



## Unlocking the potential of innovative firms

The UK is an increasingly hospitable environment in which to start a new firm, and many entrepreneurs are availing themselves of this opportunity. The country's highly favourable regulatory framework, well-developed capital markets and world-class science base are all preconditions for success in many important and emergent sectors of the economy.

Yet the UK has produced no 'gorillas' – innovative new firms that grow rapidly into world-leaders, such as Microsoft and Google. British entrepreneurs are not lacking in ambition and the general business climate is good. But a mix of conditions, institutions and attitudes is holding firms back.

New UK firms do not have access to a large domestic market like the US. Excessive family ownership, encouraged by a skewed inheritance tax system, can produce weak, unprofessional management. UK contract enforcement is relatively poor, damaging vital business relationships. And a culture of amateurism still prevails in attitudes to management. Government should use policy to address these weaknesses thereby unlocking the innovative, high-growth potential of the UK's small firms.

### Starting a firm in the UK is becoming easier

The UK has successfully nurtured an environment where starting a firm is relatively painless and increasingly popular. It currently matches the US in business start-up rates.<sup>1</sup> National Statistics report an increase in new VAT registrations for the twelfth year running, with 182,000 new companies registered in 2006.<sup>2</sup> British universities are now producing as many good spin-out companies as their American counterparts.<sup>3</sup>

A recent OECD report showed that Britain had the most favourable regulatory environment of any G8 economy, with low barriers to entry and highly competitive markets.<sup>4</sup> Britain's venture capital and private equity industry is second only to the US in size, depth and sophistication, with £869 million invested in early-stage companies last year alone – more than twice as many as in the nearest European competitor.<sup>5</sup> And British scientific papers are amongst the most cited in the world, with only American papers quoted more often.<sup>6</sup>

### The problem of growth

#### Entrepreneurship and growth matter to the UK economy

To date, UK policy has rightly focused on increasing the number of entrepreneurs. The

capacity of fast-moving new firms to undertake small-scale experimentation and innovation allows new ideas and ways of working to be tested, with the best flourishing and attracting investment.<sup>7</sup>

#### High-growth new firms drive productivity and employment

Recently-established firms are an important driver of productivity growth, both directly through their own activities, and indirectly through their interaction with established firms. Increased competition forces older firms to improve. Cooperation between older and newer firms, through joint ventures or acquisitions, allows established firms to absorb and exploit the knowledge created by newer and more dynamic enterprises.

The greatest benefits from new entrants emerge when entrepreneurs can develop their ideas, achieve a critical size and challenge the dominance of established firms. This has clear social benefits. Fast-growing new firms drive employment growth, with 4 per cent of surviving start-ups responsible for 50 per cent of the jobs created by all new firms ten years later.<sup>8</sup>

#### The UK's small businesses are not growing fast enough

Although the UK is an attractive place to establish a business, it seems less able to

1. Bartelsman, E., Haltiwanger, J. and Scarpetta, S. (2005) 'Measuring and analyzing cross-country differences in firm dynamics.' World Bank Working Paper. [Online]. Available at: [http://www.euklems.net/meetings/CM\\_Helsinki/Bartelsman\\_Haltiwanger\\_&Scarpetta\\_\(2005\).pdf](http://www.euklems.net/meetings/CM_Helsinki/Bartelsman_Haltiwanger_&Scarpetta_(2005).pdf) [Accessed 15 February 2008]. See also Vale, S. (2006) 'The international comparability of business start-up rates.' OECD Statistics Directorate Working Paper. [Online]. Available at: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=986866](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=986866) [Accessed 14 February 2008].
2. Financial Times (2007) 'UK start-ups grow in fertile environment.' 14 November 2007.
3. Library House (March 2007) 'Spinning Out Quality: university spin-out companies in the UK.' [Online]. Available at: [http://www.libraryhouse.net/publications/downloads/MTSO\\_report\\_Mar2007.pdf](http://www.libraryhouse.net/publications/downloads/MTSO_report_Mar2007.pdf) [Accessed 13 February 2008].
4. Conway, P., Janod, V. and Nicoletti, G. (2005) 'Product market regulations in OECD countries: 1998 to 2003.' OECD Economics Department Working Paper No. 419. Paris: OECD.
5. Lord Sainsbury of Turville (2007) 'The Race to the Top: A Review of Government's Science and Innovation Policies.' Table 6.1. London: HM Treasury. Some concerns can be raised about the continuing growth of venture capital investment into early-stage companies, particularly in high-tech sectors.
6. Thirteen per cent of world citations were of UK papers. See Lord Sainsbury of Turville (2007) 'The Race to the Top: A Review of Government's Science and Innovation Policies.' p.35. London: HM Treasury.
7. Bhide, A.V. (2000) 'The origin and evolution of new businesses.' pp. 356-357. Oxford: Oxford University Press.
8. Storey, D.J. (1994) 'Understanding the Small Business Sector.' London: Thomson Learning.

