A capital idea? A change of approach to helping small firms to increase their investment

BRIEFING PAPER

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The UK's long-term investment record is poor, when compared to many other developed countries. SMEs will have a key role in closing the UK's investment gap with other economies. However, to ensure that SMEs can make such a contribution a more strategic policy approach towards SME investment is needed – one that goes beyond the focus on corporation tax rate and more generous capital allowances.

KEY POINTS

- Between 1997 and 2021, investment levels in the UK were 4.9 percentage points of GDP lower than the OECD average. This equates to an annual £109 billion "investment deficit".
- SMEs account for 99% of the UK's business population and generate around half of private sector output. Therefore, any ambition to boost the UK's aggregate long-term investment levels must have a focus on increasing investment by SMEs.
- Cuts in corporation tax rates have had little noticeable long-term impact. The introduction of full expensing for plant and machinery is only expected to make a relatively small difference, with the impact on SME investment potentially smaller still.
- To achieve the kind of shift in SME investment behaviour that will feed through into a substantial long-term increase in aggregate business investment, a more strategic approach to the role of SME investment in the aggregate picture is needed. One that stands in contrast to the somewhat unnuanced focus on corporation tax rate cuts, and which is also likely to result in a larger positive impact on SME investment levels than full expensing.
- Three key challenges holding back SME investment behaviour: liquidity, lack of sufficient savings, and limited financial management capabilities.

RECOMMENDATIONS

- Make the "Fair Payment Code" compulsory for all large enterprises in the UK underpinned by a stronger Small Business Commissioner (SBC).
- Introduce a system for SME employers to recoup some of the costs that they incur acting as unpaid tax administrators.
- Introduce an allowance for retained earnings for smaller firms.
- Develop a formally accredited, nationally accessible and subsidised financial management training offer for SMEs.

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THE UK'S POOR INVESTMENT RECORD

Low investment has resulted in comparatively poor productivity performance

Business investment has a significant positive influence on long-term prosperity through its contribution to both "extensive" and "intensive" growth.[ii] [1] Despite its importance however, particularly in recent decades, the UK has had a relatively poor investment record. For example, in the UK, Gross Fixed Capital Formation (GFCF) as a proportion of GDP has been consistently below that of the OECD average (Diagram 1). Further, as observed in the recent industrial strategy green paper, the UK has regularly been found in the bottom decile of OECD countries for investment intensity.[2]

Diagram 1: UK's "investment deficit" compared to the OECD average, 1997 – 2021[iii]

Sources: World Bank, SMF calculations

As the Green Paper also noted, the main source of the low investment levels that the UK has experienced in recent decades has been the private sector.[3] It also points out that, while there is considerable variety in investment levels across sectors, sizes and geographies, amongst UK-owned firms, typically 4 in 10 do not undertake investment in tangible or intangible assets in any particular year.[4]

The UK's investment deficit is widely seen as a key cause of Britian's poor labour productivity record. Some have argued

> *"Investment rates in the UK have been low for a long time, and this has translated into a capital-output ratio that is lower than in many of its peers...this is not just the result of differences in industrial structure; the UK has a lower capital-output ratio than other service based economies...this gap in capital...brings us back to the question of why UK firms seem to invest less...?".*
>
> **Source: Tuckett, A and Dinh, T (2019). The Productivity Puzzle revisited: why has UK productivity lagged behind other advanced economies?**

[ii] "Extensive growth" describes an expansion in the total amount of output through increases in the quantity of inputs such as capital and labour. "Intensive growth" are the gains derived from more efficient use of inputs, i.e. productivity.

[iii] According to the Office for National Statistics, the UK's chain volume measure of seasonally adjusted GDP, in 2023, was £2.3 trillion. Source: Office for National Statistics, 'Gross Domestic Product: Chained Volume Measures: Seasonally Adjusted £m', 28 June 2024, https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/abmi/ukea.

that the UK's productivity problem has become particularly acute since the Global Financial Crisis (GFC).[5] [6] [7]

Others have contended that the GFC merely exacerbated a long-standing underlying problem of persistently lower labour productivity levels compared to other industrialised countries.[8] A further notable aspect of the UK's overall productivity picture is the considerable variation in levels between different parts of the country, with some regions much less productive than others.[9]

What many analyses have in common is that they attribute a large proportion of the productivity problem to underinvestment.[10] For example, one study suggested that about half of the productivity gap between the UK on the one hand and the US, France and Germany on the other, was linked to lower levels of tangible and intangible capital.[11]

THE ROLE OF SMEs IN THE ECONOMY AND THE UK'S PRODUCTIVITY RECORD

SMEs account for 99% of UK businesses and produce around half of the UK's private sector output.[12] Therefore, a large number of SMEs operating below their "productive and growth potential" inevitably results in subpar productivity levels and a slow growth rate for the whole UK economy.[13] In-turn, this means that the UK's per-capita income, is below what it could otherwise be.

A greater number of faster growing SMEs are crucial for boosting the prosperity of the UK's regions and nations, because of their importance to local economies.[14] If more of the UK's SMEs can maximise their potential, this would provide an important opportunity for achieving the widely supported goal of moving the UK away from an over-reliance on London-based financial services for growth, and towards a more geographically balanced economy.[15]

Narrowing the productivity gap between SMEs and larger enterprises is equivalent to 2.1% of GDP and would make the UK economy £57 billion larger.

Source: McKinsey Global Institute (2024). A microscope on small businesses: The productivity opportunity and SMF calculations

Increasing the positive contribution of SMEs to the economy will require closing the productivity gap with larger firms. For instance, one estimate highlighted that the average UK SME is 16% less productive than bigger firms.[16] [17] The lower productivity of many SMEs means that a large proportion of smaller firms fall into what former Chief Economist at the Bank of England, Andrew Haldane, has described as the "long tail" of underperforming UK businesses.[18] Further, as with the UK economy more broadly, the regional distribution of the most and the less productive SMEs is stark. The latter is a sizeable contributor to the economic disparities between the UK's nations and regions.[19]

Raising SME productivity and boosting firm growth should be central goals of any efforts to increase the UK's overall long-term prosperity

The points set out above imply that, for a government looking to boost the UK's long-run growth rate and reduce regional economic differences, closing the SME productivity gap and ensuring that as many SMEs as possible are achieving their scale-up potential, should be vital steps towards delivering on that ultimate aim. Central to the average SME boosting their productivity levels and maximising their growth, is investment in the factors which drive strategic capability and operational efficiency i.e. competitiveness. Key for policymakers will be ensuring that UK SMEs are in the best position possible to make those kinds of investments. This will require, as this paper explores, action to make sure that those elements which underpin and enable investment are maximised and those that hold it back, are minimised.[20]

MORE INVESTMENT BY SMEs IS KEY TO BOOSTING THEIR PRODUCTIVITY

Strategic investments are key drivers of SME productivity

Research suggests that strategic investments are particularly important to the competitiveness of individual SMEs.[iv] [21] [22] Notably however, many of the most important strategic investments which SMEs can make, especially service sector firms, are not in physical plant and machinery which is privileged by measures such as full expensing. Rather, they are in intangible assets. The latter are often less prominent in discussions of business investment, but are no less important for many firms.[v] [vi] [23] Indeed, successful investment in physical assets often requires simultaneous spending on complementary intangible capital, such as upskilling workers to use the new plant and machinery. Both the importance of intangible assets and the this close inter-relationship between different types of investment could, perhaps, be better reflected in policy measures aimed at SME investment.

