

Small Firms

Report of the Committee of Inquiry on Small Firms

Chairman

J E Bolton, DSC

Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty November 1971

LONDON

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24 August 1981

Dear Mr Latker

You were kind enough to spare some of your time in May of this year for a discussion with me on the question of the support by Government for small firms, particularly in the high technology sector. The points that you made at that discussion were very helpful and I much appreciated meeting you.

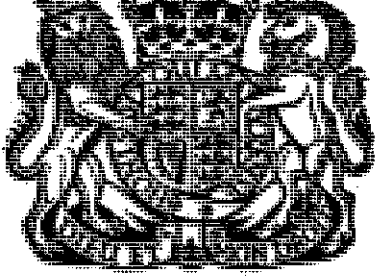
At our meeting you mentioned that you would be interested in seeking a copy of the Bolton report on small firms prepared for the British Government and I now have pleasure in enclosing a copy of this for you.

As a result of my travels in the U.S. I am in the process of drafting a report on the question of support for small firms and when this is in a presentable form I would like to send you a copy.

With kind regards.

Yours sincerely

M P D BULLOCK
MANAGER



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21 September 1971

To

The Right Honourable John Davies, MBE, MP, Secretary of State for Trade and Industry and President of the Board of Trade.

Sir,

We were appointed by the Right Honourable Anthony Crosland, then President of the Board of Trade, on 23 July, 1969, with the following terms of reference:

> To consider the role of small firms in the national economy, the facilities available to them and the problems confronting them; and to make recommendations. For the purpose of the study a small firm might be defined broadly as one with not more than 200 employees, but this should not be regarded as a rigid definition.
>
> In the course of the study it will be necessary to examine in particular the profitability of small firms and the availability of finance. Regard should also be paid to the special functions of small firms, for example as innovators and specialist suppliers.

We now have the honour to submit our Report.

J E BOLTON *Chairman*

E L G ROBBINS

J H B TEW

L V D TINDALE

D C HARTRIDGE *Secretary*

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1 We were appointed on 23 July 1969 by The Rt Hon Anthony Crosland, the then President of the Board of Trade, with the following terms of reference:

> To consider the role of small firms in the national economy, the facilities available to them and the problems confronting them; and to make recommendations. For the purpose of the study a small firm might be defined broadly as one with not more than 200 employees, but this should not be regarded as a rigid definition. In the course of the study it will be necessary to examine in particular the profitability of small firms and the availability of finance. Regard should also be paid to the special functions of small firms, for example, as innovators and specialist suppliers.

2 Our terms of reference were deliberately drawn very widely, so as to restrict the field of the Inquiry as little as possible. It is a reasonable presumption that the decision to set up the Committee was influenced partly by short term considerations: 1969 was a very difficult year for business generally and for small firms in particular, and this gave rise to considerable pressure for an investigation of the immediate position of the small firm. But it was made clear to us that the major purpose of the Inquiry was a long term one—the collection of information on the place of small firms in a modern economy as a basis for recommendations about future policy towards them. Prior to the appointment of this Committee there had never been a comprehensive study, official or otherwise, of the small firm sector in the United Kingdom. This important area is little researched and poorly documented, and the formulation of industrial policy has inevitably proceeded without adequate knowledge of the functions performed by small firms, of their efficiency and of the likely effects upon them of the actions of Government. It was hoped that we should be able to throw light on all these matters and at the same time form views on the controversial issues which were giving rise to anxiety in 1969.

3 It soon became obvious that we had undertaken a massive task, and one of great difficulty, for the small firm sector is extremely large and remarkably heterogeneous. On any reasonable definition, small firms account numerically for the vast majority of all business enterprises. Their diversity is even more striking than their number. Small firms are present in virtually every industry and the characteristics they share as small firms are sometimes not apparent because of the differences arising from the contrasting conditions of different industries. A proper understanding of the whole small firm sector therefore requires study of many industries. There is also extreme variation within the sector as regards efficiency, methods of operation, the nature of the market served and the size of the resources employed. Thus a manufacturing business employing up to 200 people has very little in common with a small shop owned and run by a married couple. Were it not for one characteristic of prime importance, it would be difficult to point to any similarities between them. The all-important characteristic which is shared by these highly disparate enterprises, and by all small firms as we are using the term, is that they are managed by the people who own them. It is this which gives unity and meaning to the elusive concept of the "small firm sector" and which distinguishes the independent small firm from the subsidiary of a big company. Our first decision was that our terms of reference should be interpreted in this sense, and that our proper concern was the owner-managed business. However, it is necessary for

survey is described in Chapter 2 and the forms used are reproduced in Appendix II. This survey has produced a great deal of new information about small firms in the UK, and is the basis for much of the description of their role and characteristics in the early chapters of the Report. The results of the survey are also reproduced in tabular form in Research Reports Nos. 16 and 17.[1] We are extremely grateful to the large number of small businessmen who co-operated in this project by completing these very formidable questionnaires. Knowing the pressure which ordinary paperwork imposes on the owner-manager of a small firm, we by no means underestimated the magnitude of the task we were asking them to undertake, and we hope that those who responded will recognise that their efforts were of great value.

8 However, neither the written evidence nor the questionnaire survey could have provided answers to certain of the important questions which we had to consider, and we therefore set up an internal Research Unit to undertake a major programme of research. This was carried out in part by the Unit itself and in part by consultant researchers working on specific projects under the general direction of our Director of Research. Each of these projects resulted in the submission of a report to the Committee, and the whole series of 18 reports is being published on our behalf by Her Majesty's Stationery Office. A list of the research reports appears at Appendix III. They fall into two broad categories—studies of the role of small firms in particular industries and studies of important questions relating to the sector as a whole, such as the small firm's access to sources of finance, its contribution to innovation or the attitudes and motivation of small businessmen. We believe these reports to be of value in themselves; they are also important as part of the background against which the Committee arrived at its conclusions. We have not always accepted the opinions expressed by the authors, but have invariably taken them into account in forming our own views.

9 Finally, as the issues came into clearer focus we found it very helpful to hold a great many discussions with businessmen, Ministers, Members of Parliament, academics, bankers, civil servants, representative bodies and others with an interest in the subject. We took oral evidence in formal session for 21 full days, held numerous less formal meetings and visited many parts of the country. We have held 100 ordinary Committee meetings. We have also paid brief visits to the United States, Canada, Japan, France and Germany to learn about the situation of small firms in those countries at first hand. A full list of those who gave written or oral evidence to the Committee is at Appendix IV. We should like to express our deep gratitude to all those who gave us the benefit of their knowledge in this way or otherwise assisted us, whether in this country or overseas.

10 The Report is presented in two parts. Part I is a description of the small firm sector, its place in the national economy and in the social fabric, and of the

[1] *A Postal Questionnaire Survey of Small Firms: Non-Financial Data, Tables, Definitions and Notes.* Research Report No. 17.
A Postal Questionnaire Survey of Small Firms: An Analysis of Financial Data by M Tamari, Research Report No. 16.

to some 6 million people or 25 per cent of the employed population, and are responsible for nearly 20 per cent of the gross national product. That part of the sector we have studied in detail—that is, with the exclusions noted in paragraph 4—includes some 820,000 small firms, employing 4¼ million people, and produces 14 per cent of the GNP. Still more important than its quantitative contribution is the fact that the small firm plays a vital role in the preservation of a competitive private enterprise system. We believe that the small firm is in fact an essential medium through which dynamic change in the form of new entrants to business, new industries, and new challengers to established market leaders, can permeate the economy. We therefore believe that in the absence of an active and vital small firm sector the economy would slowly ossify and decay. To ask whether there is a future for the small firm in the new age of giant companies, international combines and universal intervention by Governments, is therefore tantamount to asking whether the future of private enterprise capitalism as we have known it in this country is threatened. But this question is inescapably posed by the evidence of long term decline in the small firm sector which is presented in Part I of the Report. We believe that an efficient small firm sector will survive and prosper through its own efforts despite all adverse trends but neither we nor anybody else can state this with certainty. The issues raised in this Report are therefore a great deal more serious than the livelihood and happiness of those who work in small firms, important though this is. The real issue is what part have small firms to play in preserving a healthy industrial structure and in creating the kind of society we want for the future. No committee could hope to do justice to all the implications of this question in a two year study and it is essential that serious thought should be given to it, especially by those who have it in their power to destroy the small firm sector through neglect or ignorance. Our main recommendation, namely the creation within the Department of Trade and Industry of a Small Firms Division under the aegis of a Minister for Small Firms, is intended to ensure that adequate resources within Government will be devoted to this end.

14 Finally we wish to record how interesting our work has proved to be and our hope that our efforts, however inadequate will be of service to those whom we have been studying for over two years. It only remains for us to record our appreciation of the services of our Secretariat and Research Unit under the direction respectively of David Hartridge, our Secretary, and Graham Bannock, our Director of Research. It is only because of their ability to deal with an immense volume of work while at the same time providing first class guidance to the Committee that this report has emerged at all. This is of course a tribute to the professional competence of all involved, but on a personal level we also wish to record our thanks for the courteous and cheerful manner in which they have dealt with our individual idiosyncracies throughout the two year task.

CHAPTER 1: The Small Firm Defined

Object of Part I

1.1 This first part of our Report summarises the results of our inquiries into the principal characteristics of small firms and their past and present role in the economy. We have in Part I concentrated upon the factual, economic and social aspects of our terms of reference; our judgements on the policy implications of these facts and fuller discussion of the associated institutional problems are included in Part II of our Report.

1.2 Our views are based not only on written and oral evidence received but on the results of a programme of research studies that we found it necessary to commission, partly externally and partly to be carried out by our small Research Unit. Very little information had hitherto been collected in this country either within or outside Government specifically on small firms and the limited information available had been analysed only to a small extent. The main results of our research studies are referred to in appropriate places in this Report and the commissioned research and the results of our postal questionnaire survey are published in full in eighteen separate reports.[1]

1.3 Following this introductory chapter, Chapters 2 and 3 describe, respectively, the characteristics of small firms and their role in the economy as a whole. Chapter 4 discusses the performance of small firms. Chapter 5 attempts to place recent changes in the role of the small firm into historical perspective, and Chapter 6 looks at the situation in its international context. Chapter 7 outlines the main factors affecting the changing role of small firms in the economy.

Definitions

1.4 Our first task was to examine the definition of small firms (those employing less than 200 people) given in our terms of reference, to decide whether this was appropriate for all purposes and whether similarly scaled definitions could be used for small firms in other sectors of the economy. It became clear that a small firm could not be adequately defined in terms of employment or assets, turnover, output or any other arbitrary single quantity, nor would the same definition be appropriate throughout the economy. What we thought most appropriate to our Inquiry was a definition which emphasised those characteristics of small firms which might be expected to make their performance and their problems significantly different from those of larger firms. In the end we came to the conclusion that three main characteristics had to be taken into account. Firstly, in economic terms, a small firm is one that has a relatively small share of its market. Secondly, an essential characteristic of a small firm is that it is managed by its owners or part-owners in a personalised way, and not through the medium of a formalised management structure. Thirdly, it is also independent in the sense that it does not form part of a larger enterprise and that the owner-managers should be free from outside control in taking their principal decisions.

[1] See Appendix III for list of the reports commissioned by the Committee. References in the text to "Research Reports" relate to this list.

it is very much lower than the 200 maximum chosen for manufacturing, which reflects the fact that the vast majority of small firms are very small indeed.

TABLE 1.I

Small firm sector as defined for this Inquiry

Industry	*Statistical definition of small firms adopted by the Committee*	*Small firms as a % of all firms in the industry, 1963*	*Proportion of total employment in small firms, 1963*	*Average employment per small firm, 1963*
	(1)	(2)	(3)	(4)
Manufacturing	200 employees or less	94%	20%	25
Retailing	turnover £50,000 p.a. or less	96%	49%	3
Wholesale trades	turnover £200,000 p.a. or less	77%	25%	7
Construction	25 employees or less	89%	33%	6
Mining/Quarrying	25 employees or less	77%	20%	11
Motor trades	turnover £100,000 p.a. or less	87%	32%*	3*
Miscellaneous services	turnover £50,000 p.a. or less	90%	82%	4
Road transport	5 vehicles or less	85%	36%*	4*
Catering	All excluding multiples and brewery-managed public houses	96%*	75%*	3*

Source: Reports on the Censuses of Production and Distribution and other official inquiries (and Research Unit Estimates).

All figures relate to enterprises but with the exception of Manufacturing relate only approximately to the year indicated. (For definition of an enterprise see Chapter 4, para. 4.4.)

1.10 Had comprehensive statistics been available on the business population in terms of ownership, management, organisational structure and market shares we should no doubt have been able to come closer to the economic definition given in paragraph 1.4. We believe that we have set our statistical limits on the low side and hence our conclusions, in most instances, apply to a higher proportion of firms in each industry than the percentage given in column 2 of Table 1.I.[1]

[1] As an illustration from abroad of the difficulties faced in arriving at precise definitions, in the United States, where a legal definition was required for the purposes of the Small Business Act (1953), the definition adopted was as follows:

> For the purposes of this Act, a small business concern shall be deemed to be one which is independently owned and operated and which is not dominant in its field of operation. In addition to the foregoing criteria the Administrator [of the Act], in making a detailed definition, may use these criteria, among others: Number of employees and dollar volume of business. Where the number of employees is used as one of the criteria in making such definition for any of the purposes of this Act, the maximum number of employees which a small business concern may have under the definition shall vary from industry to industry to the extent necessary to reflect differing characteristics of such industries and to take proper account of other relevant factors.

Thus, in determining whether or not firms qualify for loans to small business, the US Small Business Administration uses varying numbers of employees. All firms in manufacturing employing less than 250 are classified as small but firms employing up to 1,000 people in a number of specified industries, for example metal-working, computers and oil refining, also qualify. Similar general criteria, with specific exceptions, apply for other industries: in retailing, for example, all firms are counted as small if their annual sales do not exceed $1 million (£417,000); in the wholesale trades the general limit is $5 million (£2,085,000). In addition there are different definitions of small firms for Government procurement and other purposes.

Introduction; The Committee's sample survey

2.1 Large companies have been extensively studied from many points of view, so that their activities, share in national production, organisation, and the like, are relatively well understood. But little information has in the past been gathered on small firms, partly because they are difficult to study (there are so many of them and their activities are so diverse) and partly because public interest in them was not great. After surveying the available material we thought it necessary to address a special inquiry of our own to a substantial sample of small firms and much of the material for this chapter has been derived from that survey.[1] The survey covered all the industries within our field of inquiry and, although not fully representative, does enable us to give a factually based description of the main characteristics of small firms.[2] There are clearly many problems and dangers in generalising about such a diverse group, and even the distinction which has been drawn in the description that follows between manufacturing and "service" industries, does not entirely resolve these problems. The common characteristics of small firms which are described here arise principally from:

i. their legal status, ownership, management and organisation;
ii. their financial structure;
iii. their role as employers;
iv. the motivations and social origins of their owners;
v. their role in the community.

i. *Legal status, ownership, management and organisation*

2.2 The majority (60 per cent) of small firms who responded to our inquiry are not incorporated but are either partnerships or sole traders (see Tables 2.I and 2.II).[3] The proportion incorporated depends on the industry and there are considerable variations; for example, in manufacturing industry as a whole 80 per cent of small firms are incorporated as limited companies, but only 33 per cent in non-manufacturing (which is numerically so dominated by retailers that the overall picture for these industries is virtually identical to that for retailing). The lower proportion of incorporated firms in non-manufacturing industries reflects the lower average firm size: the bigger the firm the more likely it is to be incorporated. Well over 90 per cent of incorporated small firms are "close" companies; close companies represent about one-third of all small firms, but they account for about 75 per cent of the net output of all small firms. Quoted companies account for under one per cent of all small firms and although their contribution to output would be somewhat higher they are insufficiently numerous in the small firm sector to warrant detailed consideration in this Report.

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[1] The material given here is abridged and highly selective. For a fuller treatment see: M Tamari, *A Postal Questionnaire Survey of Small Firms; an Analysis of Financial Data*, Research Report No. 16 and *A Postal Questionnaire Survey of Small Firms, Non-Financial Data, Tables, Definitions and Notes*. Research Report No. 17.

[2] The survey asked for the completion of two questionnaires, one relating to general descriptive characteristics of the firm, and the other to accounting aspects. The former questionnaire was replied to by 3,500 firms (out of 15,800 firms approached). The latter questionnaire had a somewhat lower response (2,115 respondents); the limitations of the survey are discussed further in para. 2.12.

[3] In all Tables summarising the Committee's Questionnaire Survey wherever possible the sample response has been re-weighted by population totals derived from Census data on the distribution of firms by industry and size (in non-manufacturing by industry group only).

	(b) Number of working partners or shareholders					
	1	2	3–5	6–10	11 and over	All
	Percentage of all small firms					
Manufacturing	20·8	45·9	29·9	2·2	1·2	100·0
Non-manufacturing	25·2	44·8	27·4	1·3	1·3	100·0

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

TABLE 2.IV

Family ownership of small firms

Per cent

	Manufacturing	*Construction*	*Wholesale distribution*	*Motor trade*	*Retail distribution*
Wholly owned by members of the same family:	38	44	69	49	68
Of which:					
First generation	18	11	46	35	49
Second or third generation family	20	33	23	14	19
Mixed ownership	62	56	31	51	32
All small firms	100	100	100	100	100
Number of respondents	*126*	*36*	*113*	*109*	*128*

Source: Merrett Cyriax Associates, *Dynamics of Small Firms*, Research Report No. 12.

2.4 Most firms have been established for many years; half of those that are wholly owned by one family are in the hands of the second or third generation. In manufacturing industries, half of small firms in 1963 were over 22 years old; in non-manufacturing the median ages ranged from 69 years in construction to 19 in motor trades. It should be noted, however, that the age of a company may be misleading in this context since it may change hands after its foundation.

TABLE 2.V

Average ages of small firms in 1963

Years

	Oldest quartile	*Median*	*Youngest quartile*
Manufacturing	51	22	10
Construction	93	69	44
Wholesale trades	66	29	10
Motor trades	35	19	9
Retail trades	47	19	7

Source: Merrett Cyriax Associates, Research Report No. 12, *op. cit.*

Note that these figures relate only to a 1963 sample of firms in existence in 1963 and interviewed in 1970 and hence they omit any firms founded in the intervening period as well as any 1963 firms which ceased to operate during that period. We have given the ages of the firms in 1963 rather than in 1970 as in the source.

2.5 *Age and qualifications of chief executives.* The mean age of the chief executive in the small firms in our sample is about 54 years.

Per cent of all small firms

Educational qualification of chief executive	*Industry*				
	Manufacturing	*Construction*	*Wholesale*	*Motor trades*	*Retail trades*
No higher education	71	57	78	64	82
Degree	10	9	7	—	—
Accounting	8	6	4	4	1
Other professional or trade	10	26	8	32	15
Management	1	3	2	—	1
Other	—	—	1	—	1
Total	100	100	100	100	100
Number of respondents	*133*	*35*	*91*	*78*	*80*

Source: Merrett Cyriax Associates, Research Report No. 12, *op. cit.*

2.7 The disparity between the average educational qualifications of managers of small firms and those of the very largest firms is considerable. One study among the 500 largest companies in Britain found that 40 per cent of chief executives had been to university and 20 per cent of those who had not were chartered accountants.[1]

2.8 We have collected no new information on the mobility of chief executives of small firms although it is clearly low. In manufacturing small firms 81 per cent of chief executives were members of the founder's family; 12 per cent were other persons appointed from within the firm and only 7 per cent were recruited outside. A study by J Deeks[2] indicates that a high proportion of managers not members of the founder's family have only elementary education, and the majority have no formal qualifications: hence the small firm offers them promotion prospects that would not generally be open to them in the largest companies.

2.9 *Growth by merger and acquisition.* No information has hitherto been available on mergers and acquisitions affecting small firms and particularly on how small firms grow by merger.[3] Our own inquiries show that this merger activity is important both in the form of mergers among small firms and in the form of acquisitions of small firms by larger firms. The survey questionnaire asked if respondents had been involved in a merger or takeover during the preceding five years. The replies, analysed in Tables 2.IX and 2.X, indicated that five per cent of manufacturing small firms and four per cent of those in non-manufacturing industries had been involved in mergers over the period and that the larger the firm the more likely it was to have been so involved. Thus, no less than 18 per cent of the firms employing between 100–199 responding to the survey in 1969 had taken over other small firms or had been formed as a result of a merger

[1] D Hall, H-CL de Bettegries, G Amado-Fischgrund, "The European Business Elite", *European Business*, October 1969. The other studies referred to in the footnote to para. 2.5 suggest that among large firms between 30 per cent and 36 per cent of directors and top managers are university graduates.

[2] In an unpublished paper, *Educational and Occupational Histories of Owner Managers and Managers*, Furniture Industry Training Board, 1971.

[3] Information on mergers is collected by the Department of Trade and Industry and published at quarterly intervals in *Trade and Industry*. These figures, however, exclude virtually all mergers involving small firms. See also *A Survey of Mergers 1958–68*, Department of Trade and Industry, HMSO, 1970.

Per cent

Class of mortality	*Manufacturing and construction*	*Wholesale*	*Motor trade*	*Retail*
Voluntary liquidation	5	15	5	7
Compulsory liquidation	3	4	3	8
Ceased trading	2	6	5	9
Taken over	13	8	5	4
Total mortality	23	33	19	28

Source: Merrett Cyriax Associates, Research Report No. 12, *op. cit.*

Note: These figures give the percentages of small firms in existence in 1963 going into liquidation, ceasing to trade or taken over by 1970; they exclude mortalities of firms established between 1963 and 1970.

TABLE 2.XII

Reasons for acquisition given by small acquired firms

Per cent

Reasons for takeover of firms in Table 2.XI	*Manufacturing and construction*	*Wholesale*	*Motor trade*	*Retail*
Financial failure	37	45	33	6
Succession problem	24	32	13	33
Estate duty payments	14	—	—	—
To eliminate competition	14	—	9	—
To provide tied suppliers	11	—	—	—
To acquire tied outlets	—	—	45	61
Other tax reasons	—	23	—	—
Total	100	100	100	100

Source: Merrett Cyriax Associates, Research Report No. 12, *op. cit.*

Note: These figures give the percentages of small firms in existence in 1963 going into liquidation, ceasing to trade or taken over by 1970; they exclude mortalities of firms established between 1963 and 1970.

2.11 It is not known what proportion of small firms losing their identity in mergers were acquired by very large firms. However, although large firms do not necessarily account for the majority of mergers involving small firms they do account for the major proportion by value of all mergers.[1]

Table 2.XII shows that in retailing and motor trades a substantial proportion of small firms were acquired to provide tied outlets and, in manufacturing, firms were acquired to provide tied suppliers. This Table throws little light on what we should have expected would be a major cause of mergers among small firms—to enable them to compete more effectively with larger firms. Nevertheless it is encouraging to know that merger activity is not restricted to larger firms since, in appropriate circumstances, mergers can assist in the growth of lively, well-managed small firms.

ii. *Financial structure*

2.12 *Introduction.* Our sample survey included a detailed questionnaire on financial accounts for the years 1964 and 1968 and was returned in an acceptable form by 2,115 respondents out of the sample of 15,800 firms to whom forms were sent. This is by far the largest available sample of accounts for small firms in this country; our survey, as others of this type, suffers from certain deficiencies

[1] See *A Survey of Mergers 1958–68*, *op. cit.*

companies and an ICFC sample

Per cent of total assets/capital and liabilities

	Small firms (1968–69)		*Quoted companies (1967)*		*ICFC (1967–68)*	
Tangible fixed assets	31·5		40·4		39·0	
Goodwill	2·6		2·8		0·7	
Trade investments	..		3·1		1·2	
Total fixed assets		*34·1*		*46·3*		*40·9*
Stocks and w.i.p.	24·9		24·4		25·3	
Debtors	27·0		23·0		29·1	
Cash	7·8		3·8		2·6	
Investments	..		2·1		1·3	
Other current assets	6·3		0·3		0·8	
Total current assets		*65·9*		*53·7*		*59·1*
Total fixed and current assets		*100·0*		*100·0*		*100·0*
Ordinary shares	28·2		20·9		14·4	
Preference shares	1·5		2·8		3·2	
Capital and revenue reserves	23·3		29·3		25·0	
Owners' loans	3·4		..		..	
Future tax reserves	..		2·8		2·4	
Capital and reserves		*56·4*		*55·8*		*45·0*
Minority interests	..		2·4		0·1	
Long term loans	5·1		12·5		16·0	
Bank loans and overdrafts	8·6		6·2		10·5	
Creditors	26·7		18·5		23·8	
Other current liabilities	3·3		4·5		4·5	
Total liabilities		*43·6*		*44·2*		*55·0*
All capital and liabilities		*100·0*		*100·0*		*100·0*

Sources: Committee Questionnaire Survey, Research Report No. 17, *op. cit. Annual Abstract of Statistics* 1967. *Small firm survey 1970*, by C Allen, London, ICFC.

TABLE 2.XIV

Small firms: structure of balance sheets of companies and unincorporated firms in manufacturing and in non-manufacturing

Percent of total assets/capital and liabilities

	Manufacturing		*Non-manufacturing*	
	Incorporated	*Non-incorporated*	*Incorporated*	*Non-incorporated*
Tangible fixed assets	34·8	37·5	27·6	39·4
Goodwill	0·9	2·0	2·2	5·0
Total fixed assets	*35·7*	*39·5*	*29·8*	*44·3*
Stocks and w.i.p.	21·2	16·6	28·1	19·4
Debtors	29·9	28·0	30·4	15·6
Cash	6·8	10·0	6·4	12·3
Investments and other current assets	6·5	5·9	5·4	8·5
Total current assets	*64·3*	*60·5*	*70·2*	*55·7*
All assets	*100·0*	*100·0*	*100·0*	*100·0*
Ordinary shares	18·2		18·4	
Preference shares	1·9		1·9	
Capital and revenue reserves	33·3		27·8	
Owners' loans	4·4		4·9	
Capital and reserves	*57·8*	*60·5*	*53·0*	*67·6*
Long term loans	3·6	2·0	4·3	5·6
Bank loans	7·9	4·3	9·7	6·0
Creditors	25·9	28·2	30·1	17·9
Other current liabilities	4·8	5·2	3·0	2·9
Total liabilities	*42·2*	*39·5*	*47·0*	*32·4*
All capital and liabilities	*100·0*	*100·0*	*100·0*	*100·0*

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

firms was very substantially higher, corresponding to their greater share of economic activity, but for reasons given earlier (footnote 2 to para. 2.12 above) it is not possible to provide a useful estimate of the magnitudes involved. We have been unable to check these estimates from any figures available from the banking system.