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sustain new firms' growth, especially in high-technology sectors.

Its leading role in traditional areas, such as finance and pharmaceuticals, is increasingly challenged by a more competitive global environment. But there are no UK 'gorillas' yet, no equivalents to Microsoft or Google, firms that started small in new sectors, but grew into world-class corporations.<sup>9</sup>

### **And those that are successful are often bought out**

New UK companies have a shorter average life-span than those in other developed economies.<sup>10</sup> Some recognised successes are acquired by longer-established firms, like AstraZeneca's purchase of Cambridge-based KuDos Pharmaceuticals, or leading videogames developer Lionhead's sale to Microsoft.

According to a study by Cambridge University,<sup>11</sup> 46 per cent of UK small firms that left their sample did not fail; instead they were acquired by other firms. But others do wind up. And of the survivors, the great majority never grow beyond their small-scale beginnings. Forty-one per cent of UK small business owners found growing their business harder than setting it up, compared to only 10 per cent who found establishing their company more difficult.<sup>12</sup>

### **Weak UK management is damaging the UK economy**

A recent study from the London School of Economics Centre for Economic Performance shows that UK firms typically have weaker management than US firms.<sup>13</sup> While top UK firms perform well, the tail of low-performers drives down the UK's overall score. Improving management performance for those firms would improve productivity and growth by up to 20 per cent for each firm.<sup>14</sup>

But, expenditure on management training is relatively low. UK organisations spend only a third as much per head as German organisations spend on developing managers, and about half the French total.<sup>15</sup> Managers are also less likely to receive training than those in other professional and associated occupations.<sup>16</sup>

### **A combination of historic factors is holding UK small firms back**

The UK combines stable and long-standing institutions with a modern, largely services-

oriented economy. This stability is a source of strength, but can create friction with the pressures of dynamic globalisation. Potentially fast-growing small firms can become squeezed between the two.

### **Small local market size restricts growth**

The UK's smaller market size relative to the US is one factor blocking small business growth, and the European single market cannot yet substitute for a larger home market. Despite globalisation breaking down barriers between economies, and reducing the costs of travel and distribution, it remains much easier to produce goods and services for a single home market, with the same standards, conventions and customer expectations, than it is to cater for markets segmented by geographical distance and national characteristics.

As a result, new UK firms simply do not have a vast potential market like the US. They must think carefully about how to expand their customer base outside Britain – especially when their products or services are catering for specialised markets, including those for cutting-edge technology.<sup>17</sup>

### **Small market size encourages a high firm exit rate**

Small market size also gives large corporations with established international distribution networks an advantage. Selling a new firm to an established company is more attractive than creating new networks of suppliers and customers; and this is one factor influencing the high exit rate among innovative UK businesses.

### **The UK has relatively weak contract enforcement, blocking firms' growth**

Growing a business often entails more intensive interaction with other businesses through outsourcing, mergers and acquisitions, joint-ventures or partnerships. While trust and personal contact can work for smaller organisations that collaborate with a limited number of businesses, more complex relationships are often guided by contracts.

