Government's New Deal for Self-Employed, of 100 self-employed jobs created, 28 went on to employ up to 5 people and 6 became significant growth businesses

Contrary to the myths of the "natural" founder, entrepreneurship is also a learnt skill and people get better at it. Government is well placed to support - if not to manufacture - programmes which help leaders enhance their own skills. The spirit of entrepreneurship is not in the hands of a few but the hearts of the many. We need to reduce the barriers to setting up a business, making entrepreneurship a normal career choice for more people.

Britain does not have a universal culture which breeds entrepreneurship. It is no surprise that data from The Global Entrepreneurship and Development Index shows us as 14th among developed nations in entrepreneurial attitudes, activities and aspirations – neither is it surprising that USA tops the list. In the absence of a pervasive culture of startups, the lack of widespread training in basic entrepreneurial skills keeps Britons focused on being employed, not employers.³⁵

The opportunity to use the internet to deliver top-quality informational resources has not been grasped. Business Link's online information service was poor. Gov.uk is an improvement but information remains superficial in important areas (for example access to finance).

While *taking* risk usually features prominently as a defining characteristic of entrepreneurship, the ability to *manage* risk is a key distinguishing feature of successful entrepreneurs. Entrepreneurs who manage risk use every opportunity to eliminate uncertainty and in the process develop more effective innovation strategies which are closely aligned to market requirements. This staged approach to strategy and investment enables small businesses to be flexible and agile – key attributes to finding, developing and exploiting business opportunities. Insufficient attention has been focused on risk management skills for entrepreneurs.

Following the success of Y-combinator in America, in 2007 Saul Klein, a prominent European venture capitalist, established Seedcamp as a European accelerator programme for very early stage technology businesses. Initially one week-long mentoring week took place with less than 18 participants competing for 6

³⁵https://workspace.imperial.ac.uk/innovationstudies/Public/GEDI_2012_UK_report.pdf

investments of €50,000. Seedcamp now has over 70 investments and has mentored hundreds of businesses at events throughout Europe. Its educative function is widely regarded as having led to a transformation in the quality of early-stage European software businesses.

Aston, Leeds and Manchester Metropolitan University business schools, along with UCL, manage a successful implementation of an accelerator programme relevant for slightly later stage businesses. The “10,000 small Businesses” initiative, funded by Goldman Sachs, services businesses which may be more established - often with turnover above £500,000. Over 300 companies have participated in the programme since 2010.

The global trend towards business accelerators, incubators and hubs has some notable British-based proponents. However the successful programmes are limited in number and often competitive to join: they are not resourced to accommodate all those businesses who would benefit from their assistance.

Self employment: Cultivating the three ‘C’s - Cash, Confidence & Credibility

Almost 4.2 million people were registered as self-employed in the three months to August 2012, a rise of five per cent over the previous year. This is part of a longer term trend, with the recent spurt partly a consequence of recession as job openings are fewer and redundancy packages offer some the capital needed to go it alone. But, too often, the self-employed are often overlooked when discussing small firms. There is a real need, for example, to provide dedicated support for those currently unemployed or underemployed who have the capacity to become self-employed. People aged 50+ account for more than four-fifths of the rise in the number of self-employed since 2008.³⁶

Recognising best practice: The Prince's Trust Enterprise programme

The Prince's Trust Enterprise programme supports unemployed young people aged 18-30 to work out if their business ideas are viable and whether self-employment is right for them. Depending on the outcome of this process the programme can then offer mentoring support and – for those that need it – financial support to start a business. If at the end of the exploratory phase young people do not go on to set up a business then they are provided with mentoring support to secure goals in employment, education or training.

After attending an initial Information Session, young people attend a four day Explore Enterprise course to learn about topics relevant to planning and running a business and to consider whether self employment is right for them. It is designed to be practical, interactive, visual and based around discussions and activities. It aims to enable young people to feel what running their own business would be like and what it would involve. Following the course young people receive one to one support and mentoring to start their business.

The following things – which the programme provides – are important in giving young people the best chance of successful self-employment:

- An understanding of the pros and cons of self-employment and of employment

³⁶ <http://www.ft.com/cms/s/0/9f1fcc54-7044-11e2-ab31-00144feab49a.html>

- Support for whatever path they choose (pressuring people into starting a business isn't helpful)
- A basic grounding in business/enterprise skills training (Explore Enterprise course covers tax, sales, marketing, finance, etc)
- Assistance with putting together a business plan
- Start-up funding – not all young people will need it but it is important for those who can't access finance elsewhere
- Help to know where and how to access specialist support, e.g. legal advice
- Volunteer Business Mentor to see them through the first 2 years
- One to one support throughout to help young people with other aspects of their life, such as support with benefits or housing

The obstacles to self-employment are the “three Cs” of cash, confidence and credibility. These challenges particularly relate to lone parents, those with disabilities, military leavers, ex-offenders, the unemployed, and others seeking to grow their own enterprises. Under the Labour government's New Deal for the Self-Employed programme, for every 100 self-employed jobs created, 28 developed into a small business employing one to five people; and of these firms, six became significant growth businesses.

A key part of the New Deal programme was the ability to test trade. This addressed the “cash” obstacle mentioned above. The current tax credit system provides help to the newly self-employed by providing a top-up to low earnings initially. The proposed Universal Credit is much less supportive of the self-employed and could create a real obstacle for those intending to work for themselves, which business organisation have criticised including the FSB.³⁷

RECOMMENDATIONS:

GOAL: To have effective skills support available for every type of entrepreneur

- 20 Develop, with business, a **comprehensive training programme for business leadership and management skills** which reflects the needs of different types of entrepreneurs. The existing BTEC in Enterprise and Entrepreneurship has potential to be the basis of formal education. It should now be promoted to entrepreneurs of all ages (not just school age) and be allied with practical experience of business creation, potentially with some funding for simple startups created by course participants, and hands-on mentoring by existing entrepreneurs.
- 21 Rescope the government's **online entrepreneurial resources** (currently at Gov.uk) so that it is less of a regulatory checklist and more of an always-on, comprehensive Open University-type resource for distributing any entrepreneurial knowhow which can be trained online. For example, education about governance and liability issues, hiring, HR, book keeping, credit online training materials.
- 22 **Schools should normalise entrepreneurship as a career path.** All careers services should make it clear to school leavers that startups are an option, albeit a challenging

³⁷ <http://www.cesi.org.uk/social-inclusion-news/2012/sep/professional-bodies-attack-wholly-impractical-universal-credit-regula>

one. Entrepreneurial risk management will form a key part of this programme in order to maximise the economic performance of new ventures while simultaneously minimising human and financial costs often associated with low performance business start-ups. Every school should invite local entrepreneurs - ideally developing an ongoing relationship - to present to pupils about the advantages and challenges of founding a business.

- 23 Government should **support business led and run successful incubators, accelerators and hubs** with funding, training programmes, access to key stakeholders, and promotion to entrepreneurs. Funding should reinforce success – with funding diverted from failing to succeeding programmes – so that overall there is a sufficient quantity of high quality of programmes available. In particular, new hubs in regions with an existing local specialism (e.g. gaming in Dundee, design in Brighton) can be encouraged to catalyse skills sharing for existing and potential employees.
- 24 **Extend the benefits of Employer Supported Childcare to the self employed.** The original rationale for this relief was to encourage employers to provide workplace nurseries, and so there were good reasons why it did not cover the self employed. Over time the scheme has been extended to cover all forms of registered childcare, not just workplace nurseries. There is now no substantive reason why self employed workers should not also benefit. Self employed workers are entitled to claim the childcare element of Working Tax Credit in the same way as employees. This equal treatment should be extended to Employer Supported Childcare also.
- 25 **Develop dedicated programmes to help groups of people who face particular barriers to becoming self-employed.** These groups would include long-term unemployed, those with disabilities, some ethnic minorities, lone parents, military leavers, and ex-offenders. This might include programmes to bolster business networks, promote access to finance and encourage mentoring. Experience has shown that when support for these groups is in place significant numbers of self-employed jobs can be created which in turn leads to the creation of business. This would not require an additional funding, it would require merely a ring-fencing of existing funding currently allocated for Job Start programmes to be used for self-employment. As 16% of the workforce is currently self-employed (anticipated to grow to 20% by 2020) it would be reasonable to ring-fence at least 16% of current Job Start funds for this purpose, to be spent on advice and hands-on support for business creators.
- 26 Create a **financial cushion to support the earliest stages of self-employment.** This may be either finance for test trading or a form of credit to support low earnings at start-up. As with the previous measure, this would not require additional investment but may require a proportion of low pay benefit to be allocated for those who are self-employed. Comparable schemes already exists in France (ACCRE) and used to exist in the UK under the New Deal for the Self Employed.
- 27 Government should create an **entrepreneurship-focused internship programme for long term and youth unemployed** so that they can participate in new ventures – in many cases eventually becoming employed by these businesses. The “Entrepreneurship Internship” will raise the entrepreneurial skills and confidence of the unemployed while also providing a valuable support to resource constrained business start-ups. It will also enable new ventures to learn and commence the job creation process in a low risk environment.

Employees: developing people and eliminating barriers to additional hiring

Small businesses create 85% of new jobs in Europe
GE Capital expect British small businesses to create 450,000 new jobs in 2013
The BIS Department has just 10 apprentices under the age of 25³⁸

It is in our nation's interests to ensure that industry is able to hire as many people as it needs. It is a role of government and business to help ensure employees' skills are at the right level. Employment law must strike a right balance between employee and employer needs, but there should be help and support to solve problems as early as possible, and simpler procedures to resolve more simple disputes.

Across Europe, small businesses create 85% of new jobs.³⁹ GE Capital expects British small businesses to create 450,000 new jobs in 2013.⁴⁰ This is despite smaller businesses finding hiring harder: they usually have neither the HR departments nor hiring budgets to ensure the flow of suitable employees which is enjoyed by larger businesses.

In particular, smaller businesses complain about the difficulties of finding employees with **basic skills**. Simple maths, literacy and professionalism are not as widespread as small businesses need them to be and too many youngsters leave education without them.

Recognising best practice: The Prince's Trust "Get into" Vocational Courses

"Get into" programmes are short vocational courses that develop young people's skills in a specific sector. Last year, around 50% of young people completing a Get into course moved on to work with a further 25% going on to more training. They cover a variety of sectors such as retail, customer service, construction, logistics, hospitality and cooking. Sectors are chosen according to regional employment needs and are designed and developed with local employers.

Get into aims to give young people aged 16 to 25 who are work ready, but do not have vocational skills, a mixture of practical training and experience that will enable them to get a job. It also provides them with the opportunity to meet potential employers. Courses vary in length for the intensive input from between two and six weeks. After the intensive element of the course has finished participants are offered six months support to help them into employment or further training.

To maximise the chance of young people moving into employment the courses are designed around the following key principles:

- Programmes are designed and delivered with employers around the availability of suitable jobs (entry level with opportunities for progression)

³⁸ Answer to Parliamentary Question by Jo Swinson MP, 16 January, 2103, <http://www.publications.parliament.uk/pa/cm201213/cmhansrd/cm130116/text/130116w0001.htm>

³⁹ http://ec.europa.eu/enterprise/newsroom/cf/itemdetail.cfm?item_id=5708&lang=en

⁴⁰ http://www.prospects.ac.uk/latest_news_small_businesses_to_create_450_000_new_jobs.htm

- Opportunity to bridge the vocational skills gap in a specific area of work
- Opportunity to gain any necessary qualifications appropriate to the sector
- Practical experience of work
- Young people have a buddy from the employer's staff who provides guidance and encouragement
- Opportunity to enhance their employability skills, including communication, teamwork, reliability and presentation
- Support to meet employers with job openings – we work with employers to deliver the programme but if the partner does not have enough jobs for all young people then the Celebration event at the end of the programme is an opportunity to invite and introduce other employers with suitable jobs. Sometimes this might involve a company's supply chain
- Support with job interviews and preparing their CVs
- One to one support throughout to help young people with other aspects of their life, such as support with benefits or housing

Apprenticeships are critical in creating job-readiness. Currently the UK has nothing of the size and impact of the Austrian or German apprentice programmes. UK apprentice programmes are expensive at between £3,000 and £6,000 per learner but not always effective. Some see apprenticeships as second-rate options, while colleges and schools have a financial incentive to promote staying at school rather than taking apprenticeship. This culture needs to change.

Austria: Apprenticeship training in Austria is organized in a dual education system: company-based training of apprentices is complemented by compulsory attendance of a part-time vocational school for apprentices. It lasts two to four years – duration varies depending on industry sector. About 40 percent of all Austrian teenagers enter apprenticeship training upon completion of compulsory education at 15.⁴¹

Germany: In the German dual system apprentices spend about 50-70% of their time in companies and the rest in formal education. 1.5 million people are trained annually, and around 90% of apprentices complete their 2-3 year training.⁴²

Some sectors experience small but persistent, **structural skills shortages**. For example, the UK currently has an extreme shortage in software programmers. This has real impacts: companies find it hard to discover, attract and retain talent no matter how much they are willing to spend. The high price of talent is a disincentive to business innovation.

Labour's Education Team has already been generating ideas to improve basic skills, such as the development of speaking skills. Improving job readiness is a focus of Labour's Skills Taskforce and the Taskforce is also assessing the skills system from GCSE to A-level (or Labour's proposed new TecBacc), through to employment and skills through life. Ed Miliband has signalled the intention that skills funding is passed down to firms – critical for ensuring business take the lead in developing workforce skills.⁴³

⁴¹ <http://wko.at/statistik/jahrbuch/Lehrling5.pdf>

⁴² <http://www.npr.org/2012/04/04/149927290/the-secret-to-germanys-low-youth-unemployment>

⁴³ <http://labourbisteam.org.uk/government-apprenticeship-drive-stalled>

Recognising best practice: UnionLearn

UnionLearn is the learning and skills organisation of the TUC. It works to assist unions in the delivery of learning opportunities for their members, providing education and training opportunities for workplace reps and professionals. Union learning representatives (ULRs) work with employers and workers so that both get the training and skills needed. ULRs have been instrumental in championing the importance of training and development in the workplace.