[iv] Strategic investments are ones likely to have an impact on the market position of a firm. These, therefore, include, the adoption of digital technologies, buying a new office, workshop or factory or renovating an existing one, product or service development, the implementation of organisational and process changes or putting resources into other intangibles likely to have a significant bearing on commercial success such as management or workforce skills. Product and service development specifically, includes the modification, expansion, extension or the creation of new products and/ or services. Source: Paul Burns, *Entrepreneurship and Small Business: Start-up, Growth and Maturity*, Macmillan Education (Macmillan Education, 2022).

[v] This is particularly the case for service sector SMEs. The service sector accounts for 81% of UK economic output and 83% of employment. Source: Philip Brien, 'A5: Services', Economic Indicators (House of Commons Library, 2024), https://researchbriefings.files.parliament.uk/documents/SN02786/SN02786.pdf.

[vi] A study of SMEs in six European economies found that in aggregate, a seventh of the productivity slowdown experienced since the GFC was explained by SMEs reducing investment in intangibles. Source: Sophia Chen and Do Lee, 'Small and Vulnerable: SME Productivity in the Great Productivity Slowdown', *Journal of Financial Economics* 147, no. 1 (2023).

SMEs are currently failing to invest on the scale that they would like to

Survey evidence indicates that many SMEs are underinvesting in competitiveness enhancing assets. For instance, in polling, the Bank of England identified that between 22% and 30% of UK enterprises have underinvested.[24] [25] These findings imply that, between 1.2 million to 1.7 million SMEs in the UK could be underinvesting.[vii]

Other research shows that the proportion of smaller firms investing less than they need to in strategically important classes of assets, such as information and communication technologies (ICT) is even higher than the broader underinvestment which the data implies. For example, one analysis from 2020 found that two-thirds (67%) of smaller employers wished to invest more in technology.[26] However, typically, they only invested £4 in new technology for every £10 that was considered optimal.[27]

Table 1: The average amount which smaller employers reported that they wanted to invest in technology to succeed, 2020

Number of employees	Optimal average SME investment in ICT
1	£5,000
2-9	£9,000
10-49	£10,000
50-99	£15,000
100-249	£25,000
Average	£10,000

Source: Sage and Capital Economics

If SMEs invested the total amount they wanted to in new technology in 2020, this would have seen around £14 billion spent on ICT investment. However, by typically spending only £4 for every £10 needed, they only invested £6 billion; an £8 billion "investment gap"

Source: Sage and Capital Economics (2020) Investing for Recovery – Supporting SME Jobs and Growth through Digital Adoption and SMF calculations

Work by Capital Economics estimated that, if all UK SMEs that wished to invest in more ICT did so, to the fullest extent, this could generate up to £145 billion in additional output for the UK, due to the subsequent productivity improvements that would result.[28] This picture of SME technology underinvestment helps to explain the OECD's observation that UK enterprises have typically been slower adopters of ICT, than those in other countries.[29]

Small firms are also underinvesting in human and other forms of intangible capital which, as noted earlier, are just as important to many SMEs as physical capital. For

[vii] The data suggests there were 5.6 million SMEs in the UK in 2023. Identifying 22% and 30% of 5.6 million SMEs results in the range that is set out.

example, fewer small employers invest in training for their workforce, compared to larger companies.[30] Yet, the returns which can accrue on such investments suggests that doing so would generate significant productivity gains and have considerable growth benefits for those enterprises.[31] [32] [33] [34]

THE LIMITATIONS OF FULL EXPENSING

A political consensus on full expensing

In the 2023 Autumn Statement, the then Chancellor, Jeremy Hunt, introduced permanent full expensing for business investment in plant and machinery.[viii] The aim of this measure was to increase the volume of investment by UK SMEs in such assets and in-turn, boost the UK's aggregate business investment levels (see Figure 1).[ix] [x] The new government has pledged to continue with full expensing, in the hope that it will induce a positive long-term business investment response, and help them to fulfil their wider economic growth ambitions.[35]

On balance full expensing is more likely to help investment levels than general cuts in corporation tax rates

"[full expensing is expected to]…induce a rise in the economy's optimal capital stock of 0.5 percent in the long run…[increasing] total investment by £14 billion over the forecast period [late 2023 -2029] or £3 billion a year 1.2 percent on average…"

Source: The Office for Budget Responsibility. (2023). Economic and Fiscal Outlook - The impact of corporation tax changes on business

Policymakers and analysts expect full expensing to have a positive overall impact on the levels of business investment in the UK. Further, it is likely to prove somewhat more impactful than the previous approach of primarily focusing upon cutting the corporation tax rate. As Figure 1 shows, this latter approach has made little noticeable difference to the UK's long-term GFCF and business investment levels.[36] Additionally, cross-country evidence suggests that the UK's experience is not unusual, with little indication of a strong relationship between changes in the rate of tax on profits and investment levels (see Annex 1). The lack of responsiveness from investment activity to lower corporate income tax rates, is also

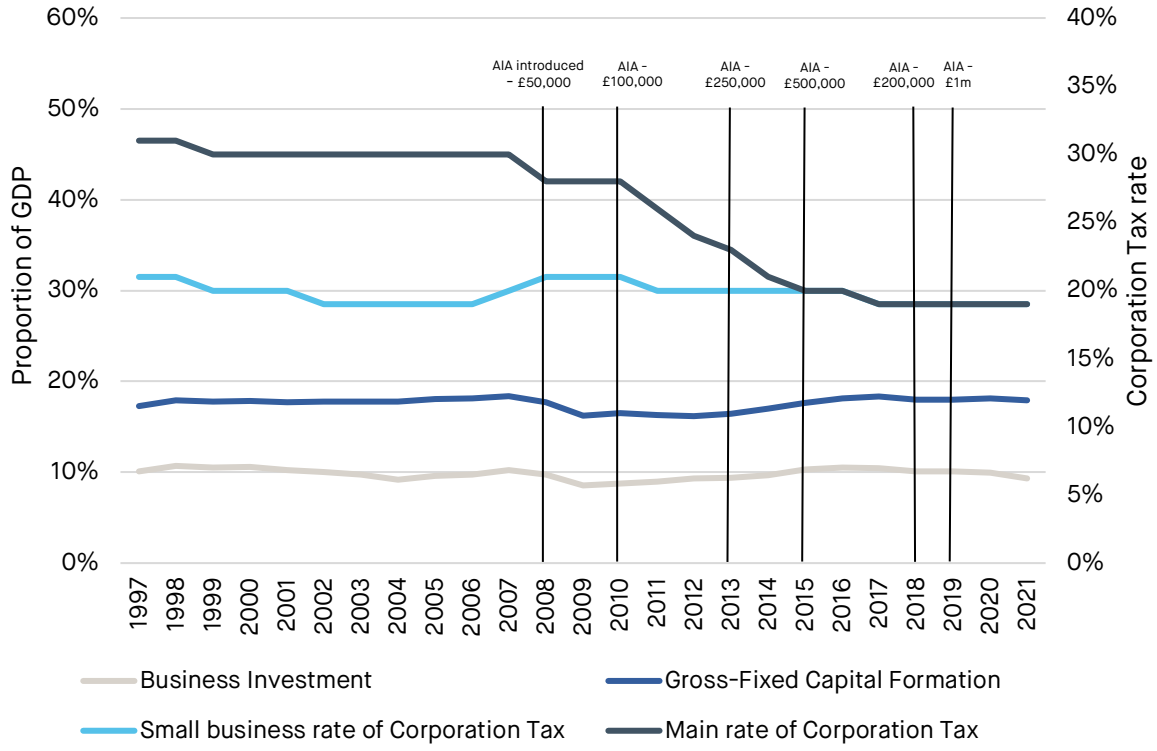
[viii] This followed the winding up of the temporary Super-deduction that was introduced in 2021 by Rishi Sunak when he was Chancellor of the Exchequer.