The UK's institutions are generally good, but its contract enforcement is relatively weak. The World Bank ranks it 24th in the world for contract enforcement, behind the US (10th), France (14th) and Germany (15th).<sup>18</sup> Enforcing a contract regarding a £40,000 transaction between two businesses in the UK is expected to take 30 procedures and 404 days, with the process costing around £10,000.<sup>19</sup>

9. Owen, G. (2004) 'Where are the Big Gorillas? High-technology entrepreneurship in the UK and the role of government policy.' [Online]. Available at: <http://cep.lse.ac.uk/seminarpapers/09-05-05-OWE.pdf> [Accessed 15 February 2008].

10. See, for example, Bartelsman, E., Haltinwanger, J. and Scarpetta, S. (2005) 'Measuring and analyzing cross-country differences in firm dynamics.' World Bank Working Paper. Washington, DC: World Bank.

11. Cosh, A. and Hughes, A. (2007) 'British Enterprise: thriving or surviving?' p. 111. Cambridge: Centre for Business Research, Cambridge University.

12. Panasonic/YouGov (December 2006) 'SMEs in the UK: seizing the growth challenge.' p. 6. [Online]. Available at <http://www.panasonic.co.uk/pukweb04-assets/pukweb04-assets-specialfeatures/seizing%20the%20growth%20challenge-report-final.pdf> [Accessed 12 February 2008].

13. Bloom, N. and Van Reenen, J. (2006) 'Measuring and Explaining Management Practices Across Firms and Countries.' CEP Discussion Paper No 176 (March 2006). London: LSE.

14. Bloom and Van Reenen find that moving from the lowest quartile of management performance to the highest increases total factor productivity by 20 per cent.

15. Mabey, C. and Ramirez, M. (2004) 'Developing Managers: a European perspective.' Northamptonshire: Chartered Institute of Management.

16. DTI (2005) 'Labour Force Survey.' London: DTI. Thirty per cent of managers surveyed had received any training in the last 13 weeks, compared to 44 per cent of professionals and associated occupations.

17. A Cambridge-MIT Institute survey found that UK firms were significantly more likely to be internationalised than their US counterparts, but that this posed difficult challenges for the UK enterprises. See Cambridge-MIT Institute (2006) 'International Innovation Benchmarking: the determinants of success.' [Online]. Available at: <http://www.cbr.cam.ac.uk/research/programme1/project3-13.htm> [Accessed 15 February 2008].

18. World Bank (2007) 'Doing Business Report.' [Online]. Available at: <http://www.doingbusiness.org/Downloads/> [Accessed 11 February 2008].

19. Ibid.

Similarly, three-fifths of small businesses with employees believe that current insolvency provisions are not effective to protect them from reckless and dishonest individuals.<sup>20</sup>

### **UK entrepreneurs rarely have the management training needed to grow their companies**

UK entrepreneurs are not particularly less ambitious than their overseas counterparts. Eleven per cent of new entrepreneurs in the UK expect to create 20 jobs within five years, compared to 13 per cent in the US, 12 per cent in Germany and 6 per cent in France.<sup>21</sup>

However, turning a small enterprise into a major company involves different risks and challenges than establishing a new firm, and many entrepreneurs find the transition difficult.<sup>22</sup> They may not lack ambition, but UK entrepreneurs too often lack the skills to apply it successfully.

Seventy-five per cent of UK small businesses with employees provide no management training to their managers.<sup>23</sup> By comparison, a majority of businesses with more than 50 employees provide this training. A majority of those starting new businesses hold no formal management qualification, and never acquire one.<sup>24</sup> Only 25 per cent of small businesses seek advice from any external source.<sup>25</sup>

### **The UK encourages family ownership, with its attendant problems for sophisticated management**

The UK has both well-established *primogeniture*<sup>26</sup> and an inheritance tax system that strongly favours the transference of business assets over other forms of property, encouraging family-owned and family-managed enterprises. Some such firms prosper, but there is a 'long tail' of stagnation, decline and wasted potential. Family owners can be biased towards family management, even where this is not ideal for company growth.<sup>27</sup>

Since 1992, inherited unlisted businesses have enjoyed 100 per cent relief from inheritance tax, while other forms of property pay tax of up to 40 per cent.<sup>28</sup> This significantly distorts incentives, biasing the system towards excessive transfers of business assets to inheritors, and encouraging an inefficiently high level of family firm ownership.