Politicians of all major political parties have endorsed the success of UnionLearn, with Conservative Minister John Hayes calling it a 'powerful tool' for improving the skills vital for economic growth.⁴⁴

Smaller businesses can be particularly fearful of **employment tribunals and HR legal compliance**. The impact of a single poorly performing member of staff may be less acute in a large business and it may have robust proven processes to remove them. On the other hand a small business can be significantly damaged by a non-performing member of staff and the processes to remove them may be unproven. This can make small businesses reluctant to hire permanently precisely those employees who the law is designed to protect.

The Government have already made significant changes to the employment tribunal regime including the introduction of pre-claim conciliation procedures. The impact of these changes on the number of cases going to tribunals – and on the success ratio of those cases – should be fully evaluated before further changes are proposed.

The use of **freelancers** as a means of ring fencing and managing the risk in innovation and business growth is significant. Successful venture development using freelancers leads to the creation of sustainable businesses and hence additional employment. This job creation process needs to be facilitated while simultaneously dealing with false self-employment aimed at tax avoidance.⁴⁵ We note the review the Labour Party is also undertaking into this.⁴⁶

RECOMMENDATIONS

GOAL: Help small business grow through effective employment of skilled individuals

- 28 **Launch an NVQ in “general employability skills”**, with appropriate teaching available free of charge for any citizen until they meet its standard. Its curriculum would cover English language, workplace skills, basic numeracy and computer literacy. Most students could be expected to pass this qualification without study: its purpose is to help those who can't. However, employers would find it a useful way to filter job applicants, and would-be employees would find it useful to understand and address their own basic skills gap. Such a programme should be designed for rapid adoption by high volume, low skills employers so as to quickly become a standard.

⁴⁴ <http://www.tuc.org.uk/industrial/tuc-18195-f0.cfm>

⁴⁵ For an overview of the issues regarding a distinction between genuine freelancing and false self-employment, see Burke, A.E., *The entrepreneurial economy*, Fabian Policy Report: New Forms of Work, October 2012.

⁴⁶ <http://www.yourbritain.org.uk/agenda-2015/policy-commissions/work-and-business-policy-commission/protecting-workers-including-the-role-of-agency-workers-the-living-wage-and-gangmasters-licensing-authority>

- 29 **Pilot a formal system of dual apprenticeships** with a plan to scale the programme to 50% of 16-18 year olds within a decade. Ensuring that there are sufficient apprenticeships available is an appropriate role for local authorities in partnership with local business.
- 30 **Redeploy apprentice subsidies from education training providers to employers.**
The Government should evaluate businesses receiving a National Insurance subsidy for recruiting apprentices. This scheme could be funded through the re-direction of some of the £3,000-£5,000 p.a. funding currently paid to Education Training Providers (ETPs) for each apprentice placed. We note the Labour Party's Skills Taskforce is looking at this area and Ed Miliband has signalled the intention to put skills money into the hands of employers, along with the responsibility to train.
- 31 Using all appropriate resource, **reinforce the success achieved by the Prince's Trust Programmes** for vocational work experience and enterprise.
- 32 **The points based immigration system must become more sensitive to the skills constraints of high growth firms, both in the way the policy is set and particularly in the speed with which it is administered.** In the longer term, meeting the skills needs of business must depend more on a well functioning system for training workers than on immigration.
- 33 **Create greater clarity in the distinction between genuine freelancing and false self-employment** to enable small businesses to use freelancers legitimately. Small businesses need clear guidelines to distinguish between work that has transformed from the freelance to the employment stage.
- 34 Work with employer organisations to **encourage firms to use insurance schemes** such as the Federation of Small Business' or call off contracts **to ensure early access to HR and employment law advice.** By offering robust early advice on the strength of a claim, this would put employers in a stronger position to decide whether and how to defend a claim, before incurring much expense.
- 35 **Channel simple employment tribunal claims based on minimum statutory rights or contractual disputes through a separate fast-track process.**

4. Customers: Lead Customers, Government Procurement, Late Payment and Exports

There is much that government can do to make it easier for small businesses to do business with larger institutions, be they government or private sector, at home or abroad.

Lead customers

Vodafone's DNA traces back to Racal and its MOD lead customer technology contracts
"... a business plan that says the first thing we are going to do is sell into the NHS makes it uninvestable" -- Dr Andy Richards, one of the UK's leading biotechnology and healthcare investors⁴⁷

"Lead customers" can play a vital role for start-ups and small businesses developing new and innovative products and services. Being the first to buy new products or engage with a new business is crucial to the launch and hence its viability. Lead customers provide early feedback and an endorsement for subsequent customers and investors. For many specialised products lead customers can do much more, by defining unmet needs or by paying for all or part of their suppliers' development and testing costs.

This kind of collaboration takes place in **many sectors of industry**, including pharmaceuticals, engineering and software. Often a series of one-off contracts for different customers helps a small business go on to develop its own products. Sometimes lead customers are very happy for their suppliers to sell new products more widely even though they may have paid for much of the development.⁴⁸

Lead customers provide a stimulus for innovation and the funding to enable entrepreneurs to grow their businesses, rather than having to rely on venture capital and the inevitable pressures to sell the business early. So **lead customer funding helps create more UK jobs**. For some specialist businesses, they represent the only source of funding available.

There are many examples where successful big businesses owe their existence to the UK Government playing lead customer to a small business in the past.

During the 1970s MOD contracts paved the way for the later success of Wolfson Microelectronics in Edinburgh, Filtronics in County Durham and Cambridge Silicon Radio. Vodafone's initial expertise derived from the experience that Racal, its parent, developed as a result of developing radio technology for the MOD.

Amersham International, now GE Healthcare, has its origins in a national centre set up in 1946 at the Government's Harwell nuclear laboratories to develop and

⁴⁷ Evidence to House of Commons, Science and Technology Committee Inquiry on Bridging the "Valley of Death": Improving the Commercialisation of Research, Wednesday, 18 April, 2012.

⁴⁸ See Connell, D. and Probert, J. (2010), *Exploding the Myths of UK Innovation Policy: How 'Soft Companies' and R&D Contracts for Customers Drive the Growth of the Hi-Tech Economy*, Centre for Business Research, University of Cambridge.

manufacture radioactive materials for healthcare and other non-military applications. It is now the first GE business unit to be headquartered outside the United States.

ARM, which supplies processors for 90% of the world's smart phones is just one of a series of successful spin outs from Acorn. In 1981 when it was awarded the contract to make computers for the BBC's Computer Literacy programmes, Acorn employed less than ten people.

But in the absence of meaningful departmental budgets for innovation the UK government now plays this role of lead customer only by chance. Even in the case of the MOD, changes in procurement procedures, together with declining budgets, mean that very little is spent on funding innovative new technology in small businesses. By contrast, the role of the lead customer is embedded in the US innovation and procurement system.

American aerospace, computer, electronics and software industries can all trace their origins to Federal Government R&D contracts. The Department of Defense, NASA and the National Security Agency have been especially important pioneering – wide ranging applications of new technologies that are later applied in mass markets. And this process continues today, with products ranging from robotic vacuum cleaners to camera phone sensors being launched on the back of Federal R&D contracts.

Ever since 1980, successive US administrations have worked hard to ensure that R&D procurements harness the innovation potential of small firms. The Small Business Innovation Research (SBIR) programme awards them some \$2.5 billion dollars each year in the form to develop new technologies and products the government needs to meet its own objectives.

The SBIR's programme managers call it the *"biggest seed capital fund in the world"*. It uses a well designed, regular process through which all the main government agencies advertise topics where they need solutions. Funding is released in two phases to manage risk and focus in on the most promising projects. It covers 100% of the contractor's costs, plus a profit element. Successful firms typically receive over a million dollars each and there are larger R&D contracts available outside the SBIR programme - as much as another \$5 billion directly and more through subcontracted R&D for larger companies.

Companies participating in the SBIR keep any intellectual property generated and are given help with commercialising it through government and non government customers.⁴⁹

The UK's comparable **Small Business Research Initiative (SBRI)** – created by the Labour Government – continues to receive the support of the current Government. It is a good programme, offering 100% funding with no requirement for an artificial collaboration. It is linked to a potential customer need, and it provides endorsement for subsequent customers and investors. Many industry associations and independent bodies have called for its expansion. But it has not yet reached anything like the scale required.

⁴⁹ *"Secrets" of the World's Largest Seed Capital Fund: How the United States Government Uses its Small Business Innovation Research (SBIR) Programme and Procurement Budgets to Support Small Technology Firms*; David Connell, Centre for Business Research, University of Cambridge, July 2006.

For public sector customers, SBRI's phased approach enables a variety of possible projects and solutions to be explored before focusing on the best. This helps to manage risk. However, despite its popularity with small businesses and those in government departments which have used it, **total SBRI spend is still only around £20-£30m per annum** and the size of each contract can be too small to make a difference. The average size of Phase 1 contracts for feasibility testing is £60k against a planned range of £50-100k. For Phase 2 prototype development the average size of contracts is only £158k against a planned range of £250k to £1m. Current budget restrictions mean many competitions do not proceed to Phase 2 at all. By March 2012, MOD had awarded only 2 Phase 2 SBRI contracts.⁵⁰

The main reason for low utilisation of SBRI is that the **Government does not ensure departments have the obligation and budgets to fund experimentation**. And while lip service has been played to innovation through procurement guidelines, innovation strategies and other forms of exhortation, without dedicated budgets, fear of being hauled in front of the Public Accounts Committee for "getting it wrong" can dominate decision making.

UK departmental budgets for research and development – the obvious source of funding for SBRI – are small and largely devoted to policy advice and academic research - whereas in the US they finance genuine technology development. Successive departmental reorganisations have resulted in even the officials responsible often not knowing how much has been spent on R&D. There has been a tendency to overstate real R&D expenditures in some important departments.

Using operational procurement budgets to fund innovation is also rarely possible under government processes. Departmental procurements focus on buying best value solutions for immediate use, irrespective of whether they come from a UK or UK based company. No other developed nation has quite this nationally agnostic approach. So the reality is that departments attach no value to trying to ensure that the best value solution can come from a UK firm next time a procurement decision is made. In the US, the opportunities from securing a government contract can often be factored into a firm's business plan, helping the business to lever in other finance.

This is damaging to the UK economy as well as to the effectiveness of government departments. To enable government departments and public bodies to play a more constructive role in economic development as lead customers for innovative products and technologies, they must have a clear mandate and accountability, as well as the budgets to do the job.

RECOMMENDATIONS

GOAL: To increase significantly the role played by government and private sector companies as lead customers by funding the development and trialling of innovative products and services by UK small businesses.

⁵⁰ Task Force analysis of data provided in answer to Parliamentary Question by then Minister of State (Business and Enterprise) Mark Prisk on 18 April, 2012, <http://www.publications.parliament.uk/pa/cm201212/cmhansrd/cm120418/text/120418w0001.htm>

- 36 **Expand the Small Business Research Initiative to £250m of contracts per year**, with dedicated budgets operated through the Technology Strategy Board⁵¹ (TSB) working with other spending departments. This figure is broadly comparable with the US SBIR after taking into account the relative sizes of the economy. As now, companies of all sizes should be eligible for innovation contracts, but with the expectation that most contracts would go to small businesses.
- 37 **Add a new “Larger Innovation Contracts” programme worth £250m for larger scale demonstration projects** above the £1m SBRI Phase 2 ceiling. Like the SBRI, this should be linked to future government needs and policies, again with a dedicated budget.
- 38 **Establish a similar £100m programme to SBRI to encourage private sector companies to play the role of lead customer to innovative small businesses.** This could be achieved while still being compliant with EU State Aid regulations, but BIS has – so far – been unwilling to take this forward.

Government procurement

UK government spends £240 billion a year on goods and services. US Federal laws and targets ensures – de facto – that 45% of US Federal procurement spend is with US small businesses. In the UK there is no precise monitoring by departments even of direct procurement spending with small businesses.

It is essential for Government to buy both directly and indirectly from smaller suppliers as small business procurement has a dramatic impact on financing innovation, growth and job creation. Government, both national and local, must therefore “go the extra mile” to work with smaller suppliers.

The United States leads the world in its pro-small business, pro-local procurement framework.

There are four main elements to US policy:

1. *Set Asides for Small Businesses*

Purchases of supplies and services between \$3000 and \$150,000 are automatically set aside for small business.

2. *Goaling Programme*

Federal Government aims to spend at least 23% of its total procurement budget **directly** with small US businesses as prime contractors. Individual goals are negotiated on an agency by agency basis. Performance against these targets are monitored closely.

⁵¹ The Technology Strategy Board is an executive non-departmental public body dedicated to promoting technology-enabled innovation. It is sponsored by the Department for Business, Innovation and Skills.

3. *Small Business Subcontracting Programme*

The SBA negotiates goals for the percentage of individual agencies larger procurements subcontracted by prime contractor to small businesses. Prime contractors must submit a subcontracting plan with each major tender above around \$700,000 and are required to report regularly against targets.

4. *Transparency, Internet Tools and the SBA Office of Advocacy*

There are a range of internet tools to ensure these objectives are achieved. The SBA Office of Advocacy monitors performance against targets closely.

Taking into account both direct and indirect procurements **45% of total US Federal Government spending is effectively reserved for small US businesses.**⁵² Some elements, notably the subcontracting targets, would entail a high level of bureaucracy if implemented in the UK. However, there are some important lessons for the UK, in particular the way that targets for direction spending with small businesses are set and accurately monitored.

UK Government procurement spend of £240bn contains substantial revenue opportunity for small business if they are able to access more of it. The government has introduced an **aspirational target of 25%** of government procurement spending going to small businesses.⁵³ However, the lack of accurate base line data makes it impossible to say if this is an appropriate target or not. According to the first Cabinet Office progress report, the proportion of central government procurement spent directly with small businesses was on track to double “from 6.5% in 2009/10 to 13.7% in 2012”,⁵⁴ and indirect spending with certain departments increased this figure to 14.5%. However, the data here is weak. The figures quoted are based on sample surveys and departmental returns, and previous surveys carried major caveats with huge margins of error, bias and partial coverage. The increases quoted may reflect the desire of officials to please.