[ix] While debate continues over the causes of the UK's productivity slowdown particularly since the Global Financial Crisis, there is considerable evidence to suggest that "capital shallowing" has played a role in the UK's poor performance: John Van Reenan, Anna Valero, and Joao Paulo Pessoa, 'How to Return the UK to Growth and Solve the Productivity Puzzle', *The Conversation* (blog), 3 March 2014, https://theconversation.com/how-to-return-the-uk-to-growth-and-solve-the-productivity-puzzle-23865.

[x] One way of measuring labour productivity is output per worker. There is clear evidence of a strong correlation between the amount of capital per worker (which is determined by capital investment levels) and output per worker: Miho Shirotori, Bolormaa Tumurchudur, and Olivier Cadot, 'Revealed Factor Intensity Indices at the Product Level', Policy Issues in International Trade and Commodities Study Series No. 44 (UNCTAD, 2010), https://www.researchgate.net/publication/238731698_REVEALED_FACTOR_INTENSITY_INDICES_AT_THE_PRODUCT_LEVEL.

why the reintroduction of a lower small profits rate, after the main rate was increased to 25% by the last Conservative government, is unlikely to make any meaningful difference to investment behaviour by the UK's nearly two million incorporated SMEs.[xi] Rather, the history of the UK's corporation tax rates over the past two and a half decades, implies that, if a government re-aligned the small profits and main corporation tax rates at the latter's higher level, it would be unlikely to have any significant, negative, long-term aggregate effects on business investment levels in the UK.[xii]

Figure 1: Business investment and GFCF as a proportion of UK GDP and main and small business UK Corporation Tax rates, 1997 – 2021



Source: Office for National Statistics (ONS), SMF calculations. NB: The AIA is the Annual Investment Allowance, which enabled businesses to write-off 100% of the costs of qualifying investment in the year it was undertaken against tax, up to the value limit of the AIA in the relevant tax year. As the charts shows, the AIA fluctuated from time to time, which was, no doubt, an additional difficulty for those who might want to try to utilise it. Further, the chart only illustrates some of the most significant changes in the value of the AIA.

[xi] There are 2.1 million companies in the UK and 8,000 large businesses, according to the Department for Business and Trade. Source: 'Business Population Estimates 2023', Department for Business and Trade, 5 October 2023, https://www.gov.uk/government/statistics/business-population-estimates-2023.

[xii] Estimates indicate that SMEs supply around a third of corporate tax receipts to the Exchequer. Source: Tim Miller and Sarongrat Wongsaroj, 'A Taxing Problem: The Impact of Tax on Small Businesses', n.d., https://www.sage.com/en-gb/blog/wp-content/uploads/sites/10/2018/05/A-taxing-problem-the-impact-of-tax-on-small-businesses.pdf.

The positive effect of full expensing on SME investment levels is likely to prove limited

Despite the likely comparative efficacy of full expensing over cuts in marginal corporate tax rates, the long-run aggregate impact of 100% first year capital allowances on investment levels, is still likely to be limited.[37] For instance, the OBR's analysis indicates that the magnitude of the business investment fillip that full expensing will deliver is almost certain to fall far short of the size needed to transform aggregate business investment levels and therefore help the UK to significantly close the £109 billion investment gap with the OECD average.[38]

Further, the magnitude of the effect on SME investment behaviour specifically, is likely to be even less significant. This is because smaller firms have been able to utilise the provisions of the Annual Investment Allowance (AIA) since 2008. This effectively provided for 100% first year capital allowances on investment in plant and machinery up to a specified value (Figure 1).[xiii] For the vast majority of SMEs, that limit would comfortably cover most physical capital investments which were likely to be made in any single year.[39] Yet, there is scant evidence that the AIA made much of a difference to overall long-term SME investment behaviour and in-turn aggregate business investment in the economy (Figure 1), even if there are many instances of individual SMEs induced to increase investment expenditure because of the AIA.[40]

Investment decisions are complex and not easily incentivised with tax measures alone

The other key reason why full expensing is likely to have only a small positive effect on overall investment levels, is because tax incentives are just one factor amongst many which influence business investment decisions, especially in smaller enterprises. Further, the latter are generally in a much more constrained position and tend to face more challenging conditions than those that larger companies operate in.[41] [42]

> *"...it is apparent that most firms do not consider investment decisions in the way that economists describe – that is that investment will be undertaken as soon as the marginal return exceeds the marginal cost of capital...In practice, for most companies...investment decisions [are] more dependent on the amount of internal funds available..."*.
>
> **Source: McCafferty, I. (2014). Achieving a sustainable recovery: where next for business investment?**

The OECD has observed, for example, that assessing how taxation impacts investment and firm growth needs to be a nuanced exercise.[43] One recent review of the evidence identified a wide range of factors at work, which are often mutually reinforcing and sometimes in tension with each other.[44] This complicated picture needs to be appreciated by policymakers, when developing policy measures aimed at trying to alter business investment behaviour. The focus on a single policy, whether that is

[xiii] The uncertainty over the value of the AIA no doubt deterred some businesses at the margins from utilising its advantages.

rate reductions or full expensing, has perhaps lacked the nuance which the research suggests is needed.

Box 1: The influences on business investment behaviour

The external environment

The research on business investment, indicates that a social and institutional environment conducive to economic activity is a prerequisite for commercial activity whether by individuals, or firms.[45] [46] [47] One component of the institutional environment is the tax system. In addition, sectoral characteristics (e.g. an industry's competitive dynamics and norms) are also important. So too, is the macroeconomy and the state of demand in particular, as well accessibility to adequate external finance (where sought), the investment practices of (any) external investors and the availability and cost of an appropriately skilled workforce.