Fifteen per cent of medium-sized manufacturing firms in the UK are family owned, managed and have a Chief Executive

Officer appointed by *primogeniture*, compared to just 3 per cent in the US.<sup>29</sup>

### **Family management helps account for one-third of the performance gap with the US**

Family management reduces the ability of firms to absorb outside expertise. An estimated one-third of the management performance gap between the UK and the US can be explained by a combination of inherited family management and weak product market competition.<sup>30</sup>

### **Growing innovative small firms means modernising UK institutions**

#### **Tracking and measuring growth**

Good small firm growth policy requires indicators that are fit for purpose.

Entrepreneurship policy has been aided by the ability to benchmark the UK against other countries and track progress, creating a focus for government.

Despite recent efforts, statistics on firm growth remain in their infancy. Growth policy has been hampered by an inability to track SME's growth trajectories. For example, current indicators do not distinguish between firms that fail and firms that are acquired, even though they have distinct implications for policy.

The UK should develop more detailed indicators of firms' dynamics that go beyond measuring entry, exit and a crude measure of survival, allowing business growth, acquisitions and failures to be tracked and providing clear evidence to guide policy.

#### **Better, more focused support**

The Business Support Simplification Programme (BSSP) is a Department of Business, Enterprise and Regulatory Reform initiative designed to streamline existing business support. NESTA welcomes the inclusion of innovation support amongst its new packages. NESTA also calls for further coordination between innovation and enterprise policy.

BSSP also provides government with an opportunity to reconsider the specific rationale for each programme, as well as to re-examine whether the instruments currently used are successful at addressing specific issues. In particular, research has shown that different support is required for high growth firms compared to 'ordinary' small businesses,

20. SBS (2005) 'Annual Survey of Small Businesses.' London: BERR.

21. Autio, E. (2007) '2007 Global Report on High Growth Entrepreneurship.' Table 4. [Online]. Available at: [http://www.gemconsortium.org/about.aspx?page=special\\_topic\\_high\\_growth](http://www.gemconsortium.org/about.aspx?page=special_topic_high_growth) [Accessed 14 February 2008].

22. Many good examples from the UK electronics industry are given in Owen, G. (2004) 'Where are the Big Gorillas? High-technology entrepreneurship in the UK and the role of government policy.' Sections 4 and 5. [Online]. Available at: <http://cep.lse.ac.uk/seminarpapers/09-05-05-OWE.pdf> [Accessed 15 February 2008].

23. DTI (2006) 'Small Business Survey 2005.' Section 9.2.3. London: DTI.

24. Only 46 per cent of those owning a small businesses hold a degree of any sort. See Barclays Local Business Survey 2007.

25. DTI (2006) 'Small Business Survey 2005.' Section 7.1. London: DTI.

26. The right of the eldest child to inherit the entire estate (or business) from his or her parents.

27. One explanation is that family members receive a non-economic value from family management, even where this is less efficient than non-family management. See Bukhart et al. (October 2003) Family Firms. 'Journal of Finance.' 63:5.

28. Reliefs provided by Section 104 of the Inheritance Tax Act 1984, as amended by Finance Act (2) 1992.

29. Bloom, N. and Van Reenen, J. (2006) 'Measuring and Explaining Management Practices Across Firms and Countries.' CEP Discussion Paper No 176 (March 2006). London: LSE.

30. Ibid.

and that these measures can sometimes be contradictory.<sup>31</sup> In pruning the thicket of current support measures, care should be taken to ensure that specific, intensive support for high-growth potential small firms is provided alongside simplified general SME programmes.