Smaller businesses often feel unable to compete in consortia against larger businesses because **consortia can be difficult to assemble**. Specifically, one interested firm may be unaware of a complementary company, and procurement officers may even refuse to share information about other possible bidders. As a result, many potentially strong small business consortia never see the light of day. This is increasingly important as pressure mounts on departments to bundle contracts to achieve economies of scale and drive down prices (as recommended in Sir Philip Green’s 2010 report to the Prime Minister). This has had the side effect of making it more difficult for small businesses and new suppliers to sell to government.

It is notable that the 25% target for small business procurement **only applies to central government**. Yet across the UK, **local authorities already spend £88 billion a year** on goods and services (£62 billion in England alone).⁵⁵

Smaller businesses often find it **as much of a struggle to win tenders from local authorities as from national government**. The tendering process is usually designed with large businesses in mind and can include cumbersome pre-qualification procedures, unreasonable turnover and cash flow requirements, and over-long, bureaucratic form-filling.

⁵² Connell, D., “Secrets” of the World’s Largest Seed Capital Fund: How the United States Government Uses its Small Business Innovation Research (SBIIR) Programme and Procurement Budgets to Support Small Technology Firms, Centre for Business Research, University of Cambridge, 2006.

⁵³ <http://procurement.cabinetoffice.gov.uk/sme-growth-agenda.php>

⁵⁴ <http://www.cabinetoffice.gov.uk/resource-library/one-year-on-implementing-government-ict-strategy>

⁵⁵ <http://www.fsb.org.uk/News.aspx?loc=pressroom&rec=7779>

Those officials who try to use procurement creatively to support their local economies often get precious little recognition or reward. It is perhaps small wonder that many adopt a “safety-first” mentality in favour of bigger firms or shelter **behind poorly-understood EU procurement rules** as an excuse for inaction.

A first step lies in the reform of national procurement rules. We are interested in how the Welsh Labour government is leading the way in small business friendly procurement by promoting the use of “**community benefit**” **requirements in tenders**. These emphasise the importance of local supply chains and social outcomes while remaining within European Union procurement law. For example, would-be contractors are asked how they will actively participate in economic regeneration activities or how they will use unemployed people.

This directly confronts the myth that all sorts of things are not possible under EU rules – for example, that contractors cannot develop the market (e.g. through “meet the buyer” events) or discuss or negotiate with tenderers. As the Local Government Association points out, there are **many possibilities under EU rules for public purchasing to stimulate local growth**, which has the knock-on benefit of supporting small businesses.⁵⁶

RECOMMENDATIONS:

GOAL: Increase government small business spend up to 25% and make government procurement work for local communities.

- 39 Our most important procurement recommendation is to **execute faithfully existing procurement policies with urgency, rigour and consistency**. This involves driving cultural change and execution across Whitehall and local government. For example:
 - Small businesses (and industry in general) need a stable long term **5 to 10 year demand signal with progressive levels of certainty** as the time horizon becomes nearer. No business can make sensible investment decisions without this.
 - There has been a commitment to **early consultation with industry** before the competitive process begins to enable industry to innovate and find different ways of meeting a requirement. This process has had great success in a few areas but needs disciplined implementation across the government estate.
- 40 To enable meaningful departmental targets and monitoring of the percentage of procurements expenditure going to small businesses, **gather accurate data on each contract exceeding a minimum and hold officials responsible for developing, executing and most importantly achieving their targets for direct spend with small businesses, as well as for maximising indirect spending.**
- 41 **Local authorities should be mandated to use government pre qualification questionnaires and to simplify small procurements** to make procurement accessible to small businesses.

⁵⁶ See *Tackling Worklessness: Using Public Procurement to Secure Jobs and Training*, Local Government Association, April 2012, <http://www.idea.gov.uk/idk/aio/27257428>

- 42 **Facilitate joint bids involving small businesses by using appropriate national portals** to advertise requirements and creating a publicly accessible on-line register to allow firms to express interest in a procurement and thereby find bidding partners.
- 43 **Update Treasury rules to encourage the consideration of wider economic benefit to a community (whether national or local) when evaluating tenders.** Wales has led in this area and others should follow.
- 44 **Disaggregate contract requirements where viable to create lots for small businesses**, if necessary requiring prime contractors to act as integrating agents without margin on margin mark-up.
- 45 **Roll out the adoption of early, collaborative procurement scrutiny across Whitehall.** We support the view of the Shadow Defence Secretary, Jim Murphy, that fear of the Public Accounts Committee and National Audit Office can be reduced by real-time reporting with a right of reply for the MOD. We believe this should be extended to other departments, allowing those with ownership of decisions to explain their actions.
- 46 **Professionalise procurement across the public sector.** This is by far and away the norm in large private sector organisations which do so because it is in their commercial interests. We must create a professional career path for procurement, if necessary creating shared service capabilities and using the private sector. Having generalist colleagues executing procurements worth billions of pounds does not deliver value and will never harness small business talent for the good of the public sector and the wider economy.

Late payment

Late payment of bills by larger organisations is common and over half of small firms say it causes them problems.⁵⁷ BACS have found that small businesses wait an average 41 days longer than agreed in payment terms.⁵⁸ 48% of this late payment is due to large companies (20% is government).⁵⁹ Currently the Government is pursuing a voluntary programme to encourage the FTSE 350 to commit to rapid payment terms – it is having limited success and a number of large businesses have flatly refused.

RECOMMENDATIONS

GOAL: Halve the time small businesses wait for payment from larger institutions

- 47 **Promote a strong culture of rapid payment among large businesses.** This should be achieved by soliciting public pledges from the largest 1,000 private and government institutions to pay all suppliers within agreed payment terms. This may require some intervention and flow down. We think it appropriate for the government to promote and celebrate good practice and to “name and shame” those who will not comply. The Forum

⁵⁷ <http://www.graydon.co.uk/media-centre-literature/news/late-payment-problems-call-for-government-intervention-to-help-prompt-business-payment.aspx>

⁵⁸ <http://www.bacs.co.uk/bacs/press/pressreleases/2011/pages/latepaymentsatall-timehighassmeswaitlongertogetpaid02-11-11.aspx>

⁵⁹ <http://www.bacs.co.uk/bacs/press/pressreleases/2011/pages/latepaymentsatall-timehighasssmallbusinesseswaitlongertogetpaid02-11-11.aspx>

of Private Business has, for example, called for the publishing of an annual Poor Payment Parade in its Hall of Shame.⁶⁰

- 48 **Consider the merits of requiring larger companies to have their payment practices independently audited and set out in their annual accounts**, to enable potential suppliers - and the media - to see how firms actually pay against how they say they will.
- 49 **Use local government procurement to tackle late payment.** We are attracted by proposals from the Forum of Private Business and the Federation of Small Businesses respectively that councils should take bidders' past payment performance into consideration when letting contracts and should require contractors to pass on no worse than the council's own payment terms to their sub-contractors.
- 50 **Require all prime contractors to pass down payment terms to sub-contractors which are no worse than those they agree with government.** Support councils in copying central government commitment to paying small businesses within 10 days.

Exports

20% of British small businesses export, vs. 25% European average, almost 35% in Belgium⁶¹
Only 1% of small businesses use UKTI for exporting⁶²

As a smaller nation, rapidly expanding global markets should be a focus of economic strategy and government must catalyse international trade as much as possible.

As the volume of global trade in goods has expanded rapidly, Germany has largely maintained its share of this trade. We haven't.⁶³ UK exporters have historically relied heavily on exports to countries that are now facing low/negative growth and with high levels of indebtedness, as opposed to the high growth emerging market economies.

There are international precedents for proactive improvement in exports. In 2010 the US President launched a National Export Initiative, appointing an Export Promotion Cabinet comprising the Secretary of State, Secretaries of six of the main agencies of the Federal Government, the National Security Adviser and the heads of other key bodies. The USA subsequently published its **Plan for Doubling US Exports in Five Years**.⁶⁴

The operational difficulties of finding foreign customers can appear overwhelming, as a result of which companies may only have confidence to do business abroad when their customers have foreign offices. Sources of difficulty include the following:

- *Management time and confidence*: Finding time to focus on new opportunities amid competing priorities, especially if accompanied by a lack of experience
- *Network and contacts*: Identifying useful contacts and sales leads

⁶⁰ <http://www.fpb.org/page/531>

⁶¹ <http://www.economist.com/news/britain/21571424-britain-open-trading-nation-does-not-export-enough-blame-lack-medium-sized>

⁶² http://www.fsb.org.uk/policy/assets/fsb_exporting_web.pdf

⁶³ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32114/10-803-uk-trade-performance-growth-patterns.pdf

⁶⁴ <http://trade.gov/nei/nei-introduction-state-of-the-union-012710.asp>

- *Market Understanding*: Establishing the relevance and price/profitability of existing products and accurately assessing potential benefits and risks
- *Procedural barriers*: Understanding legal and regulatory requirements
- *Cultural barriers*: Operating in another language and business culture
- *Financial barriers*: Need for additional working capital, exchange rate risk and operate payment systems

The internet is reducing some of these difficulties, but a partner with the resources of government is still necessary for many businesses trying to overcome them.

Reluctance to export is pervasive even as small businesses get bigger: the CBI report that **only 20% of medium sized firms currently export to their full potential**. There is a general fear amongst businesses of trading overseas which can be addressed by communications dispelling the myths and upskilling businesses through workshops, events and mentoring by experienced exporters.

Around 20% of British small businesses export today⁶⁵ but **only 1% say they use UKTI**,⁶⁶ the UK's primary trade promotion vehicle. UKTI claims to have helped 25,450 companies in 2011-12, 91% of which were small businesses. UKTI attributed an average of £219k in additional profit per company from their support, equating to £32 billion in additional sales⁶⁷. As this is almost equivalent to the annual increase in UK exports of all goods and services, including oil and gas, its impact has almost certainly been significantly overstated. Nevertheless, we believe that UKTI's annual spending of £320m on trade support represents a cost-effective investment.

The US Small Business Administration (SBA) operates three separate export loan products, managed through licensed banks which make each loan decision.

- The *Export Working Capital Programme* is a programme that guarantees 90% of eligible loans made by participating banks up to \$5m. It is designed to provide short-term loans for facilities, equipment and working capital that will enhance export ability. Refinancing of existing debt is also available.
- *Export Express Loans* provide loans and lines of credit up to \$500,000, with the SBA guaranteeing approval decisions within 36 hours. The SBA guarantees 90% of the participating bank's loan up to \$350,000 and 75% on loans from \$350,000 to \$500,000. Export Express Loans are extremely flexible. They can be used to fund participation in a foreign trade show, translate product literature, finance expansions, equipment or real estate purchases, or for inventory, working capital or letters of credit.
- *International Trade Loans* are term loans of up to \$5m with a 90% guarantee to the participating bank. It is aimed at firms that plan to start or continue exporting or that have been adversely affected by competition from imports and need working capital and investment in to become more effective.

There is **little tailored government financial support for small business exporters** in the UK. This contrasts strongly with the highly flexible family of support programmes available to US firms through SBA loans. The only UK government programmes specifically aimed at export finance are those offered by UK Export Finance (UEF), previously known as Export

⁶⁵ <http://www.economist.com/news/britain/21571424-britain-open-trading-nation-does-not-export-enough-blame-lack-medium-sized>

⁶⁶ http://www.fsb.org.uk/policy/assets/fsb_exporting_web.pdf

⁶⁷ UK Trade and Investment Annual report and Accounts 2011-12
<http://www.ukti.gov.uk/uktihome/aboutukti/item/331780.html>

Credit Guarantee Department. UEF products are strongly orientated to individual large orders for capital products and comprise insurance and credit products.

RECOMMENDATIONS

GOAL: To double UK export revenue by 2020

- 51 **Develop a national strategy for exports with ambitious goals.**
- 52 **Develop a suite of export finance products comparable to the US SBA offering.**
This should be delivered by a new UK Small Business Administration (see “Organising Government to serve Small Business”).
- 53 **Develop a plan to grow UKTI activity beyond its current 1% of exporting small businesses.** It should promote UKTI services to business and make them very visible under the SBA banner. Travel and exhibition support budgets are rapidly exhausted and should be expanded. Enhancing and expanding training and mentoring can help grow exports further. In particular, UKTI must develop a clearer plan to capitalise on opportunities in **developing economies and countries where the UK has particular advantage** via good political relationships and softer networks (such as migrant populations) which can act as a source of deal flow.
- 54 **Invest in building foreign consumer and business preference for UK products by showcasing distinctive British products.** This should be a coordinated activity that includes trade shows, media and location specific campaigns combined with support to help exhibitors follow up vigorously and successfully. This should be dovetailed with the targeting of developing economies and countries where we have close relationships.
- 55 **For those businesses working with UKTI, introduce an underwriting scheme to protect small business exporters** who despite following UKTI compliance guidance are found not to have met with foreign customs, duties or regulatory requirements. The cost of underwriting would be recouped through the increase in export sales.
- 56 **Increase awareness of the importance of global markets, and recognise the value of increasing and utilising the numbers of people who can speak business relevant languages** (Spanish, Russian, French, Portuguese, and Chinese etc) to increase trade opportunities with developing economies.
- 57 **Pilot proactive Export 'Rainmaker' offices abroad to help small British businesses identify and approach potential foreign customers.** High quality business development specialists with intimate, current knowledge of local markets would identify prospects and then broker introductions, responding rapidly to business requests. An initial offer could be two free (or low cost) leads for UK small businesses, and then a charge for additional sales support (leads, market and competitor information, mentoring, market visit support and so forth).
- 58 **Establish a network of 'export hubs' in major overseas cities which UK firms can use as an office base** and place for meetings or research. They would support firms with research and networking and could be based at embassies or elsewhere.

5. An Effective Innovation System

Innovation

The small business share of UK government support for business R&D is lower than any major competitor⁶⁸

Over 80% of government support for business R&D comes from Treasury tax credits⁶⁹
Small US firms file 16.5 times more patents per employee than large US firms and create 65% of new jobs⁷⁰

Britain's historic laissez-faire approach to R&D spend has caused a dramatic fall in R&D activity, which must be reversed by government policy designed to create an innovation-led economy.