Business characteristics

Key characteristics of individual firms are also very influential on investment behaviour. They might alternatively be termed "internal factors". Specific examples include:

- The age of an enterprise and its business model (e.g. the investment needs of service sector businesses are different to those of manufacturing firms) its commercial strategy and the degree of market power a firm has.
- The extent of the liquidity constraints faced by a business (e.g. cashflow and working capital), preferences over methods of financing (internal resources tend to be favoured) and the amount of internal capital available i.e. the volume of accumulated savings such as those derived from past profits.[xiv] [48] [49]
- The traits and capabilities of a firm's leadership and management, especially facets such as risk appetite and financial skills, perceptions (not least about tax issues), and goals and expectations, including those about future profitability and what constitutes sufficient return on any investments along with attitudes towards debt and ownership and the nature of previous work-life and business experiences.[xv] [50] [51] [52]

[xiv] Analysis indicates that in 2022 around six in ten SMEs were profitable and the median profit for a SME was £12,000. Sources: D Clark, 'Business Performance of Small and Medium Enterprises (SMEs) in the United Kingdom from 1st Quarter 2012 to 4th Quarter 2022', Statista, 3 July 2024, https://www.statista.com/statistics/291239/uk-sme-business-performance/. And D Clark, 'Median Profit Made by Small and Medium Enterprises (SMEs) in the United Kingdom in 2022, by Sector', Statista, 3 July 2024, https://www.statista.com/statistics/291409/uk-average-sme-profit-by-sector/#:~:text=The%20median%20profit%20made%20by%20SMEs%20in%20the,having%20the%20highest%20average%20profit%2C%20at%2015%2C000%20pounds.

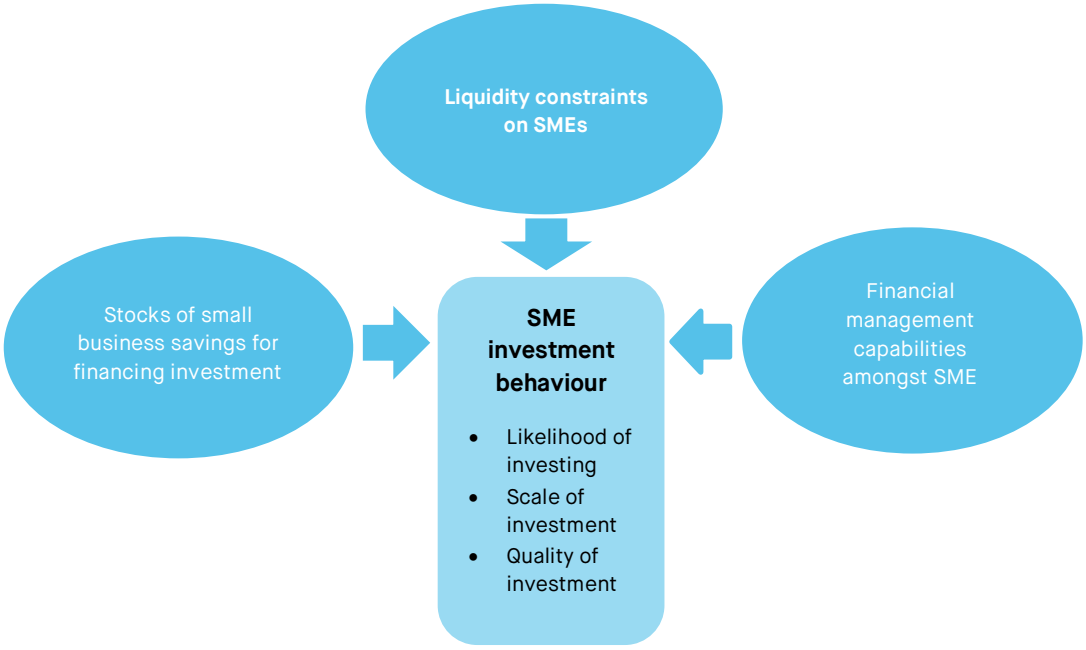
[xv] Among those expectations are those about the rate of return on investment. Evidence suggests the "hurdle rate" for making an investment has tended to be somewhat "sticky" since the GFC despite interest rate changes, macroeconomic volatility and cuts in profit tax rates, etc. indicating little elasticity in this aspect of the investment decision-making process. Source: Jon Cunliffe, 'Are Firms Underinvesting – and If so Why?' (Bank of England, 8 February 2017), https://edu.bankofengland.co.uk/-/media/boe/files/speech/2017/are-firms-underinvesting-and-if-so-why.pdf.

BOOSTING SME INVESTMENT LEVELS IN THE LONG-RUN

Three key constraints that need to be eased in order to unleash greater small business investment

Policymakers aiming to boost long-term aggregate SME investment, need to focus upon maximising the factors which drive investment and minimise those elements which hinder it. More specifically, Diagram 1 shows three of the most important areas – from the complex of influences described in Box 1 – where substantial improvements in each of them could have a significant impact on the three dimensions of investment behaviour (see Diagram 1). Positive changes in investment behaviour would then feed through into greater numbers of SMEs investing more in tangible and intangible assets which, in-turn, would make a sizeable contribution to a large increase in long-term aggregate business investment levels and bring the UK closer to closing the investment gap with the OECD average.

Diagram 1: Three key constraints on SME investment behaviour



Source: SMF analysis

The benefits of having to divert less time and money into managing cashflow and maintaining sufficient working capital, easier access to greater amounts of internal finance for investment, and improved financial management capabilities to be able to recognise, plan and implement optimal investment strategies, will include:

- A higher tendency amongst small businesses to identify opportunities for and make positive decisions to invest.
- An increase in the potential scale at which SMEs can invest at any one time.
- More chance of firms choosing the highest quality investments, when a decision to invest has been made.

Liquidity constraints on SME investment behaviour

The available research suggests that cashflow is linked to the health of a business in general and can be a significant constraint on SME investment ambitions in particular.[53] SMEs for instance, frequently have to forego investment plans in order to finance their working capital needs.[54] [55] Further, late payment by customers to smaller businesses is a major cause of cashflow problems for SMEs.

In 2022, UK SMEs were owed £23.4 billion in overdue payments and the average amount outstanding was £22,000.

Source: Department for Business and Trade (2022)

The scale of the problem across the UK's business community is significant. For instance, evidence from the Federation of Small Businesses (FSB) suggests that more than half of small firms are paid late by customers.[56] FSB commissioned research also suggested that late payments could drive as many as 50,000 smaller firms into insolvency each year.[57] SMF analysis of Department for Business and Trade (DBT) data found that 42% of smaller enterprises and 41% of high-growth firms reported late payment as a barrier to business success.[58] Extrapolating the FSB derived estimates to 2023 would indicate that perhaps as many as 2.9 million SMEs were paid late at least once.

The scale of the late payment problem also provides one reason why measures such as the AIA (and by extension full expensing) have perhaps failed to make a noticeable positive difference to SME investment behaviour. The magnitude of any stimulus effect from the AIA was almost certainly much smaller than the negative impact on businesses of having to redirect resources and time into ensuring sustainable cashflow and a secure working capital position.[59]

If the late payment problem in 2022 had been a third smaller, for example, it could have boosted the aggregate financial position of SMEs in the UK by around £7 billion. This would have given entrepreneurs and SME owner-managers more scope to make investment decisions on their merits rather than have possibilities curtailed by liquidity challenges.