TABLE 2.XV

Cash as a proportion of bank credit received in manufacturing and non-manufacturing firms, 1964–68

		Per cent
Manufacturing	*1964*	*1968*
1–24 employees	217	108
25–99 employees	166	124
100–199 employees	66	42
All small firms	141	92
All quoted firms	74	58
Non-manufacturing		
1–24 employees	167	137
25–199 employees	81	35
All small firms	130	96
All quoted firms	72	54

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.19 Naturally enough unincorporated businesses tend to be smaller than incorporated businesses, and we find that the tendencies with respect to size described above are also to be detected in unincorporated firms (see Table 2.XIV); the data are, however, subject to greater reservations since unincorporated businesses do not necessarily keep a full set of accounts and will have found greater difficulty in completing the questionnaire. These businesses, both in manufacturing and non-manufacturing industries, have a lower proportion of external debt in relation to total assets than do companies; in particular, unincorporated small firms tend to borrow less from banks than do companies. Apart from the effect of size, the inability of a lender to obtain a floating charge from an unincorporated borrower would lead us to expect lower borrowing ratios for the unincorporated firm.

2.20 Approximately five per cent of the small firms surveyed showed a "negative equity" in the accounts returned. Owners' capital becomes negative when accumulated trading losses, or owners' drawings in excess of earnings exceed the book value of capital invested in the business and may indicate insolvency, although not necessarily so. Only very limited further checks were possible on these firms. These suggested that in a few cases it was possible that the imputation of a negative equity was not justified and may have resulted from an error either in completing the questionnaire or in editing (for example, treating owners' loans as a current liability); in general, however, there seemed to be little doubt that a significant number of small firms are technically insolvent according to balance sheet criteria.

2.21 *Asset structure.* The asset structure of a firm is naturally mainly determined by the characteristics of the business in which it is engaged. Firms in

also higher in relation to sales. Although partly attributable to the fact that cash requirements do not fall commensurately with sales, the greater conservatism of small firms in financial matters (noted in paragraph 2.47) may also be responsible.

2.27 *Profitability.* Subject to the usual limitations of the assessment of profitability as recorded in accounts, it appears that the average small firm in our survey had higher profit ratios than the average quoted firm. The higher relative profit performance of small firms is dealt with in detail in Chapter 4 (paragraphs 4.11 to 4.18) where we also note that profitability is much more variable among small firms than among large.

2.28 The period 1964–68 was one of declining profitability both in the small firms surveyed and in quoted companies. The ratio of profits (before tax, but after all other charges) to equity (the book value of capital and reserves) for the average small survey firm fell from 19·6 per cent to 18·7 per cent over the period, and the comparable figures for quoted companies were 17·2 per cent and 16·5 per cent. The decline in the profitability of small firms was fairly general and not merely the result of changes in a few of the larger firms in the sample: 54 per cent of the firms surveyed showed an absolute decline in profits over the period, and there was a decline in the value of sales (at current prices) amongst 28 per cent of the firms during the same period.

2.29 *Growth.* We made a special study of two sub-samples of our surveyed firms, those that we classified as fast and slow growers. We defined a fast growing firm as one in which sales grew during 1964–68 by 15 per cent or more a year at current prices in manufacturing, or by 10 per cent or more a year at current prices in non-manufacturing; such firms formed 11 per cent of the total sample. A slow growing firm we defined as one in which sales remained stationary or declined, and such firms formed 17 per cent of the sample. Their balance sheet structures are set out in Table 2.XVI. As mentioned above, the fast growing manufacturing firms were more dependent upon external borrowing and had greater recourse to bank loans than slow growing firms. Among non-manufacturing firms there was little difference in the dependence on external borrowing in total or in recourse to bank credit between fast and slow growers.

2.30 Fast growing firms had somewhat younger chief executives (average age of 51, as against 56 for slow growers); but there was no evidence within the predominantly owner-managed firms in our sample that the extent of the chief executive's equity participation, or the number of owners, was related to growth. There was, however, a suggestion in the Merrett Cyriax survey that firms managed by second and subsequent generations of the founder's family grew more slowly than those under the founder.[1] Book values of total assets of fast growing firms grew by 150 per cent among the manufacturing firms, and by 88 per cent among the non-manufacturing firms between 1964 and 1968. Amongst the slow growers assets grew by 20 per cent in manufacturing, and by 10 per cent in non-manufacturing during the same period, but this represents very little, if any, growth in real terms over the period.

[1] See Merrett Cyriax Associates Research Report No. 12, *op. cit.* Table 5.5; it should be noted that this suggestion is based on a small sub-sample of only 18 firms compared with other relatively small sub-samples.

proportion of the funds raised by the fast growers than amongst the slow growers.

2.32 Fast growers tended to be less liquid than slow growers and this shows itself in a lower ratio of current assets and of liquid assets to current liabilities. Fast growing firms tend also to hold less stocks relative to their sales and to extend more credit to their customers in relation to their sales than do slow growers. Finally, the fast growers tend to have a higher rate of profitability than the slow growers and this difference widened over the period. It was striking that the successful firms paid out a higher rate of dividend than the others but, as profits fell over the period, the fast growers reduced their dividends while the slow growers maintained theirs.

iii. *Small firms as employers*

2.33 *Labour relations.* Only eight per cent of small firms are completely unionised and in each industry these tend to be the larger of the small firms. Almost two-thirds of small firms have no trade union members on their payroll.

2.34 On the employers' side about 40 per cent are members of some form of employers' federation or association and, as with unionisation, the likelihood of a firm being a member increases with the size of firm. There is a tendency for firms with a high level of unionisation to be members of an employers' body.

2.35 The small firms which responded to our Inquiry are affected by strikes to only a very small extent: under 8 per cent had been affected at all in the two years to 1969, and of these only 1½ per cent experienced strikes in their own firm, the remaining 6 per cent were affected by strikes in other firms.

2.36 *Wage rates and earnings.* It is often asserted that small firms pay lower wages than larger firms. In fact, there are differences in the nature and conditions of work as between large and small firms which prevent any very precise comparisons of wage-rates between them. To take one example: large firms tend to be more capital-intensive so that shift work is more economical, and we believe it is also more customary for them (see Table 2.XVII)[1]; earnings and wage-rates reported for both large and small firms consequently include an element of shift premium which cannot be satisfactorily isolated but which probably affects the large firm figures more than the small. Official inquiries into *earnings* always emphasise that the results cannot be taken as indicating any difference in *wage-rates* offered for "comparable classes of work people employed under similar conditions";[2] and, as far as can be ascertained, there have been no official inquiries specifically concerned with making precise comparisons in respect of wage-rates. Assessment of the limited information that is available is not a simple matter but because of its importance this question is dealt with here at some length.

[1] Table 2.XVII refers to proportions of *firms*; data are not available on the proportion of *employees* who work shifts in firms of various sizes.

[2] See, for example, Average earnings and hours of men in manufacturing, in *Ministry of Labour Gazette*, April 1959.

evidence on this point although small firms do employ more women than large firms[1] and may be more likely to make special arrangements for those over 65 who desire to work, in return partly for money earnings limited to the ceiling permitted by the official pension arrangements, and partly for some other non-pecuniary compensation.

TABLE 2.XIX

Average hours worked weekly by size of firm

	Average hours per week			
	Size of firm (employees)			
	25–99	*100–999*	*1,000 and over*	*All firms*
Normal time	40·42	40·09	39·76	40·22
Overtime	6·08	6·18	6·42	6·15
Total	46·50	46·27	46·19	46·37

Source: National Board for Prices and Incomes. See Table 2.XVII.

2.39 The difference in earnings between employees of small and large firms, as reported in official inquiries, is of the order of 20 per cent; selected figures are reproduced in Table 2.XX relating to certain broad classes of occupations (the semi-skilled grades are quantitatively the most important). The two sets of factors enumerated above undoubtedly account for some of this reported difference but in the absence of fuller information we are of the opinion that only a small part of the difference is to be so explained so that the lower earnings in small firms, as compared with large, must be mainly attributed to lower wage rates for similar jobs.[2] We shall see in Chapter 4 that as a result of this and because small firms employ more women and a lower skill mix, total wage and salary costs in small firms are relatively quite substantially lower compared with large firms.

2.40 In many respects the small firm provides a better environment for the employee than is possible in most large firms. Although physical working conditions may sometimes be inferior in small firms, most people prefer to work in a small group where communication presents fewer problems: the employee in a small firm can more easily see the relation between what he is doing and the objectives and performance of the firm as a whole. Where management is more direct and flexible, working rules can be varied to suit the individual. Each employee is also likely to have a more varied role with a chance to participate in several kinds of work and better opportunities to learn and widen his experience.[3] No doubt mainly as a result of this, the turnover of staff in small firms is very low and strikes and other kinds of industrial dispute are relatively infrequent. The fact that small firms offer lower earnings than larger firms suggests that convenience of location, and generally the non-material satisfactions of working in them, more than outweigh any financial sacrifice involved.

[1] See Chapter 4, para. 4.5.

[2] This conclusion is consistent with the data for other countries that earnings are less in small establishments than in large. See for example E Kleiman, "Wages and Plant Size: A Spillover Effect?" *Industrial and Labour Relations Review*, January 1971.

[3] Although in small firms the opportunities for progression for junior staff, especially those without qualifications, may be superior to those in large firms, this is less likely to be true for salaried managers who, unless they can grow with the firm, must be forced to change companies more frequently to further their career than do large firm managers.

largest firms' shareholders only very rarely take a direct part in the management of the company they own.

2.43 The divorce of ownership from managerial control, although it may bring other advantages, obviously fails to take advantage of the fact that people instinctively look after their own money more diligently than other people's. It is thus in the social interest that wherever possible the owner of any concern should manage his own resources and that the manager should own a substantial interest in the resources he manages. The full implications of the growing separation of ownership from control that has accompanied the concentration of industry and the emergence of very large companies have been a matter of controversy among economists since at least the 1930s.[1] The fact that small firms are owned and managed by the same people has a great many practical consequences: in particular it helps to explain the flexibility of the small firm, its special role in innovation and risk-taking, its vulnerability to high rates of direct taxation, and its reluctance to seek outside finance.

2.44 *The motivation of small firm managers.* Our own research and observations do show that the owner-managers of small businesses see themselves as making a very special contribution to the economy in a qualitative sense. In our commissioned study by C W Golby and G Johns, *Attitude and Motivation*, (Research Report No. 7) the authors concluded that small business certainly saw itself as being of special benefit to the customer because "there was a feeling of emotional involvement, a determination to find a way round difficulties and a pride in performance which, it was felt, larger firms with their rigidity and bureaucratisation could not equal". For example:

> When you get bigger, you can't give the customer the service . . . nobody can give as good a service as the small businessman. The larger you grow the more the customer suffers.
>
> (Owner, Retail Confectionery, Home Counties)

> The small man can relate a piece of paper to an individual—he knows what it means. But you can't in a larger firm. For instance, you give an order to large firm X for £600, say, and it means nothing to the man you are dealing with, you're just Joe Soap to him, just a lot of paper. You get a personal touch in a small firm.
>
> (Managing Director, Wholesale Distribution, Cheshire)

> Everyone in the factory knows the customer by name and the word goes round "Sam needs these cuff-links tonight". There's a feeling of personal involvement that you don't get with a larger firm.
>
> (Owner, Manufacturing Jewellery, Yorkshire)

2.45 The same study, and much other evidence, also suggests that owner-managers are in general somewhat different in temperament and character from other businessmen. The study summarised the underlying motivation of their respondents as "the need to attain and preserve independence":

> This need for "independence" sums up a wide range of highly personal gratifications provided by working for oneself and not for anybody else. It embraces many important satisfactions which running a small business provided—the personal supervision and control of staff, direct contact with customers, the opportunity to develop one's *own* ideas, a strong feeling of personal challenge and an almost egotistical sense of personal achievement and pride—psychological satisfactions which appeared to be much more powerful motivators than money or the possibility of large financial gains.

[1] See A A Berle and G C Means, *The Modern Corporation and Private Property*, Macmillan, 1932.

the economy as a whole; but as it is all the pressures of society are against going into small business. Another symptom of pressure is that, as we have already noted (paragraphs 2.6 and 2.7), the educational qualifications of small businessmen are relatively narrow: most of them, whether through lack of opportunity or through lack of inclination, have not received a higher education; the majority of those who have such an education must obviously have been diverted into other occupations.

2.49 Though we have adduced this fact as a sad reflection on the restricted appeal which small business enjoys as an eligible career in our contemporary society, we recognise that many people would not take such a gloomy view and that there is, at least, the consolation that small business continues to offer one of the few remaining career opportunities for the able and ambitious youngster who has not passed through the higher educational "mill". For one of the main advantages conferred by higher education, the ability to persuade and impress others by sophisticated argument, is certainly less important for the independent businessman than it is for a member of a large organisation, and there undoubtedly are many talented people, and not only ones without higher education, who find it difficult to achieve the standards of group activity appropriate to large organisations. In a large organisation it is not only necessary for an individual to be capable of doing things and of seeing better ways of doing things, it is also necessary to be able to persuade others to give him the freedom to act or to obey or support him. In a small firm the owner-manager can act very much on his own initiative: it is his action and its success or failure alone that counts. The scope for a shrewd but inarticulate person, therefore, inevitably tends to be greater in a small firm than in a large one. (It is certainly true that small businessmen themselves have been less articulate in the defence of their interests than many of the others whom we have consulted or who have submitted evidence. The independent nature of the owner-manager which inhibits group action may, of course, also be an equally important factor.) It follows that any reduction in the scope for small business might well diminish the opportunities for people who value independence and who cannot, in any event, make their fullest contribution to society in large organisations. Quite apart, therefore, from the economic importance of the small firm in a structural sense, we think it vital that these human considerations should be given due weight. We believe, moreover, that these social considerations are rarely in conflict with the national economic interest, which is usually best served by providing opportunities for everyone to make his contribution to the economy by following, as closely as is practicable, his natural bent.

v. *Role in the community*

2.50 It is easy to be over-impressed by quantitative evidence and to ignore other major factors not susceptible to statistical treatment. It is indeed difficult to express fully in words what we believe to be a major characteristic of the small firm sector—its contribution in myriad ways to the quality of life. We have already referred to the satisfaction that owner-managers of small business derive from their work, through their own self-fulfilment, and also to their contribution to the contentment of their employees, but beyond this our experience is that in

in amorphous commuter suburbs that these areas lack many of the features which make life pleasant in villages and towns with strong community ties. It is probably true to say that much of community life as we know it today is the result of the efforts of generations of small businessmen (including farmers) and it is fundamentally important that they continue to be a major factor in local life. For this and the other reasons mentioned above, small business has an even greater social importance than even its substantial share of economic activity would suggest.

[1] See for example E S Mason (Ed), *The Corporation and Modern Society*, Harvard U P, 1959.

others, but what is important is that total unit costs should decline if the firm is to continue to expand.

3.5 The foregoing remarks about scale economies are, as we warned they would be, an over-simplification, even as a theoretical explanation of the forces that determine the size distribution of firms. It is, of course, possible and it no doubt commonly occurs in uncompetitive conditions, that a firm continues to grow beyond the point at which total unit costs fall. Where the firm faces sufficient competition from other smaller firms with a lower output and lower costs, of course, this situation could not last, but under monopolistic conditions an inefficient firm may have the power to keep out competitors and to sell at higher prices than would obtain under competitive conditions. Where monopoly conditions exist it will, in fact, be exceptionally difficult to judge whether or not a firm has grown too large: where profits are low this may be the result either of a failure of the monopolist to exploit its market power, or simply of its inefficiency —this in turn may be either because it has grown to a point where its unit costs have started to rise or because, through lack of the spur of competition, it is not being managed as efficiently as possible. Under monopolistic conditions there is also the possibility that firms will not introduce new products and processes through the lack of competitive incentive to do so.

3.6 There are, therefore, other dimensions to efficiency over and above that of production at lowest cost. First, an efficient economic system is one in which not only is production organised in units of most efficient size, but one where low production costs are passed on to the consumer. Secondly, an efficient economic system is one that is flexible and adaptable enough to meet the changing needs of consumers, to exploit existing technology and to develop new technology. Small firms, historically, have played an important part in both these other dimensions of efficiency. It is important that small firms should emerge to test new products and processes, to supplement the innovative efforts of larger firms and to provide a potential competitive threat to established firms, as well as to carry out functions which are most efficiently performed in small units.

3.7 It should be clear, therefore, that a full understanding of the special role of small firms requires reference to the working of the economic system as a whole. The private sector of our economy as we know it today originated almost entirely through the establishment and growth of small firms. Almost all the present large firms started off as small firms and grew, in one way or another, to their present size.[1] Moreover, the population of firms, especially of small and medium size, is not a static thing but something which is changing and developing all the time. New firms are being formed, some grow, some decline, others fail and, although most of our very largest companies may have their origins outside the working lives of their present managers, quite a number of firms at the bottom end of our 1,000 largest industrial and commercial companies[2] have started from nothing and grown to substantial size, even since World War II.

[1] The great railway and public utility companies, now mostly state-owned, are exceptions, being examples of companies that started as large organisations.

[2] See *The Times 1,000*, 1970–71, Times Newspapers Ltd. Many of these firms have not, however, retained their independence.

other firms and this is why we place so much importance on the need for new small firms to be formed and thrive so that the numbers of firms necessary to apply the competitive sanction are maintained.

3.10 Attempts have been made[2] to classify the roles of firms according to the type of market they supply. We were attracted, for example, to the notion that small firms can be classified according to the type of market in which they sell their output and are either satellites, specialists or marketeers.[3] By *satellites* we mean firms that are heavily dependent on one large customer. In these cases it may be that a large customer absorbs a high proportion of the firm's output or, alternatively, that the customer designs the product or service and sub-contracts its manufacture or supply to the small firm because it is more economical to do so than to manufacture the item itself. In the latter case the firm may, in effect, be completely dependent on its customers who may provide advice and even finance so that the small firm behaves in most respects as a subsidiary.[4] Both these classes of satellite activity are common in the motor, aircraft and engineering industries.

3.11 In order to find out more about this subject the CBI and the Committee Chairman each wrote to a number of the largest firms in the country enquiring about the relative importance to them of small firms (as defined by the Committee). The replies showed how dependent large companies are upon small firms although, of course, the small suppliers mentioned in the following examples are not all necessarily satellites. A large London department store indicated that virtually all its turnover of women's fashions and half its sales of top quality clothing were supplied by small firms. Of the suppliers to the furnishing accessory divisions of the same store, 85 per cent were small firms. One of the largest diversified manufacturing companies had 950 suppliers of which 40 per cent were small firms. A tractor manufacturer replied that 60 per cent of the parts and components entering its main plant came from small firms. A large rubber company estimated that 35–40 per cent of its total purchases were from small firms "from local tradesmen supplying canteens, etc, through to specialised equipment, small chemical firms, builders, garages and factors". One of the "Big Four" motor manufacturers had 1,200 suppliers of which 13 per cent were small firms accounting for 3½ per cent of total purchases, although small-medium sized companies, just outside the Committee's terms of reference, accounted for very much more. A division of one major aero-space company had 76 suppliers in the United Kingdom manufacturing parts and components under sub-contract, and of these 43 per cent were small firms; of its 104 material suppliers 12 per cent were small firms. Most of the large companies praised small firms

1 Some people would deny that there is any effective limit to the growth of a firm and if this were so then it would be possible for one firm to grow and supply the whole market. We do not subscribe to this view.

2 H F Lydall, "Aspects of Competition in Manufacturing Industry", *Bulletin of the Oxford University Institute of Statistics*, 20, 1958, or see P Lund and D Miner, *Three Studies on Small Firms* (No. (I)), Research Report No. 11.

3 See Merrett Cyriax Associates, Research Report No. 12, *op. cit.*

4 See J R Davies and M Kelly, *Small Firms in the Manufacturing Sector*, Research Report No. 3.

rest of this chapter some estimates of the contribution of small firms to the principal economic aggregates of employment, net output, exports and the total population of firms, although we emphasise that to discuss the role of small firms in the economy as essentially distinct and apart from larger firms is to some extent misleading in that it draws attention away from the organic, inter-related nature of the economic system as a whole.

Employment, net output and number of firms

3.16 Three possible ways of measuring the share of economic activity held by small firms come to mind: their share of employment, of output and of the total number of firms. Estimates of the shares of small firms for the industries covered by our Inquiry, relating generally to 1963 (the most recent period for which the necessary information is available[2]), are set out in Table 3.I.

TABLE 3.I

The relative importance of small firms in different industries, 1963

	Small firms as % of all firms		
	Numbers employed	*Net output*	*Number of firms*
Miscellaneous services	82	68	99
Hotel and catering trades	75*	73*	96*
Retail trades	49	32	96
Road transport	36*	26*	85
Building and construction	33	27	92
Motor trades	32*	29	87
Wholesale trades	25	11	77
Manufacturing	20	16	94
Mining/quarrying	20	20	77
Total: all groups	31	21	93

Source: Estimated from Reports on the Censuses of Production and Distribution, and other official inquiries; adjustments and interpolations have been made to bring the data on to the definitional basis required here. Working proprietors are included in the census definition of employment but no allowance has been made for the shorter working hours of part time employees; it has not been possible to compile a Table on the basis of full time equivalent employees. As far as possible the data in this Table are on an enterprise basis.

Note: "Net output" is used here in the sense customary in the Census of Production; it is a measure of the work done by each industry and is obtained by taking the value of its sales and subtracting from it the value of *materials* purchased (allowing for stock changes). It constitutes the fund from which wages, salaries, rents, rates and taxes, advertising, other selling expenses and all other similar charges, as well as depreciation and profits, have to be met. Since payments for *services* rendered by other firms are not deducted, e.g. for repairs, research work, plant hire etc., net output is not identical to the contribution of the industry to the gross domestic product, sometimes described as "valued added". See also Chapter 4, para. 4.7.

3.17 There are approximately 820,000 small firms in the industries covered by our Inquiry and they account for the vast majority (93 per cent) of the total number of firms in these industries. They employ 4·4 million persons and their

[1] Published separately and listed in Appendix III.

[2] Long term trends in the relative importance of small firms are dealt with in Chapter 5 where later estimates are given for manufacturing based on preliminary results of the *1968 Report on the Census of Production.*

that form the field of this Inquiry. Table 3.III sets the net output of the small firms covered by our Inquiry in relation to national output as measured by the Gross National Product (GNP).[1] The GNP is generated within two distinct sectors, Private and Public, the latter including public corporations, nationalised industries, central and local government. (By definition there are no small firms in the public sector.)

Two central points emerge from this Table[2]:

i. All small firms contributed 19 per cent to GNP in 1963 and 24 per cent of the output of the private sector.

ii. Small firms covered by our Inquiry accounted for 14 per cent of GNP (£3,800 million out of £27,005 million), and 18 per cent of the net output of the private sector as a whole (£3,800 million out of £21,144 million).

TABLE 3.III

Net output of small firms in relation to GNP, 1963

	All firms £ *million*	*Small firms* £ *million*	*Small as % of all*
Industries covered in this Inquiry	17,816	3,800	21
Other private sectors (farming, financial and professional services etc.)	3,328	1,300	39
Total private sectors	21,144	5,100	24
Public sector	5,861	—	—
Total	27,005	5,100	19

Source: Research Unit estimates based on *National Income and Expenditure Accounts.*

Note: This Table is intended only as a guide to the magnitudes involved; the figures have been derived ignoring the difference in coverage between net output as used in the Censuses and in the National Accounts.

Incorporated and unincorporated small firms in the economy

3.23 We present in Tables 3.IV and 3.V very rough estimates of the share of incorporated and unincorporated firms in the employment of the small firm sector, and in total (national) employment. In manufacturing industry, *companies* are overwhelmingly predominant: only 7 per cent of employment in small manufacturing firms and 1½ per cent of national manufacturing employment being in unincorporated small firms. In the non-manufacturing industries, where firms are generally smaller, unincorporated firms are rather more important and account for a third of the employment in small firms, and some 12 per cent of national employment in these industries.

[1] The GNP consists of the gross domestic product (GDP)—the total of net output of all industry, i.e. the value of goods and services produced—plus net property income from abroad. The GDP is equal to the sum of factor incomes (wages, salaries and profits). It is "gross" because depreciation has not been deducted.

[2] Our estimates of the net output of small firms are based on Census sources which employ a slightly different definition of net output from that used in the national accounts and this will lead to a very slight over-estimation of the contribution of small firms to the GNP. (See note to Table 3.I.)

— manufacturing has averaged only £85 per person employed in the five year period 1964–68. This compares with a figure of £189 for all firms over the same period[1] and there is some evidence that although capital expenditure per head in small manufacturing firms is increasing it is increasing less rapidly than that for all manufacturing firms, so that the difference between small and large firms is widening[2]. On this basis small firms in manufacturing annually invested some £126 million, or 9 per cent of total capital expenditure in private sector manufacturing over the period.

Exports

3.26 Little information has previously been collected on the contribution of small firms to exports. However, a special study was carried out for the Committee in 1969 by the Board of Trade (now the Department of Trade and Industry) relating to exporters in the North West Region of the United Kingdom.

3.27 The first point to be made about exporting is that most small firms, and even some large ones, are not in a position to export directly, as they predominate in trades catering for local markets. A launderette, tobacconist shop, village store or garage cannot export its services overseas although some small firms in the service trades do export, especially brokers and wholesalers.

3.28 Since small firms tend to predominate in service and other industries which may not export directly, it follows that a smaller proportion of small than large firms export directly. The North West Region survey found that among potential exporters, that is, firms in industries that did engage significantly in direct exporting, 15 per cent of small firms and 25 per cent of large firms engaged in direct export. (See Table 3.VI.)

TABLE 3.VI

Exporting firms in the North West Region of Britain, 1969

	Total number of firms	*Total number of exporting firms*	*% Exporters*
Small firms	6,193	926	15
All other firms	2,300	566	25
Small as % of total	73	62	—

Note: These data were compiled by the field staff of the North Western Regional Office of the Board of Trade based on interviews with exporters and on returns made to the Board by exporters in the region. There is no means of checking whether all exporters have been included or even if all firms in the region (exporters and non-exporters) have been surveyed, but it is considered that most exporters are covered.