Historically, UK Government funding of business R&D has been strongly influenced by the **unwillingness of officials and politicians to be associated with anything that might be described as “picking winners”**. Trying to defend such accusations, whether justified or not, has come to be seen as career-limiting - leading to the stultification of innovation policy over many years. This fear derives from the failure of large scale UK Government investments in Concorde, nuclear reactor technology and the National Enterprise Board during the 1960s and 1970s. The result is that Government budgets for R&D grants to companies have been minimalist and spread too thinly.

In the absence of significant leadership from Government, Britain saw a serious **decline in overall R&D expenditure in the 1980s and early 1990s**, where UK spend on R&D fell from 2.4% to 1.9% of GDP. Many major manufacturing companies were acquired by foreign corporations or broken up, with privatisation leading to the closure or downsizing of government and nationalised industry laboratories. In contrast all Britain's major competitors significantly increased R&D as a percentage of GDP over this period.

Looking more closely at *Government* spend on R&D as a percentage of GDP, most of the UK's industrial competitors saw **a reduction** but the decline was particularly marked in the UK, down from 1.1% in 1981 (when only the US committed more as a percentage of GDP), to 0.5% in 2001,⁷¹ (a smaller percentage than any of our major competitors). Today this picture is remains.

The share of total government financed support for business R&D going to small businesses is lower in the UK than any of our major competitors⁷². Had the UK government maintained its expenditure on R&D in line with the average of our competitors at 0.9% of GDP, in line with the US and our major European industrial competitors, total British R&D would be 16% higher than it is today. This is equivalent to an extra £4.6 billion per annum in funding, even assuming that this additional government expenditure had no impact on industry's own R&D

⁶⁸ The UK R&D Landscape, Alan Hughes and Andrea Mina, Council for Industry and Higher Education and UK Innovation Research Centre Enhancing Value Task Force , 2012

⁶⁹ HMRC R&D Tax Statistics: <http://www.hmrc.gov.uk/statistics/research-tc.htm>

⁷⁰ US Small Business Administration Office of Advocacy; “Frequently Asked Questions”

⁷¹ Source: OECD, Small Business Task Force calculations

⁷² The UK R&D Landscape, Alan Hughes and Andrea Mina, Council for Industry and Higher Education and UK Innovation Research Centre, January 2012.

spending. This is equivalent to fifteen times the annual budget of the Technology Strategy Board. It is the kind of mission-driven R&D which the TSB funds (rather than academic research) which is where the shortfall exists.

Small business plays a pivotal role in the innovation process. US firms with less than 500 employees produce 16.5 times more patents per employee than large patenting firms. They also generate 65% of net new US jobs, hire 43 per cent of high tech workers, and are responsible for 31 per cent of US exports.⁷³

Sadly, **Technology Strategy Board grants for small businesses tend to be too small** for most projects to make much progress and the requirement for companies to cover a significant proportion of project costs makes them unsuitable for small firms, especially the majority of start-ups who do not have venture capital. The average grant paid out under the TSB's Prototype Development Grants scheme, the largest and most relevant to small businesses, is just £167k with companies required to provide over one and a half times as much from their own resources. In 2011/12 just £21m in grants was awarded under this scheme.

The majority of the **TSB's other grants require complex collaborations** with universities and other companies, whether this is appropriate for the project or not. This model is generally ill-suited to small businesses. In terms of the percentage of small business costs covered, TSB collaborative grants have been significantly less generous than direct EU funded projects operating in accordance with State Aid regulations.

A study by Cambridge University showed that whilst nearly twice as many UK as US firms received some form of government funding for R&D, those **US firms that did receive support got between two and a half and six times as much money as UK firms.** Amongst smaller companies, the percentage of R&D costs covered was over three and a half times larger.⁷⁴

The lead programme for Federal US funding of R&D in small firms is the Small Business Innovation Research Programme, discussed in Chapter 4. Awards are typically worth over \$1 million and cover 100% of project costs. Collaboration is entirely at the discretion of the company and any IP generated belongs to the firm. In the US **a single SBIR award is enough alone to fund a startup for two years**, providing time to build a team, find partners and additional customers and negotiate with possible investors. The contrast with the UK could not be more stark.

Not everyone has been prepared to wait for a change in UK policy. The experience of Dr Helen Lee, Director of the Diagnostics Development Unit at the University of Cambridge Department Of Haematology, illustrates the benefits of locating a business in the US. After a distinguished career as manager of a 100 person R&D group for Abbot and founding her first biotech company in Palo Alto, she selected Cambridge as the best place to establish an academic research group in 1996. However, she chose to set up a company to exploit the results of her Cambridge research in California, partly to benefit from SBIR awards. Between 2002 and 2010,

⁷³ US Small Business Administration Office of Advocacy; "Frequently Asked Questions"

⁷⁴ Ref CBR Report.⁷⁴ UK plc: Just How Innovative are we? Findings from the Cambridge MIT Institute International Benchmarking Project; Dr Andy Cosh, Professor Alan Hughes and Professor Richard Lester et al; Cambridge-MIT Institute 2006

her company, Diagnostics for the Real World, received \$6.7m in SBIR awards and total R&D funding of at least \$16.6m from the US National Institutes of Health.

In an attempt to strengthen innovation funding for small businesses, Labour **introduced a system of R&D tax reliefs** in 2000. This has the benefit of being relatively simple to operate and avoids officials having to make choices. But as a result of lobbying pressure, R&D tax credits have been steadily extended to companies of all sizes and eligibility criteria relaxed. The result is that well over 80% of government support for business R&D takes the form of R&D tax credits, designed and administered by the Treasury, a department with minimal expertise in innovation policy. The Government spends over three times as much on R&D tax credits a year as it does on the Technology Strategy Board. In 2010/11, Small businesses received £340m in benefits under this programme, large firms £750m.⁷⁵

R&D tax credits work by returning a small percentage⁷⁶ of a firm's total expenditure on R&D many months later. There is no distinction between R&D that is straightforward or risky, hard to finance or easy, short term or long term, incremental or genuinely innovative. As a result, there is no reason to believe that most firms do anything other than spread the extra cash received across their full range of expense items, from marketing to dividends. **R&D tax credits are therefore best seen as providing a subsidy to firms that do R&D** rather than an incentive for them to do more.

The **UK makes greater use of R&D tax credits** than almost any of our major competitors. Germany and Sweden have no such scheme and US tax breaks are focused on *incremental* R&D rather than the total amount spent each year as in the UK. They are also less generous. As a result only around 2.9% of the R&D costs of US businesses are recovered through R&D tax credits as against around 6.3% in the UK.⁷⁷

The biggest weakness in Britain's innovation system is the funding of "**exploratory development**" - the crucial stage in the commercialisation of research that requires a professionally managed and market-focused R&D environment, but which is too high risk and long term for private sector to fund on its own. Small businesses and specialist "intermediate" R&D institutes, most themselves not for profit small businesses, have a crucial role to play.

Successive governments have made great play of investing in the UK's outstanding research universities and encouraging venture capital backed research spin-offs. However, the results have been disappointing. The reality is that the gap between university research results and commercial sales is often just too big to be bridged in one go.

Germany's Fraunhofer programme is a network of 66 intermediate research institutions that develop new products and manufacturing processes to commercial prototype stage and sometimes undertake pilot manufacturing. Together they employ 22,000 people. Each Institute is closely linked to a German university, but unlike universities they are staffed and equipped to undertake R&D to commercial standards rather than being focused on teaching and writing scientific papers.

The German Fraunhofer's receive significant support from government but the aim is to earn 50% of their revenue from the private sector. The core government funding

⁷⁵ HMRC R&D Tax Statistics: <http://www.hmrc.gov.uk/statistics/research-tc.htm>

⁷⁶ Around 25% for smaller companies, 7% for companies with more than 500 employees

⁷⁷ Task Force analysis based on US and Government data

enables them to invest in longer term technology developments that can then be commercialised through nearer to market projects with partners and customers.

The Fraunhofer Institutes have played an important role in bringing innovation to the Mittelstand and other small and medium sized enterprises, but get less than 10% of their income from outside Germany.

The Fraunhofer model is very similar to that of the large group of independent private sector technology consultancies that have grown up around the City of Cambridge. However the Cambridge firms are considerably more competitive internationally, typically earning over 60% of their revenues from export markets. They receive little or no government funding, and have together generated more jobs in product spin-off companies than all the Fraunhofer Institutes combined.

An important new feature of UK innovation policy is the **Catapult Centres** currently being set up by the Technology Strategy Board. These are supposed to be closely modelled on the Fraunhofer system and the initiative was first announced at the end of the last Labour government. However, there are concerns about how the Government has taken forward the proposals including that their effectiveness is being compromised by funding restrictions. The level at which they are funded is not comparable to equivalent institutions in Germany and on which they were modelled. In addition, the political pressure to create “virtual” institutes spread over different geographic locations risks that they will lack sufficient focus. What are required are centres with national credibility, closely linked to industry or startups, and with the commitment and the stability to develop and support an area of technology over an extended period of time.

RECOMMENDATIONS

GOAL: To make the UK the most innovative country in Europe

- 59 **Bring together management of the current BIS business R&D programmes managed by TSB and the Treasury’s R&D tax credit system under a single budget and refocus it on policies and programmes likely to deliver the best value for money.**
- 60 **Introduce a stronger demand pull element into UK innovation policy** by developing lead customer based programmes worth £600m per annum to complement the technology push approach that has dominated traditional thinking.
- 61 **Enhance SBRI programmes** in the manner outlined Chapter 4. Finance the government investment in these new programmes through savings achieved by **refocusing R&D tax credits** on where they can make a real difference: longer term R&D, firms in which R&D expenditure is high in relation to revenues and profits, and those in which R&D investment is being increased from year to year, especially small businesses.
- 62 As growth and improvements in the nation’s finance permit, **increase the overall level of government support for business R&D.** The aim should be an extra £1 billion per annum after five years.

- 63 Prior to the next election, undertake a **review of progress in implementing the Catapult programme**, to establish whether it needs to be adapted to meet the original vision more closely and can be expanded.

Levelling the digital playing field for small businesses

Online activity is a higher proportion of UK GDP than any other G20 nation⁷⁸

In e-business, as in any market, unhealthy concentrations of market power can undermine that very market. This will stifle innovation. In the long term, a digital economy which looks after its smaller players is likely to be more successful and dynamic.

The **internet contributed 8.3% of British GDP** – a higher share than any other G20 country – in 2010 according to Boston Consulting Group who predict a £221bn value in 2016.⁷⁹ However, e-commerce can often be a “winner-takes-all” environment where smaller businesses struggle to compete against larger competitors.

Industry leading internet companies have great power in critical parts of the online economy. Google, for example, controls search engine ranking for the overwhelming majority of searches. If Google considers that a company is not complying with its Webmaster Guidelines it can choose to allocate a lower ranking or to remove the company from search results.⁸⁰ PayPal can freeze the payments accounts of e-commerce businesses.⁸¹ It is right for government to consider interventions to ensure fairness and transparency for small businesses that rely on these e-business mechanisms.

The Labour Party’s Consumer Investigation has produced a very useful report which includes looking at how small businesses are served as consumers, ensuring that they have adequate rights and information to challenge unhelpful behaviours and ensure markets that serve them – including e-commerce – work effectively.⁸²

⁷⁸ <http://www.bbc.co.uk/news/business-17405016>

⁷⁹ <http://www.bbc.co.uk/news/business-17405016>

⁸⁰ <http://support.google.com/webmasters/bin/answer.py?hl=en&answer=35769#3>

⁸¹ <http://www.independent.co.uk/money/spend-save/simon-read-is-paypal-right-to-freeze-customers-accounts-2360058.html>

⁸² <http://labourbisteam.org.uk/policy-review-documents>

RECOMMENDATION

GOAL: To enable further innovation by ensuring that small businesses benefit from the new economy

- 64 **Create an e-commerce ombudsman at the OFT** with responsibility to enforce high standards of customer care including appeals processes when monopoly behaviours are unfair and recommend how marketplaces can be influenced to protect small business margins.

Creating a world-leading digital infrastructure

In Estonia, 94% of tax returns and 100% of medical prescriptions are handled online

Britain has opportunity to capitalise on sector strengths and tempt foreign innovators to create a leading global environment for digital innovation. However, this opportunity demands world-beating infrastructure.

The UK has substantial advantages in the new economy: location (Europe), country size, volume of top universities, world-leading financial and creative sectors. However, Britain is not exploiting the opportunity to become known as the best place to launch a digital business in Europe, and is perceived to be losing ground to Germany and Eastern Europe.

Unnecessary irritations, like slow internet connections and the lead times to have broadband installed in business premises, make it difficult for Britain to present itself as a pre-eminent digital economy.

Estonia is a leading case study in rapid development of an internet based economy. By 1997, 97% of Estonian schools had the internet and since then the country has become one of the world's leading web-enabled economies. Free wifi is now ubiquitous. 94% of tax returns are submitted online. Elections permit votes by laptop and doctors' prescriptions are all electronic.⁸³ As a result of this transformation, and other factors, Estonia now has one of the highest GDP growth rates in Europe.⁸⁴

RECOMMENDATIONS:

GOAL: To be known as the best place in Europe to start a digital business

- 65 **Facilitate a national roll-out of free wifi in urban areas.** This does not need to take place at cost to the taxpayer: Labour Camden Council is already tendering for a

⁸³ <http://www.guardian.co.uk/technology/2012/apr/15/estonia-ussr-shadow-internet-titan>

⁸⁴ <https://www.cia.gov/library/publications/the-world-factbook/geos/en.html>

commercial free wifi scheme, funded by advertising, which will be free to the taxpayer and is working on the procurement of this across 13 other authorities.

66 Ask Ofcom to investigate whether BT and other cable providers could deliver broadband within one week to 90% of business customers.

67 Prioritise support for rollout of superfast national broadband to ensure that the UK remains in the vanguard of the internet age, with business having the platform it needs for future growth and innovation. The platform is important: we may not be able to predict in advance exactly how it will be used and the benefits it will create, but we can be confident of its future value. In addition, being seen to be in the second or third wave, rather than the first wave of economies deploying superfast broadband may damage our standing among international technology leaders.