Late payments are not the only source of cashflow difficulties for SMEs. For instance, the ongoing administrative burdens associated with the UK's complex tax system are also a cause. These burdens fall relatively heavily on smaller businesses because of their size and therefore the limited revenue base across which such costs have to be borne.[60] For instance, research commissioned by the European Commission found that the average tax compliance cost for a UK SME was around £16,000 a year, or more than 2% of annual turnover.[61] Another study found that the total annual cost of tax administration for UK SMEs was in the region of £25 billion, which equates to just under £1,500 per employee.[xvi] [62]

Specific causes of these tax administration costs include those that result from small employers having to act as unpaid tax administrators of the Pay-As-You-Earn (PAYE) system, along with frequently poorly drafted tax law, a myriad of (often) complicated

[xvi] SMF calculations using FSB's tax administration burden estimate.

tax breaks, the inconsistent treatment of similar activities and sources of income, the lack of alignment between many accounting practices and tax rules and the design and operation of VAT.[xvii] [63] [64] [65] [66] [67]

Cutting tax administration costs by a third could inject £8 billion annually back into smaller enterprises in the UK. As with late payment relief, this would reduce cashflow challenges in aggregate across the small business population. As a result, many SMEs would have more resources available for alternative uses, such as investment.

The availability of internal financial resources to fund investment

> *"Internal funds, generated through retained earnings, are an important…source of funding for investment for all firms….in an average year, firms have relied on internal funds for at least 60% of UK business investment…".*
>
> **Source: McCafferty, I. (2014). Achieving a sustainable recovery: where next for business investment?**

The main source of financing for investment by SMEs is retained earnings.[xviii] [xix] [68] [69] [70] For example, one 2015 study uncovered that 78% of micro-businesses that had made a recent investment did so using retained earnings .[xx] [71] Another analysis found that 51% of high-growth enterprises and 61% of non-high-growth businesses preferred to use retained earnings as their source of funds for growth, while 34% of high-growth firms aimed to use a "mix" of internal and external funds for growth – showing that many of those who do access external financing for scaling-up are still dependent on at least having some savings for investment.[72] Relying solely on external finance is rare amongst SMEs. Further, research shows that the preference for using retained earnings for investment is consistent across both tangible and intangible assets, i.e. plant and machinery, ICT and intellectual property (IP).[xxi] [73]

> *In 2021, SMEs, on average, had around £45,000 in retained earnings, with six in ten small businesses having savings of less than £10,000.*
>
> **Source: Federation of Small Businesses (2022). Credit where credit's due: small businesses and the need for external finance for**

[xvii] Research from the Federation of Small Businesses found that 63% of small firms described the number of taxes as too confusing, 53% said that the system was too complex and 51% highlighted a lack of transparency over taxes as an issue. Source: Daryn Park, 'A Duty to Reform: Making Tax Work for Small Businesses in a Digital World', 2021, https://www.fsb.org.uk/resource-report/a-duty-to-reform.html.

[xviii] Research has identified a hierarchy of finance preferences and usage by small firms in the UK. Internal financing is the most widely used, followed by mechanisms such as credit cards and overdrafts. Next in the hierarchy tends to be loans from family or directors of the business and asset finance. These are followed by bank loans, government sources and equity. Source: Burns, P. (2022). "Entrepreneurship and Small Business: Start-up, Growth and Maturity".

[xix] There is some evidence that preferences vary across the life cycle of businesses. Source: Maurizio La Rocca, Tiziana La Rocca, and Alfio Cariola, 'Capital Structure Decisions During a Firm's Life Cycle', *Small Business Economics* 37, no. 1 (2011), https://doi.org/10.1007/s11187-009-9229-z.

[xx] See Figure 3 in Annex Two for more data on the proportion of UK firms that source their investment financing from retained earnings.

[xxi] See Figure 3 in Annex Two for more data on this.

There are good reasons why SMEs primarily rely upon retained earnings. For example, internal sources of financing are more efficient. This is because they minimise the "credit friction" problem.[xxii] [74] Notably, the latter has been identified as a contributing factor to the UK's low investment levels, and one that impacts SMEs particularly badly. [75]

Given the clear preference for and benefits of retained earnings as the primary source for investment financing it is unsurprising that research conducted for HMRC found that the higher the level of retained earnings, the more likely businesses are to make investments.[76] Consequently, it seems clear that insufficient stocks of savings, especially amongst smaller firms, act as a significant obstacle to more investment for many SMEs. Further, low levels of retained earnings are not only a constraint on the likelihood of micro, small and medium-sized businesses investing in the first place, but perhaps most significantly, it inhibits the scale at which firms are able to invest at and the quality of the investments that can be made, e.g. inadequate reserves is likely to mean that a SME inclined to invest in ICT may not be able to buy as much or as high quality technology as would optimally benefit their business.

> *"Companies with retained earnings tended to report higher profit overall…Furthermore, the median profit for those with retained earnings was £50,000, compared with £27,000 for those without….Similarly, companies that retained a proportion of their profit also tended to report higher turnover…".*
>
> **Source: Graham Keilloh, G., Chhatralia, K and Johnson, C. (2015). Profit Distribution and Investment Patterns of Unlisted Companies**

However, the current structure of the business tax system mitigates against the retention of earnings by SMEs and their reinvestment in the business, as has been observed by numerous small business scholars. Whether intended or not, the design of the tax system favours the extraction of resources out of a business, which could otherwise help fund investment in efficiencies and future growth. For example, research by leading SME expert Professor Francis Chittenden and others has suggested that the tax treatment of pension contributions discourages the retention of earnings. One paper by Poutziouris, Chittenden and Michaelas, observed that in some instances, owner-managers of SMEs can consume more than 90% of a firm's profits through the combination of pension contributions, salaries and other drawings from the business, which benefit from favourable tax treatment compared to retained earnings.[77]

Moreover, the anti-retention bias in the overall structure of the tax system for SMEs can be particularly detrimental to the long-term success of micro-businesses. This is because such firms tend to have the lowest amounts of retained earnings, they are the least likely to invest in tangible and intangible capital and also typically face the most challenging operating circumstances.[78] [79] [80] Consequently, a tax system that

[xxii] "Credit frictions" are the total direct and indirect costs associated with engaging in a transaction over a financing arrangement. Source: David Jacobs and Vanessa Rayner, 'The Role of Credit Supply in the Australian Economy', Research Discussion Paper (Reserve Bank of Australia, 2012), https://www.rba.gov.au/publications/rdp/2012/pdf/rdp2012-02.pdf.

facilitated the build-up of savings amongst such enterprises would help put many in a stronger commercial position than they otherwise would be. The result would be more smaller enterprises with stronger foundations for future growth.