3.29 In fact, the difference between the proportion of output exported even directly by small firms and by larger firms is probably not very great among firms that actually engage in export work. Table 3.VII, also based on the North West Region survey, suggests that small exporting firms on average export 32

[1] Calculated from *National Income and Expenditure*, 1970.

[2] For evidence on the widening gap between capital expenditure per head in small and large firms see Reports on the *Census of Production*, 1954 and 1963, Board of Trade. It should be noted that the basis of our estimates is not very firm and we have not attempted the calculation for non-manufacturing industries.

The export performance of selected small firms winning the 1970 BNEC Export Award

Product	*% of turnover exported*	*Number of employees*	*Export turnover in the year ended 1969*	*% increase over previous year*
			£'000	
Agricultural spares and accessories	n.a.	10	128	157
Tweed cloth	n.a.	16	162	120
Furniture	99	28	111	1,649
Parts for agricultural machinery	65	74	527	51
Industrial process chemicals	36	199	625	131

Source: British National Export Council.

3.32 It would be difficult to estimate the *indirect* exports of small firms or even the number of small firms which contribute indirectly to exports.[1] This indirect contribution is clearly very substantial. We have already noted (in paragraph 3.10) that virtually all large firms have many small suppliers. And most, if not all, exporting firms must purchase some goods and services from small firms and many of them incorporate components or services supplied by these firms directly into products or services for export.

3.33 We have discussed above visible exports. Small firms also contribute both directly and indirectly to invisible exports. The contribution of the hotel and catering industry in earning foreign currency in the tourist trade is an outstanding example.

[1] The Association of British Chambers of Commerce carried out a survey of small firms in 1969 and submitted the results to us. 50 per cent of the 1842 respondents claimed to export, directly or indirectly, ranging from 66 per cent of respondents in manufacturing to 28 per cent in distributive trades, 15 per cent in financial and professional services, and 70 per cent in construction. However, these replies are not representative: the response rate was only 6 per cent, the size limit was 250 employees for all trades and it seems likely that larger firms tended to participate disproportionately.

TABLE 4.I

Net output per person employed in UK manufacturing industry 1963, by size of enterprise and establishment

Number of employees	*Net output per person in* *Enterprises* £	*Establishments* £
1– 24	..	..
25– 99	1,116	1,174
100–199	1,143	1,212
Total under 200	1,097	1,197
over 200	1,425	1,441
Total	1,361	1,366

Source: Report on the Census of Production, 1963.

Note: For establishments employing under 25 persons, the Census does not generally require returns to be made of information to permit the calculation of net output. The information for this group published in the Census Reports is generally based on the net output per head in the rest of the industry (i.e., those employing 25 and over); however, for 1963 the published information for small enterprises and establishments employing under 25 persons were not sufficiently reliable to be used here.

TABLE 4.II

Employee remuneration and net output in UK manufacturing industry, by size of firm

Number of employees	*Wages and salaries per person, 1954* (1) £	*Net output per person, 1954* (2) £	*Net output per £100 wages, 1954* (3) £
1– 24	400	691	173
25– 99	406	706	174
100–199	416	743	179
Total under 200	409	719	176
over 200	469	852	182
Total	454	808	178

Source: Report on the Census of Production, 1954.

[1] In this Report we use the terms *firm* and *enterprise* synonymously, that is to say a unit with ultimate control over a business. In the census a distinction is made between an *enterprise*, which is defined as "one or more firms under common ownership or control as defined in the Companies Act 1948", and an *establishment*, which is a reporting unit and generally consist of a factory or plant. Thus a firm (or enterprise) may consist of a single establishment, or, as with a holding company or a firm with factories in different parts of the country, of a number of establishments at different addresses which, although under common ownership, may keep separate accounts and report separately to the census authorities. Larger enterprises generally consist of larger establishments and, in addition, have more establishments per enterprise. Almost the whole of the difference noted in net output per person appears to be attributable to differences in establishment size: when census returns are classified by establishment-size, as in the final column of Table 4.I, small establishments show a net output per person 22 per cent below that of large establishments, almost identical to the 23 per cent difference on the enterprise-classification. This relatively small difference between the results of the establishment-classification and the enterprise-classification is fortunate, and allows us to use data in the paragraphs that follow, which is available on only one of these bases, where the other basis would ideally have been preferred.

information from the Census of Production relates to capital expenditure per person in the Census year:[1] for 1963 it was 44 per cent lower in small enterprises than in large (see column 2); the data for 1954 show capital expenditure to have been 31 per cent lower in small establishments than in large (see column 3). A similar adjustment to that used in paragraph 4.6 to allow for the over-statement of the labour input is applied to the figures on capital expenditure in column (4) of Table 4.III. When capital expenditure is related to remuneration in this way it remains lower in small firms than in large, at £13 of capital expenditure per £100 spent on wages and salaries in small establishments, compared to £17 of capital expenditure per £100 wages in large establishments: a difference of 22 per cent, although again, and for the same reason, this adjustment over-compensates for the differences in labour input.

TABLE 4.III

Capital equipment and expenditure per employee in UK manufacturing, by size of enterprise or establishment

Number of employees	*Horse-power installed per person employed in firms, 1924* (1)	*Capital expenditure* *Per person in enterprises 1963* (2) £	*Per person in establishments 1954* (3) £	*Per £100 wages, 1954* (4)
Under 24	1·02	69	46	11·6
25– 99	1·51	77	52	12·7
100–199	2·22	89	57	13·8
Total under 200	1·68	79	53	13·0
over 200	2·86	140	78	16·7
Total	2·44	128	70	15·6

Source: Reports on the Censuses of Production.

4.9 On all measures, therefore, capital intensity rises with size of firm among small firms and these firms as a group employ less capital than do large firms. It would be desirable to relate in some precise way the 3 per cent to 18 per cent lower net output per unit of labour input in small establishments to those just quoted showing that small firms have a 22 per cent to 44 per cent lower capital expenditure per unit of labour input. To do so, however, requires information on the rate of depreciation, the value of the stock of capital, and the rate of interest to be charged on that stock; none of this, of course, is available from the Census and the margins of error in the exercise would not, of course, permit precise conclusions even if it were.

4.10 All that we can do is to turn from comparing the relationship between labour input and net output in the Census to that between capital employed and the return on capital (as measured by profits) in the financial accounts of businesses. This is the second of the two types of study we mentioned earlier although,

[1] See also Chapter 3, para. 3.25 for information on capital expenditure from our postal questionnaire survey.

from the sample, as were all companies making losses. The omission of loss-making companies is an important one and inevitably leads to an overstatement of average profitability; the omission of the other small companies (those earning profits up to £4,000), however, may not be serious.[1]

4.15 An earlier inquiry sponsored by the Oxford University Institute of Statistics into a sample of small firms secured accounts from 335 respondents for the years 1954–6; these showed a somewhat lower arithmetic mean rate of return for small firms than for quoted companies (total profit as a ratio of net assets was 11·9 per cent for small companies, and 14·5 per cent for quoted companies). However, the variability of the data was very great (it appears that the median rate of return for the companies was 18·2 per cent, compared with the arithmetic mean of 11·9 per cent just quoted), and the author concluded that "it is not possible to generalise from this data".[2]

4.16 The results of our own inquiry based on the replies of 2,115 firms for 1968 conform with those of the Inland Revenue survey (quoted in para. 4.13) in showing a higher rate of return on capital for small firms.[3] Various measures are set out in Table 4.IV.

TABLE 4.IV

Profit as a ratio of net assets, total assets and equity, small firms and quoted firms, 1968

Per cent

	Profit before interest as a ratio of net assets	*Profit before interest as a ratio of total assets*	*Profit before interest as a ratio of equity*
Small firms	17·8	11·2	18·7
Quoted firms	13·5	9·5	16·5

Source: Taken from M Tamari, Research Report No. 16, *op. cit.*

Note: Equity includes capital and reserves; net assets equate to equity and long term loans; total assets equate to net assets plus current liabilities.

[1] We have made the following further calculations assuming that the omitted group of companies had average net assets of £10,000 (which is the maximum that seems likely, having regard to the averages in the other group), the omitted group would account for at most 7 per cent of net assets. Their rate of return would have to be extremely different in order to affect the calculated weighted average by a significant amount. It should be borne in mind that most of the omitted group will not be in the loss-making category, but will be making small (gross) profits on small assets.

[2] The results of the survey are conveniently available in *The Financing of Small Business*, by J Bates, Sweet and Maxwell, 1964. See also P Lund and D Miner, Research Report No. 11, *op. cit.*

[3] See Chapter 2, Section ii.

productivity rises with firm size, but when net output is related to fixed assets, or profits related to capital employed, the reverse appears to be true. Neither of these two sets of comparisons indicates anything conclusive about the relative efficiency with which small and large firms use economic resources. This is because the apparently inferior return of small firms in terms of labour employed is attributable (to an unknown extent) to the smaller amount of capital used per worker while the apparently superior return on capital by small firms is attributable (again to an unknown extent) to the greater amount of labour employed per unit of capital. What this means is that the proportionate contribution of labour alone to the output of small firms is greater than the contribution of capital alone while the reverse is true for large firms. There is no practical way in which the individual contributions of labour and capital to the profit or net output of a firm can be isolated and therefore no way in which the relative efficiency with which firms use the resources they employ can be compared.[1] All we can conclude is that our analysis so far provides no evidence for assuming that small firms are, in general, any less efficient than large, or vice versa.

The variability of profitability among small firms

4.20 There is one other point to which we wish to refer and that is the greater variability in the profits of small firms compared with large. This manifests itself both in a greater spread of rates of return on capital employed, and in a greater year-to-year volatility of profits; the phenomenon has been observed in many studies of business profitability[2] and is to be observed also within our own sample survey of small firms. Table 4.VI shows that for the very smallest firms, those employing 1–24 persons, the spread of rates of return was 2½ times as great as for the larger firms, i.e. those employing 100–199 persons.[3]

TABLE 4.VI

Variability of rate of return and size of firm 1964

Number of employees	*Rate of return*[a]	Per cent
	Median	Variability[b]
1– 24	18	35
25– 99	17	21
100–199	17	14

Source: Committee Questionnaire Survey, Research Report No. 17.

Notes: a. Pre-tax profits as percentage of net assets.
b. Inter-quartile range (i.e. the range of rates of return which is spanned by the central 50 per cent of firms, see footnote 3 to paragraph 4.20).

[1] Unless, that is, returns on capital or output per head can be compared between firms using identical proportions of capital and labour. Even then the comparison would be subject to the other difficulties referred to in para. 4.1 above. See also D Todd, *The Relative Efficiency of Small and Large Firms*, Research Report No. 18.

[2] See, for example, the last two references quoted in the note to Table 4.V.

[3] Variability was measured by the difference between the upper and lower quartile rates of return. These quantities are arrived at as follows: The firms in each group are ranked in order of rate of return; the firm which is a quarter of the way from the bottom (the lower quartile—in a sample of a hundred firms it would be the twenty-fifth firm) has its rate of return noted, and similarly the firm that is a quarter of the way from the top (the upper quartile, the seventy-fifth firm in a sample of a hundred); the difference between these two rates of return is the measure of the variability used in Table 4.VI. For example, in the smallest size group, the bottom quarter of the firms had a rate of return under 4 per cent; the top quarter had a return in excess of 39 per cent; the difference between these two figures is the 35 per cent quoted in the Table.

present structure of industry, the more practicable objective of policy is to attempt to ensure that each market should be supplied by a sufficient number of sizeable firms with no single firm able to dominate the market and with no collusion between the market leaders.

4.24 The maintenance of adequate competition under oligopolistic[1] conditions and the implications for monopoly and restrictive practices policy are not simple matters. We do not wish to imply that the nature of competition is not affected by the number of firms. Clearly, a reduction in the number of firms in any market from 10 to 4 has considerably more impact on the nature of competition than a reduction from 100 to 40 firms. Typically, however, small firms do not operate under oligopolistic conditions; their role in such industries should be to ensure the constant possibility that the existing oligopoly may be expanded by the emergence of new sizeable competitors. This last condition in our view requires that there should in each industry be a substantial force of small firms (constantly reinforced by new starters) some of which may be expected to grow into serious rivals to the present major competitors. It is not in our view, however, as we shall suggest in Chapter 16, anything like so clear that intense competition needs to be preserved as between the separate firms constituting the fringe of small firms which in most markets fortunately co-exist with the oligopoly of sizeable suppliers.

4.25 To state that a vital role of the small firm sector is to act as a source of new firms and industries to challenge existing ones is not, in itself, to predicate any view about the desirable size of the small firm sector. It is essential, for this purpose, only that there be an adequate number of potentially successful small firms which could survive to grow into medium and larger firms. We do not know and we do not know how to discover whether or not the present number of small firms is adequate. If we were concerned only with the role of small firms as the seedbed for larger firms of the future, then it could be consistent with the national economic interest for the sector to contract, provided that the proportion of firms successfully growing to medium size were raised commensurately.

Innovation

4.26 Interrelated, but conceptually distinct from the question of competition itself, is the question of innovation. Innovation is important because it is the source of technical progress which not only may permit the production of existing goods and services at lower cost through improvements in design, materials or production processes, but which also stimulates economic growth and allows the widening of consumer choice through making available entirely new goods and services.

4.27 The relative performance of small and large firms in the innovative process has been a subject of increasing interest and controversy in recent years. Two extreme positions have been taken. At one extreme it is argued that the largest firms are so inflexible and bureaucratic that new ideas rarely receive the necessary

[1] We use this term for a market situation where a small number of suppliers (say, less than five) account for the majority of sales.

[illegible] the evidence of patent statistics is by no means conclusive since these statistics include both minor and major inventions in unknown proportions. On the one hand, small firms may, because of their greater need for protection, patent a larger proportion of their inventions. On the other hand small firms may introduce a mass of small innovations which individually are not worth patenting, but which cumulatively may contribute significantly to economic progress; it is also not unknown for large firms to patent important new ideas and not introduce them. Again, the fact that large firms account for the bulk of R & D expenditure, even if defence and aerospace are excluded,[1] does not necessarily prove that their productive research activity is proportionately greater than that of small firms: it could be that much more of large firms' expenditure is wasteful and unproductive than that of small firms. It is also possible that R & D expenditure by small firms is under-recorded and it is highly likely that the inventive activity of large firms is R & D-intensive, that is to say it is concentrated in fields of study requiring exceptionally costly equipment, as in nuclear engineering.[2]

4.32 The study by J G Cox (Research Report No. 2, *op. cit.*), indicates that firms employing less than 200 persons in manufacturing in Britain employed about 16 per cent of the QSEs in manufacturing in the year 1967/68, a concentration only half that of the bigger firms. These figures relate to all firms; the employment of QSEs amongst small firms actually carrying out research would presumably be much higher. In the electronics industry, for example, according to the same study, small firms account for 10 per cent of the employment in the industry but 14 per cent of the QSEs. Moreover, as we noted in Chapter 2, small firms are more likely than large firms to employ unqualified staff (and of course formal qualifications are by no means essential for the inventor); it can also be seen from Table 4.VII that small firms account for a higher proportion of the employment of technicians than of QSEs. The same source estimates that small manufacturing firms spent about £21 million on R & D in the year 1967/68. Annual R & D expenditure per employee in small firms was therefore about £9 per head compared with £65 per head for all firms; R & D expenditure by small manufacturing firms was only 4 per cent of total R & D expenditure in manufacturing.

4.33 Whilst it does seem highly plausible that the greater flexibility of small firms would favour inventive activity, especially where exceptionally expensive and elaborate facilities are not required and where the inventor is an owner-manager, it seems less likely that small firms would be at any advantage in the process of innovation itself. Developing an invention to the stage at which it can be produced economically and in quantity and launching it on the market

1 300 companies alone accounted for 92 per cent of total R & D expenditure in US manufacturing in 1966 and 85 per cent of total expenditure if Federal funds were excluded. These companies accounted for 63 per cent of employment amongst the firms in manufacturing that carried out R & D. (National Science Foundation.)

2 A further complication pointed out below is that most of these data relate, or purport to relate to *all* firms. Many small firms, especially in service and "jobbing" industries, carry out no research at all. J C Morand has shown that in a wide range of industries in France, at least, among those firms which actually do research the proportion of "turnover" devoted to R & D, as well as the productivity of research measured by the number of patents per unit of expenditure, are inversely related to firm size. It is not clear whether Morand's sample consisted of enterprises or establishments. J C Morand, *La Recherche et le Développement selon la Dimension de L'Entreprise, Le Progrès Scientifique*, September 1968.

whole period 1945–70 (there was a slight tendency for this share to increase over the period). Their share of innovation is thus less than half their share of employment and output but more than twice their estimated share of R & D expenditure and less than their share of the employment of scientific manpower. The contribution of small firms to industry innovation was, as might be expected, lowest in the capital-intensive industries. An experimental attempt to re-weight the data to allow for opinion on the relative importance of the innovations selected did not significantly modify the results.

TABLE 4.VIII

Number and percentage share of sample innovations by size of firm

Years	(1–199) *Small firms*		(200–999) *Medium firms*		(1,000+) *Large firms*		*All firms*	
	No.	% *Total*	*No.*	% *Total*	*No.*	% *Total*	*No.*	%
1945–53	17	9	25	12	160	79	202	100
1954–61	38	10	43	11	313	80	394	100
1962–70	54	11	53	10	399	79	506	100
Total 1945–70	109	10	121	11	872	79	1,102	100

Source: C Freeman, Research Report No. 6, *op. cit.*

4.35 Although this study confirms broadly the results of the other work referred to, it cannot be regarded as conclusive for the same reasons that have led us to be cautious in interpreting earlier work in this field and more particularly because it deals only with the more important innovations. As we found in assessing the contribution of small firms to exports, it is doubtful if it is entirely appropriate to assess the innovative contribution of small firms in the same terms as those of larger firms, that is to say not taking account of the relative scope that large and small firms have for making innovations of the kind selected. We have seen that when this factor is taken into account (by comparing the innovative contribution of small firms to their share of total employment of R & D staff or R & D expenditure), the picture is quite different. Equally important, over-emphasis on the share of small firms in major innovations tends to minimise the complementary roles of small and large firms in the innovative process. A very large number of innovations in large firms result from inventions and ideas originating outside the company, in universities and Government laboratories, for example, and many of them in small firms. A recent study by Langrish, Gibbons and Jevons found that "of 158 important technical ideas contributing to the innovations which won Queen's Awards for technological innovation during the years 1966 and 1967, 102 originated outside the firm".[1] Possibly the majority of innovations, therefore, arise from a little understood process of movement of people: through small firms being acquired by larger firms or licensing large firms or acquiring licences from them; by staff leaving one company and joining another and also through the so-called spin-off process where an individual leaves a large

[1] Quoted in M Gibbons and D S Watkins, *Innovation and the Small Firm, R & D Management*, January 1971.

Introduction

5.1 This chapter describes the development of the small firm sector and its relative importance in the British economy in recent decades.[1] Our analysis is centred on manufacturing industry (for which our comparisons go back to 1924) and retail distribution (for which our comparisons go back to 1950) because these are trades for which some statistics exist. Manufacturing is also of special importance to our task because of its overall substantial contribution to the Gross National Product (34 per cent in 1963) while retail distribution accounts for a high proportion by number of all small firms (almost half of the firms covered by our Inquiry). Furthermore, these two branches of industry account for over 60 per cent of all employment in small firms within the scope of our Inquiry (see Chapter 3, Table 3.II). Other trades and industries are dealt with more briefly towards the end of this chapter.

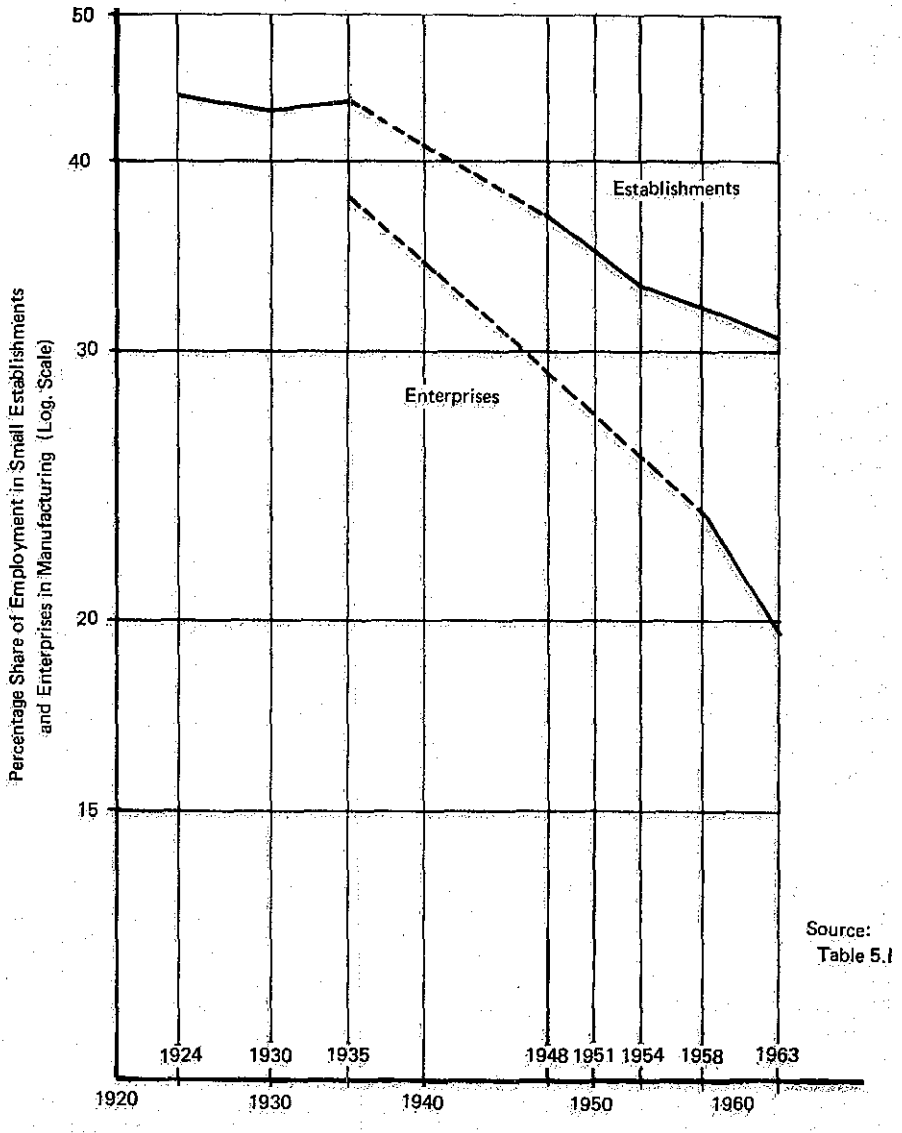
5.2 We have already explained the meaning of the terms "firm", "enterprise" and "establishment" (Chapter 4, para. 4.4) and we have been able for the most part to use these terms synonymously. In this chapter, however, we have to adhere to the precise terminology. This is because the longer term comparisons can generally be made only in terms of statistics relating to establishments, rather than to enterprises which would have been better for our purposes (an enterprise, it will be recalled, groups together with the parent company all establishments either directly owned or belonging to its subsidiaries); this complicates our exposition but, as will be seen, the long term trends shown by the statistics emerge sufficiently clearly.

5.3 We must also add here that we consider the way in which the census statistics are compiled in this country tends to under-estimate the degree of concentration, however it is measured, throughout the economy as a whole. (This point is referred to again in Chapter 6, where we make comparisons between the British statistics and those of the US, and forms the subject of a recommendation in Chapter 16). Basically this under-estimation arises because the data are collected only for specified industries and on an *establishment* rather than an *enterprise* basis. Establishments whose activities are outside the scope of any particular census (be it manufacturing or retail distribution) are generally excluded from that census. For example, a large retail chain may own several manufacturing establishments as well as its retail stores; those manufacturing establishments will, in general, be counted in the *Census of Production* as one enterprise and the retail stores counted as another enterprise in the *Census of Distribution*. A general census of enterprises, as is taken in the USA, would indicate only one enterprise in this case; it would eliminate the double-counting in the number of enterprises and the understatement of their size that occurs

[1] It is based on statistics derived by our Research Unit from the various reports on the *Censuses of Production and Distribution* with additional material from other official and private publications, including our own commissioned Research Reports. The Censuses, as published, are not comparable over time since the area covered varies (Northern Ireland is sometimes omitted), the industrial scope varies (for example, some industries were moved to the *Census of Distribution*), and the breakdown by size is not always as required. A number of detailed adjustments haye been made to the published Census material to yield the series set out in the Tables in this chapter.

CHART 1

Employment in Small Manufacturing Firms as a Percentage of Total Manufacturing Employment in the United Kingdom, 1924-63



Source: Table 5.I

	In establishments			In enterprises		
	All establishments	*Small* establishments*	*Small* as a percentage of all*	*All enterprises*	*Small* enterprises*	*Small* as a percentage of all*
	£ million	*£ million*	*%*	*£ million*	*£ million*	*%*
1924	2,586	1,079	42	..	..	..
1930	3,687	1,470	40	..	..	..
1935	4,541	1,870	41	4,087	1,413	35*
1948	6,089	2,241	37	..	..	..
1951	6,253	1,979	32	..	..	..
1954	7,259	2,110	29	..	..	..
1958	8,467	2,364	28	8,361	1,707	20
1963	10,851	2,908	27	10,612	1,682	16
1968[1]	..	..	25*	..	..	..

Source and Notes: As for Table 5.I.

5.11 The movements shown in terms of net output are broadly similar to those in terms of employment; the decline in the relative importance of small manufacturing establishments is marginally sharper, and throughout the period the relative contribution of small establishments is between two and four percentage points lower in terms of net output than in terms of employment. In 1963, small enterprises accounted for 16 per cent of net output in manufacturing, as against 20 per cent of employment, probably as a result both of the lower usage of capital equipment in small firms and of differences in the labour mix (these matters were discussed at length in Chapter 4).

5.12 The total net output of small *enterprises* was somewhat higher in 1963 than in 1935, but slightly lower than in 1958; bearing in mind that there is a margin of error associated with the adjustment to constant prices, it may be said to have been static, especially when compared with the general rise in output over that period.

5.13 As can be seen from Table 5.III, the most dramatic changes in the small firm sector of manufacturing have taken place in terms of the number of firms. In the period between 1924 and 1963 the net fall in the total number of manufacturing establishments was 73,000, that is some 45 per cent. This net fall is the result of a somewhat greater fall in small establishments, offset by a small rise in the number of large establishments. (As some of the original small establishments will have grown into large establishments, but more important, many new small establishments will undoubtedly have been set up, the total number of small establishments that have gone out of existence in the past forty years will, of course, have exceeded the 78,000 recorded in the Table.) Most of the fall took place in the period 1935–48 but it has continued at a fairly steady rate since then. In terms of *enterprises* even in the period 1958–63, the population of small firms in manufacturing has declined by a thousand manufacturing firms a year, that is to say four firms per working day have gone out of business and have not been replaced by new firms.