6. Organising Government to Support Small Businesses

Government can have substantial impact on small businesses: both good and bad. It needs to be aware of its structural limitations and should focus on being a help, not a hindrance, to British business. In previous chapters we have set out the many ways in which government can support small business to thrive – from finance to exporting to support for innovation and more. But if government is to play this role as well as possible it needs to focus its efforts, smarten its performance, and invest in its own capabilities. And it will be better able to meet the needs of local business where the voice of business is itself better organised and representative.

Government

The head of the US Small Business Administration reports to the US President
None of the 15 direct reports to the permanent secretary in BIS is responsible for small businesses

Small businesses are too important not to have their own agency in government, so Labour should create one. Other departments should also have mechanisms designed to optimise their impact on the small business ecosystem.

Small business policy is diffused across government, leading to a lack of action, a lack of accountability and a profound lack of private sector experience. This situation contrasts directly with best practise overseas.

In the USA, the head of the Small Business Administration is responsible for all Federal small business policy and finance programmes, and serves in the Cabinet of the US President. The head of the SBA's advocacy office (which lobbies for small firms within government) is also appointed by the President. In Singapore, the current Chairman of the SPRING business agency came from the Prime Minister's office and has chaired numerous government agencies, as well as private company boards. SPRING's board comprises members from leading private companies as well as civil servants.

There is a range of departments with responsibility for different aspects of small business. These include BIS, HMT, FCO, CLG, DCMS and DECC in addition to many other public bodies too. Within many of the departments, especially BIS, there are a large number of groups with different responsibilities, however in the current BIS published organisation⁸⁵ **none of the 15 direct reports to the permanent secretary in BIS have any responsibility for small businesses and just one of the next hundred most senior roles has a specific small business responsibility.** Small businesses are currently one of six responsibilities of one of the six junior ministers within BIS. BIS partners associated with small business and

⁸⁵ <https://www.gov.uk/government/publications/bis-organisational-chart-june-2010>

growth policy include Capital for Enterprise Ltd, The Technology Strategy Board, UK Export Finance, and UK Trade and Investment.

In general **small businesses find government inaccessible and incomprehensible**: it is not clear who to call or where to search for information. Large companies are able to invest in lobbying companies giving them access to the heart of government: small businesses do not have this option available to them.

Britain has a **complex government funding and support environment** that is difficult to track and monitor. There are at least currently nine major government programmes which target small businesses.⁸⁶ They are uncoordinated, overlap and are complex to understand. Government funds, such as the Regional Growth Fund, have the threshold set too high for small businesses to apply.

Government is habitually shy of innovation. The priorities are typically to get major programmes rolled out by the end of a four or five year electoral cycle, rather than to maintain a programme of small experiments and scale the successes.

There is **no significant incentive for government officials to engage with small businesses** as part of their day-to-day activity, let alone to find ways to help them develop business with government. The skill-set required to do so are quite different from those expected of most civil servants.

RECOMMENDATIONS:

GOAL: Reform aspects of government creating a 21st century infrastructure to support small business growth

- 68 Lord Adonis is currently leading a Review of the role and operational capabilities of the Department for Business, Innovation and Skills. A **Small Business Agency** should be a critical component of ensuring that BIS serves all UK businesses as effectively as possible. The British SBA should be comparable in scope to the US SBA, with the objective of co-ordinating and streamlining and signposting government services to help grow the small business sector. It should:
- Be responsible for driving the entire programme of reforms in this document.
 - Be a hybrid agency made up of individuals from the public and private sectors, headed by someone with knowledge of both, with a board chaired by a senior minister.
 - Sit within BIS and report directly to the Secretary of State for Business Small and focused, co-ordinating resources from other parts of government to benefit small business, using test-and-learn and competitive funding approaches to distribute business growth funds to different institutions. It will not allocate funds directly to companies. There are further detail about our recommendations for a British Small Business Agency in Appendix 4.
- 69 UK economy has stagnated for over two years, with borrowing rising as a result. **To kick-start the economy and drive longer term reform, establish a crisis committee chaired by the Prime Minister – the “Business COBRA”**. The Business COBRA would manage the progress of the Government's industrial strategy against longer term goals,

⁸⁶ https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/51594/13-580-access-to-finance-schemes-that-support-entrepreneurs.doc

and remove blockages to growth. Along with a range of other relevant cabinet ministers, membership would include the Secretary of State for Business as well as the head of the proposed new Small Business Administration. This would help to put the vital needs of small business at the heart of future plans for growth.

- 70 **Each major government department should appoint a Director of Economic Development (DED).** The role of each DED would be to identify specific areas where a proactive initiative could stimulate creation of new private sector products and services that would benefit the department and generate export revenues for UK companies. The DED should be appointed from the private sector for three years with the option of a three year extension. Of the £500m per annum in funding budgets proposed for the expanded SBRI and Larger Innovation Contracts programmes, a proportion should be held by the Technology Strategy Board, and available for co-funding DED initiated competitions. It would be the responsibility of the DED to provide a lead customer or 'specifier' and a serious funding commitment alongside TSB. Departments would be expected to cover the operating costs of their DED and supporting team, and to provide co-funding to companies that win SBRI and LIC contracts.
- 71 **Each Department should publish an annual report on innovation and other projects designed to assist economic development,** including a detailed analysis of expenditure by project.
- 72 **Measure and publish overall business satisfaction with central and local government, to inform annual plans for improvement.**

Facilitate a more united voice for local business

It is important that small businesses have access to a network of business people to share best practice, collaborate, and to express the considered opinion of business in their region or district. In Germany, business support relies heavily on the local Chamber of Commerce of which all businesses are members (by statute).

In the UK, organisations such as the Federation of Small Business (FSB) or the British Chambers of Commerce (BCC) do excellent work but represent a relatively small percentage of local business. The benefit of widening membership of such organisations is that they can be not only an authoritative voice for local business but also their members' mechanism for ensuring that government spending is focussed on their priorities (by being the vehicle for that spend). Any measures the government can take to encourage active membership of the BCC, the FSB or other similar organisations are particularly welcome.

RECOMMENDATIONS:

- 73 **Facilitate a more united voice for local business.** There are a number of options for improvement. For example:
- The government could work with the FSB, the BCC and others to incentivise wider participation. This could be mandated but that may be overly directive (unless such an organisation was given a mandatory role, which effectively all organisations must "join", like that of Companies House).

- If this is too radical then government could require all exporting firms - or firms greater than a particular size - to become members.

There may be sensitivities to overcome, but it is worth pursuing the prize of local business having truly representative organisations which both represent it and serve as a vehicle for directing spend. Silicon Valley teaches us that businesses thrive when they are part of vibrant, supportive networks. The FSB and the Chambers of Commerce can help to knit this ecosystem together. They can present a powerful alternative to needing a centralised, London-based BIS to address the myriad of business challenges and priorities across the UK. The importance of proximity in determining how support is targeted must not be underestimated.

Regulation

There is no doubt that the current economic climate is a challenging environment for small businesses, from the weaknesses in the macro-economy to the difficulties of accessing the finance they need to survive or to grow. In this context, the language of cutting regulatory 'burdens on business' resonates with many fighting for survival. It has become a truism of public policy that government should cut the 'red tape' business faces. There should always be a drive to make regulation risk-based, simple, effective and easy to comply with. But gimmicky arguments about a 'bonfire' of red-tape often fail to make actual and real progress because they fail to address the process of how regulation is made and implemented.

It is time for a different kind of conversation about the role of regulation in a modern economy. Such a conversation must take account of the *positive* impacts regulation can have on business growth – and on the nature of that growth – as well as the *negatives*. It must distinguish between the substantive costs and benefits of a regulation in achieving its goals from the costs of compliance which must always be minimised. It must focus on how the quality of regulation can be improved, so that firms are given maximum flexibility over how they meet legitimate policy goals in the least burdensome way. Regulation must be proportionate. And it must expect more of government in how regulation is designed, demanding that government has a much better understanding of the impact on business of changes before they are made. The Federation of Small Businesses, for example, have argued persuasively in support of this type of approach.

Aggregate impact assessments are not good enough. Governments should not be allowed to regulate without a true, understanding of the granular impact this will have on individual firms. This applies not just to the marginal impact of a new regulation, but to the cumulative impact as well. And even where it is possible to make small improvements to regulations, the value of stability must also be understood.

Having said this, governments should not be afraid to regulate where doing so will improve the functioning of markets, the environment for business, or the long term health of our economy and our society. In many cases it will be small businesses who are the primary beneficiaries of these regulations, as consumers in business-to-business services, as well as insurgent challengers to established players in a market. Well-designed regulation can, for example:

- **Set standards**, creating new markets and encouraging innovation;

- **Give consumers confidence in the integrity of markets**, especially in markets that are new, or where information is asymmetric;
- **Reduce barriers to entry, preserve competition in markets, and ensure that power imbalances are not exploited**; and
- **Ensure a level playing field** so that, in Winston Churchill's famous formulation, "the good employer is [not] undercut by the bad and the bad by the worst".

But when government does act, it must do so with its eyes open, and with due humility about the risks of government failure too. For example:

- **Misconceived regulation undermines business activity** and costs jobs;
- **Poorly designed regulation increases compliance costs** for no wider gain;
- Regulation that creates **uncertainty deters economic activity**; and
- **Inconsistent enforcement undermines the level playing field** and rewards the non-compliant

The challenge for policy makers is in understanding the full impact of regulation on individual firms before it is introduced. What alternatives to the new regulations have been considered? How will it interact with the existing body of regulation? How difficult will it be for firms of different shapes and sizes to comply? Can it be improved to increase the benefits and reduce the compliance costs? What impact would a new regulation have on the cumulative compliance requirements? How would it interact with other administrative requirements from public bodies, business to business services, surveys and data collection exercises, and other demands made on smaller businesses from government on non-regulatory matters?

Here, government must get beyond aggregate desk based studies and "guesstimates" of impact and develop more sophisticated tools to understand the interdependencies with the rules that already exist and the firm level impacts. There are numerous alternative technologies available, from dynamic computer simulations used in 'war gaming' to the visualisation centre used by Jaguar Land Rover to design new cars. These technologies demonstrate that it is possible to understand the impact of changes on systems before they are implemented.

The Jaguar Land Rover visualisation centre

In the design of new models, Jaguar Land Rover use a virtual reality, engineering and design studio based at their research centre in Gaydon. It has been used to design the company's highly successful new models like the Jaguar XJ saloon and the Range Rover Evoque. In two years of operation, it saved the company over £8m,⁸⁷ more than three times its development costs. It achieves this by allowing those working on new designs to see in 3D and in real time the full impact on the design of changes made changes to any individual part. Engineers working in the visualisation centre can view these impacts from any angle and at any level of specificity. In doing so, they can test to see if things work and to optimise the design without the need to manufacture physical parts. The system is easy to learn and operate and, because changes can be uploaded and viewed from anywhere in the building, it encourages collaborative working.

The behaviour of firms across an economy interacting with changes to regulation is more complex than the impact of a single design change on a single car. Rather than averaging

⁸⁷ <http://www.automotivecouncil.co.uk/2010/11/jaguar-land-rovers-virtual-cave/>

averages to assess aggregate impact there is a need for detailed simulation of the interdependencies and their detail impact on specific example firms. Such an approach can draw on simulation approaches used in industry and will allow policy makers implementing new regulations to do so, based on a richer understanding of their impact.

RECOMMENDATIONS

- 74 **Conduct a complete overhaul across all departments on how regulation is designed, implemented and monitored, including investing in new technologies – learning from examples like JLR’s visualisation centre – that could help to improve the design of regulation, to understand its impacts, and to reduce the risks of unintended consequences.**
- 75 **Abandon aggregate paper-based ‘impact assessments’** for rigorous testing of the impact of new regulation at the company level.
- 76 **Focus on outcomes and give business time and flexibility** over how to comply. Good examples here include:
 - The right to request flexible working which gave firms maximum flexibility over how they complied, and permitted non-compliance where the impact on the business would be disproportionate to the objective of the regulation.
 - Zero carbon homes regulations which set tough environmental standards for future house building, but gave the industry a decade to prepare.
- 77 Require all departments to **synchronise the introduction of all new regulations** on the agreed common commencement days (6 April and 1 October)
- 78 Develop a **cross-departmental website for small businesses**, bringing together all the regulatory and compliance issues, as experienced **from the point of view of small business**.
- 79 Start upstream: focus **advice on helping business to comply**, through access to ‘health checks’
- 80 Reward the proactive who achieve recognised kite marks or ISOs in **procurement processes**
- 81 **Make all enforcement risk-based** to level the playing field, and reduce the costs and increase the benefits for the compliant.
- 82 **Simplify resolution processes**. For example, introduce more rigorous streaming of Employment Tribunal cases and simplify procedures for all but the most complex or serious cases.

Tax, HMRC & Companies House: reducing compliance burdens

The average small business spends 36 days/annum working on tax compliance⁸⁸

Tax is necessary for a strong economy and a fair society, but the levels of tax, and the mechanisms by which it is calculated and collected, must be regularly reviewed for efficiency and to ensure that they support and do not discourage valuable business activity.

Britain's tax system is **complex, not streamlined, and difficult for small businesses to navigate**. VAT, business rates, corporation tax, PAYE and other taxes all conspire to create complexity which is only ever a burden on small businesses who cannot afford skilled accounts departments to make it easier. To handle the burden, many businesses outsource their accounting – this is often seen as an expensive cost which adds no value to the business beyond compliance.

Interaction with HMRC is typically time-consuming. Processes are often manual and far too much communication takes place by phone or letter (rather than self-serve internet), even for the most mundane of tasks. Furthermore, access methods are inconsistent: questions on VAT cannot be answered on the phone whereas PAYE and corporation tax questions can. Late payment is dealt with inconsistently: sometimes payments are allowed to be delayed for a number of months; in other situations a bailiff will visit within days.

Where possible, **taxation systems should not create unnecessary disincentives on those trying to grow a business**, either substantively or through the way they are administered. As much as possible, they should actively support business growth, and make compliance fair and simple.