The financial management capabilities of SME leaders and managers

Two other key influences on investment behaviour are SME leadership and management.[81] Some facets of small business leadership and management relevant to investment decision-making are less amenable to policy interventions e.g. the inherent risk-appetite of individual entrepreneurs and owner-managers for example, or their intrinsic preferences for the shorter-term over the long-run.[82] However, other elements pertinent to investment behaviour could be. For example, research indicates that better management practices in general and improved financial management skills amongst SME owner-managers in particular, can lead to better investment decision-making.[83] This is consistent with the wider evidence on the importance of leadership and management quality to SME performance.[84] [85]

> *"...management practices can help alleviate agency conflict...[and]...problems of "managerial myopia", whereby managers are driven by short-term objectives...managerial capital enables firms to plan ahead better...Better managed firms can anticipate cash flows, investment opportunities, and future financing needs more efficiently..."*
>
> **Source: Roland, I (2020). Unlocking SME productivity: Review of recent evidence and implications for the**

Having more financially capable leadership and management in a small firm tends to result in more adeptness at cash management. This helps ameliorate the magnitude of the cashflow related constraints described earlier which, in-turn, can lessen the pressures on working capital that many SMEs regularly face releasing resources for alternative uses.[86] [87] [88] [89] Further, better managed firms frequently save more overall. As a result, such enterprises are more likely to have greater quantities of reserves available compared to those SMEs with less capable managers, from which entrepreneurs and owner-managers can draw to make investments.[90]

However, as had been observed in numerous studies, there is considerable variability in the quality of SME leadership and management in the UK, in part at least as a result of a large skills deficit.[91] [92] [93] One implication of this state of affairs is that upskilling more SME leaders and managers in financial management is likely to prove challenging, just as raising the quality of leadership and management in general has been.

> *"There are three core elements of financial management: (1)...liquidity... management. Cash is a company's most precious nonhuman asset...(2) long term asset acquisition – which directs the long-term course of business....(3) funding, capital structure and [the] cost..."*.
>
> **Source: Jindrichovska, I. (2013). Financial management in SMEs**

Consequently, understanding the key obstacles hindering the spread of better SME leadership and management in general across the UK's, is vital to making successful

efforts to improve the standards of financial management specifically. The evidence indicates that some of the most salient barriers include:[94]

- A failure amongst many small businesses to realise that they may have a skills deficit to address.
- A lack of awareness of the opportunities to and understanding of how, such capability gaps might be closed.
- Difficulty in assessing the value-for-money of such training made more difficult by a complex landscape of potential support that is difficult to navigate.

A STRATEGIC POLICY APPROACH TOWARDS SME INVESTMENT

A more integrated set of measures are needed to boost SME investment

A strategic policy response that could tackle the liquidity constraints facing many SMEs, help smaller firms build-up more savings and reduce the financial management skills deficit would have positive influences on the three key dimensions of investment behaviour (see Table 2). As investment behaviour changes percolated through much of the UK's small business population, the result would be a sustained contribution to a rising proportion of UK GDP dedicated to business investment.

Table 2: How easing the liquidity, savings and financial management capability constraints will help deliver improved SME investment behaviour

	Liquidity	SME savings	Financial management capabilities
Propensity to invest	✓	✓	✓
Quantity of investment	✓	✓	✓
Quality of investment	×	✓	✓

Source: SMF analysis

Tackling the liquidity constraints on SMEs

Improving SME cash-flow by reducing the late payment problem

The culture of late payment that pervades much of the UK's commercial culture has proven immune to a number of efforts to tackle it. The latter has included the ability to charge interest on overdue monies and the creation of the Prompt Payment Code (which is soon to be replaced by the Fair Payment Code) and the Small Business Commissioner to oversee it.[95] [xxiii] Ultimately, this piecemeal approach has not

[xxiii] The replacement of the Prompt Payment Code by the Fair Payment Code was announced in September 2024. Source: Department for Business and Trade et al., 'Crack down on Late Payments in Major Support Package for Small Businesses', 19 September 2024, Crack down on late payments in major support package for small businesses - GOV.UK (www.gov.uk).

delivered the expected results, suggesting more decisive action is required from policymakers.[96] The latest consultation from the new Labour government is an opportunity to put in place those more effective measures.[97]

Recommendation One – The government should make the Fair Payment Code compulsory for all large enterprises in the UK, boost the investigatory capacity of the Small Business Commissioner over late payments, give the Commissioner the power to fine those breaching the Code and the ability to bring representative collective legal redress actions against firms that regularly fail to pay on time

The Small Business Commissioner was established to lead on re-shaping the culture of poor payment practices, especially amongst the UK's larger businesses. To be more effective, the Commissioner needs more capacity to investigate payment issues and the powers to take stronger action by, for example, being able to levy large financial penalties for breaches of the Fair Payment Code.

The Commissioner should be able to go further and pursue repeatedly failing companies through the civil courts on behalf of smaller firms using representative collective redress mechanisms. When large companies are subject to having to pay significant damages (i.e. punitive) practices will change in both those individual businesses and across the business community as a whole.

Easing cashflow challenges by tackling the costs associated with the tax system

Alongside easing the late payment problem, relieving SMEs of some of the burdens of the tax system will also help reduce the liquidity constraints plaguing many smaller businesses.[98] Therefore, a concerted policy effort to tackle the causes of these costs, i.e. the requirements of administering PAYE and the cutting of the cost of compliance through less complexity, would help free up resources in SMEs for alternative activities like investment.

Recommendation Two – The government should introduce a system for SME employers to recoup some of the costs they incur acting as unpaid tax administrators alongside implementing a broader programme of simplifying tax arrangements for SMEs

Small employers should be able to deduct (or reclaim) a proportion of the costs they accrue as a result of their role in administering the PAYE system in order to relieve some of the cost pressures that carrying out such functions generates for SMEs.[99] Supporters of this kind of policy have suggested that the amount deducted or rebated should be proportionate to the costs incurred, i.e. the smallest firms should benefit the most because the per employee cost is relatively greater for them.[100] Thereafter a sliding scale could be instituted to reflect the fall in costs that occur as firms get larger.[101]

The contours of a broader programme of tax simplification that could have significant cost reduction benefits for SMEs have already been set out by the now abolished Office for Tax Simplification (OTS). The OTS examined options for simplifying different aspects of the tax system which could reduce the tax compliance costs for SMEs. Of particular note were options for simplifying the VAT and corporation tax regimes.[xxiv] In relation to the latter for example, the OTS examined the case for taxing accounting profit as a way of eliminating considerable complexity for SMEs in particular. The government should revive this work, turn the OTS' simplification insights into a policy programme, and lay out a five-year implementation roadmap.

[xxiv] The now abolished Office for Tax Simplification (OTS), looked into a number of the causes of the complexity of the tax system and proposed simplification ideas. Sources: Office of Tax Simplification, 'Simplification of the Corporation Tax Computation', 2017, https://assets.publishing.service.gov.uk/media/5a747bc7ed915d0e8e3988dd/CT_Review_-_final_report_June_17_web.pdf., Office of Tax Simplification, 'Simplification of the Corporation Tax Computation: Progress Report and Call for Evidence', 2016, https://assets.publishing.service.gov.uk/media/5a80379eed915d74e33f9242/OTS_CT_Review_-_Progress_Report_.pdf. and Office of Tax Simplification, 'Value Added Tax:: Routes to Simplification', 2017, https://assets.publishing.service.gov.uk/media/5a8224f8ed915d74e3401f77/Value_added_tax_routes_to_simplification_print.pdf.

