

SCOTLAND'S ENTERPRISE DEFICIT

What It Is

What Can Be Done

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The Business Birth Rate: Scotland's Achilles' Heel

Professor Sir Donald Mackay

Executive Summary

This paper reviews the evidence on business birth rates and the growth performance of small and medium sized establishments (SMEs) in Scotland and considers whether the observed entrepreneurial deficit is due to difficulties in securing loan and equity finance. Its key findings are:

- **Scotland lags Britain in business density**

Business density (measured by the number of VAT registered businesses per 10,000 resident population) has increased in Scotland over the period 1980-99, but remains

significantly below the average for Great Britain (GB). In relative terms, the position has changed very little over this period.

- **London and the South East pulling away**

Within this aggregate picture, business density in Scotland has risen compared with GB excluding London and the South East (LSE). But it has fallen compared with the LSE, an area which displays a high and increasing level of business density.

- **Scots near the bottom of the table**

In 1999, Scotland had a lower business density than all other GB regions, save only Merseyside and North East England.

- **Business deficit widens with growth**

Relative to its resident population, both the business birth rate and the business death rate are lower for Scotland than GB over 1980-99, but the cyclical pattern of births (and the net change in business density) follow fairly closely on that for GB. However, when the economy is expanding rapidly, the gap in birth rate (and the net change in business density) widens, and the contrast with LSE becomes more acute.

- **Central belt is where the problem lies**

Rural Scotland (that is, all areas outside the Central Belt) has a high birth rate by GB standards and this matches the birth rate achieved in most rural areas of GB. The entrepreneurial deficit is a Central Belt phenomenon.

- **A smaller share of high growth firms**

Scotland has a lower share of high growth businesses, but this appears to be due to the low business birth rate and not to a comparative failure to develop high growth businesses from a given number of business starts.

- **Average deal size smaller in Scotland**

Scotland's share of companies which attract private venture capital funding is higher than her share of VAT registered businesses. But the latter is close to Scotland's share of the value of venture capital invested i.e. the average deal size in Scotland is smaller than the GB average.

- **Fewer MBO deals**

Smaller deal size reflects the greater prominence of early stage and expansion deals in Scotland and a much smaller representation of management buy out / management buy in

(MBO/MBI) deals which are more capital intensive. This suggests that any equity gap will be less significant in Scotland.

- **Lack of deals in services**

The industrial spread of venture capital investment indicates that the chief weakness is a lack of deals in tradeable services, a rapidly expanding sector of the UK economy. This appears to reflect a structural weakness in the Scottish economy - a poor representation of such businesses - rather than a financial market failure.

- **Big questions over public funds**

Scotland has a high representation of public sector or public sector assisted funds established to assist new and growing businesses. These funds have ranged from professionally managed funds, such as Scottish Development Finance (SDF), to a large number of relatively small funds, mainly regional in their scope. The cost effectiveness of the latter appears highly questionable.

- **Business angels on the rise...**

In recent years there has been a substantial increase in business angel activity, providing a more informal channel for private funding and, often, a more 'hands on' approach to business development.

- **Venture capitalists responsive**

Attracting equity funding to high tech businesses may present a particular problem, but this may reflect a greater reluctance by the business owner to part with equity. On the evidence, however, the venture capital industry appears to have adapted well to the particular needs of Scottish business.

- **Finance barrier declining in importance**

Scottish Enterprise survey evidence indicates that the perceived difficulty of accessing finance is identified in Scotland, England and Wales, Germany and the United States as the main problem in starting a business. There is little inter-country variation in the percentage of respondents identifying this problem. Over time, in Scotland, this barrier appears to have diminished in importance and only 10 per cent who actually approached a bank for funding, reported the bank response as discouraging.

Why small business matters especially to Scotland

It is commonly assumed that, because there is a lower business density in Scotland and a lower rate of business start-up, SMEs are less important relative to business as a whole. In fact, small business matters more. According to the latest DTI statistics, there were 233,400 small and medium sized businesses in Scotland at the start of 1999. Together

they employed 1.49 million or just over 60 per cent of those employed in all businesses. This SME employment share in Scotland compares with 58 per cent in the South East of England, 54 per cent in England and 42.5 per cent in London. In terms of turnover, SMEs account for 55 per cent of total business turnover in Scotland. This compares with 50 per cent in England and 47 per cent for both London and the South East regions. SMEs are therefore a more, not less important part of the business constituency in Scotland from an economic and policy-making point of view.

Policy implications

- **A 'significant entrepreneurial deficit'**

Business density has increased in Scotland. But Scotland continues to have a significant entrepreneurial deficit compared with GB as a whole and, particularly, with London and the South East.

- **No evidence of a funding gap...**

There is no evidence that this entrepreneurial deficit is due to a failure on the part of the financial institutions operating in Scotland - on the evidence, any equity or loan gap in Scotland is less serious than in the rest of GB.

- **...or barriers to entry for lenders**

The three major Scottish banks have a dominant position in the market for small business lending, but there is no evidence that this results in an inferior service to business clients. Moreover, the evolution of the systems which control small business lending and the decreasing importance of the branch network in this process, make the market for small business loans more contestable for other banks. The lack of other contestants is more likely to be due to the limited profitability of the business, rather than to barriers to entry.

- **Equity and loan funding 'not a problem'**

The evidence does not support the proposition that the entrepreneurial gap in Scotland is due to particular problems in obtaining equity and loan funding. Compared with the rest of GB, Scottish businesses are well served in terms of access to equity and loan funding.

- **Cultural factors may hold the key**

The entrepreneurial deficit remains a matter of concern, but it appears to be historical, sociological and cultural, not financial in origin.

How micro businesses are big players

Micro businesses (defined as those employing between one and ten people) are frequently overlooked in government policymaking, their voice often drowned out by the big battalions of the Confederation of British Industry. Yet in aggregate they have a huge macro impact on the UK economy.

These micro businesses account for 94.7 per cent of the total business population, 21 per cent of total business turnover, and 31 per cent of total employment.

Taking the wider definition of small business - firms employing up to 99 people, the figures are even more startling. There are 3.7 million in total. And they account for 99 per cent of the total business population, 44 per cent of total turnover and 51 per cent of the total employed in business.

The total number of firms registered for VAT is 1.6 million. This suggests more than half of all small business go unrecorded in many business monitoring statistics and opinion surveys. Large businesses (those with 500 or more employees) often cede the argument on the burden of ever rising workplace regulation as it is a proportionately much smaller addition to costs and they are better able to cope. But these businesses account for barely a third (36 per cent) of all employees in business and represent just 0.2 per cent of total businesses in the UK.