Britain's legally recognised **company and employee models are increasingly out-of-date**. This leads to, for example, contractors operating as limited companies who are unsure of their tax obligations under IR35.⁸⁹

RECOMMENDATIONS:

GOAL: To minimise the overhead of tax and compliance on small businesses

To reduce complexity...

- 83 **Complete (and publish) a bottom-up review of HMRC processes from the customer perspective**, including more self-serve and willingness to use email and the web for communications, while ensuring that telephone contact is also available. This should include:

⁸⁸ <http://www.prweb.com/releases/2013/2/prweb10393796.htm>

⁸⁹ For an overview of the issues regarding a distinction between genuine freelancing and false self-employment, see Burke, A.E., *The entrepreneurial economy*, Fabian Policy Report: New Forms of Work, October 2012.

- Offering clearer guidance for new businesses.
- Moving away from occasional letters from HMRC to a programme of compliance advice with clear online guidance and support.
- Creating a single start-up process incorporating PAYE, VAT and other registrations.

84 **Scope the achievability and cost to benefit of single-point-of-contact relationships at HMRC**, potentially with “account managers” assigned to each business.

85 **Examine the case for simplifying complicated tax reliefs, recycling any savings back into support for business** including through the tax system by, for example, reductions in corporation tax.

86 **HMRC should allow businesses to pay all taxes in monthly instalments if they prefer to do so**, to spread the burden over the year. There should be a consistent approach for dealing with late payment requests.

87 **Simplify payroll by equalising the Income Tax threshold and National Insurance threshold**. Class 4 and class 2 NI should be combined into one National Insurance payment.

88 **Create a single reporting date (e.g. 19th of each month) for all employer information**, e.g. PAYE, NICs, etc.

89 **Remove requirements for small businesses to handle statutory payments**. Instead they should be handled directly by HMRC.

To reduce cost and risk...

90 **Develop a procedure for pre-approval (advanced assurance) for innovative tax structures**. HMRC should be able to charge for this service.

Focus tax on incentivising growth

91 **Consider 0% Capital Gains Tax for founders of businesses with over 100 employees**. This would incentivise the most ambitious global entrepreneurs to start businesses in UK rather than abroad. The loss of personal CGT is far outweighed by the other taxes generated on highly successful businesses. In order to avoid abuse, set a threshold, so that (for example) the benefit may be applied to businesses whose previous 12 months PAYE payroll was 100 times the UK median wage.

92 Business rates tax location rather than profitability, which has some merits but also creates distortions. In light of the principles set out above, **consider how business rates might be reformed in fiscally neutral ways**.

93 **Increase the VAT registration threshold to £100,000 turnover** to reduce the administrative burden on smaller businesses, and make them more competitive against larger businesses.

Clarify legal framework

- 94 **Clarify definitions of self-employment** so that wealth-creators can ensure that they are on the right side of the law.

Managing insolvency

The disqualification rates of errant directors have dropped from 45% to 21% over the last decade

An additional 2000 businesses might be saved annually if suppliers continued to supply on the same terms in insolvency

Government estimates a net benefit of £88,000 to the market for every company director disqualified

Business failure is a necessary, healthy part of an innovative economy. Government must ensure that the UK insolvency regime supports and preserves viable businesses, whilst minimising risk to all other participants in the ecosystem.

Overall Britain enjoys a sound insolvency regime: the World Bank ranked the UK insolvency regime 8th in the World in October 2012.⁹⁰ However over recent years there have been several criticisms about the so called '**phoenix**' **pre-pack**, where a struggling business is sold back to the directors or a connected party. Pre-packs are an important business rescue tool, which ensure that value in a business is retained and employment is preserved, but at times the process leaves creditors disgruntled and out of pocket.

A thriving private sector is vital to the economy but unfortunately not all businesses and directors are good for the UK. **Grossly incompetent or dishonest directors** can cost small businesses dearly and it is down to Insolvency Practitioners to report the conduct of these directors to the Government. In 2011-12, Insolvency Practitioners submitted 5,401⁹¹ reports about directors who they felt were unfit to be involved in the management of a company. There is no cost or qualification needed to become a director in the UK, so the disqualification regime is a vital protection for the business community. The Government estimates a net benefit of £88,000⁹² to the market for every company director disqualified (in terms of the economic damage they would otherwise cause). The current disqualification regime needs to be modernised and the Insolvency Service needs additional resources. This is evident from the trend in falling disqualification rates over the last decade and concerns that directors are able to flout the terms of disqualification and act as 'shadow directors' relatively easily.

The UK can enhance the business rescue culture by usefully adopting a feature of the US system. The US Chapter 11 procedure is a court driven process, which leaves the company in the hands of the original management. The considerable judicial involvement means that the process is usually too expensive for the small business community. Despite receiving positive press coverage in the UK, insolvency experts generally consider that the **US Chapter 11 procedure** is time consuming and costly and would require a significant overhaul of the court system. However, one of its best features is ensuring that suppliers cannot terminate their contracts on the grounds of insolvency alone (provided they get paid on time

⁹⁰ <http://www.doingbusiness.org/~media/GIAWB/Doing%20Business/Documents/Annual-Reports/English/DB13-full-report.pdf>

⁹¹ <http://www.theyworkforyou.com/wrans/?id=2012-07-13a.115781.h&s=directors+speaker%3A24845#g115781.q0>

⁹² <http://www.theyworkforyou.com/wrans/?id=2011-11-10a.79956.h&s=directors+speaker%3A12005#g79956.q0>

and in full for continued supply). This gives the company valuable breathing space to restructure and can be a real advantage to viable businesses attempting a turnaround.

RECOMMENDATIONS:

GOAL: To help rescue viable businesses and encourage entrepreneurialism, but ensure that appropriate safeguards are in place to shield creditors, consumers and other well run businesses from unscrupulous directors.

- 95 **To increase confidence in pre-packs, create a process for the appointment of an independent liquidator to investigate creditor concerns.** If it is found that the insolvency practitioner (IP) had not acted reasonably in advising a pre-pack, the independent liquidator could bring a claim against the IP and recover monies lost by the creditors.
- 96 **Introduce an updated electronic disqualification system.** This could save vital resources and will ensure the Insolvency Service can easily identify the most serious cases. Ultimately, this small change would enable a better use of resources and ultimately a greater number of disqualifications.
- 97 **Extend the period of time disqualified directors stay visible on the central register.** Currently, disqualified directors are required to stay on the disqualification register (at Companies House) for the length of their disqualification order, after which their name is removed. Disqualifications should remain visible for a period time after their expiry, to provide a warning for small businesses who are considering extending credit.
- 98 **Require companies to state on their annual return to Companies House the names of all directors 'howsoever described' rather than just the appointed directors.** The annual return should also contain a 'health warning' about the consequences for directors who break the terms of their disqualification and other directors who are complicit in allowing disqualified directors to be involved in the management of a company.
- 99 **To address the Insolvency Service's funding problems, examine the merits of a costs system, whereby fixed costs would be levied on disqualified directors.** These costs would directly fund the Insolvency Service's disqualification effort.
- 100 **Amend insolvency law to oblige suppliers to continue to supply on the same terms during insolvency.** Research suggests that if this key aspect of America's Chapter 11 were introduced into the UK it could save an additional 2,300 businesses every year and reduce pre-packs by 22%⁹³ In February, the Government agreed to consult on introducing legislation to ensure IT and utility suppliers continue to supply on the same terms in insolvency. The scope of the Government's consultation should be extended to include all suppliers, to ensure businesses the best chance of survival.

⁹³ www.r3.org.uk/media/documents/policy/policy_papers/corporate_insolvency/HRR_R3_Survey_results_-_Oct_2010.pdf (assumes 14% of 16,000 insolvencies are affected).

Concluding Remarks

Some may argue that an active industrial strategy for small business of the type that we advocate is a return to government “interfering” with the market to “pick winners”, a strategy discredited in the last century. We would not accept this criticism and are greatly concerned that there is a ghost in the machine in Whitehall that always raises the spectre of failing industries of the 70’s every time government intervention in industry is suggested. What government can do – through strategic direction setting, underpinned by a stable policy framework – is to provide support to enough of those with potential and drive to ensure that winners emerge through the competitive process. To exercise no choice is to ensure that every new business and new product idea starts at a disadvantage.

The plain fact is that we are the only member of the G20 without a dynamic industrial strategy and in particular an effective, robust strategy to promote and grow small business. We in the UK are the exception and the price we pay is measured in fiscal deficit and quality of employment.

During the period of the last four summer Olympiads of the 20th century (1984 to 1996) British government was characterised by being non-interventionist in many areas of public life and in the sporting world in particular. Government did not interfere: it stood back and let free choice and market forces reign. We won just 16 gold medals in those four Olympiads.

In the first four Olympiads of the 21st century sport in Britain was in a very different place. Government had become heavily involved in promoting, supporting and funding sporting excellence. We won 68 gold medals in those four Olympiads.

No government minister would claim to have picked Sir Chris Hoy or Jessica Ennis as future winners, but they could claim to have helped create an environment where winners could emerge and thrive. They could claim to have helped create options for success. The same sea change is now required in industrial policy. Britain has wonderfully innovative, entrepreneurial businesses. Imagine how many more we could have and what heights they might aspire to if the same spirit of collaboration and support that enabled the 2012 Olympics permeated the relationship between British government and British business.

Appendix 1: Taskforce Members

Taskforce Chair

Bill Thomas

Bill is a former Senior Vice President and General Manager of Hewlett-Packard and an independent director of XChanging plc and GFI Software SA. He is the Proprietor of Hopton Estates and Chairs the International Advisory Board of Cranfield School of Management.

Coordinating Vice Chair

Tony Roulstone

Tony has broad and senior experience at Rolls-Royce in aerospace and leading its nuclear business group. Subsequently, he has advised large companies on business strategy and investment and he now is the Course Director for the masters in nuclear energy at the University of Cambridge.

Sub-Group Chairs

Ed Ainsworth

Ed is a successful entrepreneur who has co-founded four innovative growth businesses over the last ten years. He is a partner in Ansor Ventures and currently Managing Director of 4C Associates and Chairman of Ansor Environment.

David Connell

David was co-founder of TTP Ventures, an early stage venture capital fund. He is a Senior Research Fellow at the UK Innovation Research Centre at the University of Cambridge, and is the author of several publications on innovation policy, procurement, lead customers and small business financing.

Tim Hames

Tim is Director of Policy at the British Venture Capital Association. He has lectured at Oxford University and worked at The Times as Assistant Editor, chief leader writer and columnist. He served as an adviser to the Speaker of the House of Commons.

Alex Mitchell

Alex is the co-founder of the Young Brits Network, UK President of the G20 Young Entrepreneurs Alliance, UK representative on the European Confederation of Young Entrepreneurs and is the Institute of Directors' Head of Influencer Relations (although he served on the taskforce in a personal capacity).

Members

George Bevis

George is the CEO of Groovy Bananas, an internet innovation business. Previously he was founder of SpeedSell, an angel-funded retail startup. He also has many years experience of consumer and business banking, most recently as Business Strategy Director at Barclaycard

Professor Robert Blackburn

Robert Blackburn is Director of the Small Business Research Centre, Kingston University. He is an authority on entrepreneurship and small firms, having undertaken research for numerous private and public sector organizations.

Cllr Stephen Alambritis

Stephen is the Leader of Merton Council and was formerly the Head of Public Affairs at the Federation of Small Businesses in addition establishing and running his own successful small business in the property sector.

Professor Andrew Burke

Andrew is the founding Director of the Bettany Centre for Entrepreneurship at Cranfield School of Management. He is a Board Member of Cranfield Ventures Ltd focusing on the commercialisation of technology from Cranfield University. He is founding editor of the International Review of Entrepreneurship and his work is widely published on top international research journals.

Ben Coleman

Ben worked for seven years as a management consultant and since 2001 has run his own public affairs communications consultancy, Oceans Consulting. He helped establish Labour's first small business taskforce in the mid-1990s.

Lesley Davies

Lesley is Deputy Chief Executive (Policy) at the Association of Colleges. She previously held positions at the Learning and Skills Council and several blue chip companies in the travel industry including British Aerospace and Coopers & Lybrand.

Cllr James Frith

James is Founder of All Together, a social business committed to tackling the underlying issues of Youth Unemployment. He is an expert on skills, education and employability issues. James is also an elected member for Bury Council.

Peter Haden

Peter is a management consultant working in the retail and consumer sector. He has extensive international experience, and has also worked with several of the UK's leading international development organisations on issues including trade.

Deborah Leary

Deborah is founder and CEO of Forensic Pathways. She holds a number of board positions in the areas of Entrepreneurship, International Trade and Corporate Social Responsibility. She has an Honorary Doctorate from Birmingham City University

Dr Angela Maxwell OBE

Angela is Managing Director of Acuwomen, a company offering advice on strategy to small businesses and formerly Commercial Director of Fracino and adviser to UK Trade and Investment. She was awarded an OBE for Services to Business in 2010.

Terry Owens

Terry founded InBiz, a company which promotes enterprise skills. Under Terry's leadership Inbiz helped over 30,000 people to move out of benefits by setting up their own business, and over 80% of these were still trading after two years.

Martin Phillips

Martin has worked in direct marketing and e-commerce around the world, running his own companies since 2000. He is also a member of the Labour Party's National Policy Forum, representing party members on economic policy.

Iain Simpson

Iain has an academic background in economics and works in financial markets. He also does policy work on financial reform and improving small businesses access to capital.

The Taskforce were assisted by: Jeff Masters, Matt Kelcher, Sonia Sodha, Laura Harvey, Henry Piaskowski, Helen Gibson

Appendix 2: Table of Recommendations

FINANCE

Reforming the banking system

1.	Complementing the foundation of a British Investment Bank, signal a clear commitment to the development of new local solutions for small business finance, inspired by the German Sparkassen. As an example, the Taskforce has itself developed its own model for a network of new lending institutions for small businesses called Sparks.
2.	Expand the range of loans offered under the Enterprise Finance Guarantee Scheme to be closer in utility to the US SBA lending programmes.
3.	Develop an SBIC-like programme for higher-risk business lending and venture debt.
4.	Deliver a British Investment Bank, including a focus on small business finance.