[1] This provisional figure is based on data kindly supplied to us by the BSO in July 1970.

...to consider changes that took place before that date. Two of the four Censuses, those in 1957 and 1966, were based on sample inquiries and because the published estimates for organisations in those years do not provide as much information as for the other years, the only data relating to organisations that we have been able to use relate to 1950 and 1961.

5.16 It may be recalled from Chapter 1 that our statistical criterion for a small firm in the retail trades was one with an annual turnover of £50,000 or less. Naturally for a study of long term trends a criterion in money terms is not appropriate and we have therefore made allowance for the changes in retail prices between 1950 and 1966. The results of these adjustments on to a constant price basis have been substantial: if the analysis had been considered only from the money value basis there would have appeared to have been a large and rapid fall in the number and relative contribution of small retail establishments. Our turnover analysis at constant prices also shows falls in the number of small establishments and in their relative contribution to employment, but while the fall in the number of establishments is clear, the fall in the share of employment and turnover is very slight and, in view of the errors attached to our methods of estimation, we must regard the relative contribution of small retail establishments as having remained substantially unchanged in the post-war period up to 1966.

5.17 This finding is, of course, contrary to the views of many of those who have given evidence to us, but we believe there are two reasons for this. Firstly, we recognise that our witnesses may have been influenced to a greater extent by more recent trends on which the 1971 *Census of Distribution* should cast light but secondly, there can be little doubt that the relative stability in the share of small retail establishments as a whole in total turnover and employment conceals important changes that have been going on within the small firm sector of the retail trades. It appears that the numbers of small retailers in the lowest category, having an annual turnover of £10,000 or less, have declined markedly but that the remaining small retailers (with annual sales of more than £10,000 and up to £50,000) have increased their sales substantially so that as a group small retailers retained their share of sales and employment at least up to 1966.[1]

5.18 The number of retail establishments in Great Britain[2] fell by about 9 per cent between 1950 and 1966. The rate of decline was most rapid in the five years between 1961 and 1966 when there was a loss of about 40,000 establishments (or 7 per cent).[3] The *proportion* of both small *establishments* and small organisations in the total has declined slightly over the periods for which figures are available although these changes are probably within the margin of error attaching to our statistics.[4] These data are set out in Table 5.V below.

[1] See Margaret Hall, *The Small Unit in the Distributive Trades*, Research Report No. 8 and A D Smith, *Small Retailers: Prospects and Policies*, Research Report No. 15.

[2] All the figures we give for retail distribution relate to Great Britain whereas those we have given for manufacturing relate to the UK as a whole.

[3] Since the figures we give here have been adjusted to the same coverage as the 1966 census, the omission of certain market traders and mobile shops from the 1966 census which were included in earlier censuses is not responsible for this sudden fall.

[4] It may seem surprising that there was an apparently higher proportion of small organisations than small establishments in 1961, but the likely explanation is that while most small shops are independent the bigger ones are more likely to be members of retail chains.

full-time equivalent employment have been estimated using the convention adopted in the Censuses that two part-timers are equivalent to one full-time employee; they suggest that there have been only slight changes in employment so measured in retail trades in the post-war period. There is no evidence to enable us to judge whether the pattern of part-time employment in small establishments differs from that in large ones.

5.22 Turnover at current prices more than doubled between 1950 and 1966 and in real terms it rose by nearly 20 per cent; turnover in small retail establishments increased by only 14 per cent in real terms in the same period. The proportion of turnover accounted for by small establishments declined slightly from 63 per cent in 1950 and 1957 to about 60 per cent in 1961 and 1966 (again this change is probably not statistically significant). We appreciate that turnover is not an ideal indicator of the proportionate importance of small retail establishments and that a measure similar to that of value-added in the manufacturing industries would be preferable; such a measure is the gross margin, and though the census publications include information on this in other Tables, no analysis of gross margin by size of establishment has been published: we therefore have to rely on turnover data (as summarised in Table 5.VII).

TABLE 5.VII

Turnover and gross margins in the retail trades, 1950–1966

	Establishments			*Organisations*	
	Total	*Small*	*Small as a percentage of total*	*Turnover small as a percentage of total*	*Gross margin small as a percentage of total*
	£ million	*at 1963 prices*	%	%	%
1950	8,097	5,085	63	42	38
1957	8,613	5,538	63	..	..
1961	9,353	5,518	59	37	32
1966	9,674	5,804	60	..	..

Source and Notes: As for Table 5.V.

5.23 We also give in the Table the equivalent figures for retailing *organisations* for 1950 and 1961; they show a sharper decline in the share of small firms than the establishment data: in 1950, 42 per cent of retail turnover was in small organisations (compared with 63 per cent in small establishments) and in 1961 only 37 per cent of turnover was in small organisations (compared with 59 per cent in small establishments). Data in terms of gross margins are available on this basis and indicate that in terms of gross margin small organisations accounted for 38 per cent in 1950 and 32 per cent in 1961.[1]

Changes in other trades

5.24 So far in this chapter we have surveyed the changes in the manufacturing and retailing trades in considerable detail; in the remainder of the chapter we

[1] It will be noted that small organisations consistently have a higher share of turnover than of gross margin; we consider this to be largely attributable to higher wholesale prices paid for their goods by small firms compared with large.

picture yielded by the various sources is that the industry is moderately concentrated and that this concentration is increasing; in 1964 multiple hotel organisations (those with 10 or more establishments) accounted for about 14 per cent of total turnover of all licensed hotels; hotels with an annual turnover greater than £100,000 accounted for 40 per cent of turnover of licensed hotels. Amongst the restaurant, cafe and snack bar organisations, the smaller units, those with a turnover of less than £10,000 accounted for 69 per cent of the number and were responsible for 22 per cent of total turnover; the larger organisations with turnover greater than £50,000 accounted for only 3 per cent of organisations but nearly 40 per cent of the trade. It remains true that there is much scope for small units, especially when unlicensed hotels and boarding houses are also taken into account, but the authors of our Research Report on this industry (No. 14) nevertheless comment that "clearly the trend towards increased concentration has continued since 1964".

5.28 Concentration has proceeded quite rapidly in the *construction industry*; between 1959 and 1969 the number of small firms declined by about 13,000, their employment fell by about 20 per cent in this period, and the share of small firms in employment fell from 31 per cent to 25 per cent. The value of work done by small firms increased by about a quarter in real terms while large firms managed to increase their real value of work done by approximately one-half; there was a concomitant fall in the contribution of small firms to total work done from 26 per cent to 23 per cent in this period.

5.29 We concluded our survey with some statistics relating to *wholesale distribution* and to several of the smaller trades grouped under "*miscellaneous services*" (laundries, launderettes and dry cleaners; hairdressing and manicure, and boot and shoe repairers). In terms of employment and turnover, wholesaling is bigger than the miscellaneous service trades taken together.[1] It appears that large firms predominate in wholesaling, laundries and dry cleaners; and that small establishments or organisations account for at least three-quarters of turnover or employment in shoe repairing, launderettes and hairdressing. (See Table 5.VIII).

5.30 Recent changes in the position of small firms appear to have depended on the fortunes of their trade: the number of establishments, turnover and employment in hairdressing and launderettes have been growing, dry cleaning has remained fairly static, wholesaling has increased in turnover but remained static in employment, while shoe repairing and laundries have been in decline however measured.

[1] The statistics on the miscellaneous service trades were taken from the various *Censuses of Distribution*, as were the figures on wholesaling in 1950. Since that date the only information relating to wholesaling is contained in separate inquiries undertaken in 1959 and 1965 that were reported in subsequent issues of the *Board of Trade Journal*.

small firms between 1961 and 1966 (after making due allowance for the effect of the change in the value of money on our definition of a small firm) as might be expected over such a short period. We have not been able to find comparable data to judge the position of small firms in these trades before 1961; the next data likely to be made available on these trades will come from the 1971 *Census of Distribution* for which the collection of statistics will not start until 1972.

Summary

5.33 In manufacturing the share of small firms in employment and output has fallen substantially and almost continuously since the mid-1920s. There was also a dramatic fall in the numbers of small manufacturing firms up to 1948 and a slower but continual decline has been going on since then. Except in manufacturing and to a lesser extent, the distributive trades, statistical information on small firms is very inadequate for an accurate assessment of trends in the relative contribution of small firms to economic activity and only in manufacturing and road transport can comparisons be made with the pre-war period. Since World War II there has been a substantial decline in the numbers of small firms in the retail trades, although up to 1966 their share of retail turnover and employment has declined relatively slowly. In the motor trades small firms apparently increased in importance up to the early 1960s but the number of establishments contracted sharply between 1962 and 1967 and this contraction has undoubtedly continued since then. Only in road transport has there been little change in the size distribution of firms since the 1930s. Thus we conclude that up to the middle 1960s the contribution of small firms to economic activity was declining in most industries with the possible exceptions of road transport and some of the miscellaneous service trades. Although there have again been exceptions we think it likely that in most industries this decline has been going on at least since before the war and there are indications that it has continued since the middle 1960s.

our examination, it appears that the basis of the statistics in the following five countries is reasonably close to that adopted in Britain: Germany,[1] the United States, Canada, Sweden and Norway; for the other countries quoted, the coverage is wider and would tend to overstate the importance of small firms in relation to Britain. However, even if we restrict ourselves to the smaller group of five countries just mentioned, with the possible exception of Germany, the British situation emerges as one which is significantly different.

6.4 A lack of comparable data for most other countries has obliged us to present the data in Table 6.I in terms of establishments, rather than enterprises, which we have been able to use for at least part of our analysis of the situation in the United Kingdom, and which are, of course, much closer to our own definition of a small firm.[2] The extent to which some of the establishments included in the figures in Table 6.I will be owned by larger enterprises may vary from country to country; for this reason the relative importance of the small firm sector among the countries listed might be different on an enterprise basis than on the establishment basis shown in that Table, although the conclusion that the UK situation is significantly different would not be affected. The only country for which sufficient information is available to permit a comparison between the share of small firms in manufacturing employment on both an enterprise and an establishment basis is the United States (see Table 6.II). On both bases small manufacturing firms are relatively more important in the US than in the UK and in terms of enterprises—which is the more meaningful comparison—the difference is somewhat greater than on an establishment basis.

TABLE 6.II

Proportion of manufacturing employment in small establishments and enterprises in the United States and United Kingdom in 1963

Per cent

	In establishments employing fewer than 200 persons	*In enterprises employing fewer than 200 persons*
United States	39	30
United Kingdom	31	20

Source: US Enterprise Statistics 1963 and for the UK, *Report on the Census of Production* 1963.

Note: The US data have been adjusted to bring them on to a UK basis.

[1] The proportion quoted for Germany in Table 6.I is based on the German census of industry excluding "Handwerker"; the EEC publication includes the latter category which raises the proportion employed in small firms by four percentage points. As an illustration of the complexities and dangers of these international comparisons, the exclusion of Handwerk involves the deduction of some 331,000 establishments in 1963—more than three and a half times the total number of UK manufacturing establishments. Although, in Britain, many of these artisan establishments (e.g. potters, sausage-makers, woodworkers and upholsterers) might be classified to retail distribution or the other service trades, the numbers involved are much greater than can be explained by difference in classification and suggest that there may be fundamental differences in industrial structure affecting the nature of the small firm in Europe.

[2] Though statistics are also compiled on what is termed an "enterprise" basis for many European countries, it appears that these are in terms of legal units and do not group the activities of subsidiary companies together with their parent company; each subsidiary is treated as a separate "enterprise". They are obviously not comparable with UK enterprise statistics.

than that of small establishments. Table 6.IV shows that the number of establishments per enterprise among all firms in manufacturing rose from 1·4 in 1958 to 1·5 in 1963 in the United States and from 1·2 to 1·3 over the same period in the United Kingdom. The share of small enterprises in manufacturing employment in the US appears to have fallen over this shorter period although this decline was only half as fast as in the UK. No doubt the share of small enterprises in Canada also declined over the period shown in Table 6.III; since comparable enterprise data are not available for Germany it is unfortunately not possible to say whether or not the levelling off in the share of small establishments in that country referred to in the previous paragraph, also concealed a continuing decline in the share of enterprises.

TABLE 6.IV

Average number of establishments per enterprise and the shares of small enterprises in manufacturing employment in the US and UK, 1958–1963

	Average number of establishments per enterprise among all firms in manufacturing		*Share of manufacturing employment in small enterprises*	
	1958	*1963*	*1958*	*1963*
	No.	*No.*	*%*	*%*
United States	1·4	1·5	32	30
United Kingdom	1·2	1·3	24	20

Sources: US Enterprise Statistics 1963, and for the UK, *Report on the Census of Production* 1963.

Note: Comparable data on an enterprise basis are not available for the United States for the period 1954–63 given in Table 6.III.

6.8 Although the available information is limited, it appears that the declining share of small enterprises in economic activity is a universal process and, with the possible exception of Germany, a continuing one, and that it has gone further here than elsewhere.

6.9 Not only is the small firm sector smaller here than in the United States (and in several other countries with higher per capita incomes than the United Kingdom) but the US presents a further contrast in their experience over the last generation in respect of *numbers* of small manufacturing establishments. Whereas in the UK that number has approximately halved since the 1930s (as we saw in Chapter 5) in the US it has approximately doubled (from 160,000 in 1935 to 290,000 in 1963). Demographic changes and geographical factors certainly account for a major part of this difference. We have not been able to attempt similar comparisons with other countries.

6.10 The smaller contribution of small firms to total employment in this country compared with other countries raises the question of the extent to which this is due to differences in the birth rate of firms or death rates or both. We have therefore made a number of comparisons with the United States; as

may be the result of, or indicative of, a lower degree of competition. However, there are a number of reasons (set out in the footnote below[1]) for thinking that the difference between the two countries is over-stated by these statistics due to the different ways in which they have been compiled. It is not possible to make any satisfactory allowances for the differences in methods, but it is difficult to believe that differences as great as those noted could arise merely as a result of differences in methods of measurement.[2]

Death rates

6.16 A greater average age of firms in Britain could be the result of a low current birth rate; but the level of the death rate is at least equally important and requires examination. In Great Britain the number of companies dissolved or removed from the register has been abnormally high since the changes in company taxation in 1965 (see Chapter 13); the average proportion of companies removed from the register in the years 1967–69 was as high as 5·3 per cent a year. For purposes of comparison with other countries it may be better to take a period before corporation tax was introduced, such as 1961–65; in that period the proportion removed each year averaged 2·2 per cent. About half of those removed in that period were due to liquidations; the other half were struck off for other reasons, such as amalgamations, but these must also be presumed to include a proportion of failures. Roughly speaking, it may be said that between one and two per cent of companies in Great Britain die each year due to failure.[3] Nothing is known explicitly about the failures of unincorporated firms but, since they are generally smaller than companies, we can only presume (from what is known about the relation between failure and size) that the failure rate for unincorporated firms would be higher.

6.17 For the United States, published statistics of industrial and commercial failures relate to failures involving court proceedings, or loss to creditors, in relation to the number of concerns listed in the *Dun and Bradstreet Reference*

[1] Probably the major difference is that the US statistics treat an unincorporated firm as dying when it is sold by one owner to another, as well as if it fails. The UK data are based on replies to the question: what is the approximate age of the company? No clear instructions appear to have been given to interviewers in the Merrett Cyriax Survey with regard to this question (which should, in any case, have related to the "firm" rather than the "company") and it must be presumed that the owners of some firms that have changed hands will have given the original date of the firm's foundation, and not the year in which they acquired ownership, so giving a longer length of life. There are other biases that also act in the same direction. The sample was chosen from a 1963 frame, but the interviews were not conducted till 1970; it follows that new firms (that is those born since 1963) are not represented, and since these have a lower average age, the calculated average age is biased upwards. Those which died in the period 1963–70 are probably also under-represented; this also leads to an upward bias, since deaths probably have a greater proportion of young firms; but this last bias may not be very serious since a supplementary sample of 96 firms that had ceased trading in the period were included in the sample interviewed.

[2] The only previous investigation that we know of the age of companies is that due to D H Macgregor in *Enterprise, Purpose and Profit* (Oxford, 1934). This relates to 737 companies formed in 1880(!); the median company then survived only for five years (the author worked in terms of arithmetic averages which are, of course, higher in a positively skewed distribution; we have quoted the median for comparison with the other data above). Regrettably there has been no parallel subsequent investigation.

[3] The term "failure" must be interpreted broadly to include the formation of companies that never begin trading and are later disbanded.

Introduction

7.1 In the preceding chapters we have set out the results of our research into the distinguishing characteristics of the small firm and its role in the economy. We paid more attention to long term, rather than more immediate, issues because it became apparent that the problems of small firms are not transistory but deep rooted. We have seen that the *contribution* of the small firm to national output and employment is declining in the long term not only in this country but in all the other developed countries for which we have collected information, and in the United Kingdom at least since the 1920s. The *number* of small firms in existence in the United Kingdom is also decreasing and the total real output of small firms in manufacturing was virtually static between 1958 and 1963, a period in which total manufacturing output rose by 25 per cent. The extent to which the continuous decline is the result of an increasing death rate or a declining birth rate of small firms is difficult to establish: both factors may be operating but we believe the declining birth rate to be the more important of the two in Britain. Behind these statistics lie a number of factors which amount to an increasingly hostile environment for the small firm. Indeed we have found it extremely difficult to identify any factors working strongly in favour of the small firm. Two only have emerged, although, as we shall note below, one of the adverse factors, technological change, is now becoming less adverse than formerly.

7.2 The first of the two favourable factors is the transition from the under-employed economy of the inter-war period to the more fully employed economy of the period since World War II; the second is the very substantial increase in the general standard of living that has occurred over the last half-century. The problems of small firms in the 1930s were overwhelmingly those stemming from the chronic insufficiency of demand. Since 1945, on the whole, small firms have not been in difficulty for this reason. It is true that the higher and more stable level of overall demand has favoured large firms as well as small but in the 1930s large companies in many industries (such as steel) were able to protect their position to some extent by agreements to maintain profit margins, a possibility normally denied to smaller firms that typically operate in a more competitive market. The second favourable factor we have noted, rising real incomes, ought to affect small firms more favourably than large in two distinct ways. First, it ought to permit expansion in the demand for specialised goods, luxury goods and all kinds of services, all of which fall more into the natural province of small rather than large firms. Secondly, it ought to make it possible for a much wider section of the population to accumulate sufficient funds to start up a business of their own (moreover the improvement in social security provisions provides a better cushion against the possibility of failure). The combined influence of these factors favourable to small firms has, however, been outweighed by other factors which have operated to their detriment. These unfavourable factors are discussed in the remainder of this chapter. The order in which they are discussed, and the space devoted to each of them are not intended to reflect their relative importance.

moulding and vacuum forming) rather than from steel, which requires heavy and costly equipment for both the forming and the subsequent finishing processes. Electrical power is used in these industries rather than coal, equipment incorporates electronic rather than hydraulic or mechanical devices and frequent design changes have dictated batch rather than mass-production. Another important development favouring the small firm has been the steadily declining cost and increasing availability of labour saving equipment on a small scale, e.g. desk accounting equipment, data processing equipment on lease or time sharing, small power tools and mechanical handling equipment. Other technological changes, notably those in storage, transport and communication, have also recently had important effects on the small firm population, as will be considered in paras. 7.10 to 7.12.

Research and development

7.6 Research and development expenditures have been rising sharply since World War II;[1] costly equipment and substantial numbers of research staff are, in many industries, needed to keep up with the necessary development of new products and processes. The importance of economies of scale in research and development cannot, however, be given great weight amongst the forces now working against the small firm. This is firstly because, in general, as with plant costs, R & D costs tend to be highest among industries that are already highly concentrated (as in aerospace and chemical industries) and are not, for this reason, contributing significantly to the declining importance of small firms.

7.7 Second, costly research facilities are increasingly available to all at industrial research associations, Government establishments, universities and (as with data-processing equipment) from commercial establishments also, and thus do not necessarily inhibit the R & D efforts of the minority small firm population requiring such facilities.[2] Moreover, there is ample evidence that economic growth in the United Kingdom is being impaired more by a failure to apply existing knowledge than by shortcomings in new R & D.[3] Finally, as we noted in Chapter 4, original research as well as development from existing knowledge depend heavily on the individual; many of the greatest technical advances right up to the present day have been made by small firms, and often by individuals working in small firms, or even on their own with the minimum of equipment.

Managerial factors

7.8 Developments in telecommunications and data processing have undoubtedly eased some of the management problems of large organisations. Improving management techniques, notably systems of financial control, have worked in

[1] Jewkes, Sawers and Stillerman, *op. cit.*, and Ministry of Technology, *Statistics on Research and Development.*

[2] J G Cox, Research Report No. 2, *op. cit.*, estimates that of those UK manufacturing firms (large and small) spending under £25,000 annually on R & D, one half made use of research associations, universities or Government research establishments.

[3] *Technological Innovation in Britain*, Report of the Central Advisory Council for Science and Technology, July 1968, *The Technological Gap*, the Atlantic Institute.

through the use of the motor car has also encouraged concentration, especially in the retail sector.

7.12 Other factors have been at work in the creation of national from what were previously local markets, for example the development of new food preserving and processing techniques; the substitution of national frozen foods for local fresh foods and the location of food processing plants near the point of consumption rather than where the food is grown or caught has favoured the large vertically integrated firm.[1]

Marketing

7.13 Apart from transport and communications, there are other aspects of marketing which have now come to enjoy substantial economies of scale. For example, improved techniques of distribution and the use of national media for advertising (themselves affected by technological changes) are powerful factors working against the small firm. Indeed, we consider that lack of access to economies in large scale marketing may be the most important single reason why the competitive strength of the larger firm has improved over the last fifty years (see Chapter 3, para. 3.8).

Social factors

7.14 One other factor that was mentioned earlier (in Chapter 2, section iii), which may not be an independent one but which is noted here for the sake of comprehensiveness, is the apparent decline in the social standing of small business and the limited sector of the population from which owner-managers are now being drawn.

The State

7.15 The role of the State in both economic and social affairs has been steadily increasing. In the United Kingdom the public sector, even excluding the public corporations and the nationalised industries, accounted for approximately 16 per cent of GNP in 1969. If public corporations and nationalised industries are included, along with the central Government and local authorities, the public sector accounted for 25 per cent of the employed population and 27 per cent of GNP.[2] The increased role of the State is not, of course, fully reflected in its share in national output and employment. Economic, social and technological changes have led the State to intervene more and more in the industrial affairs of the private sector as well as to absorb more and more of the economy into the public sector. Though these changes may in large part have been inevitable they have had side effects seriously detrimental to the small firm sector.

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[1] See J R Davies and M Kelly. Research Report No. 3, *op. cit.*

[2] Source of estimates: *National Income and Expenditure 1970*, Table 13. The public sector in Britain is not exceptionally large compared with other western industrialised countries.

taxation and more especially the increases in taxation of profits, incomes and of wealth that has, in all developed countries, followed the extended role of the State. Such taxation, especially at a time when there has been inflationary pressure, has both reduced the ability of small firms to finance their expansion through re-invested earnings and has also, by redistributing wealth, threatened the continuation of family businesses. Taxation may be expected in these two ways to affect firms of all sizes but may well bear more heavily on small than on large firms which have access to a wider range of other sources of finance and whose ownership is more widely dispersed, although the available evidence of these effects is at present, in our view, regrettably inconclusive. Taxation may also have affected small firms in two further ways: through the incentives to set up in business; and through the incentives to expand existing small business. Again, however, we feel that on presently available evidence[1] we cannot accurately assess the importance of this factor, although we shall attempt to interpret it as well as may be when we return to the subject in Chapter 13.

Concentration and the emergence of the giant company

7.22 Much more striking than the decline of the small firm in the last fifty years has been the emergence of the very large company. This has meant not only that in many industries three or four companies now account for a prominent share of the market but that, as a result of this, and of the diversification of these companies into other industries, the share of the largest companies in total economic activity has been steadily increasing. It has been demonstrated, for example, that the share of the 100 largest non-financial companies in the total profits of United Kingdom companies has roughly doubled since World War II.[2] As another indicator, the share of enterprises in manufacturing employing more than 5,000 people, as a percentage of total manufacturing employment rose from about 25 per cent in 1951 to 34 per cent in 1958 and 43 per cent in 1963.[3] Today probably more than half of those working in manufacturing are employed in firms each employing over 5,000 people.

7.23 Thus the decline of the small firm should be seen in the context of a more general process of concentration that is going on, despite the continued entry of new firms and despite public anti-monopoly policy, not only in the United

[1] So far as we are aware no satisfactory empirical evidence on the economic effects of direct tax rates upon incentives has ever been collected and there are obvious difficulties in the way of doing so. It seems clear that the pattern of tax rates affects the financial structure of businesses and the disposition of individual wealth but we are not convinced that high rates of taxation (especially in a system which taxes capital gains at a lower rate than marginal income), in themselves have a major effect upon the decisions to set up new small businesses, although it does seem more probable that, especially in conjunction with high rates of estate duty, incentives to expand existing businesses may be affected.

[2] "Non-financial companies" here refers to companies in manufacturing, mining, construction and distribution. The share of these companies in total assets is also increasing but this is a less reliable guide since large firms may revalue their assets more frequently than small firms. See S J Prais, The financial experience of giant companies, *Economic Journal* 67 (266) June 1957, and G Bannock, *The Juggernauts*, Weidenfeld, 1971. See also Department of Trade and Industry, *A Survey of Mergers 1958–68*.

[3] The 1951 figure is a rough estimate based on the 1951 census results for establishments. The 1958 and 1963 figures are calculated from *Report on the Census of Production, 1963*.

CHAPTER 8: Introduction to Part II of the Report

Lessons of Part I

8.1 In the first Part of this Report we have sought to provide an objective analysis of the role of the small firm in the UK economy and of the changes in that role, both qualitative and quantitative, which have taken place over the past 50 years. We have also compared the quantitative importance of small firms in the UK with that of small firms in other developed economies for which comparable information is available. We have so far refrained from drawing conclusions about the desirability or otherwise of the trends we have identified, thinking it best to segregate matters of fact from questions of judgement as far as possible. We have now reached the stage at which deductions must be drawn from the facts and their implications for public policy elucidated. What then are the lessons of Part I?