### Transforming procurement

UK government procurement accounts for over £120bn annually, creating a huge potential market for small firms. NESTA supports government proposals to transform its procurement policies to give more support to innovative small businesses. The proposed reform of the Small Business Research Initiative (SBRI) is particularly welcome, with the potential to make this scheme a useful source of additional finance for high-potential small firms.<sup>32</sup>

However, SBRI addresses at best only 2.5 per cent of government research and development spending; reforms could go much further, opening up government procurement to innovative businesses. Better training for government buyers, and a more flexible approach to managing financial risk would allow procurement to use smaller, less well-established, but potentially more innovative firms in delivering government contracts.<sup>33</sup>

### Improving Business-to-Business collaboration and interaction

The UK government should reduce the complexity and costs of contract enforcement, allowing businesses to form stable and credible relationships.

The number of legal procedures necessary to enforce contracts could be reduced, whilst ensuring front-line legal services are adequately resourced would help lower costs and delays for businesses.

### Building professional management

A professional culture of management should be encouraged, improving both basic management skills and the ability of firms to access management talent. Graduate training is steadily improving through the provision of MBAs, which remain the single most popular postgraduate qualification,<sup>34</sup> but an expansion of enterprise education and business training throughout the education system would help improve management practices.

NESTA welcomes the expansion of Train to Gain<sup>35</sup> to improve UK management practices. Empirical evidence shows that managers are often unaware of the weakness of their

management practices,<sup>36</sup> and more focus should be given to raising their awareness of the need for explicit training. The financing and provision of tailor-made consulting services and training should generally be left to the private sector and credible academic institutions.

### Tackling biases in inheritance tax

Streamlining the inheritance tax system to place business and other assets on a more equal footing would help remove a distortion in the tax system, encouraging business owners to think more strategically about their firms' futures.

Government should simplify the inheritance tax system to minimise unnecessary distortions across different forms of business ownership, while providing enough flexibility to avoid threatening the continuation of businesses.

## NESTA is helping innovative firms grow

### Investments

NESTA is investing £50 million in early-stage businesses over the next five years, providing finance to firms with high growth potential and experimenting with novel methods of business support.

### Creative Innovators Programme

In 2008, NESTA will launch a £3 million Creative Innovators Growth Programme, to improve the innovative capacity of growth-oriented, small and medium-sized creative enterprises. Three sector-specific pilots will explore new business models that enable creative businesses to exploit new technologies or other sources of major structural change. The programme will generate evidence to help identify what specific support is required by creative businesses.

### Open Innovation Challenge

The NESTA Open Innovation Challenge is exploring new collaborative business models between multi-national corporations such as Procter & Gamble and small design-led businesses, helping them to grow through collaboration.

### Future research

NESTA is launching a new research strand on growing innovative firms. This work will investigate the path that growing firms follow, the barriers that they face and the role of policy in helping to overcome them.

31. Autio, E., Kronlund, M. and Kovalainen, A. (January 2007) 'High-Growth SME Support Initiatives in Nine Countries: analysis, categorization, and recommendations.' Report for the Finnish Ministry of Trade and Industry. [Online]. Available at: [http://www.baf.cuhk.edu.hk/research/gem/materials/GEM\\_report/High\\_Growth\\_Policy\\_ReportB.pdf](http://www.baf.cuhk.edu.hk/research/gem/materials/GEM_report/High_Growth_Policy_ReportB.pdf) [Accessed 12 February 2008].

32. Lord Sainsbury of Turville (2007) 'The Race to the Top: A Review of Government's Science and Innovation Policies.' London: HM Treasury.

33. Georgiou, L. (2007) 'Demanding Innovation: lead markets, public procurement, and innovation.' London: NESTA.

34. Graduate Prospects (2007) 'What Do Masters Graduates Do?' [Online]. Available at <http://tinyurl.com/2ajd4r> [Accessed 8 February 2008]. Approximately 10 per cent of all postgraduate degrees awarded in 2005 were for MBAs.

35. Train to Gain is a demand-led training programme and brokerage service which assesses business training needs and helps firms to access the right training for their employees. See [www.traintogain.gov.uk](http://www.traintogain.gov.uk)

36. Bloom, N. and Van Reenen, J. (2006) 'Measuring and Explaining Management Practices Across Firms and Countries.' CEP Discussion Paper No 176 (March 2006). London: LSE.