Diverse sources of credit for business

5.	Support the creation of Challenger banks.
6.	Promote risk-based capital requirements for banks and building societies.
7.	Legislate for comprehensive bank data portability and APIs.
8.	Support and encouragement to emerging alternative finance marketplaces and their participants.

Equity (from private sector investment funds)

9.	EIS-like tax relief for institutional funds.
10.	Set targets for the number (and value) of ECF funds to be raised each year.
11.	Encourage larger ECF funds to be formed with total investment capital of £100m and longer fund lifetimes.
12.	Encourage the creation of an ECF-type fund specifically for highly employee-intensive business models.

Personal investments (from founders and business angels)

13.	Extend (S)EIS tax advantages to debt investors and company founders.
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14.	Extend Entrepreneurs Relief beyond capital gains to dividends.
15.	Reduce the 5% threshold for on Entrepreneurs Relief to 1% or below.
16.	Promote (S)EIS awareness and participation among affluent individuals.
17.	Support and promote nascent startup equity marketplaces.

Listing on public markets

18.	Ensure London has the right market offering for high growth businesses, in particular to compete with the US (Nasdaq).
19.	Eliminate stamp duty for companies quoted on growth markets such as AIM and ISDX.

PEOPLE & SKILLS

Equipping entrepreneurs

20.	Develop, with business, a comprehensive training programme for business leadership and management skills.
21.	Re-scope government's online entrepreneurial resources (currently at Gov.uk) so that it is more of an always-on, comprehensive Open University-type resource.
22.	Schools should normalise entrepreneurship as a career path.
23.	Support nascent incubators, accelerators and hubs with funding, training programmes, access to key stakeholders and promotion to entrepreneurs.
24.	Extend the benefits of Employer Supported Childcare to the self employed.
25.	Develop dedicated programmes to help groups of people who face particular barriers to becoming self-employed.
26.	Create a financial cushion to support the earliest stages of self-employment.
27.	Create an entrepreneurship-focused internship programme for long term and youth unemployed.

Employees: developing people and eliminating barriers to additional hiring

28.	Launch an NVQ in "general employability skills".
29.	Pilot a formal system of dual apprenticeships.
30.	Redeploy apprentice subsidies from education training providers to employers.

31.	Using all appropriate resource, reinforce the success achieved by the Prince's Trust Programmes for vocational work experience and enterprise.
32.	Make the points based immigration system more sensitive to the skills constraints of high growth firms, both in the way the policy is set and particularly in the speed with which it is administered.
33.	Create greater clarity in the distinction between genuine freelancing and false self-employment.
34.	Work with employer organisations to encourage firms to use insurance schemes to ensure early access to HR and employment law advice.
35.	Channel simple employment tribunal claims based on minimum statutory rights or contractual disputes through a separate fast-track process.

CUSTOMERS: LEAD CUSTOMERS, GOVERNMENT PROCUREMENT, LATE PAYMENT, EXPORTS

Lead customers

36.	Expand the Small Business Research Initiative to £250m of contracts per year.
37.	Add a new "Larger Innovation Contracts" programme worth £250m for larger scale demonstration projects.
38.	Establish a similar £100m programme to SBRI to encourage private sector companies to play the role of lead customer to innovative small businesses.

Government procurement

39.	Our most important procurement recommendation is to execute faithfully the existing policies with urgency and rigour.
40.	Local authorities should be mandated to use government pre-qualification questionnaires and to simplify small procurements.
41.	Gather accurate data on each contract exceeding a minimum and hold officials responsible for developing, executing and most importantly achieving their targets for direct spend with small businesses, as well as for maximising indirect spending.
42.	Facilitate joint bids involving small businesses by using appropriate national portals.
43.	Update Treasury rules to encourage the consideration of wider economic benefit to a community (whether national or local) when evaluating tenders.
44.	Disaggregate contract requirements where viable to create lots for small businesses.

45.	Roll out the adoption of early, collaborative procurement scrutiny across Whitehall.
46.	Professionalise procurement across the public sector.

Late payment

47.	Promote a strong culture of rapid payment among large businesses.
48.	Consider the merits of requiring larger companies to have their payment practices independently audited and set out in their annual accounts.
49.	Use local government procurement to tackle late payment.
50.	Require all prime contractors to pass down payment terms to sub-contractors which are no worse than those they agree with government.

Exports

51.	Develop a national strategy for exports with ambitious goals.
52.	Develop a suite of export finance products comparable to the US SBA offering.
53.	Develop a plan to grow UKTI activity beyond its current 1% of exporting small businesses.
54.	Invest in building foreign consumer and business preference for UK products by showcasing distinctive British products.
55.	For those businesses working with UKTI, introduce an underwriting scheme to protect small business exporters.
56.	Increase awareness of the importance of global markets, and recognise the value of increasing and utilising the numbers of people who can speak business relevant languages.
57.	Pilot proactive Export 'Rainmaker' offices abroad to help small British businesses identify and approach potential foreign customers.
58.	Establish a network of 'export hubs' in major overseas cities which UK businesses can use as an office base.

AN EFFECTIVE INNOVATION SYSTEM

Innovation

59.	Bring together management of the current BIS business R&D programmes managed by TSB and the Treasury's R&D tax credit system under a single budget and refocus it on policies and programmes likely to deliver the best value for money.
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60.	Introduce a stronger demand pull element into UK innovation policy.
61.	Enhance SBRI programme. Finance new programmes through savings achieved by refocusing R&D tax credits.
62.	Increase the overall level of government support for business R&D.
63.	Review progress in implementing the Catapult programme.

Levelling the digital playing field for small businesses

64.	Create an ecommerce ombudsman at the OFT with responsibility to enforce high standards of customer care including appeals processes when monopoly behaviours are unfair and recommend how marketplaces can be influenced to protect small business margins.
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Creating a world-leading digital infrastructure

65.	Facilitate a national roll-out of free Wifi in urban areas.
66.	Ask Ofcom to investigate whether BT and other cable providers could deliver broadband within one week to 90% of business customers.
67.	Prioritise support for rollout of superfast national broadband.

ORGANISING GOVERNMENT TO SERVE SMALL BUSINESSES

Government

68.	Establish a British Small Business Agency comparable in scope to the US SBA, with the objective of co-ordinating and streamlining government services to help grow the small business sector.
69.	To kick-start the economy and drive longer term reform, establish a crisis committee chaired by the Prime Minister – the “Business COBRA”.
70.	Each major government department should appoint a Director of Economic Development to identify specific areas where a proactive initiative could stimulate creation of new private sector products and services.
71.	Each Department should publish an annual report on innovation and other projects designed to assist economic development.
72.	Measure and publish overall business satisfaction with central and local government.

Establish a united voice for local business

73.	Facilitate a more united voice for local business, working with the FSB, the BCC and others to incentivise wider membership of business organisations.
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Regulation

74.	Conduct a complete overhaul across all departments on how regulation is designed, implemented and monitored, including investing in new technologies that could help to improve the design of regulation, to understand its impacts, and to reduce the risks of unintended consequences.
75.	Abandon aggregate paper-based 'impact assessments' for rigorous testing of the impact of new regulation at the company level.
76.	Focus on outcomes and give business time and flexibility over how to comply
77.	Require all departments to synchronise the introduction of all new regulations on the agreed common commencement days (6 April and 1 October).
78.	Develop a cross-departmental website for small businesses, bringing together all the regulatory and compliance issues, as experienced from the point of view of small business.
79.	Start upstream: focus advice on helping business to comply, through access to 'health checks'.
80.	Reward the proactive who achieve recognised kite marks or ISOs in procurement processes.
81.	Make all enforcement risk-based to level the playing field, and reduce the costs and increase the benefits for the compliant.
82.	Simplify resolution processes. For example, introduce more rigorous streaming of Employment Tribunal cases, simplifying procedures for all but the most complex or serious cases.

Tax, HMRC & Companies House: reducing compliance burdens

83.	Complete (and publish) a bottom-up review of HMRC processes from the customer perspective.
84.	Scope the achievability and cost to benefit of single-point-of-contact relationships at HMRC.
85.	Examine the case for simplifying complicated tax reliefs, recycling any saving back into support for business.
86.	HMRC should allow businesses to pay all taxes in monthly instalments if they prefer to do so.
87.	Simplify payroll by equalising the Income Tax threshold and National Insurance threshold. Class 4 and class 2 NI should be combined into one National Insurance payment.

88.	Create a single monthly reporting date for all employer information.
89.	Remove requirements for small businesses to handle statutory payments
90.	Develop a procedure for pre-approval (advanced assurance) for innovative tax structures.
91.	Consider 0% Capital Gains Tax for founders of businesses with over 100 employees.
92.	Consider how business rates might be reformed in fiscally neutral ways.
93.	Increase the VAT registration threshold to £100,000 turnover.
94.	Clarify definitions of self-employment so that wealth-creators can ensure that they are on the right side of the law.

Managing insolvency

95.	Create a process for the appointment of an independent liquidator to investigate creditor concerns.
96.	Introduce an updated electronic disqualification system.
97.	Extend the period of time disqualified directors stay visible on the central register.
98.	Require companies to state on their annual return to Companies House the names of all directors 'howsoever described' rather than just the appointed directors.
99.	To address the Insolvency Service's funding problems, examine the merits of a costs system, whereby fixed costs would be levied on disqualified directors.
100.	Amend insolvency law to oblige suppliers to continue to supply on the same terms during insolvency.

Appendix 3: SPARKing Growth – Building a Local Lending Network

There is no exclusive model for setting up a British equivalent of the German Sparkassen. Here we propose one idea called **Sparks** – a specific model for a network of new lending institutions for small businesses to stimulate local development – which could contribute to the solution. This is only one of many approaches that could be developed to achieve Sparkassen-like objectives. At this stage, more important than the particular model is a clear commitment to this development process.

The problems

UK small business lending suffers from two structural problems:

- **The “computer says no” problem.** UK banks are 100 times too big to make effective decisions, with studies showing that \$10bn is the optimal balance sheet size for retail commercial banking.⁹⁴ The big UK banks have balance sheets greater than \$1tn.⁹⁵ Small business lending is heterogeneous, there is a need for lending decisions to be made on a case by case basis with the applicant often being coached by a loan officer to ask the right question. However the big UK banks have lending policies set by a central risk committee, based on numerical scoring with little local context. Loan officers have little or no authority to override policies set many levels of management above them. In the Sparkassen banks local loan officers do a great deal of work helping small business owners ask for the right assistance to enable them to say “Yes”.
- **The “no one else does it like that” problem.** A lack of competition in UK small business lending is restricting small business access to capital. Currently the big four banks control the overwhelming majority of small business lending. The absence of meaningful non-big bank lenders means there is little competitive pressure on established practices around availability, loan rates, speed of decision etc. This lack of pluralistic competition offers small businesses little real ability to shop around, if one bank will not lend, chances are none will. The absence of smaller, more nimble players also removes pressure to innovate.

The solution - making lending local, harnessing proximity

A network of UK Sparks can channel private capital into small business lending. Each individual Spark would be small, and focused on a particular geographic area or industry sector, so as to build up expertise. Sparks small enough to be effective lenders are probably too small to be able to access capital markets on their own. The solution is to have a central Spark Umbrella, which borrows on capital markets on behalf of all the Sparks, and allows for a pooling of back office costs. While the first round of Sparks would require central government investment, they would leverage this through borrowing. Over time other groups

⁹⁴ Dean Amel, D., Barnes, C., Panetta, F., and Salleo, C., *Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence*, Federal Reserve, Journal of Banking & Finance Volume 28, Issue 10, October 2004, Pages 2493–2519

⁹⁵ From the banks’ annual reports RBS balance sheet was £1,507bn (December 2011), Barclays £1,490bn (December 2012), HSBC US\$2,556bn (December 2011), and Lloyds £971bn (December 2011).

(local government, entrepreneurs or philanthropists) could set up their own Sparks, and would be allowed access to Spark Umbrella finance. This is loosely based on the German Sparkassen network, where 423 local banks chains account for around 40% of German corporate lending. Sparks could relate to the British Investment Bank as the Sparkassen relate to the KfW, which does not have a distributed structure.

How it might work

Government could establish 20 pilot Sparks, each in a different geographic area. Each Spark would be initially capitalised with £10m of public equity. Each individual Spark would be small and focused on a particular geographic area or industrial sector so as to build up expertise, with a mandate to promote employment and economic growth through profitable lending. Each Spark would be a separate trust, answerable to local stakeholders (including, for example, local government, LEPs, and local chambers of commerce) but largely left to run itself.

A central Spark Umbrella would support the individual Sparks. It would raise capital by selling long term (10 year) bonds to private investors. It would loan the proceeds to individual Sparks (at a slightly higher rate), who in turn would loan the money out to individual small businesses, allowing the Sparks to leverage the initial government investment. These Spark Umbrella bonds would be collectively guaranteed by the individual Sparks. The Spark Umbrella would also, for a fee, provide back office support to individual Sparks. This fee, and the profit it made on lending to Sparks, would cover running costs. The Spark Umbrella would be collectively owned by individual Sparks. Sparks might also use National Savings as a source of finance, perhaps with some local hypothecation of funds.

The first round of Sparks would result in 20 local lenders, each capitalised through £10m of public equity and £90m of private debt, for total small business lending power of £2bn. The impact on central government finances would be the £200m cost of initial Spark capitalisation. The subsequent private debt would not be government liabilities and would not count towards PSNB. Once established Sparks should make a collective profit of £20m a year (10% return on equity). While some of this should be reinvested in further growth, part of it could be paid as dividend back to central government.

The barriers to entry in setting up a Spark are much lower than the barriers to entry in setting up a bank. This should attract considerable private sector interest. Small business lending can be very profitable but at the moment there is no easy way to enter the market. Any organisation able to pull together the necessary start-up capital (£10m) could set up a Spark, subject to oversight from the Spark Umbrella. As borrowing from the Spark Umbrella is an essential part of the Spark model, and the Spark Umbrella is collectively owned by all Sparks, the network should be relatively self-regulating.