8.2 First, it is evident from Chapter 3 that even in mere arithmetical terms small firms comprise a large and important sector of the economy. Small firms according to our statistical definition—and a much wider definition could be defended—total some 820,000, accounting for 93 per cent of the total number of firms, for 31 per cent of employment and for 21 per cent of net output in the sectors that form the field of this Inquiry.[1] If we expand our purview to include the whole of the private sector of the economy, small firms (including those in agriculture and the professions) number 1¼ million, and contribute some 24 per cent of the net output of the private sector, or some 19 per cent of GNP.[2] Though there is clear evidence that the number of small firms and their share of employment and output is decreasing, structural changes of this kind are invariably slow, and the small firm sector will therefore continue to be of great economic significance for many years, even if present trends continue unchecked.

8.3 Secondly, Part I shows that one cannot talk of the "role" of small firms in the economy, as if there were a single function that could be uniquely assigned to them. Small firms perform a large number of very varied functions, the relative importance of which depends on the particular industry concerned. Much of the evidence we have received has stressed the value of the social and political contribution of small firms—to the preservation of a democratic society for example—but in the following analysis we have concentrated on the economic benefits; and we have distinguished eight important economic functions now performed by small firms which may collectively be termed their "role" in the economy. They are as follows:

i. The small firm provides a productive outlet for the energies of that large group of enterprising and independent people who set great store by economic independence and many of whom are antipathetic or less-suited to employment in a large organisation but who have much to contribute to the vitality of the economy. (Chapter 2)

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[1] Research Unit Estimates based on *Census of Production 1963* and *Census of Distribution 1966*. See Chapter 3, para. 3.17.

[2] See Chapter 3, para. 3.21.

rewarding, the value which the community attaches to a wide choice of merchandise is best measured by its willingness to meet the cost of its requirements. In conditions of reasonably free and fair competition—an important proviso—we can assume that the public benefit derived from these functions is parallelled by a benefit to the firms performing them, and their performance could not therefore be advanced as a reason for discrimination by the Government in favour of small firms; if such intervention were necessary it would merely prove that the functions were not being performed efficiently. If small firms—or any other element in the economy—cease to be competitive their preservation can only be achieved by imposing a cost on the rest of the community. The only grounds on which we should feel justified in recommending support at the expense of the rest of the community for any business activity are, first, that it is essential to the health of the economy and, second, that it cannot be self-supporting. We do not find this dual condition to be satisfied in any of the first six of the functions of the small firm sector listed in paragraph 8.3. It is of course open to Government to decide that the happiness of those employed in small firms, or the preservation of consumer choice, is sufficiently important on social or political grounds to warrant the support of small firms which would otherwise succumb, and such judgements might be entirely justified. But they are essentially political judgements which it is not for us to make.

8.5 The remaining two functions, however—as a breeding ground of new industries and the source of dynamic competition—are of a different order in that, while their performance is of great benefit to the economy, they are not necessarily adequately self-rewarding. A vigorous and successful small firm sector, by its very existence, keeps open channels of entry into business and provides a continuing incentive to the ambitious and enterprising to start up in business on their own account. We believe that the health of the economy requires the birth of new enterprises in substantial number and the growth of some to a position from which they are able to challenge and supplant the existing leaders of industry. We fear that an economy totally dominated by large firms could not for long avoid ossification and decay, nor can we think of any long term alternative to the maintenance of a thriving small firm sector as a safeguard against this. This "seedbed" function, therefore, appears to be a vital contribution of the small firm sector to the long-run health of the economy. We cannot assume that the ordinary working of market forces will necessarily preserve a small firm sector large enough to perform this function in the future.

The significance of the decline in the small firm sector

8.6 This brings us to the third and possibly the most important of the findings in Part I. This is that the small firm sector in this country represents a significantly smaller proportion of the national economy than in other industrialised countries. It is also in a state of long term decline in terms of the number of small firms in existence and their proportionate contribution to output and employment. A similar decline is taking place in all the other developed countries from which we have collected information, but it has gone further here than elsewhere and is still proceeding more rapidly than in some other countries. The principal causes of the decline are summarised in Chapter 7. The important question thus

place in the number of small firms and in their share of economic activity does not in itself constitute a case for remedial action. To a large extent the decline is a natural and desirable response to changes in technology and increases in the effective size of markets. For example, in the retail trades, town centre redevelopment schemes, the abolition of resale price maintenance, the development of new retailing methods and perhaps above all the increased use of cars for shopping, have brought about the closure of many small independent shops. Yet it would be difficult to maintain that to date the interests of the public had suffered, that competition in the industry was endangered or that there were serious barriers to entry as a result of this process. We would not recommend that action should be taken to halt or reverse these trends in retailing because we do not believe that the structure of the industry is or is likely to become seriously unbalanced. There are other industries where reduction in the number of small firms can likewise be ascribed to technical changes or market developments which have raised the optimum level of operation.

8.10 Given the present lack of statistical and other information about small firms, and of adequate guidance from serious academic study of their function in the industrial structure, assessing the gravity of the decline of the sector must be a matter largely of subjective judgement. Our own researches over the past two years have enabled us to throw some light on these areas, but a "scientific" answer could only be discovered, if at all, by monitoring, over a much longer period, certain basic indices of the health of the sector, on some of which, at present, there is no systematic collection of information.

The question of discrimination in favour of the small firm

8.11 In the meantime our best judgement, in the light of information presently available, is that the decline of the small firm sector has not yet reached a stage at which deliberate discrimination in favour of small firms on the part of the Government would be justified. That is to say, we believe the sector as it now stands to be capable of performing the regenerative function which is its special contribution to the health of the economy. We base this belief mainly on the quality of new formations: the number of well-qualified, competent and ambitious young men starting in business on the strength of a sound, marketable idea and carrying it through to commercial success appears at least as high as it has ever been. (Their number is partly obscured by the growing tendency to buy an existing trading company rather than incur the trouble and expense of forming a new one.) Furthermore, in spite of the falling number of small firms, we have seen no evidence of an abnormal rate of business failure (see Chapter 6) or other symptoms of widespread distress, apart from that associated with the exceptionally severe credit squeeze of 1969. The evidence of small businessmen themselves, though often expressing discontent, reveals no consciousness of a state of crisis: indeed, most of it specifically repudiates any need or desire for special assistance for small firms.

8.12 Nevertheless, it is not enough to be satisfied with the present state of the sector: to justify a policy of non-intervention we also need to be satisfied that the process of decline will not continue to the point at which the economic viability of the sector is undermined. This judgement is much more difficult to

background of an economy that has been virtually stagnant for a long period. There is no doubt that if the economy had been buoyant for the past ten years or so, the position and outlook of the sector would now be very different. Small firms cannot be insulated from the general economic climate—indeed, they are especially vulnerable to its effects—and the solution of the problems that now beset the sector will in large part depend on the solution of our national economic problems.

8.14 We are aware of the risks involved in taking this optimistic view, and in particular of the risk that our doing so may be held to justify continued neglect of the problem. This would be very dangerous. Not only is our information imperfect, but the response of the system to changes in the forces operating on it is subject to very long lags. It may take many years for the full effects of new tax measures to become apparent in the behaviour of businessmen or the structure of industry, and this is even more true of essentially long term changes in competition policy or company law, or in the distribution of wealth in the community. We therefore have to accept that the state of industry as we now see it is the result of an extremely complex interaction of forces, some of which originated ten, fifteen or even sixty years ago (e.g. the introduction of Estate Duty in the Finance Act of 1909), and that, in the nature of things, the full effects of more recent changes in the environment will not yet be apparent.

8.15 If it were possible, therefore, to guard against excessive decline of small firms by relatively minor and painless changes in Government policy, we should have no hesitation in recommending this, as a kind of cheap insurance policy. However, if market forces are continuing to exert pressure towards a decline in the small firm sector, it is certain that nothing less than discrimination on a massive scale in favour of small firms would be effective in counteracting them, to say nothing of the other profound and fundamental changes in society and the economy which are reducing the importance of the small firm sector. The simplest, and probably the most effective, form of discrimination would be a tax concession to small firms themselves, their proprietors or potential investors in them; but to tilt the balance of forces in favour of the small firm would require a concession of a size that we would judge to be politically unacceptable to the majority of the population, and which we could not at present defend on economic grounds. A cut of ten or twenty per cent in the effective rate of tax on the profits of small firms, for example, would have only a marginal effect on the economic viability of the sector. But to justify a still larger concession than this to a group whose members are certainly not as a group among the less fortunate and underprivileged, and who include some of the more wealthy people in the country, would be impossible in the absence of much stronger evidence than is now available that the future of the small firm sector is in jeopardy to an extent that threatens the national well-being. Discrimination on a significant scale is therefore unacceptable unless the need for it can be proved beyond all reasonable doubt.

8.16 This is not to say that positive discrimination in favour of small firms should be renounced on principle and for all time. We should regard the decline of the small firm sector past the point of economic viability as so great an evil that energetic discrimination to avert it would be justified. In the next chapter

optimal structure of particular industries is in its infancy and in no case, so far as we know, has it extended to serious consideration of the place of small firms in the structure. Even on the rate of business failure present information is inadequate; we cannot deduce the number of bankruptcies of business proprietors (and thus of business failures) from the official bankruptcy figures, which make no distinction between businessmen and other individuals. Before it could begin the job of monitoring the health of the sector, therefore, a Small Firms Division would need to ensure that the necessary statistical data were collected and analysed. This will not be done easily or quickly, but it should be possible after, say, five years, to review the findings of this Committee in the light of more complete information than has been available to us, and to judge whether our rejection, for the time being, of discrimination in favour of small firms is justified by events. In any event, the results of the *1968 Census of Production* should be urgently studied from this point of view as they become available, since it is of the utmost importance to know whether the process of decline which we have traced up to 1963 has continued at the same rate.

8.18 Our rejection of positive discrimination in favour of small firms as being at this stage unjustifiable and impractical does not imply that we are content with their present situation. On the contrary, we believe that they suffer from a number of inequitable and unnecessary disabilities, mostly imposed by Government, which amount to discrimination against them. The fact that this is unintentional is irrelevant. We have made it our purpose in the remainder of this Report to recommend ways of removing or reducing these disabilities, whose effect is to restrict the freedom of small firms to compete on even terms. We do not deceive ourselves as to the potential effects of these recommendations: they will certainly not in themselves be sufficient to arrest the downward trend of the small firm sector, though they may help to prevent an acceleration. But it is our hope that, collectively, they will represent an important improvement of the climate in which small business operates. For if it is true that because of major changes in the economic environment it is becoming increasingly hostile to small-scale private enterprise, there is all the more reason why inadvertent or unjustified impediments to their competitive efficiency should be removed. We have therefore tried to identify areas in which small firms or their proprietors are discriminated against, or fail to qualify for some privilege already extended to others, or for any reason suffer a differential disadvantage. In many cases we have been able to suggest means of alleviating, or compensating for, these disadvantages, but in others we have been unable to make any recommendations, since the disability in question cannot be directly remedied at acceptable cost to the community.

of the small trader"—National Federation of Retail Newsagents, Booksellers and Stationers.

"We emphasise that the best immediate way in which the Government can help the small business is to slow down considerably its headlong rush into legislation of reform which is so often directed towards the decimation of the small business by its very nature"—National Chamber of Trade.

"For business to flourish, one of the essentials is confidence. There are, of course, many factors which affect this, but in the United Kingdom since the war, the factor with the most widespread and continued effect has been Governmental action. Attempts at influencing businessmen by legislation have often seemed to businessmen to be threats to the continuance of their enterprises"—The Smaller Businesses Association.

9.3 We have not of course taken all such comments at their face value, because we recognise that businessmen hoping for remedial action by Government are unlikely to make the mistake of understating the need for it. We must also bear in mind that those businessmen who have felt it worthwhile to write to us or their trade association on these matters are a self-selected group—necessarily those who feel strongly about the impact of public administration on industry. Interviews conducted on our behalf with randomly selected groups of entrepreneurs suggest that the "typical" small businessman is less concerned about public affairs than these quotations would imply, his main worries being the difficulty of raising finance and labour problems.[1] In addition it has to be said that much of our evidence, which was received before the change of Government in June 1970, reveals a large measure of straightforward political prejudice against the Labour Government of that time. It is commonly assumed that the overwhelming majority of small businessmen are Conservative in politics and we have seen no evidence to the contrary: indeed, there appears to be a tendency to mistrust initiatives of Labour Governments on principle and irrespective of their merits. It is perhaps not for us to comment on this, though it may help to explain the relative insignificance of the small firm lobby as a political factor; unqualified loyalty to one party may result in the small firm vote being taken for granted by one side and written off by the other. It is not so in other comparable countries; in the United States, for example, small business lobbies are very powerful, most probably because the political parties profess strong attachment to the values of small business.

9.4 We believe that the apparent indifference, and certainly the ignorance, of successive Governments about small firms is in large part the fault of small businessmen themselves who, in spite of their numbers, have been extremely ineffective as a pressure group. There is still no national organisation claiming to speak for the whole of small business; though the recent formation of the Smaller Businesses Association and the Smaller Firms Council of the CBI has improved matters, even they often speak with a divided voice on matters of common concern. The main reasons for this are that small businessmen are often fiercely independent, very reluctant to join in group activities, and also heavily overworked, so that even if they have the inclination for such activities it is very hard to find time for them. The consequence is that the sector is so weakly and diversely represented that it cannot bring effective pressure to bear on Government. *Since we think it necessary that so large a sector of the economy should have a more powerful voice in public affairs, we hope that the present*

[1] See Golby and Johns, *Attitude and Motivation Study*, Research Report No. 7.

found no evidence of deliberate and consistent discrimination against small firms by Government departments. In our view, it is simply untrue to say that Government policies have been aimed at the suppression or liquidation of the small firm sector. We have taken evidence from the Department of Trade and Industry and its two predecessors, the Board of Trade and the Ministry of Technology, from the Department of Employment, the Ministry of Agriculture, Fisheries and Food, the Inland Revenue, the Department of the Environment, the Treasury and from the Central Statistical Office. In every case we have discussed this evidence with the Department at Ministerial or senior official level and we are completely satisfied that there is no deliberate discrimination against small firms. All departments have accepted that the health of the small business sector is a proper concern of Government and have sought to demonstrate that their own policies, though they may not be formulated with the small firm particularly in mind, are at least modified by recognition of the potentially severe effects of Government action upon the small firm. The most telling criticism of Government in this field is not that its policy towards small business is misconceived or hostile, but that it has no policy. As far as we can ascertain, this has always been the case; it is not a recent development. Indeed, most of the rare initiatives of Government designed to help small firms, such as the creation of the Industrial Liaison Service and the Low Cost Automation Centres, are comparatively recent developments and it is undoubtedly true to say that more attention has been paid to the sector in the past ten years than ever before. This is not to say that Government policies in the post-war period, and particularly in the last ten years or so, have been neutral in their effects. We believe that they have been on balance disadvantageous to the small firm sector. But they were neutral in intention.

9.8 There are some obvious examples of overtly neutral policies whose effects have in fact been harmful to the sector. The Selective Employment Tax, to take one example, though it made no distinction between firms of different sizes, was intended to discriminate against those trades—the distributive and service trades—in which small firms predominate. SET, in fact, was initially justified as an attempt to alter the structure of industry in favour of manufacturing by fiscal discrimination. (It should be pointed out that within the service trades the very smallest firms were largely exempt from SET since they have no employees in the true sense, either being one-man firms or employing only the proprietor and his immediate family in a form of partnership. Such firms therefore enjoyed a slight advantage over their larger competitors.) The Investment Grants scheme introduced in August 1966 under the Industrial Development Act was also ostensibly neutral as to firm size, but applied only to investment in manufacturing. The scheme could therefore be said to have discriminated against the distributive and service trades since they were declared ineligible for grants (except for the purchase of computers). Both systems have been in force too short a time for it to be possible to assess their structural effects, and the announcement of their abolition has now rendered this an academic exercise. However, these measures, though not overtly discriminatory between firms of different sizes, no doubt helped to account for the belief expressed by the National Chamber of Trade among others, that Government policies were designed to force small firms out of business. The abolition of Resale Price Maintenance in 1964 was also traumatic for the small trader, and though of great value to the consumer, will

that may arise, than with a small firm which has none of these advantages and which anyway has little inclination to invest managerial time in developing cordial working relations with Government. If familiarity with the individual small firm is impossible for Whitehall, however, it is all the more important that central Government should overcome its ignorance of the small firm sector in general.

9.12 The complaint that Government neglects the interests of small firms is not incompatible with the equally common plea for freedom from unnecessary "interference". This is a very vague phrase which is applied, according to the taste of the speaker, to any and every aspect of Government: the introduction of new legislation, the collection of statistics, the control of industrial development, the levying of taxation and even the provision of services and advice—there is no official activity, however legitimate or necessary, which will not be resented by some small businessmen as an intrusion on their freedom and a waste of their time. Big business may share this resentment, but it is particularly acute among small firms for the simple and sufficient reason that almost every manifestation of Government is likely to involve extra work for the small firm owner or managing director *in person.* The real administrative cost of Government procedures is therefore relatively much higher for the small firm than the large; it must normally be measured in terms of the distraction from its proper function of the controlling intelligence of the business. We believe that the value of the work done by the Industrial Training Boards, for example, as far as small firms are concerned, has been largely nullified by the administrative costs they have imposed on employers by the cumbersome levy/grant system. For this reason the growth of the public sector and the incursion of Government into every corner of economic life has serious implications for the small firm. It is of course very difficult to take a view on the total impact of public administration on small firms—but it is surely wrong that at present nobody in Government is required to attempt it. Every new imposition, whether it be a statistical inquiry or a change in the law, should be subject to stringent examination whose purpose would be to determine whether its benefits outweigh its costs, and on whom they respectively fall. The demand that small firms should be left to get on with the job in their own way, repeatedly voiced in our evidence, may be unrealistic, but this contention depends on the premise that Government requirements are justifiable on the basis of a reasonable balancing of costs against benefits, which in practice has frequently been allowed to go by default.

9.13 The malaise of small business thus appears to be compounded of three elements: resentment caused by a long term and irreversible decline in the small businessman's ability to control his environment; a sense of persecution caused by the detrimental side effects, deliberate or not, of the activities of Government; and frustration at the delays and impediments arising from the sheer multiplicity of official regulations and requirements. In our view not much can be done about the long term decline in the relative social status of the entrepreneur, which is parallelled in other sectors of the economy, such as the professions, and is only one among many inevitable consequences of the growing egalitarianism of society. It remains true that the owners of businesses are as a group among the better-off members of the community, not because their incomes are necessarily higher than average but because our tax and social systems place a premium on

with its own political head, who is directly responsible to the President, financed by an annual appropriation on the federal Budget. It is frankly and powerfully committed to the cause of small business, both responding to and reinforcing the national small business lobby. It is above all an executive agency, operating four major programmes for the assistance of small firms through its headquarters in Washington and its network of 73 "field offices" around the country, but it also has an important political function in mobilising support and funds for these programmes and in ensuring that the interests of small firms are not neglected by other Departments. We shall refer to the SBA's assistance programmes, where they are relevant to policy in this country, in other chapters; here it must suffice to describe them very briefly.

i. *The loan programme.* The provision of business loans has always been the most important of the SBA's functions. The policy is based on the presumption that small firms which are otherwise viable may have difficulty in providing the level of security demanded by the banks, or in paying a commercial rate of interest. Under the Direct Loan programme, the SBA itself would lend at long term to such businesses, charging a statutory fixed rate of 5½ per cent. For many years this meant that the SBA was lending at well below the commercial rate, and latterly even below the rate at which its own funds were raised from the Treasury. For this reason, and because Congress has drastically curtailed the funds voted for this programme, direct loans have now largely been abandoned. The SBA's direct lending is now virtually confined to racial minorities and the underprivileged. These "Economic Opportunity Loans" are justified on social rather than economic grounds: the low standards of creditworthiness applied to borrowers and the high rate of loss put them outside any criteria of commercial lending. In place of direct loans, the SBA now concentrates on Loan Guarantees under which an approved small firm obtains capital from a bank on commercial terms (normally 2 per cent above the New York prime rate) and the SBA guarantees the bank against loss to the extent of 90 per cent of the loan. Under the Participation Loan scheme the SBA itself puts up a proportion of the loan, but interest rates on these are fixed at less than the commercial rate.

ii. *The procurement programme.* It is stated in the Small Business Act that "a fair proportion" (not defined) of Government purchases, contracts and sub-contracts must be placed with small firms. The SBA has powers to enforce this, by requiring other departments to "set aside" the whole or part of specific contracts for bidding by small firms only. In open contracts, if a small firm's bid is rejected because of the buying agency's doubt of its ability to perform, the SBA may after inspection issue a "certificate of competency" which binds the agency to accept the bid. In such cases the SBA assumes responsibility for defaults and losses. In all Government contracts worth more than $500,000, the prime contractor must undertake to give small sub-contractors an opportunity to participate. Perhaps most important, the SBA seeks to ensure that Government contracts are let in the smallest economic lot sizes, to enable small firms to compete for the work. The SBA claim that justification for their procurement programme lies in the fact that it results in substantial saving to Government by bring-

pressure group politics, may therefore be appropriate. But in the United Kingdom the allocation of funds is decided according to the system of priorities agreed in Cabinet and ratified by Parliament. Central control of the departments is very much stronger here, and success is achieved less by public pressure than by powerful Ministerial representations.

9.18 The same problem of organisation was faced by Japan, where there is a massive, and relatively inefficient, small firm sector. The solution adopted there has been to create, within the Ministry of International Trade and Industry, a Smaller Businesses Agency responsible for rationalising the sector and for improving its efficiency through a series of policies much like those pursued in the United States. The main difference is that the actual execution of policy is delegated to a series of specialised agencies financed by the Government. Among these agencies, we were particularly interested in the work of the Small Business Finance Corporation, a specialised institution providing long term funds (at low interest) to small firms, the Small Business Credit Insurance Corporation, which provides loan guarantees through 51 Credit Guarantee Corporations and the Small Business Promotion Corporation, which encourages the formation of co-operatives and mergers among small firms by providing them with cheap credit, consultancy services and training. Free management services are provided, by chambers of commerce and trade associations to the smallest firms and by the local prefectures to those up to medium size. They consist essentially of in-firm diagnosis of problems, followed by recommendations for actions. The consultants employed by the prefectures are licensed by the Government, having either passed a written examination or undergone a year's training under official supervision. Most of them are university or college teachers in technical subjects.

9.19 The concern of the Japanese Government with small businesses, and the vigour of its intervention in the sector, are fully understandable, since their small firm sector is proportionately much larger than ours and faces grave problems. Japan has some 4·2 million small firms (as defined in the Small Business Basic Law) which comprise over 99 per cent of all business establishments in the country. (95 per cent of them are very small, i.e. with less than 20 workers if in manufacturing or less than 5 in the service trades.) In 1966 they employed nearly 80 per cent of the private sector working population and were responsible for 50·8 per cent of manufacturing output, and for 82·3 per cent of retail and 43·6 per cent of wholesale turnover. In the last ten years, largely as a result of the movement of 10 million peasant farmers out of agriculture, who are responsible for one-third of all new starts, the number of small firms has increased by about one million. It is still increasing at some 3 per cent a year, in spite of a very high rate of bankruptcy and business failure. (The proportionate annual increase in the number of larger firms is much faster but their absolute number is still a very small proportion of the total.) The Japanese Government is greatly concerned about the efficiency of small firms which it judges to be much inferior to that of larger companies. Small firms have so far survived by paying much lower wages than big industry and by virtue of the protection afforded by high tariffs against imports. A growing labour shortage, especially of skilled labour, and the reduction of tariffs are rapidly removing these advantages, and the Ministry of

weak, unattractive to the more able officials, and the volume of executive work which could be assigned to it would certainly not justify the appointment of a controlling Minister. Previous experience of small highly specialised departments with little executive power has not been encouraging, and the present trend towards very large super-ministries must make it even more difficult for small departments to be effective. In any case, it is undesirable that small businesses should be segregated from the rest of industry; the needs which all firms in an industry have in common are more important than the disparate needs of small and large firms: moreover it is essential that those who are responsible for policy towards small firms should be aware of new thinking and new developments throughout industry. Even more important, we recognise that truly effective presentation of the case for small firms would in the last resort require the backing of a Cabinet Minister, and the present organisation of the super-ministries, in which junior Ministers hold responsibility for specified blocks of work under the general authority of a Cabinet Minister, lends itself to this. If a body responsible for small firms is to be created, therefore, we believe it should be a special Small Firms Division within the Department of Trade and Industry, responding directly to a junior Minister and ultimately to the Secretary of State.

9.24 Second, we consider that such a Division, though part of a larger Department, must be identifiable by the businessman as an individual entity. The most effective way to achieve this would be to name a Minister of the Department as the "Minister for Small Firms", since it is easier to identify with a person than with an organisation. This would be desirable in any case, in view of the need for a forceful exposition of the interests of the small firm sector, both in public and inside the Government. Initially it would not of course be necessary or realistic for this to be his sole responsibility.

9.25 Third, it is clear that a general responsibility for "policy" towards small firms could easily become a vague and meaningless remit—and the policy itself an unrealistic one—unless it were associated with a worthwhile executive role which would bring the staff of the Division into close and regular contact with individual businessmen and concrete business problems. For this reason we should wish to see vested in the Small Firms Division responsibility for the administration of all advisory and management services financed by Government which are of particular value and relevance to small firms. (These are discussed in the next chapter, where we recommend the creation of a network of local Advisory Bureaux, whose main function would be to provide information to small firms.)