Increasing the availability of internal financing for investment

Helping SMEs to save in order to increase their pool of capital

The tax system should "work with the grain" of the financing preferences of most entrepreneurs and owner-managers and encourage the most efficient form of investment financing – retained earnings. At the same time, the tax structure should avoid favouring investments in some types of assets over others and consequently ensure individual firms have the latitude to decide what investments are best for their survival, productivity and growth.

These goals can be achieved by reducing the discrimination built into the current tax regime against the build-up of reserves by SMEs.[102] This would create a more favourable context for SMEs to accumulate savings. The available international evidence suggests that changes along such lines will ease cashflow constraints on SMEs, boost their reserves, reduce leverage ratios and, as a result, lead to an increase in firm-level investment (see more in Annex 3). The same evidence suggests such changes at the micro-level ultimately feed through into noticeable positive effects on the aggregate amounts of business investment in the economy too (see Annex 3).

Recommendation Three – The government should introduce an allowance for retained earnings which exempts from corporation tax the annual amount of profits saved in the business by incorporated SMEs

In order to eliminate the bias in the tax system against the build-up of business savings by SMEs, an allowance should be legislated for which exempts from corporation tax the proportion of annual profits made by smaller incorporated businesses that is retained in the business.

Further, to ensure unincorporated firms are not excluded from this kind of rebalancing of small business taxation, work should begin on how a similar approach might be developed and implemented for this part of the small business population, too.

Improving financial management capabilities in smaller businesses

A new programme for the upskilling of SME leaders and managers

Boosting the financial management skill levels of leaders and managers in SMEs will result in better long-term financial decisions being made by more small firms, which will see greater numbers making investments and often higher quality investments, too. The potential contribution to higher aggregate business investment over the long-term of higher standards of financial management in SMEs, justifies the development of a nationwide skills programme for entrepreneurs and owner-managers to help ensure such outcomes can be obtained.

Recommendation Four – The government should build on the Help to Grow scheme and develop a formally accredited and subsidised financial management training offer for SMEs underpinned by national quality standards

The government's Help to Grow scheme which currently offers free management training for SME owner-managers seems like the obvious envelope within which to develop an accredited financial management skills offer.[103] Such a programme should be developed by the government in partnership with key stakeholders, including business groups, entrepreneurs, university business schools, further education institutions and third and private sector training providers.

The scheme would need to be:

- Adaptable in its content order to apply to the wide variety of SMEs operating in the UK. For example, shorter-term financial management practices tend to be the most important for the smallest and youngest enterprises, i.e. understanding and working with basic financial concepts such as working capital and profitability management.[104] [105] Whereas, for larger and more established SMEs more sophisticated financial management ideas and practices such as detailed financial analysis, are more applicable.[106] [107]
- Rigorously quality assured by the government and provide a rigorous and respected qualification that not only adds value to the day-to-day activities of businesses and tasks like strategic planning, but which becomes widely recognised as a minimum competence standard that, for example, external financing organisations and investors could use to help guide their financing decisions.
- Flexible in the channels through which it can be delivered, i.e. training could be delivered online or in-person through a wide range of entities including further education colleges, private and third sector training providers as well as business bodies such as local Chambers of Commerce. The key would be ensuring that strict quality standards are met.

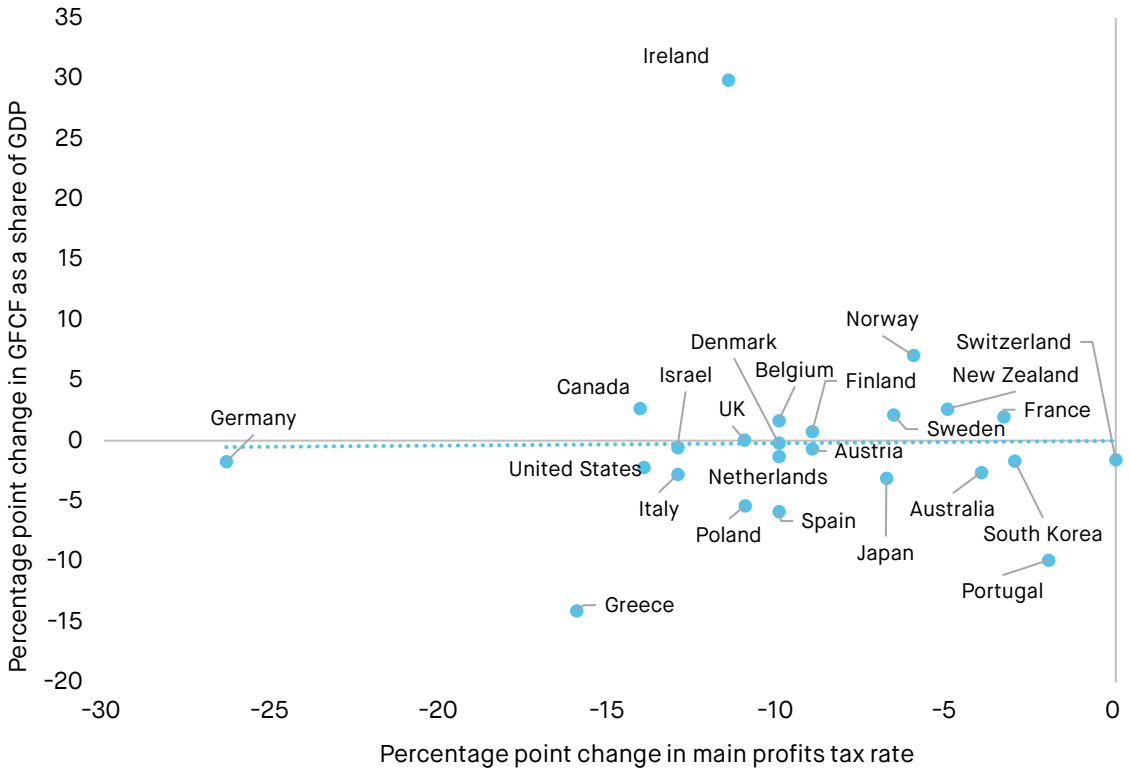
An officially sanctioned standard should help reduce the problem of navigating a confusing landscape of different training offers that holds many SMEs back. However, awareness and understanding are also key barriers to such schemes making a large-scale impact. Therefore, considerable effort would need to be put into awareness raising making the "business case" to entrepreneurs and owner-managers for such training clear and unambiguous. This will require utilising imaginative routes to reach out to SMEs, e.g. through business groups, accountants, and accounting software providers (perhaps pairing purchasing such services with access to the training) as well as banks, universities and the eco-

system of business incubators and accelerators as well as leveraging public procurement requirements at all levels.

ANNEX 1 – INTERNATIONAL EVIDENCE ON THE ASSOCIATION BETWEEN CHANGES IN PROFIT TAX RATES AND THE IMPACT ON INVESTMENT

The cross-country evidence showing the inefficacy of lowering corporate profit tax rates to incentivise sustained increases in aggregate investment aligns with the UK's historical experience. Figure 2 shows that overall, across 24 industrialised countries, reductions in main corporate tax rates are not linked to any noticeable positive change in GFCF levels.