Likely external founders of Sparks could include entrepreneurs, local governments, private equity, pension funds, philanthropists etc. All Sparks would have to be dedicated to small business lending, and focussed on lending to a particular geographic area or industrial sector (like credit unions), to allow them to build expertise. To prevent cross-subsidisation of private sector Sparks by public trust ones through the collective guarantee, private sector Sparks would have to pay an additional levy to the Spark Umbrella. This could be used to fund new Sparks in areas that were struggling to attract one.

Clearly central government could also decide to fund additional rounds of Sparks, but once the critical infrastructure of the Spark Umbrella was in place the network should be able to

grow itself without additional central government investment. Other than through potential direct investment in subsequent Spark rounds, the growth of the Spark network would have no PSNB impact.

What Sparks are not

They are specifically not banks, or deposit taking institutions. The necessary regulations to protect depositors would be too expensive for the small Sparks that are envisaged. Nor, as envisaged, would they lend to consumers. The idea is to keep Sparks focussed solely on small business lending, for the maximum broader economic benefit and so they can build expertise in one area. Nor are they a potential breeding ground for a “challenger bank” to the big four. To keep Sparks small enough so that they can continue to make lending decisions on a case by case basis, and that no one Spark could be any threat to the solvency of the wider Spark network, each Spark would have a balance sheet cap beyond which it was not allowed to grow.

FAQ

If lending in this way to small businesses would work, why hasn't the private sector already done it? The central Spark Umbrella is required to make the scheme work by accessing capital markets in size and also by pooling risk to make it attractive to investors. This needs government coordination to establish.

Borrowing not using deposits, isn't this Northern Rock? Northern Rock borrowed short term, 30 days, and lent 25 year mortgages. They had to re-borrow every 30 days or go under. The Sparks will be borrowing long term (selling 10 year bonds) and lending medium term (2-5 years). If markets stopped working in another crisis, worst case is they just don't make any new loans for a while.

Who would buy Spark Umbrella bonds? Pension funds have to keep most of their assets in bonds, but the interest rate they get paid if they buy government bonds is the lowest it's been for decades. This would be an attractive investment opportunity for them. The Spark Umbrella bonds are in turn invested in lots of different Sparks and their loans all over the country, this diversification reduces risk.

Isn't there a risk government has to bail this out? With no depositors, the only investors would be sophisticated institutions/entrepreneurs who bought the bonds or set up more Sparks.

Appendix 4: British Small Business Agency (SBA)

Lord Adonis is currently leading a Review of the role and operational capabilities of the Department for Business, Innovation and Skills. A Small Business Agency should be a critical component of ensuring that BIS serves all UK businesses as effectively as possible.

A British SBA should have responsibility for creating a strong culture of successful small business in Britain, including building business clusters and working closely with local authorities, headed by a strong business leader, the agency will be entrepreneurial in approach. It must remain small and focused.

We recommend that it should have particular characteristics different from the current BIS culture, in particular:

- Take an external perspective
- Looking at Government from the outside not the inside
- Looking for Entrepreneurial solutions
 - 'Bootstrap' resource approach
 - Keep small and focused
 - Want to create business sectors and opportunities, not crowd out
 - Create choice and competition
- Use Business approach
 - Trial, test and learn
 - Understand that not everything will work
- Building on past successes
- Learn from Labour and coalition successes
- Start to build a long term approach

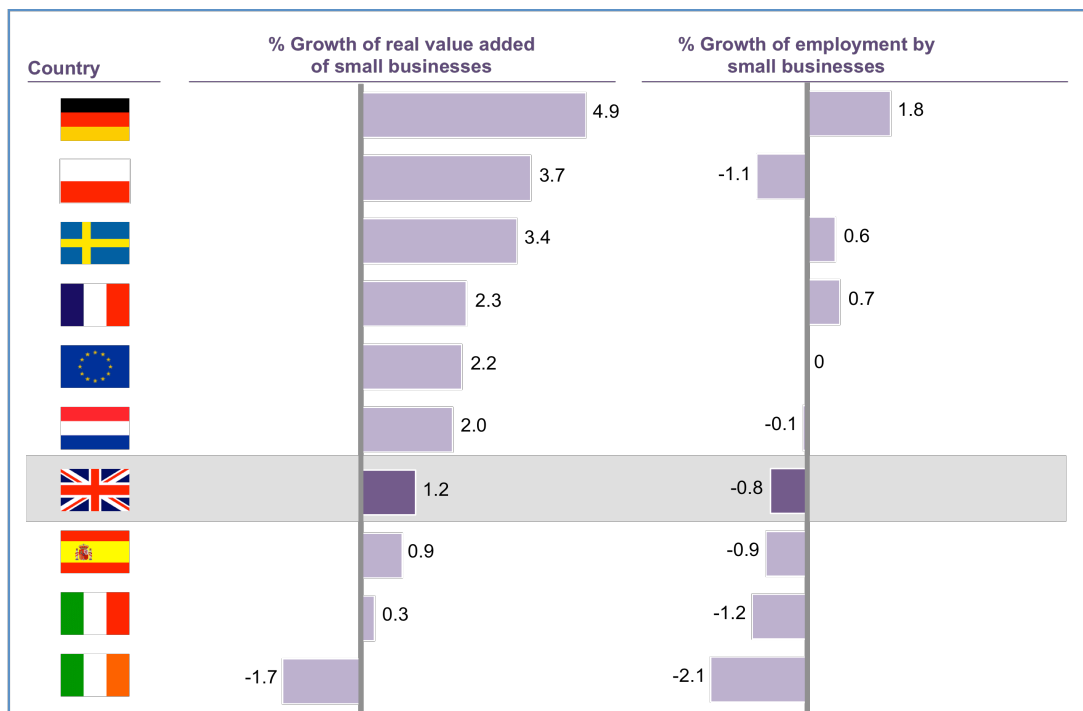
Board members should include experienced entrepreneurs, business leaders and government experts. It is critical that senior individuals are recruited into this department, with experience and expertise in starting up and growing small businesses. It will need excellent marketing and communications so that businesses and pre-starts are aware of where to go and what to expect from the Agency. The offer must be simply and clearly explained and any applications or signposting should be user friendly.

There must be simple signposting, and seamless passing of clients to other departments and organisations where appropriate. Activities should be co-ordinated and comprise a holistic offer. An fast-track category for high growth, high potential companies should be offered where companies are assisted through the system with high levels of relevant support across A2F, skills, mentoring and international trade.

Appendix 5: Modelling the Impact of Igniting Small Business Growth

Our small business sector is the bottom of the pack in productivity growth, compared with European rivals. If the UK could halve the gap in performance versus the EU average this would be worth the equivalent of **£140bn of growth** in the economy and **380,000 new jobs** over the next 10 years. If we could close the gap with Germany this would more than treble.

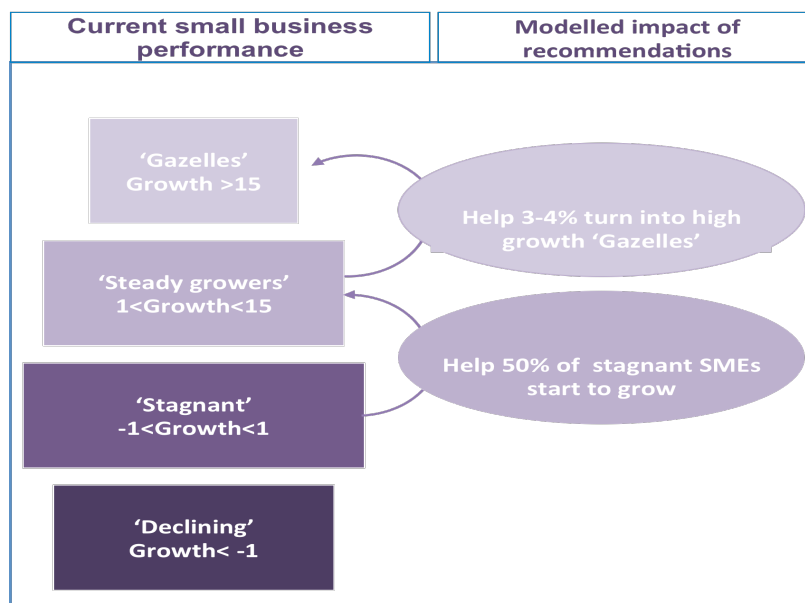
1. On productivity growth, small businesses compare unfavourably with those in other European countries.



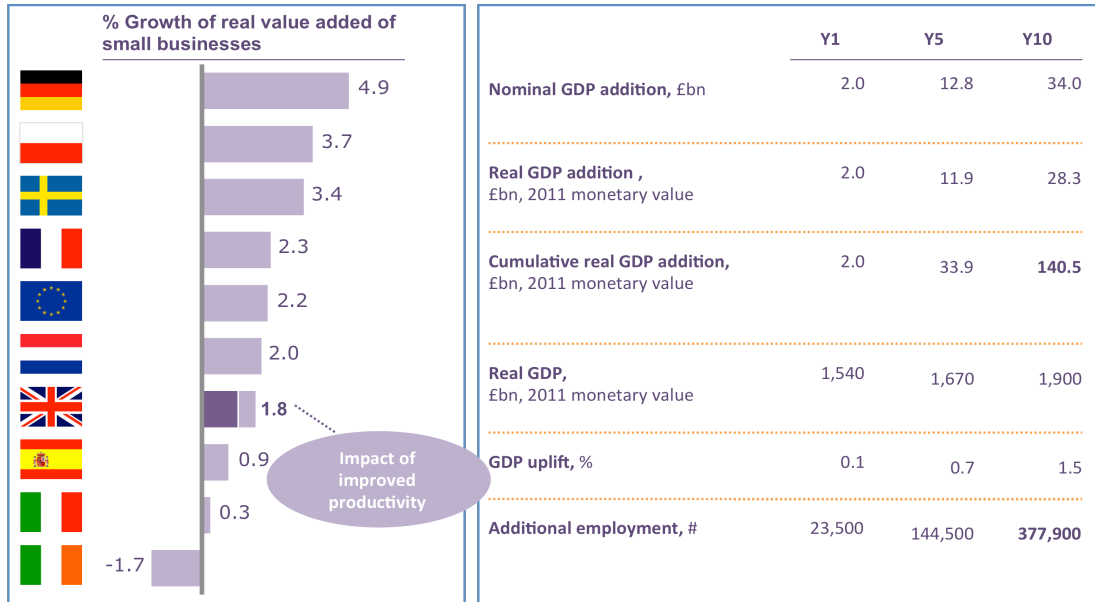
SOURCE: Eurostat; National Statistics Offices of Member States; Cambridge Econometrics; Ecorys

2. We modeled the impact of helping a large number of small businesses improve their productivity as a result of the report's recommendations:

- Start with c16,000 small firms that provide accounts to Company House
- Cluster into groups based on recent performance (declining, stagnant, steady growers, and gazelles)
- Model impact of helping a large proportion of 'stagnant' small firms to become 'steady growers', and a few 'steady growers' becoming 'gazelles'
- Calculate the total impact on output and employment over 10 years
- Check how this compares with European economies that have strong small business sectors



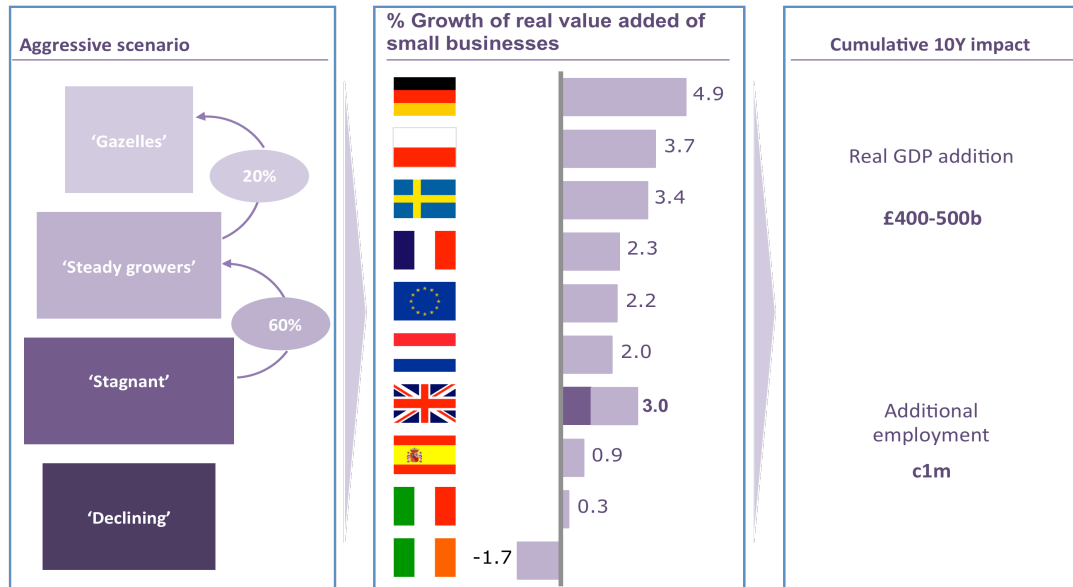
3. Our modeled scenario (£140bn growth and 380,000 new jobs over a decade) assumes only that we halve the gap compared with the EU average.



	Y1	Y5	Y10
Nominal GDP addition, £bn	2.0	12.8	34.0
Real GDP addition, £bn, 2011 monetary value	2.0	11.9	28.3
Cumulative real GDP addition, £bn, 2011 monetary value	2.0	33.9	140.5
Real GDP, £bn, 2011 monetary value	1,540	1,670	1,900
GDP uplift, %	0.1	0.7	1.5
Additional employment, #	23,500	144,500	377,900

SOURCE: BIS, ABS, ELMR, Oxford Economics

4. If the improvements were greater – for example, closing the gap with Germany – the impact on growth and employment could be much greater. In this more aggressive scenario, the cumulative impact on GDP over a decade would be £400bn-£500bn, and the addition of around 1m new jobs.



SOURCE: BIS, ABS, ELMR, Oxford Economics, Eurostat; National Statistics Offices of Member States; Cambridge Econometrics; Ecorys

Appendix 6: Acknowledgements

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