9.26 It has been pointed out to us that in the Department of Trade and Industry, as in other economic departments, work is organised either on a functional basis —as when a Division, Branch or Section has responsibility for a particular service to industry or for policy on a subject such as restrictive trade practices— or on the basis of industrial "sponsorship", when the responsibility is for policy towards and relations with a given industry. To allocate to one division responsibility for the whole of the small firm sector, which is heterogeneous and exists in almost all industries, would cut across this system. It can be argued, moreover,

it will be argued that there are few if any problems common to all small firms and that the concept of a "policy" which would be appropriate to the whole sector is unrealistic. Again we see the force of this, and although we are convinced, as this Report will demonstrate, that the common problems of small firms are many and serious (this is perhaps more easily appreciated if they are seen as the problems of the owner-manager), we have not tried to formulate a "small firms policy" which could be stated in a few words or embodied in an Act of Parliament. Other countries have done this: the United States, for example, has its Small Business Act and Japan its Basic Law of Small Business; these define the small firm for legal and tax purposes and enunciate a general policy towards the sector. But the essence of all these enactments, and the base on which they rest, is the assumption that the small business sector is worthy of special consideration for political and social as much as for economic reasons. They are essentially expressions of the social and political values of these societies, representing a consensus viewpoint which makes it easy to gain public support for discrimination in favour of small private enterprise. Such a consensus does not exist in this country and though we might wish it were otherwise we have not thought it right to advance our own preconceptions as a basis for what must be essentially political decisions. We certainly would not suggest that the policy of the Government should be one of uncritical support for small business, still less that the function of the Small Firms Division should be to give expression to this. Indeed, we believe the policy should be essentially neutral—that is, to ensure that small businesses are not prevented from making their full contribution to the efficiency and competitiveness of the economy by unfair and unnecessary impediments. To this end, the Division should carry out the following functions:

i. It should be consulted on, and where appropriate help to formulate, any new legislation or changes in policy, particularly in the fields of taxation and competition policy, likely to affect the interests of small firms. Its first duty should be to see that these interests are no longer overlooked.

ii. It should be the channel through which the views of small businessmen, their reactions to policy and their problems, should be communicated to the rest of Government, so that policy is no longer formulated in ignorance of these factors.

iii. It should have executive control over all advisory and technical services primarily used by, or intended for, small firms. In particular it should be the headquarters staff of the network of Small Firms Advisory Bureaux whose creation we recommend in the next chapter.

iv. It should endeavour, in co-operation with sponsoring departments, to form a view of the present and future role of small firms in all industries in which they are important, and should collect the statistical and other information needed to enable it to do so.

We suggest other functions for the Division later in this chapter, and in Chapters 10 and 16.

9.29 At some later date it could possibly prove necessary, for reasons explained in Chapter 8, for the Government to depart from strict neutrality and discriminate decisively in favour of small firms: this would, however, represent a major

competition, of course. Retail and other service enterprises, which still depend essentially on a local market, are hardly likely to be affected by it, but many manufacturers are bound to feel the extra weight of competition. Some will be shielded from it by a close relationship with a big customer; these are the "satellites" whose value to their major customer is their responsiveness, flexibility and cheapness, all of which are enhanced by proximity. Specialist manufacturers, though they may encounter competition within their special field for the first time, are perhaps the most likely to be able to exploit the Community market. But those firms to which we referred in Chapter 3 as "marketeers", that is, those which are in competition with many other firms, including some large ones, will certainly be vulnerable to foreign competitition. On the other hand they will have greatly enhanced opportunities in the larger market provided that they make the necessary effort to promote their sales within the Community, using to the full the export advisory services available, and provided that they receive the necessary co-operation from the banks. Furthermore, to the extent that the economy as a whole benefits from the stimulus of entry, small firms in all trades will also benefit.

9.33 We are informed that in the Netherlands the formation of the EEC was followed by a tendency to larger scale production and an increase in the number of mergers and takeovers, and that in general the relative position of small business has deteriorated. Adaptation to the demands of the wider market imposed an additional strain on the slender management resources of the small firm. The national Governments of the Six and the EEC Commission have shown appreciation of these problems of the small firm and various studies have been undertaken by the Commission of ways in which small firms can be assisted to adapt to the new circumstances.

9.34 We think it vital that the Department of Trade and Industry should begin to prepare the small business community for the changes which must be expected upon our accession to the Treaty of Rome, both through publications and by supplying information and answers to questions through its Regional Offices and the Small Firms Advisory Bureaux. It is also necessary for the Department's own purposes, and in pursuance of the monitoring function we proposed in the last chapter, that it should form a view of the future of the United Kingdom small firm sector within the Community. Before it can do any of these things it must study the impact of entry on small firms. **We recommend that this should be given immediate attention by the Department of Trade and Industry and that it should be an urgent priority of the Small Firms Division when this is formed.**

Government procurement

9.35 A second subject which the Small Firms Division should study as a matter of urgency is the pattern of Government purchases. This is important in our view both because the allocation of Government contracts should be reasonably fair as between firms of different size, and because there is scope for the deliberate use of the Government's purchasing power to foster enterprise and innovation among small firms. Though the White Paper entitled *Public Purchasing and Industrial Efficiency* (Cmnd. 3291) gave considerable attention to the potential for positive use of the Government's buying power, no special thought has been given to its implications for small firms.

the United States. The US Small Business Act of 1953 stated: "It is the declared policy of the Congress that the Government should . . . insure that a fair proportion of the total purchases and contracts or sub-contracts for property and services for the Government . . . be placed with small business enterprises". We are told that about 20 per cent by value of US Government prime contracts go to small firms. In all contracts worth more than $500,000, the prime contractor is required to give specialist sub-contractors an opportunity to participate; he may also be given up to an additional 3 per cent profit on his prime contract if his programme of appointing, training and advising small sub-contractors is particularly successful. We do not suggest that the policies of the SBA should be imitated here, but there are some important lessons to be learned from the United States. Foremost among these is the ability of the Government to support and foster new science-based enterprises by judicious allocation of research and development contracts. A recent sample of 400 such companies in the famous "Route 128" complex near Boston showed that even four years or more after foundation, Government work accounted on average for 60 per cent of their turnover. The huge expenditure of the US Government on defence research has no counterpart in this country, but there is nevertheless a great deal of Government-financed R & D, of which only a small proportion appears to go to small firms. On the basis of a survey carried out on our behalf by HM Treasury it appears that of the research and development contracts placed by the former Ministry of Technology in 1969–70, rather more than ten per cent by number, but less than two per cent by value, went to small firms. The great majority of defence contracts (for which at that time Mintech had important responsibilities in the aerospace field) are "nominated" contracts, usually with the largest aerospace companies, and small firms are of course unable to compete for them, though they may benefit as sub-contractors.

9.38 In other fields small firms fare better. It is difficult to identify all contracts placed with small firms because departmental records are not kept in that way, but certain major purchasing departments have carried out surveys on our behalf at the instigation of the Treasury. These show that in 1969–70 the Department of Health and Social Security, for example, placed with small firms some 75 per cent by number and over 50 per cent by value of its direct purchases for hospitals. The Ministry of Defence estimated that between 14 per cent and 28 per cent of their purchases, plus most of the small orders made by outstations, go to small firms. The former Ministry of Public Building and Works, which grades contractors by size according to the value of the projects they are thought capable of handling, carried out a sample of projects costing less than £10,000 for which small firms were in theory competent. This showed that the smallest categories of contractors—those approved for projects costing up to £10,000 and £20,000 respectively—were each awarded some 20 per cent of the contracts. Details of all these cases were sent to us, and we saw none in which the decision to use a large rather than a small firm was obviously unjustified. The Ministry's "approved list" of building and maintenance contractors includes some 25,000 firms.

9.39 In the light of these figures it is not clear that American small firms do significantly better in this respect than ours. They are certainly more fortunate,

and Industry, responsible for the development, inter-departmental co-ordination and implementation of policy towards small firms and for the administration of such official services as are provided for them (paragraph 9.27).

2. A Minister of the Department of Trade and Industry should be expressly designated as the Minister responsible for small firms and oversee the work of the Division (paragraph 9.27).

3. So far as is possible the separate identity of the Small Firms Division should be stressed and publicised (paragraph 9.27).

4. All other departments with trade or industry sponsorship functions should designate an official with specific responsibility for liaison with the Small Firms Division of the Department of Trade and Industry, and for his department's policy towards small firms (paragraph 9.27).

5. The Small Firms Division should endeavour, in co-operation with sponsoring departments, to form a view of the present and future role of small firms in all industries in which they are important and should collect the statistical and other information needed to enable it to do so (paragraph 9.28).

6. Immediate attention should be given by the Department of Trade and Industry to the study of the impact of entry into the EEC on small firms, and this question should be an urgent priority of the Small Firms Division (paragraph 9.34).

7. Major purchasing departments should have regard to the effects of their buying policies on the structure of industry in general and particularly on the small firm sector, in addition to their overall concern with achieving value for money (paragraph 9.39).

8. The Small Firms Division should give early attention to the effect of official procurement policies on small firms, and promote policies designed to maximise competitive participation by small firms in suitable Government contracts (paragraph 9.40).

9. We have recommended other functions for the Small Firms Division in Chapter 10 (control of Advisory Bureaux) and in Chapter 16 (continuing assessment of the effects of competition policy on small firms).

accountants, and sporadic or "once-off" services such as management consultancy. We are concerned primarily with the second category, not because we think it more important but because there is little room for argument about the first. For certain purposes the employment of an accountant or a solicitor is virtually obligatory, and we are interested in situations where it is open to the businessman to choose whether or not to seek advice. We recognise, and various surveys have confirmed this, that in such situations his accountant, solicitor or bank manager is probably the first person he will turn to, and it is in this role of trusted advisers, rather than as providers of routine professional services, that we shall principally consider them.

The needs of small firms

10.5 It is very widely believed that the general level of management in small firms is low, although all would agree that there are brilliant exceptions. Most financial institutions, for example, when asked why they are unable to invest more in small firms, cite weak management as the major difficulty. The same theme recurs repeatedly in the research reports commissioned by us on various industries within the sector, in the evidence of specialists in the field such as the Small Business Centre of Aston University and the British Productivity Council, and in that of 21 large companies who were asked to comment on the strengths and weaknesses of small firms as suppliers and sub-contractors. When particular weaknesses are specified, in spite of the special interests of witnesses, a strikingly consistent picture emerges. It suggests that the main areas in which small businessmen could improve their performance are the following:

i. *Finance.* Small firms frequently lack knowledge of the appropriate sources of development finance and working capital, and are unaware of the advantages of different methods of raising capital. They are also unskilled in presenting a financial case to potential investors and lenders.

ii. *Costing and control information.* Cost control and costing data are often so poor that mangement frequently learns of an impending crisis only with the appearance of the annual accounts or following an urgent call from the bank manager. In less serious cases, lack of costing data may make it impossible to gauge the effects on profits of different levels of activity or courses of action, especially where there is a variable product mix. Credit control and stock control information is often inadequate.

iii. *Organisation.* Poor organisation of the routine administration of the business, in such matters as office procedure, delegation of duties and job specification, can leave the manager with no time for thinking, let alone for longer term planning, since he becomes fully occupied with daily problems.

iv. *Marketing.* Most small manufacturers are product-orientated and they are inclined to concentrate on the design and production of goods at the expense of proper attention to the crucial marketing function. In consequence opportunities for expansion and for specialisation or diversification may be missed and firms may find themselves trapped in a declining market, or at best tossed around by the ebb and flow of a fluctuating

the concern of managers should be to confine them to their proper place; they are not a substitute for systematic routine administration. There are quite enough genuinely difficult problems of judgement without artificially preserving others; whatever can be measured and recorded, ought to be, so that judgement can be exercised in its proper sphere on the basis of the most accurate and relevant information obtainable.

10.7 In talking as we have above about the weaknesses of small firm management, we may have appeared to neglect the views of those most immediately concerned, the businessmen themselves. While readily conceding that the standard of management in the majority of small firms (excluding their own) leaves a good deal to be desired, most of those we have met have rejected the idea that the wider use of advisory and management services would much improve matters. One of the complaints most commonly made to us by businessmen and their representatives is that they are weary of receiving unsolicited advice from well-meaning outsiders (ourselves included) on how their businesses should be run. Advice from Government employees is resented most of all. These are not idle complaints: that they are seriously meant is demonstrated by the massive refusal of the small business sector to make use of the extensive array of services provided, even when they are free. This may in part be due to ignorance of the services' existence, but sheer hostility to outside "interference" is an important factor. The study we commissioned of the attitudes and motivation of small businessmen (Golby and Johns, Research Report No. 7) summarised this as follows:

> Detailed awareness of sources of advice and assistance open to the businessman appeared to be low, presumably because of the insistence upon being self-reliant and the suspicion that caused respondents to shy away from anything which smacked of Government interference. As would be expected, respondents in the larger firms sampled were rather more knowledgeable than the remainder. Possibly because informants appeared to have had very little experience of using the facilities available, attitudes towards them tended to be critical.

One result of this combination of hostility and lack of awareness is that much of the effort of the advisory bodies has necessarily been devoted to "salesmanship" —that is, to persuading businessmen to make use of services, often free or heavily subsidised, whose justification ought to be their potential contribution to the profitability of the firms using them. There is a basic difficulty here, which is that the "missionary" adviser has not only to persuade the businessman that a given course of action will result eventually in higher profits, but also that the risk is low enough to make the project worthwhile: and invariably the businessman's assessment of the risk will be more cautious than the missionary's, since it is he, and not the missionary, who will have to bear the consequences of misjudgement. In part this explains the suspicion, amounting to prejudice, against outside advice which is shown by many small businessmen. Rationalisation or improvement of the services will bear little fruit among small firms unless this prejudice can be overcome. Since official services arouse the prejudice in its most acute form, we shall discuss it more fully in connection with them. But it must be stressed that the first essential, if any service is to be of value, is that it should be acceptable to an adequate number of those for whom it is intended.

ii. trade associations and chambers of commerce and other representative bodies;
iii. management consultants;
iv. universities, technical colleges and research associations;
v. Government departments and bodies sponsored by them.

There is some overlap between these categories; research associations, for example, are heavily subsidised by Government; but we think this is a helpful way to break down a very diverse field, and we shall discuss each group in turn. The greater part of the chapter will be devoted to Government departments and bodies sponsored by them, because it is in this group that the taxpayer's money is invested and because only this group gives rise to any points of principle on which our views could have much bearing. There is a danger that the simple classification we have adopted will obscure the enormous range and diversity of advisory bodies that exist. The National Economic Development Office, in their publication entitled *Business Efficiency: An ABC of Advisory Services*,[1] described 269 Government-sponsored, voluntary and non-profit making organisations which offer general advisory services for the improvement of efficiency and profitability in industry. The Ministry of Technology also published a booklet, *Technical Services for Industry*,[2] which described all the technical services available from research establishments administered or supported by the Government and from other Government departments. This has since been revised by the Department of Trade and Industry. We do not propose to duplicate these lists, which are large and very useful productions in their own right, but we commend them to the small businessman and we hope that those responsible will continue to bring out revised editions when necessary. It must therefore be understood that this Report is not intended to be a comprehensive guide to the services available.

Accountants, solicitors and bank managers

10.11 By far the most frequently consulted source of advice, on general management problems as well as on their professional specialities, are the accountants, solicitors and bankers regularly used in their professional capacities by small businessmen. Apart from their special advantage of frequent personal contact with the businessman, their professional status commands his respect, they are familiar with his business and have something of a vested interest in its prosperity, and they are near at hand, so that consultation with them is a simple matter. Moreover, generalised advice, as opposed to strictly professional services, will often be provided without charge, and almost always for less than would be charged by a business consultant for the same type of advice, simply because it is easy and cheap to advise on a situation with which one is already familiar. The value of the services provided in this way is incalculable, though no doubt they are very variable in quality. In the natural order of things the experience and personal aptitudes of accountants, solicitors and bank managers vary greatly, and some are neither willing nor qualified to give this type of advice.

[1] Published in October 1968 and revised in June 1970. Available from HMSO.

[2] Published in 1968 by the Ministry of Technology and republished in revised form by the DTI in October 1970. Available from Department of Trade and Industry, 1 Victoria Street, London SW1.

management succession, the administration of trusts and the apportionment of shares in a family business may all be crucial to the survival of a family business, and their proper handling demands legal advice. Some solicitors, like some accountants, are also valuable intermediaries in the provision of finance to small businesses, effecting an introduction either to a private individual or trust seeking an investment opportunity or to some institution, such as an insurance company, for which they act as agents.

10.14 The role of the bank manager as a business adviser is necessarily more limited. This is not true of the specialised investment houses, like ICFC or the merchant banks, whose interest in the management of their client companies is very close, but the great majority of small firms do not seek advice from them. Branch managers of the Clearing Banks naturally vary a great deal in their ability and readiness to give management advice of a general nature and it would clearly be unrealistic to expect them to spend much time in doing so: the cost of a day spent on the affairs of a small customer could easily exceed the annual profit of the bank on that customer's account. Even if management advice were charged for, the bank manager might merely be operating, in so far as he strayed outside financial matters, as a relatively inexpert management consultant to the detriment of his main function. *We hope, however, that the Clearing Banks will consider whether they could further improve their services to the small businessman in two particular respects.* First, if it were possible for the banks to impose as a normal condition for the grant of an overdraft to a firm the production of regular cash-flow statements, or the employment of adequate estimating and budgetary systems, and if such disciplines, valuable in their own right, came to be recognised as being helpful for obtaining bank finance, the efficiency of small firms might be much increased. We do not suggest that a control system should be insisted on as a kind of bureaucratic formality, but rather that the bank manager might be able to improve the efficiency of his customers, in their interests and his own. He could also help them by pointing out the benefits of regular attention to certain simple indices of the health of a business—the profit/sales ratio, the debtor/sales ratio, the stocks/turnover ratio, return on capital employed and so on.[1] In this way he would give powerful support to the efforts of the accountant in improving the performance and hence the overall viability of the small firm sector. Second, the bank manager should be ideally placed to advise small businessmen on the availability, the cost and the advantages of different forms of finance, in cases where an overdraft facility is not the appropriate kind of finance for the purpose in mind. The Clearing Banks have represented to us that their branch managers are already providing advice of this kind, especially as regards the facilities offered by the Banks' own subsidiary and associated companies, and we do not doubt that many branch managers now go to considerable trouble to keep themselves informed about the terms on which other financial institutions are prepared to do business with small firms. Nevertheless we have repeatedly been told by the specialist finance institutions that the quality of the advice on available sources of finance given to most small firms by their bank

[1] See the British Institute of Management leaflet on *Management Ratios and Interfirm Comparison for Management*. First published January 1969 and reprinted June 1970. Available from Management House, Parker Street, London WC2B 5PT.

numbers of small traders with similar problems". The EDC also concluded, however, that a subvention from Government would be required, at least in the early stages, to bring about a significant expansion of trade association services. We should make it clear that the element of public subsidy, as envisaged by the EDC, was to be strictly limited both as to conditions and duration, though they expected that services started on this basis would need indefinite support from trade association funds. To the extent that they depend on Government subsidy we are not in sympathy with the EDC's proposals. However, the point we wish to make here is that the EDC believed that among small traders, where there would be no effective competition from independent consultants, trade association services could not be run on a commercial basis, and therefore by implication that those for whom the services are intended would be unwilling to support even a low-cost service. Few associations, in distribution or other industries have, however, put this proposition to the test.

10.17 Possibly even more inhibiting than their fear that services would be uneconomic is the conservative and unambitious view of their proper role which is taken by so many trade associations. Small in membership, ill-financed and understaffed, they are hard-pressed to perform even the representational and informational functions which have traditionally been their main concern. Still less are they able to employ sufficient staff of the quality needed to make an advisory service successful, even though, as we have said above, concentration on a limited number of common problems would permit the development of standard solutions and therefore the employment of men less well qualified than general consultants have to be. *We should like to see the development of larger and more ambitious trade associations, recognising that this probably entails drastic reduction of their number, because only thus can the standard of their educational and advisory services to members be significantly improved.* In the past five years there has been an encouraging move in this direction in the distributive trades, where until recently well over 100 independent associations claimed to represent different sectors of the industry, but there was no authoritative spokesman for the industry as a whole. The independent associations still exist, but the most important of them now combine on many matters of common interest, and the development of a distributive trades confederation seems only a matter of time. No doubt the Committee of Inquiry on Industrial Representation under the Chairmanship of Lord Devlin, which was set up by the CBI and the Association of British Chambers of Commerce, will be paying attention to this aspect of the role and organisation of trade associations. *Our own hope is that their Inquiry will result in a thorough rationalisation of the structure of trade associations, the diversity of which still reflects their essentially defensive pre-occupations of the past.* Small and highly specific trade associations made good sense at a time when their main function was to regulate trade in the interests of stability and against the background of a rather static economy, but they are ill-suited to modern conditions.

Management consultants

10.18 We are using the term "management consultant" in a very wide sense, to mean those who provide in-firm counselling on the whole range of manage-

business), and generally acting as a trusted counsellor. It is very hard for a young and inexperienced man, however able, to fulfil this role, so for this reason also a more senior man is required. But it takes time to build up such a relationship, and the time of such men is expensive. Though it may be possible to expand still more rapidly the total number of consultants, the number of those who meet the small firm's needs will always be limited, and there will always be other calls on their time.

10.21 Much of what the consultant does in a small firm could best be described as training the proprietor—inducing him to examine his situation objectively and honestly, opening his eyes to new ways of solving problems and overcoming his prejudice against unfamiliar techniques—and this element of management training is probably their most enduring and valuable contribution to efficiency. Small firms offer little opportunity for the application of very sophisticated specialist techniques. Attempts to apply such techniques when more simple methods would serve—and the specialist is inevitably tempted to see all problems in terms of his own speciality—are counterproductive. Unfortunate experiences of this kind are no doubt rare but every businessman seems to be able to quote such a case, though it may only be at second or third hand, and there is no doubt that these stories cause much of the prejudice against management consultants which undoubtedly exists.

10.22 This brings us to the difficulty of selling consultancy to small firms. Those who regularly attempt this have told us that by far the most commonly advanced reason for rejecting the services of consultants is their cost. Firms will either maintain that the fees are excessive or that they are temporarily short of the necessary cash, and no reputable—or prudent—consultant will undertake an assignment unless he is satisfied that the clients can afford the fee. It is, of course, true that management consultancy is necessarily expensive; even NUMAS, who charge lower fees than the majority of consultants, made (May 1971) a standard charge of £300 per man/week (with some remission for the smaller firms). To a small business such sums are very significant. Yet we think it likely that high cost is very often advanced as a "respectable" ground for refusal by businessmen whose real objections to consultancy are unwillingness to disturb a comfortable routine and the fear, perhaps without foundation, that close investigation will reveal their own inadequacy. There is also a strong element of prejudice against outside "interference", based on the common idea that expertise in how to run a business is best gained, and most profitably exercised, in running one. NUMAS told us that "It is our experience that the firms which are most receptive to outside assistance are those which are already fairly efficient or those which have a specific problem they have attempted to define. Others who are prepared to listen include those with a serious setback in results and those in a desperate plight financially—though for these it may already be too late". Other evidence confirms this: the best small firms are more likely to use consultants or other management services than the great majority of run-of-the-mill firms which would appear to stand in greater need of them.

10.23 In our view this widespread prejudice against management consultants among small firms is unfortunate. It is easy to make exaggerated claims for the

...gy — the (both large and small) associated with the Massachusetts Institute of Technology around Boston, USA, and there is evidence of a smaller but generally similar development near Cambridge in the United Kingdom. It is highly desirable that industry should make more use of the appropriate teaching institutions, since they employ a very high proportion of the country's best qualified scientists and engineers, and where they have made special efforts to reach small business, the results have been very encouraging. The Small Business Centre at Aston University, since its establishment in 1967 with a grant from the Department of Economic Affairs, has carried out much valuable research on the management problems of small firms and has already completed consultancy assignments or training programmes for over 500 of the 6,000 small manufacturing firms in the surrounding area. The Aston Centre is now self-financing, and its success is a valuable proof of the fact that the academic community can build up mutually rewarding relationships with small businesses. Similar centres are planned at other institutions and those at the Bristol and Sheffield Polytechnics are already operating. We have also been much impressed by the work of the Centre for Industrial Innovation at the University of Strathclyde. Equally convincing evidence of the potential value of contacts between small businesses and the academic world is provided by the success of the Industrial Liaison Centre Scheme. 75 ILCs have been established in universities or technical colleges, staffed by Industrial Liaison Officers who are members of the college staff, though the greater part of the cost of the service is paid by the Government. In addition to their very valuable advisory and referral functions, one of the main effects of the centres has been to provide a means of harnessing the resources of the host institutions to the needs of small firms.

10.25 *We believe that co-operation of this kind between industry and the staff of teaching institutions should be more positively encouraged than it now is.* This is not to deny that there are obvious dangers in over-dependence of the universities on the business community, as on any other patron. Too close an involvement with industry may lead to misuse and misapplication of time, effort or resources, Nevertheless we consider that the general advantages and benefits of active co-operation between industry and the world of higher education more than outweigh the possible disadvantages and we feel that co-operation between the two communities should be fostered and promoted. There is indeed a case for relieving suitably qualified teachers from some of their teaching duties in order to permit them to undertake part-time consultancy work in industry. To a limited extent this is done already, but in a haphazard way. The major difficulty, of course, would be to find time for this activity. Except during vacations, it could not readily be done in addition to a full teaching schedule; in most technical colleges time even for research is very limited. It would therefore be necessary for the Department of Education to make it clear that advisory work in industry is a proper and desirable use of faculty time. It would also be necessary to give thought to the scale of fees to be charged, and to their allocation between the lecturer and his college. Present practice on this varies widely—even between different departments of the same college. In some cases the fee is decided between the lecturer and the client firm, and the whole of it remains with him; in others the whole of the fee goes to the college. It is perhaps not important which method of fixing and collecting fees is adopted, but the present lack of

10.28 For many years it has been accepted that the Government should concern itself with promoting the internal efficiency of firms, as well as with its major task of providing a legislative and economic framework within which they can work efficiently. This belief underlay, to take one example, the foundation in 1952 of the British Productivity Council, whose aim was to promote higher productivity by spreading knowledge and acceptance of better technical and managerial methods. Government subsidies to industrial Research Associations, which date from as long ago as 1918, are another example. In recent years, however, and particularly during the early years of the Labour Governments of 1964–70, the involvement of Government in this area became much wider and more direct than ever before. A multitude of new Government-controlled or subsidised organisations devoted to improving the efficiency of industry by offering advice and technical services came into being, most of them under the aegis of the Ministry of Technology, and Government expenditure for this purpose rose substantially. There has followed a period of rethinking and retrenchment which is still going on. Financial support has been withdrawn from some services and the future of others is in doubt. While official policy, and the services themselves, are in this fluid state the best we can hope to do is to identify those of the existing services which appear to be most valuable to small firms and to suggest some principles which in our view should govern their organisation in future.