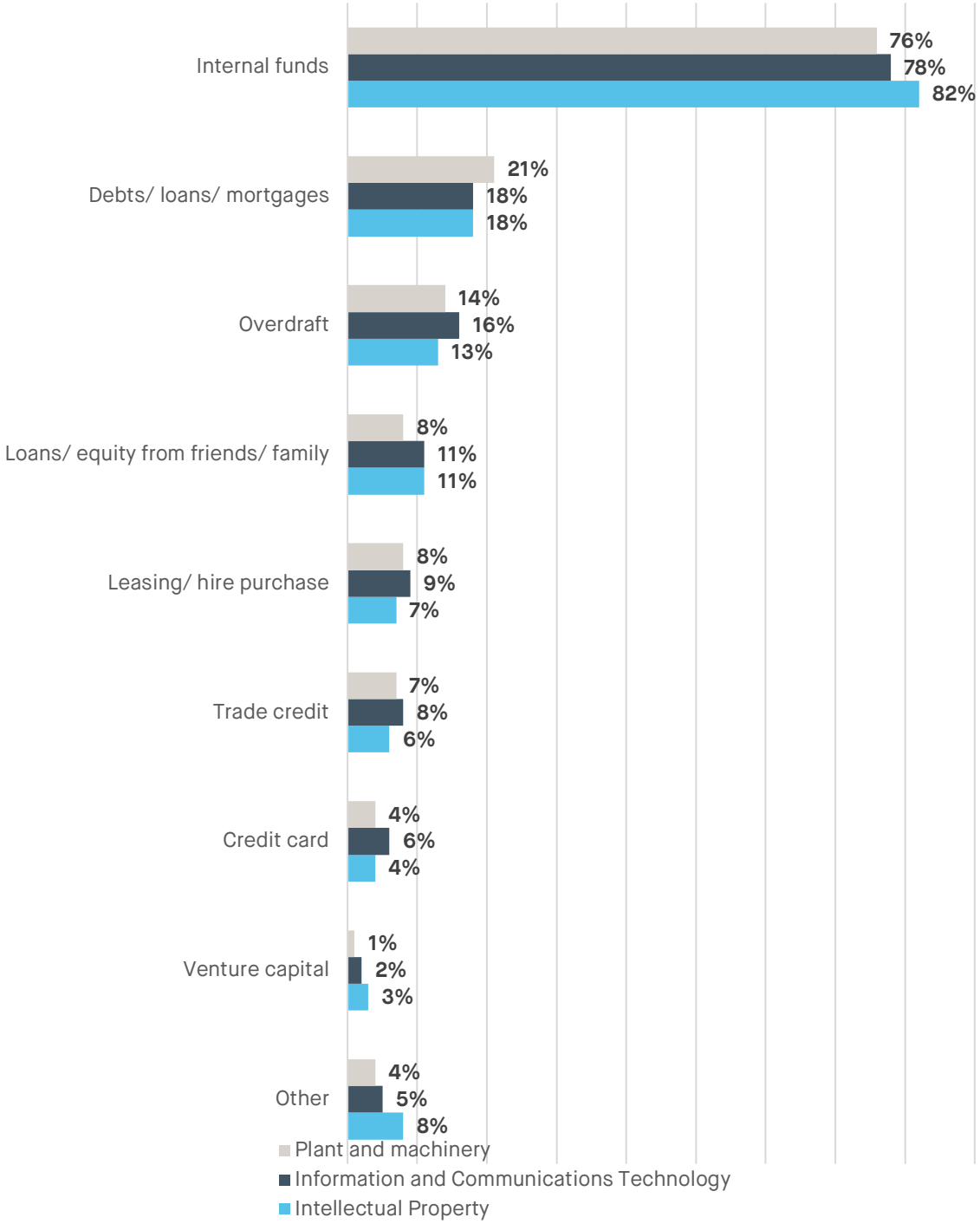
Figure 2: Changes in the main profits tax rate in 24 countries and GFCF as a proportion of GDP, 2000-2019



Sources: OECD, World Bank and SMF calculations

ANNEX 2 – RETAINED EARNINGS IS THE PRIMARY SOURCE FOR FUNDING UK BUSINESS INVESTMENT

Figure 3: Main sources of funding for business investment in key tangible and intangible assets



Source: Ipsos-Mori and HMRC (2015)

ANNEX 3 – SUMMARISING INTERNATIONAL EVIDENCE ON THE BENEFITS OF EXEMPTING RETAINED EARNINGS FROM TAXATION

Two countries that have experimented with providing a fillip in the tax system for retained earnings are Chile and Estonia. Whilst the reform proposed in Recommendation Three is not exactly the same as the changes brought in by Chile and Estonia, nevertheless, the evidence from these two countries offers policymakers a good idea of the kinds of benefits that could accrue to SMEs from such a change and in-turn the gains that are likely to be enjoyed by the wider economy as a result of the impact on SME investment behaviour.

Further, the evidence from the Estonian and Chilean reforms appears to suggest that the relative impact on the economy would prove larger than that expected to be generated by the introduction of full expensing into the UK's tax system. For instance, as noted earlier in this paper, the OBR estimates that the 100% first year capital allowances will add 0.5% to the UK's long-term gross capital stock and 0.2% to long-run GDP.[108]

The Chilean experience

Between 1984 and 1986, Chile reduced the tax the retained earnings of businesses, from 50% to 10%.[109] This precipitated a substantial uptick in investment. For example:[110]

- Business savings increased after the tax reform, while public and private savings did not, highlighting that there was a singular effect on the savings behaviour of businesses which was not the result of any wider macroeconomic trend, for example.
- Within 12 months of the tax change business investment grew by 4.5% of GDP.
- After five years, investment was 10 percentage points higher than before the reform. It reached 25% of GDP in 1989, and was still above 20% in the mid-1990s.

An analysis found that for Chilean firms where cashflow was strongly linked to the ability to invest (as is the case with many smaller firms) the tax changes triggered substantial increases in investment spending.[111] Further, the same study identified that enterprises with small quantities of short-term reserves (typical of the smallest firms) also increased their investment activity.[112]
Ultimately, it can be confidently stated that the investment boom that followed the introduction of the 80% reduction in the tax rate on retained earnings made a large contribution to the 4.5% annualised growth rate that the Chilean economy enjoyed for the decade after 1983.[113]

The Estonian experience

In the year 2000, the Estonian government introduced a distributed profits tax. This kind of tax exempts a business's retained earnings from corporate income taxation. Research has suggested the overall impact of such a change has been a positive one

for Estonian businesses and the wider economy. For instance, evidence from two studies suggested that the reform:

- Reduced firm leverage with the share of liabilities in total assets falling by 7 percentage points, while the holding of liquid assets rose by between 2 and 3 percentage points.
- Led to the proportion of total business assets accounted for by reinvested earnings to increase by 11 percentage points and the investment rate (measured as a ratio of investment to capital) to rise by 20 percentage points.[114] [115] Further, gains were found to be particularly pronounced amongst smaller enterprises and those in the service sector with firms reporting that the reforms enabled them to make larger investments.[116]
- Drove an estimated long-term boost in Estonia's capital stock of between 9% and 12%.[117]
- Contributed to a 3% to 5% increase in overall economic output.[118]

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