10.29 As we said at the beginning of this chapter, we shall concentrate on the more generalised management services: we have given little study to the technical services, and their value is in any case difficult for a committee of laymen to judge. They have been mentioned in paragraph 10.10, however, and some of our conclusions are in principle applicable to them. The "general" services comprise a wide range of organisations and activities which are wholly or in large part financed by Government but which vary greatly in their objectives, in the manner of their financing and in their relationship with Government. The number of such services is such that to list them all would be wearisome—and unnecessary, since the excellent publication by the National Economic Development Office to which we referred previously is available.[1] However, in the next paragraph we briefly describe those which appear to us to have most relevance for small firms. (The Table at the end of the chapter reproduces this factual information in summary form for ease of reference.) It must not be assumed that these are the only services which are available to small firms. In principle most Government services are available to the whole of industry without distinction as to size, though some concentrate on smaller firms. Since some of these services, such as the export services of the DTI, are inseparable from the general administrative functions of the Department, it is difficult to arrive at an estimate of the total cost to Government of the advisory services and it is certainly impossible to allocate any given proportion of the total to small firms. The Government has also at various times made grants of money for special purposes to otherwise independent bodies such as the Small Business Centre at Aston University, The

[1] *Business Efficiency: an ABC of Advisory Services*. Published October 1968, revised June 1970. HMSO.

set up by the Ministry of Technology to persuade industry of the benefits of low-cost automation; to provide information and advice on this subject; and to provide training and consultancy. They thus have a tripartite role like that of the ILOs, though more specialised, and they too are required to give priority to the assistance of small firms. In their "missionary" role they seem likely to overlap the work of the ILOs, who frequently refer firms to the centres for specialised advice but who are presumably competent at least to describe the benefits of inexpensive automated equipment. Although fees are charged for consultancy, which includes the evaluation of firms' needs and advice on suitable equipment to meet them, the level of business done by the centres is small; we were told that the turnover of a typical centre is unlikely to exceed £7,500 a year. We have considerable doubts as to the viability of the centres if the DTI subvention were removed, since we have seen little evidence that small firms attach much value to them. However, if the centres were placed on a commercial footing they would presumably be free to sell their services to large as well as small firms.

iii. *The Production Engineering Advisory Service.* This service was set up in 1967 and was run on behalf of the Department of Trade and Industry by the Production Engineering Research Association. Its purpose was to improve the efficiency of small firms in the engineering and allied industries by means of technical advice and training. Seven mobile units visited firms free of charge to demonstrate the possibility and the value of improved production methods; firms wishing to follow this up might even engage a consultant from the PEAS staff at a subsidised rate for the first assignment. About one in ten of all firms visited took advantage of this, but only one in fifty of the smaller firms. The Government's contract with PERA was terminated in March 1971 and PEAS is therefore no longer in existence. We have no doubt that the service did useful work. In the period of more than four years during which it was in existence a large proportion of the smaller firms in the engineering industry were offered an opportunity of benefiting from its services. However, we would not quarrel with the decision to terminate the contract, since the danger of premature closure of a service is usually smaller than the danger that activities will be continued after the point of diminishing returns has been reached. We understand that PERA may continue to offer consultancy at commercial rates.

iv. *The British Productivity Council.* The BPC was set up in 1952 as an independent body sponsored by the CBI, the TUC, the ABCC and the nationalised industries, but the bulk of its funds have always derived from Government. Its main aim was to promote higher productivity by spreading knowledge of better methods and encouraging acceptance of the need for change. It did this on the national level by means of publications, films and its own work study unit, and on the local level through 143 Local Productivity Associations. The latter are autonomous bodies affiliated to the BPC which organise productivity courses and seminars, visit local firms and offer advice on productivity problems. Originally entirely voluntary, most LPAs have taken on some staff and about 40 have full-time Productivity Officers whose salaries are paid by the BPC.

Government productivity service. Since its inception in 1968 its aim has been to locate and remove obstacles to the efficient use of resources, with particular reference to problems of industrial relations and the use of manpower, and to assist with the standard conciliation work of the Department. Its staff of Manpower Advisers, partly recruited from industry, is located in nine regional centres, from which they visit firms throughout their regions, either to give advice and information or occasionally to undertake more detailed diagnostic surveys into problems of manpower utilisation and management structure. Some 4,000 advisory visits and 300 diagnostic surveys have been carried out annually. The Service has recently been given a new mandate, and will in future concentrate on work related to the manpower and industrial relations functions of the Department of Employment. In addition to conciliation in industrial disputes the service will continue to provide advice to industry on such matters as the efficient use of manpower, labour productivity, labour turnover and absenteeism, payment systems and personnel practices. It will no longer concern itself with questions of general efficiency outside these fields except to the extent necessary to carry out its main tasks. It is to be hoped that the service will not lose all contact with small businessmen, by some of whom, at least, it is highly regarded.

vii. *The Council for Small Industries in Rural Areas (COSIRA).* COSIRA is financed by the Development Commission. Its purpose is to strengthen the economy of the rural areas of the country by supporting existing small firms and assisting the establishment of new ones, thus ensuring a variety of employment in the countryside. The service is confined to firms employing less than 100 persons in all and less than 20 skilled workers, and situated either in the country or in small country towns. Special attention is paid to areas suffering from high unemployment and rural depopulation. COSIRA provides, usually free of charge, in-firm advice on a very wide range of technical matters and management skills such as accounting, marketing and work study. It also runs free training courses on these subjects. Most important of all, it is empowered to make loans for equipment, buildings or working capital where no other capital is available. Loans of up to £20,000 are made for industrial projects and £25,000 for the tourist industry. Rates of interest charged are considerably lower than commercial rates, and the standard of security demanded is somewhat lower. These loans are financed from revolving funds which in 1970 totalled £3·75 million. The total cost to Government of COSIRA's activities was £630,000 in 1970/71. Though assistance is given to the traditional craft industries, the emphasis is on industry using modern techniques, particularly light engineering, and on tourism. (Agriculture, horticulture, and retailing are ineligible for assistance.) The average number of employees in firms using COSIRA's services is five and they have established contact with about 14,000 of the firms within their purview. The quality of the services is very high. Their provision is however dictated largely by social rather than economic considerations and we do not believe that it would be practicable or justifiable to do the same for industry as a whole. If rural industry must be serviced on this scale, therefore, it should continue to be done by a separate agency. In

[illegible] Ministry of Commerce for the duration of the scheme. It has been noted that the number of applications for grant have tended to decrease with the size of firm, contrary to the trend in the Board of Trade pilot scheme. There is evidence that significant benefits have accrued from the consultancy assignments undertaken. Although in terms of the reaction it elicited from industry the Board of Trade pilot scheme was an undoubted success, we regard the expenditure of nearly £400,000 of public money as an expensive way of persuading some 113 small firms (the remainder had used consultants before) of the value of management consultancy, although we are aware that this might be justified on the basis that the tax contribution from the increased profit of these firms will quickly eliminate the cost to the National Exchequer. For reasons given in the paragraphs which follow we would not support the further provision of subsidised consultancy. *If however the contrary view were taken by a future Government, we recommend that subsidies should be offered to the users of services, as in this case, rather than the providers,* on the grounds that the providers will then be in the position of competing for business, which will impose a useful discipline upon them. To that extent, the consultancy grants scheme introduced a welcome new principle.

Export services

10.33 The Government's services to exporters are in a different category from the management services we have dealt with so far, and with which this chapter is mainly concerned. They are different because they are beyond question essential—all trading countries give assistance to their exporters—and because they could not conceivably be provided by private enterprise on a commercial basis. (Indeed, no private organisation could match, on any basis, the Government's access to foreign commercial intelligence through the system of Foreign and Commonwealth Office posts abroad.) Their purpose is not to increase the general efficiency of the firms using them, but to help overcome the inherent difficulty of selling overseas. We do not propose to describe the services in any detail; they are fully described in the Department of Trade and Industry's *Export Handbook: Services for British Exporters* which is freely available from the Department, and they are also widely advertised. The following very brief account of the services provided by the Department of Trade and Industry in this country and by Foreign and Commonwealth Office posts abroad must serve to indicate their range and comprehensiveness.

10.34 The basic function of the DTI in this field is the provision of information and guidance on every conceivable subject of interest to the exporter. These include: export opportunities; market assessments; the appointment of agents and distributors abroad; finding partners for joint manufacturing ventures abroad; status reports on foreign firms; the organisation of overseas business visits; overseas publicity; tariffs, import regulations and other relevant legislation of foreign countries; and problems of individual exporters. This general information is backed up by one of the world's most comprehensive collections of statistics and other published information on export markets, in the Statistics and Market Intelligence Library. Much of this information is collected in the first instance by the diplomatic and consular posts and transmitted to the DTI. Posts will also respond to direct requests for information from firms—though it

[illegible] the number of complaints about them was very small indeed; in general they appear to stand in high repute. To guard against the possibility that the dearth of complaints merely reflected the fact that the proportion of small firms who are direct exporters is relatively small, we asked the British National Export Council to carry out a survey on our behalf among small firms known to be successful exporters. This was done by sending a questionnaire to entrants to the BNEC's Small Exporters Award Scheme. Of the 20 respondents, all but one said the advisory services were good, though four suggested that they suffered from the unavoidable limitation of excessive generality, in that it was sometimes hard to get answers to specific problems as opposed to generalised information. We did receive some complaints about the Computerised Export Intelligence Service, whose original subscription charge—£25 a year, regardless of the number of notices received—was said to be unfair to small and highly specialised firms which might expect to receive notices only rarely, but this has been remedied by altering the basis of the charge; £25 now pays for 500 notices, spread over any length of time. The most common subject of complaint was the complexity of export documentation, which is not strictly relevant to the advisory services, and which has been very fully considered by the UK Committee for the Simplification of International Trade Procedures, whose valuable Report was published in April 1970.[1] Action is now being taken to implement the Committee's recommendations, and we can add nothing to their findings. We would only remind the small firm that professional assistance with all the documentation and other formalities associated with exporting is available from export houses who can provide relatively cheaply facilities which it would be impossibly uneconomic for the individual small firm to maintain on its own account. Export finance, another common subject of complaint, is dealt with in Chapter 12.

10.38 We therefore have no recommendations to make on the subject of export services. We would however express the hope that the Government's pursuit of cost-effectiveness in this field, which we whole-heartedly endorse in this as in other fields, will take proper account of the benefits to be derived from encouraging small exporters, which will only arise in the longer term: it must not be assumed that only the large or well-established exporter is worth helping. It is certainly true that very large firms account for the greater part of our exports, and that the proportion of small firms which export directly is small. But the danger of relying on a few very large exporters has been so vividly demonstrated of late that the need to broaden the base of our export effort is self-evident. It also goes without saying that some small firms have great export potential: who could have foreseen, in 1950, the enormous successes in 1971 of the recipients of the BNEC export awards? (See Chapter 3.) We would suggest also that there are lessons to be learned from Japan in the realisation of the export potential of small firms. We were informed by the Small Business Agency of the Japanese Ministry of International Trade and Industry that small businesses produce between 30 and 50 per cent of Japan's exports, being particularly important in textiles, in miscellaneous goods such as toys and sports equipment, in transistor radios and the like. Small firms in Japan do not in general export directly; they sell their output to the great export trading companies, usually financed by the banks, who carry out the export function. The export houses may also arrange

[1] Sitpro Report 1970. National Economic Development Office, HMSO.

efficiency of the economy that there should be an active and growing consultancy industry, and the development of the industry ought not to be inhibited by Government-subsidised competition. If, on the other hand, the market mechanism is failing in the small firm sector because the level of demand for such services among small firms is inadequate, how far should the Government go in attempting to stimulate demand? This question merits serious consideration, and we return to it in paragraph 10.43.

10.42 Secondly, the implicit assumption that the users of most of these services should not be expected to pay their full cost seems to us highly questionable. The services were set up with varied objectives, but they have one main purpose—to improve the performance of the economy by raising the efficiency of the individual firms that use them. To the extent that this is achieved, the profitability of the users will also be raised. Indeed, the only sensible reason for making use of any service, from the businessman's point of view, is that it is likely directly or indirectly to increase his profits; if it does not, time spent on it is time wasted. This being so, it would seem reasonable that users should be required to pay the full cost of management services. The view underlying Government policy has apparently been that much of industry, particularly small firms, would not of its own accord take the action necessary to improve its performance and that incentives were needed to make it do so. We think it wrong in principle that firms should in effect be bribed to take action which, if it is worthwhile at all, will increase their profitability. The evidence suggests that the main users of the advisory services have been the more dynamic and efficient small and medium sized firms—precisely those who are best able to assess the pay-off from any course of action: the existence of the services appears to be comparatively ineffective in persuading the more reluctant, backward or inefficient firms to improve their performance. We therefore doubt the effectiveness of the "missionary" role of the subsidised services and note that their successes have tended to be among the already converted. A better case for subsidies could be built on the proposition that many actual or potential users of the services cannot afford to pay commercial rates for them. The basic costs of a consultancy assignment, for example, cannot normally be reduced below several hundred pounds whatever the size of the client firm, and there are very many small firms for which such costs are prohibitive. However, though we have more sympathy with this argument, its implication is that scarce resources—in this case the time of highly qualified advisers—should be artificially diverted towards businesses unable to justify their employment in economic terms; this cannot be a sensible policy in the long term.

10.43 In paragraph 10.41 we raised the possibility that the market mechanism may be failing in this area not because the commercial supply of advisory services is deficient, but because of a lack of effective demand for them. This could arise if potential users of the services were ignorant of their existence or of their purposes, or if, knowing of the services, they were simply unwilling to make use of them. Our commissioned study of the attitudes and motivation of small businessmen[1] pointed out that:

[1] Golby and Johns, *Attitude and Motivation*, Research Report No. 7.

men are confused by the profusion of services, commercial and otherwise, which now exist. This confusion reinforces their suspicion of outside advisers and we believe is an important reason for their failure to seek help when it is needed. Basic information on other matters—Government policies, planning problems, tax questions for example—is also needed; usually a mere reference to the relevant authority or published guide would suffice. The closest analogy to what we have in mind is the Citizens' Advice Bureau. We are quite confident that no commercial organisation could provide a pure information service of this kind on the necessary scale and this is one context in which the image of a Government service might be more helpful than otherwise; since it could not be suspected of having an axe to grind its advice on the merits of different advisory services would be particularly acceptable. Moreover, since many of the small businessman's perplexities stem from the requirements of Government, an official service would be best placed to resolve them. We do not believe that such a service could be made self-supporting. The great value of the kind of service we have in mind is that the businessman would be able to get a quick answer over the telephone to a vast range of simple, straightforward questions. Charging fees for this, even modest ones, would destroy the essential simplicity of the operation and the administration involved, more than the cost, would deter many potential users, thus undermining the purpose of the service. Moreover, the cost of collecting fees of the small size that would seem appropriate would be disproportionately high. Finally, we believe that such a service could be provided at modest expense, and that the return, in terms of greater efficiency in industry, would more than cover this. It can therefore be said that for the Government to finance such a service could be justified on all four of the grounds laid down in paragraph 10.40.

Future organisation

10.47 If we have correctly identified as the only proper field for permanent subsidy the provision of an information and referral service, how should such a service be organised? Many existing bodies, such as research associations, Local Productivity Associations, trade associations and the Regional Offices of Government departments already do some signposting and information work, but for most of them it is very much a secondary activity, ancillary to their main functions of carrying out research, training, consultancy, the solution of technical problems or whatever. For this reason the small businessman who wants only a quick answer to a simple question is unlikely to think of approaching them, or, in some cases, to find the right source of information if he tries. The point is that it is nobody's function to be an all-purpose compendium of basic information; some trade associations attempt it, but most are inadequately staffed and financed, and are obliged to specialise. **We should like to see the signposting and information function vested in a single, easily identifiable organisation with a network of local offices in all the most important centres of industry and commerce.** It would not be necessary, or possible, to remove this function from the other advisory bodies; they could hardly be expected to turn away enquiries, particularly those arising from their other functions. But they would no doubt be glad to leave this financially unrewarding work to the new organisation as far as possible.

opportunity for close involvement with the businesses they advise is the greatest attraction of their jobs. Moreover most of them would probably wish to retain their academic status and their relationships with colleges, whereas we think it necessary that the Advisory Bureaux should be wholly financed and controlled by Government. We therefore cannot hope that many of the Industrial Liaison Officers would be prepared to join the new service. Nor do we believe that colleges and educational authorities would be prepared to make their premises available to a Government service over which they had no control, even where such locations were thought suitable for Advisory Bureaux. Since we believe that there is no case for more than one government-financed local service we must therefore face the fact that creation of the Advisory Bureaux entails the eventual withdrawal of Government support for the Industrial Liaison Centres.

10.50 We do not believe that this would necessarily result in the cessation of the work now done at the Centres. Where they have been successful we think it likely that the work would be carried on, probably on a more commercial basis, by the Colleges themselves and that most Industrial Liaison Officers would continue to be employed by their Colleges, retaining a responsibility for liaison with industry. Some Universities and Colleges are already running their own units for liaison with industry and are successfully carrying out consultancy in industry. We think this may become more widespread. It would be possible for the most characteristic and valuable elements of the ILCs' functions—the definition and diagnosis of problems (which is a form of pre-consultancy and could be placed on a commercial footing)—to be continued, thus maintaining the mutually beneficial relationship between small business and the academic community.

10.51 One question we have had to consider in relation to the proposed Advisory Service is whether it should be clearly identified as part of Government and staffed by civil servants on the same lines as, for example, the Regional Offices of the Department of Trade and Industry, or whether it should be separated from Government as the Industrial Liaison Centres now are. Most of the businessmen we have consulted have preferred the latter arrangement, and in view of what we have said earlier about the widespread prejudice against Government services, there are obvious attractions in "independent" status. However, what is at issue here is only the appearance, not the reality, of independence; there is no question in our minds that the cost of the Bureaux will fall on Government, and financial dependence is hard to reconcile with independence in action. Moreover, we believe the Advisory Bureaux could be a very valuable means of keeping Government continuously informed on the current needs and problems of small firms, thus contributing to the formulation of policies affecting them. **The lack of such a source of grass-roots intelligence has been a serious handicap in the past, and we envisage that the Bureaux should be widely publicised not merely as a source of advice on official policy (among other things) but also as a medium through which the individual small business can make its views and problems known to Government.** Government could greatly improve its image among small businessmen merely by showing itself ready to listen. We have recommended in Chapter 9 that there should be a Small Firms Division within the Department of Trade and Industry with overall responsibility for policy towards small firms. **We suggest that the Advisory Bureaux should report to this Division, thus acting as a two-way channel of communication between small business and the Department.** In

Scope of Retired Executives (described in Chapter 9) deal with some 10 per cent of all the inquiries received by the Small Business Administration. In Los Angeles, where the SBA can call on 150 volunteers, the SBA office is permanently manned by two or three retired businessmen whose function is to deal with telephone inquiries either by giving advice on the spot, by arranging a visit to the firm or by putting the businessman in touch with the appropriate source of specialist advice. They are paid nothing for this but their direct expenses. It seems to us that there is scope in this country for calling on the wide knowledge and experience of the many retired business executives who would no doubt be glad to contribute to the improvement of industrial efficiency. We have considered whether the Advisory Bureaux might be a suitable organisational system within which these retired executives might work, but felt that this would not be appropriate, since the work of the Bureaux would not offer sufficient scope for direct counselling to be attractive to such men. A number of organisations, including the CBI, the British Institute of Management and the Institute of Directors, have shown interest in the potential contribution of retired executives, and others are already making use of them. The Industrial Training Foundation currently has some forty retired executives in its service, who carry out paid assignments, and the Merseyside Productivity Association has four such men doing valuable and much appreciated work among small firms on a voluntary basis. As to whether such advisers should be paid, there are good arguments on both sides and we have no strong views, but it will be obvious that their payment or non-payment would have important implications for the organisation of the service. There are of course, some pitfalls to be avoided. A volunteer must be personally acceptable as well as technically qualified and great care must be taken to ensure not only that he is up to date with new procedures and techniques, but that he is assigned to appropriate tasks within his experience and expertise. US experience suggests that the training and supervision of volunteers is a very important function to which adequate staff resources must be permanently assigned.[1] Nevertheless there are obvious possibilities here and **we recommend that the proposed Small Firms Division should consider, in consultation with the relevant interested organisations, all possible means of enlisting the services of retired executives for the assistance of small businesses.** It is likely that, as in the USA, the greatest number of requests for such services might come from the retail and service trades. One of the best ways in which the experience of retired executives could be used with advantage would be in the capacity of non-executive part-time directors. It is likely that the establishment of a successful advisory relationship would in some cases lead to a closer link of this type with the firm concerned.

Recommendations

10.56 Our recommendations on the provision of management advisory services by Government are as follows:

1. The provision of free or subsidised services is only justifiable if the four criteria we have identified are met, and wherever possible those services which

[1] See the written evidence received by the Committee from the Management Consultants Association, the University of Aston in Birmingham, and A G Cruft Esq., (copies available for consultation in the DTI library).

Advisory services of particular relevance to the small firm

Service	*Objective*	*Types of activity*	*Clients*	*Status*	*Fee-charging or not*	*Cost to Government (in 1970/71 except where otherwise stated)*	*Sponso Departi*
Industrial Liaison Service	To help small firms find the right sources of advice, information and assistance	1. Missionary 2. Advisory and 3. Referral	Firms with up to 500 employees	Outside Government	No	£250,000	DTI
Production Engineering Advisory Service	To promote use of new and improved production engineering techniques	1. Missionary and training 2. Advisory and consultancy service	Smaller engineering firms	Outside Government	1. No 2. Yes	£195,000	DTI
Low-cost Automation Centres	To demonstrate the benefits of low-cost automation equipment	1. Missionary, informative and advisory 2. Consultancy and educational	Small firms	Outside Government	1. No 2. Yes	£80,000	DTI
British Productivity Council and Local Productivity Associations	To promote higher productivity by spreading knowledge and use of better methods	1. Missionary 2. Advisory and training 3. Publicity	Industry generally, but especially small firms	Outside Government	Usually not (fees are adjusted according to ability to pay)	£643,000	D. Em.
(Following the Government's decision to phase out their grant the BPC have restricted their Headquarters activities to the production, sale and hiring of films, and the servicing of the Local Productivity Associations)							
National Council for Quality and Reliability	To improve quality and reliability of the products of industry	Mainly exhortation and publicity	Industry generally	Outside Government	No	£25,000	DTI
Manpower and Productivity Service	To promote the more productive use of resources, with particular reference to industrial relations and the use of manpower	1. Missionary and advisory 2. Conciliation in industrial disputes 3. Incomes policy work	Industry generally	Integral part of Department of Employment	No Entirely reliant on Government funds	£920,000 (approx cost of advisory work only)	D. Em.
Council for Small Industries in Rural Areas and Small Industries Council for Rural Areas in Scotland	To develop the prosperity of small firms in rural areas of England and Scotland respectively	1. Advisory, consultancy, educational and training 2. Financial loans	Small firms in rural areas (excluding agriculture and the retail trade)	Independent but wholly financed by Government	1. Usually not 2. Interest is charged	£630,000 (COSIRA) £141,000 (SICRAS)	HM Treas (through t Developm Commissi

greater, because he is unlikely to regard himself as a businessman at all, and may well have chosen his way of life precisely to avoid the stresses and routines of business. He enjoys working with his hands and making things of beauty, and would ideally like to spend all his time doing it. Furthermore, he is unlikely to be skilled or interested in the functions of business management. We are told that his salesmanship is commonly very weak. The Director of the Crafts Council told us that selling is crucial to the success of independent craftsmen but "they do not know how to sell. When they do try to sell they waste a lot of time going to see this person or that, making long journeys". A successful designer of jewellery whom we met at oral evidence stated that "what the designer is really about is designing things and seeing that they are made properly. As soon as one starts to employ people one very quickly becomes and has to become a businessman essentially. Therefore we spend all our time sitting in an office filling in bits of paper rather than actually sitting down at the bench or drawing board doing what we set out to do. This is the situation one finds onself in purely so that the business can survive. I would rather be sitting at the bench or indeed spend all my time at the drawing board. Probably 60 per cent of my time is spent at the desk surviving".

11.4 If the independent craftsman felt he could take employment in a larger organisation which offered him the same satisfaction and scope for developing his skills, and so make his special contribution to society in that milieu, there would be little problem. Many craftsmen, however, would not willingly give up their independence. If forced to do so by circumstances their creativity, and hence their contribution, would suffer. Independence is in itself an attraction, as it is to other small businessmen. There is in addition a distrust of industry. The Director of the Crafts Council stated: "there is a very considerable degree of satisfaction to be gained from independence. Because you are to that extent a free man. You can work when you want to work, and you need not work when you do not want to. The craftsman has been afraid. He has felt that industry was swallowing him up and would not allow him any freedom or any creative ability". This fear is perhaps misconceived but it is a real factor nonetheless, and we respect his insistence on economic independence even at the cost of harder work and, probably, poorer rewards than might be available in a big company. We think it extremely important that this route to independence should remain open, for social and cultural as much as for economic reasons. Unfortunately, there is comparatively little that Government or any outside body can do to help the craftsman; his difficulties, like his rewards, are inherent in his situation and he would not exchange his troubled freedom for secure dependence. His main need is for an appreciative public to buy his wares, and this cannot be provided to order.

11.5 The only policy of Government about which we received serious complaints from craftsmen was the operation of Purchase Tax, which gives rise to three problems:

i. Certain craft products, notably jewellery and articles of precious metals, are classified as luxuries and are subject to the highest rates of tax, whereas the tax on competitive mass-produced products may be much lower;

if the headmaster is not interested, then it is out". The contents of school curricula are of course far beyond our terms of reference, but we think it will be generally agreed that both in social and economic terms there is much to be gained from encouraging respect and feeling for skilled handwork among the young.

11.8 In recent years the Government has also supported the craft industries more directly, by providing money to some of the representative bodies in the field. From 1966 to March 1971 the Board of Trade and its successor the Department of Trade and Industry made an annual grant of £10,000 for the promotion of the crafts, of which £5,000 went to the Crafts Council, £4,000 to the Craft Centre and £1,000 to the Scottish Craft Centre. The Crafts Council exists to foster public understanding and appreciation of the value of craftsmanship, to which end it organises travelling exhibitions of craft work, national publicity through the mass media and general educational programmes. It also maintains a "Craftsmens' Index" for the use of potential buyers, in which are recorded the capacities and interests of all working craftsmen known to the Council. The Craft Centre and its Scottish counterpart are essentially shops in which craftsmen can exhibit and sell their products. They also provide help in exporting, particularly in assisting craftsmen to exhibit overseas. It is obvious that an annual grant of £10,000, shared between three such bodies, can serve little practical purpose other than to demonstrate the benevolent interest of the Government in the crafts, and the withdrawal of the grant, which was explicitly provided on a short term basis, has therefore done no great harm to the cause of the craftsman. The Board of Trade, which had no special responsibility for the crafts, made it clear that its concern was not with the crafts in general, but with their potential contribution to industry and exports. Since the Department of Education were equally unwilling to accept departmental responsibility for the crafts outside the education system, responsibility remained ill-defined. We are glad that this unsatisfactory situation has now been resolved, with the assumption of responsibility by the Department of Education and Science. In our view this is the proper location for it, since it makes sense to place the crafts on the same footing as the arts, for which the Department is also responsible, and since the essential contribution of the crafts is more cultural than economic. However we should like to see the new responsibility, and the residual interest of the Department of Trade and Industry, unequivocally and publicly spelled out; it should not be a subject for inter-departmental horse-trading. We do not know whether the Department of Education and Science will think it proper or necessary to give financial support to the independent craftsmen. We hope that this will not be ruled out, if a need is established, for many benefits flow from the existence of a flourishing crafts industry. We do not think our readiness to contemplate support for the crafts inconsistent with our general rejection of subsidies for small businessmen. In this respect we consider that support for the crafts is justifiable on the same social and cultural grounds as is the excellent service to rural industry provided by the Council for Small Industries in Rural Areas and its Scottish counterpart and to the arts by the Arts Council. Respect and care for these values is in our view obligatory for any rich and civilised nation. Since a lively crafts sector may also produce substantial economic benefits, complementing the contribution of the arts to the promotion of tourism, we think that effective, if modest, financial support is well worth consideration.

firms will face in this field in future, for it appears that there are to be profoundly important changes in the methods used by the Bank of England to control the banking system, which should obviate the need for lending ceilings in the future. In their discussion paper "Competition and Credit Control", published in May 1971[1], the Bank propose the replacement of the present system of direct controls by means of ceilings on bank lending, by a system based on a modified form of reserve ratios and special deposits, which is to be applied universally to all banks, with similar arrangements for finance houses. The Bank also propose that the clearing banks should abandon their cartel agreements on lending and borrowing interest rates. The main purpose of these changes is to introduce much greater flexibility and competition into the banking system and to bring about a more efficient allocation of resources. The new methods of control will involve greater reliance on techniques acting directly on the money supply both through "open market" operations and through alterations in the role of special deposits. We believe that on balance the change will be of benefit to the small firm sector. We have nevertheless thought it right to discuss the effects of lending ceilings at some length, since they go far to explain the financial difficulties of small firms in recent years and since there is always a danger that a return to the direct control of bank lending will again come into consideration. If that were to happen we should wish it to be known how direct controls have affected the small firm sector.

The use of external finance by small firms

12.3 In order to assess the adequacy of the provision made for small firms by the financial institutions, it is necessary to place the small firms' need for external finance in the context of the financial structure of the sector as a whole and to take a view on what it is reasonable for the small firm to expect of the institutions. External finance of all kinds comprises a very small proportion of the total capital employed in the small firm sector; as we saw in Chapter 2, long term loans together with bank loans and overdrafts accounted for about 14 per cent of the total assets of the firms in our sample survey, compared with 19 per cent for quoted companies. These average figures are misleading, however, since in the case of small firms they conceal extremely wide dispersions—from nil borrowing in a very large number of the smallest and static companies to very heavy borrowing indeed among the fastest growers. In general, nevertheless, internally generated funds are an even more important source of finance for small firms than for large, and the role of the institutions in providing for them is necessarily limited. The joint stock banks are the most common source of funds, yet about half the respondents to our postal inquiry had no overdraft facility. As regards other institutional sources, the Merrett Cyriax Survey[2] found that in manufacturing industry no less than 92 per cent of their respondents "had not been concerned in any attempt to obtain finance through financial institutions other than their local commercial bank" and that "in the service sector *no* attempts at all had been made by respondents to obtain finance from institutions other than the commercial bank". These remarkable findings can be accounted for by three main factors.

[1] Reprinted in *Bank of England Quarterly Bulletin*, June 1971.

[2] Research Report No. 12, *Dynamics of Small Firms*, by Merrett Cyriax Associates.

be acquired, and second, an adequate level of profit after tax for reinvestment. High rates of taxation, and still more the severe inflation of recent years, have been making it increasingly difficult for these conditions to be met. This is demonstrated in our discussion in Chapter 13 of the taxation of "notional" profits arising from inflation. These fundamental problems could not be remedied by any conceivable reform or expansion of the financial institutions: nor could the institutions replace owners' capital to a major extent, even if funds for that purpose were made available, without destroying the essential character of the small business. It must therefore be understood that the proper role of the institutions is limited and that it would be quite possible for them to be fulfilling that role admirably while yet the small firm sector was in a state of decline because of a lack of capital in private hands. Not all financial problems are capable of solution by institutional means.

12.5 The contribution of the financial institutions is nevertheless of crucial importance, for though "external" funds comprise a very small proportion of total assets employed in the small firm sector, institutional funds tend to be concentrated on the more efficient, expanding firms. Given the increasing difficulty of financing start-ups and growth out of personal wealth or retained profits, it seems likely that such developments will in future depend increasingly on the injection of finance from outside to supplement the initial investment of the founders. The dynamism of the sector is thus intimately related to the adequacy of the provision made for it by the institutions. This brings us back to the question posed at the beginning of this chapter, which might be rephrased as follows: "Are the financial institutions capable of meeting and are they in fact meeting, the proper capital requirement of the small firm sector?"

The Macmillan and Radcliffe Reports

12.6 This question has been considered by two earlier committees. The Report of the Macmillan Committee on Finance and Industry,[1] published in 1931, identified the phenomenon which became known as the "Macmillan Gap"—that is, the lack of provision for small and medium sized firms of long-term capital in amounts too small for a public issue. The relevant paragraph of the Report (paragraph 404) ran as follows:

> It has been represented to us that great difficulty is experienced by the smaller and medium-sized businesses in raising the capital which they may from time to time require, even when the security offered is perfectly sound. To provide adequate machinery for raising long-dated capital in amounts not sufficiently large for a public issue, i.e., amounts ranging from small sums up to say £200,000 or more, always presents difficulties. The expense of a public issue is too great in proportion to the capital raised, and therefore it is difficult to interest the ordinary investor by the usual method; the Investment Trust Companies do not look with any great favour on small issues which would have no free market and would require closely watching; nor can any issuing house tie up its funds in long-dated capital issues of which it cannot dispose. In general, therefore, these smaller capital issues are made through brokers or through some private channel among investors in the locality where the business is situated. This may often be the most satisfactory method. As we do not think that they could be handled as a general rule by a large concern of the character we have outlined above, the only other alternative would be to form a company to devote itself particularly to these smaller industrial and commercial issues. In addition to its ordinary capital, such a company might issue preference share capital or debentures secured on the underlying debentures or shares of the companies which it financed. The risks would in this manner be spread, and the debentures of the financing company should,

[1] *Report of the Committee on Finance and Industry*. Cmd. 3897.

Radcliffe recommended that the joint stock banks should be ready to offer term loan facilities "as an alternative to a running overdraft for creditworthy industrial and commercial customers". Secondly, it was recommended that the upper limit on the size of transactions in which ICFC were permitted to engage "should be reviewed in the light of the change in the value of money since it was first fixed at a level at which it will once again correspond to the lowest practicable amount for market issue". Thirdly, Radcliffe recommended the creation of a Corporation "to facilitate the commercial exploitation of a technical innovation". As a general point, the Radcliffe Committee suspected that the small business community lacked information on the financial services available through ICFC and its competitors.

12.9 Each of Radcliffe's three specific recommendations has since been implemented in some form. Term loans are now provided by all the Clearing Banks, official credit policy permitting, either directly or through their subsidiary and associated companies; moreover we believe this business would have developed much more rapidly in the absence of official ceilings on bank lending. There is now no formal upper limit on the size of ICFC's investments; their initial investments may be as high as £350,000, with further support, if needed, up to £500,000, or more in exceptional cases. The "technological gap" has been met, at least in part, by the creation of new institutions such as Technical Development Capital Ltd, now an ICFC subsidiary, which has provided some £5 million of high risk finance to small and very small businesses for whom innovation is the *raison d'être*. Whether these attempts to fill the gaps noted by Radcliffe have been wholly successful is a question we shall consider later in this chapter, but the fact remains that they have been made. In addition there has been, since 1959, a remarkable expansion in the number of bodies providing finance and, more particularly, in the number of services they offer. ICFC itself has expanded its branch system and has now 18 branches. The last 10 years have thus been a period of rapid growth and change in the capital market. Many of the new developments are irrelevant to the needs of small firms: nonetheless the willingness of the institutions to cater for smaller customers is attested by the emergence of a number of venture capital companies specialising in small firms, by the expansion of the London merchant banks into the provinces, by the development of local merchant banks or issuing houses in most major cities, and by the entry of the clearing banks into new types of business through the acquisition of hire purchase companies and other specialist subsidiaries. On the face of it, therefore, the flexibility of the capital market and its ability to meet new demands as they arise need no demonstration.

Evidence on the current position

12.10 Notwithstanding all these improvements in institutional arrangements, our early investigations revealed a very widespread belief that the institutions were failing to meet the legitimate capital requirements of the small firm sector. Eight hundred and three out of 1,724 respondents to the CBI questionnaire in late 1969 claimed that shortage of finance from external sources had been a major impediment to their expansion in the preceding three years. The same complaint

12.12 It seemed to us important to discover whether it is true that lending ceilings have caused special harm to small firms, since in one form or another these or similar restrictions have been a recurring factor in economic policy throughout the post-war period. We also needed to establish whether or not, in the absence of the ceiling on bank lending, the UK financial institutions would be capable of meeting all legitimate demands from small firms at rates of interest not excessive in relation to those which larger firms are expected to pay—in other words whether or not it is true that the Macmillan Gap has finally been closed. If it were found that a significant number of small firms judged to be creditworthy by some objective criterion are refused finance for projects which appear likely to be profitable, or are offered it on terms which are onerous in relation to the comparable rates charged to larger firms, it would be fair to deduce either that the institutions are being excessively cautious or that there are some legitimate demands which they are incapable of meeting. We felt it impossible to answer these two questions on the strength of the written and oral evidence we collected because we saw no means of reconciling fundamental differences of opinion. We therefore decided to commission a programme of research on the adequacy of financial provision for small firms. The Economists Advisory Group were chosen to carry out the research and were given the following terms of reference:

i. to produce a detailed survey of institutions providing finance for small firms and of the availability of the various types of finance;
ii. to identify the main reasons for failure to obtain adequate finance;
iii. to consider the effects of credit restrictions on small firms;
iv. to investigate the information available to small firms about the alternative sources of finance;
v. to make comparisons with the situation in other major countries, mainly by desk research;
vi. to make suggestions for improving facilities.

The Report of the EAG is published in its entirety as Research Report No. 4. It also provides the basis for much of the remainder of this chapter, which incorporates, in a highly condensed form, most of the factual results of the EAG survey. Their judgements, and our own, will emerge from the discussion which follows of the various financial services available.

Sources of finance

12.13 We now pass to a consideration of the various types of institutional finance available to small firms under the three broad categories of short, medium and long term capital. This section of the chapter is intended both to give expression to our views on the adequacy of the existing sources, and to provide small businessmen with basic information on the options open to them and the borrowing conditions they must expect to meet. In a Report of this kind it is impossible to provide a complete catalogue of the services available or a list of the institutions providing them: continuous and rapid changes in the capital market and in interest rates speedily render all such guides out of date, and they must

used by the Bank of England to control the banking system. We must assume that the proposals set out by the Bank will in fact be accepted as the basis for a new framework of controls in which lending ceilings will have no part. Since we believe that small firms have suffered differentially from ceilings on lending, their disappearance is to be welcomed. The eventual outcome of the new system seems likely to be that credit will be more freely available to the small firm than hitherto but at higher rates of interest: "rationing" by control of the credit supply will have been replaced by allocation by a pricing mechanism. This can only be speculation, of course, but for some time there have been signs of a move in this direction on the part of the clearing banks, who have increasingly brought their lending rates into line with those of other lenders; it would not be surprising if the introduction of greater commercial freedom into banking were to reinforce this tendency.

12.16 Since the end of the war there have been more years of squeeze conditions than of "normality", for successive Governments have repeatedly restricted the supply of bank credit to industry and the public. This has been done by means of higher interest charges, control of hire purchase transactions, calls for special deposits and the imposition of official ceilings on bank lending. Since 1964 we have suffered the longest and most severe credit squeeze since the war, which in 1969 reached a pitch of acute difficulty for the small firm sector and did much to undermine their confidence in the banks.

12.17 We have no doubt that the squeeze, and in particular the official ceilings on bank lending, have operated differentially against the small firm in several respects. First, those small firms which borrow at all (and very many do not) are relatively more dependent on bank finance than large firms, which have more alternative sources open to them. Even if a squeeze were administered with complete impartiality, therefore (say, in the form of a 10 per cent cut in all overdrafts) it would present more severe problems for the smaller customers of the banks. Second, the banks had perforce to interpret the official priority in favour of exporters as applying to *direct* exporters only. Since proportionately fewer small than large firms are direct exporters, most of them were outside the priority category. In this respect the distribution and construction trades (where small firms are particularly important) were hit hardest. Third, the general standard of creditworthiness imposed by the banks rises in times of credit squeeze and more new or marginal borrowers, who are most frequently small firms, are refused. Fourth, there is some evidence that when credit is rationed large firms may preempt, by virtue of their greater bargaining power with the banks, a larger share of the total. Fifth, the development of other facilities, such as term loan services, which would have been of special benefit to small firms, and which would otherwise have been provided by the banks and the Finance Houses, was probably held back by the ceiling. All this was of less consequence to large firms since they have had access to the Euro-Dollar market. These findings are broadly in line with those of the Economists Advisory Group. Moreover, the Radcliffe Committee, who considered this question in relation to earlier squeezes, also found that:

> Witnesses generally agreed that the credit squeeze bore more hardly on smaller firms than on larger; this impression was confirmed by the FBI and ABCC surveys . . . The smaller

size, either of borrower or loan, is applied; in this, as we shall see, the overdraft facility is almost unique, so that for the smallest firms it may genuinely be the only available source of institutional finance. Most small firms will be expected to put up some security, as well as showing good trading results and competent management, but we were told that banks occasionally help firms whose security is weak out of serious financial trouble if they have confidence in the manager and also assist new ventures by means of overdrafts. Traditionally overdrafts are advanced only for short term purposes, and the banks prefer all accounts to be in credit for part of every year. This short term character, and the possibility that the facility will be withdrawn at short notice, are serious disadvantages in theory, but in fact the overdraft facility of a viable firm is rarely terminated completely and some advances run on until they become in effect medium or long term finance—so that the borrower may come to rely on them as a permanent part of the firm's capital. Interest rates are normally related to bank rate, with a narrow spread to take account of risk. Until very recently—that is, until the latter part of 1969—the most favoured borrowers (such as nationalised industries and major companies) have normally paid 0·5 per cent over bank rate and the smallest and most risky 2 per cent over. Even at the upper rate, therefore, some firms were obtaining medium or long-term finance very cheaply by comparison with rates charged in other markets. This is essentially the picture as seen by the Radcliffe Committee, who were satisfied that the clearing banks could continue to meet through the overdraft system most of the needs of the small firm up to a limit of about £5,000.

12.21 This picture is now changing significantly, partly under the stress of the credit squeeze, particularly the unhappy experience of 1969, but mainly because of fundamental changes in banking policy. The credit squeeze revealed the unwisdom of allowing overdrafts to be regarded as, in effect, medium term or even permanent capital. Many small firms have become accustomed over the years to the availability of bank finance at interest rates which by comparison with rates for other forms of finance were unrealistically low. They have rarely been pressed to fund these overdrafts or convert them into more conventional medium term finance. The withdrawal of the overdraft facility, or reduction of the limit, which happened to very many small firms in 1969, accordingly came as a severe shock, which strained relations between the banks and their customers. Our postal survey, carried out at the end of 1969, showed that 30 per cent of the firms which enjoyed overdraft facilities had suffered a cut in their overdraft limit in the twelve months preceding the survey. Respondents were asked to state whether their limits had been cut, maintained or increased. The replies received from manufacturers were as shown in Table 12.I.

TABLE 12.I

Alterations in overdraft facilities in previous twelve months

	Percentage of firms with overdraft facilities
Overdraft limits reduced	30
Overdraft limits maintained	56
Overdraft limits increased	14

Source: Committee's Questionnaire Survey, Research Report No. 17.

transaction costs, per £ lent, of small advances are undoubtedly higher than for larger ones. We anticipate that, where the small firm formerly paid perhaps 1 per cent more for its overdraft than a large firm, the differential is likely to be larger in future. We see no means of averting these developments, which in fact may not work wholly to the detriment of the small firm sector; we believe that in the past many small firms which would have been able and willing to pay more than the going rate for overdraft finance (and indeed were already doing so in respect of some of their borrowings, e.g. on HP) may have been denied it because the traditionally narrow spread of interest rates made the business relatively unprofitable for the banks. Moreover as overdraft rates become relatively higher, some larger firms might turn increasingly to other sources available to them, leaving a greater volume of clearing bank loans for small firms.

12.23 We reject the idea that small firms should be given preferential treatment within any ceiling on bank lending (as has been given to exporters, for example) on the ground that to create a new, and large, class of privileged borrowers would distort the capital market even further than the ceiling already had. Furthermore, it would be simple for "privileged" credit extended to small firms to be siphoned off by large firms insisting on longer credit. It would also be very difficult to identify genuine business borrowing and thus avoid subsidising what would in effect be personal loans to businessmen, and there would be an element of inequity as between different industries, since some inevitably borrow less than others. Most important of all, to exempt small firms from the squeeze, thus narrowing still further the basis on which it is applied, would seriously aggravate the position of others remaining outside the priority categories. In any case, we take it that official policy now favours the abandonment of lending ceilings as a tool of monetary policy.

Bill finance

12.24 In law, a bill of exchange is "an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinate future time, a sum certain in money to or to the order of a specified person or to the bearer" (Bills of Exchange Act 1882). A bill is normally drawn by the seller of goods or (in the case of a finance bill where no goods change hands) by the person raising finance. The person receiving a bill may either "accept" it (by signing) himself or pay a commission to a bank or accepting house to do so on his behalf. In the first case the document is known as a "trade bill", in the second as a "bank bill". When a bill is accepted it becomes a negotiable instrument and can change hands by endorsement. Firms may use bill finance in three ways:

i. By themselves obtaining acceptance credits.
ii. By drawing on customers who have acceptance credits.
iii. By drawing and discounting trade bills.

Only the last two of these are effectively available to small firms. The accepting houses are normally very reluctant to give acceptance credits to them, so

... the client's approved customers, commonly advancing at this point 80–90 per cent of the value of the relevant deliveries and making a charge for interest and service. He then collects from the customers on his account at the due date, remitting to the client the outstanding balance. The main advantages of factoring for small firms are that it provides ready money at the time of the delivery of goods and that it relieves them of the costs of collecting and accounting for debts. Furthermore, there is normally no recourse against them if the debt goes bad; the factor assumes both the onus of collection and the risk of loss. The size of client is largely immaterial: a small client with a few large, sound customers is more acceptable than a large client with many small customers. However, though some factoring firms will go lower for clients with particularly good growth prospects, the factor will generally require that a client should channel through him a minimum turnover of £100,000 a year, that there should be an average annual turnover per customer of at least £1,000 and an average invoice value of at least £100. For these reasons very small and retail firms cannot effectively make use of factors and the service is in fact mainly confined in this country to manufacturing industry. These limitations on the size of accounts accepted stem from the fact that the overhead costs of investigation and administration involved in running each account are very high, and we can see no remedy for them.

12.27 If considered purely as a means of raising finance, factoring is undoubtedly expensive, but its cost is not directly comparable with other borrowing rates because a substantial proportion of this cost is a charge for accounting and collection services and for 100 per cent credit insurance on approved customers, compared with 85–90 per cent cover offered by the conventional insurance companies. The costs of investigating the creditworthiness of the customers of a potential client are very high—it is said that 40 per cent of a factor's staff are likely to be involved in credit rating work—and the recording and collection of debts is also expensive. The total charge therefore reflects two elements—an interest charge on the advance of the money (usually 2–4 per cent over bank rate on the balance outstanding), and a service charge for credit control and collection, bad debt insurance and other financial and general management services. Whether or not it is worthwhile for a client who has other options open to him to pay these charges depends largely on the efficiency of his own accounting and debt collection procedures. If he is not well organised in this area, the factor's services may be well worthwhile. Some clients, of course, have no option; one of the great values of factoring is that it may be available even to firms which have difficulty in qualifying for bank advances. Furthermore the facility increases as the company expands so that the small firm may have the chance of expanding at a rate which their own cash and clerical facilities would not permit. We know of no evidence that small firms generally pay higher charges than others, though the rates charged do tend to vary inversely with the size of turnover in the account.

12.28 Though the total amounts involved are small, the larger small firms account for a high proportion of factoring turnover. The annual turnover in factoring has been estimated at between £150 million and £200 million, and it is estimated that the proportion going to small firms is at least two-thirds. Thus the potential value of this service to firms at the top of our size range is substantial. The effect of credit restrictions has been to reduce the total volume of credit

repayable before the due date. The Radcliffe Committee considered the effective absence of term lenders unfortunate, since they recognised that for some purposes the term loan is preferable to the overdraft in that it is not liable to recall or reduction at short notice. Radcliffe accordingly recommended that "the banks should be ready to offer term loan facilities within reasonable limits, having due regard to their liquidity requirements, as an alternative to a running overdraft for creditworthy industrial and commercial customers". This recommendation bore fruit in that several clearing banks established formal term loan schemes for small firms: although these schemes fell into abeyance owing to the lending ceiling, all of the clearing banks now offer term loans, either directly or through their subsidiary and associated companies. Term loans are also available from finance houses, from specialised institutions like the ICFC and to a small extent from the other banks. As we mentioned earlier in this chapter, there is now a growing tendency for the clearing banks to press their customers to replace "permanent" overdrafts by term loans. In most respects the banks or their term lending subsidiaries are closely comparable with the independent finance houses and merchant banks offering the same service, but their potential importance is obviously much greater since the resources at their disposal are so large. Because it cannot yet be seen what the institutions could do given freedom from credit restrictions, it is too early to quantify the amounts which may be channelled into this form of lending.

12.32 The obvious advantages of the term loan are that it cannot be recalled in advance of its stated maturity and that it improves the short term creditworthiness of the borrower. Compared with the "running overdraft", however, it has some disadvantages. First, the standard of creditworthiness required by term lending institutions is higher than that applied in overdraft financing—reasonably enough, since the money will be committed for a considerable time. It is normal to require a cash-flow forecast covering several years ahead to ensure that the loan is capable of being repaid, and for larger loans a fairly detailed accounting investigation may be necessary. Secondly, term loans are generally significantly more expensive than overdrafts. Finally, term loans lack the flexibility of overdrafts; repayments must be met on the due date however well or ill the borrower's business is doing, so that there are dangers in a high degree of indebtness of this sort. On a more general level, American experience suggests that the term loan lends itself rather better than the overdraft to squeeze policies: the difference is that the squeeze is automatic, since the rate of repayment by instalment is fixed in advance and the facility may not be renewed. It is by no means certain, therefore, that the replacement of overdrafts by term loans for all medium term purposes would be to the advantage of small firms. Some may find it more difficult, and all will find it more expensive, to borrow by this method. Nevertheless, on balance we believe that it is right that borrowers, including small firms, should pay the economic price for loan capital, since there is no other way of ensuring efficient allocation. It is also dangerous for small firms, as we have seen in the past few years, to rely on an overdraft as part of their permanent capital. We therefore see no reason in principle to object to the switch from disguised to open medium term lending by clearing banks.

the fear from time to time that the development of its business might be hampered by difficulty in raising funds during the credit squeeze, it is currently investing at the rate of over £30 million per annum—more than six times the average rate for its first 15 years of existence. ICFC would not claim to be the only source of such loans—they have many competitors in this field. The Economists Advisory Group found that there is a large number of institutions supplying medium term capital in different forms and that there were no barriers other than the credit ceiling to the entry of new ones. In spite of this, the EAG found that the total supply of medium term funds to small firms is small, and that a high proportion of small applicants is refused.

12.38 This finding contrasts strangely with the experience of the Midland Bank with their Term Loan Scheme, which was specially directed to the provision of small loans, with a maximum of £10,000. The progress of the scheme, which started with total funds of £1 million, was disrupted by the credit squeeze, but even allowing for this the response from the small firms at which it was aimed was disappointingly poor. This makes it difficult to sustain the proposition, referred to in the first paragraph of this chapter, that there was a large unsatisfied demand for small term loans. The bank found that the scheme aroused only slight interest, and it never accounted for more than about 0·1 per cent of their total lending. Since 1969 the scheme has been in abeyance. It appears that most loans were made to very small manufacturing businesses, usually for the purchase of equipment, and that most borrowers were already customers of the bank. It is difficult to draw conclusions for the future from the comparative failure of this scheme since we cannot gauge accurately the effects of the credit squeeze on firms' ability to borrow, nor of the fact that for most of the period overdrafts, both cheaper and more familiar, were freely available. It does suggest, however, that term loan schemes directed specifically towards small firms may be difficult to run successfully. This is borne out by the fact that although all the clearing banks now offer term loans for between three and seven years, in some cases through subsidiaries specially set up for the purpose, on the whole they avoid lending in very small sums. There appears however to be a welcome move towards making smaller sums available.

12.39 There is one further problem which ought to be mentioned though at this point it can only be hypothetical. This is the possibility that, even after the removal of credit restrictions, the institutions will be unwilling or unable to lend on acceptable terms to small firms because the risks and the overhead costs of doing so are held to outweigh any interest rate differential which could be charged. At present the institutions require a higher standard of creditworthiness for term loans than for overdrafts and it may be that the average small firm which now has no difficulty in sustaining a running overdraft would be unable to meet this higher standard. We do not believe this to be likely, but we return to this question later in the chapter.

Hire purchase and leasing of equipment

12.40 Instalment credit is an important source of medium term finance. In January 1971 the total instalment debt in Great Britain was £1,377 million. The

hire purchase, but there are differences in tax treatment and a down payment is normally unnecessary. This activity has grown rapidly in recent years; finance house assets in leasing roughly trebled from June 1966 to June 1970, and rose from 5 to 15 per cent of total instalment credit. However, leasing is as yet little used by small firms. This may be due to lack of information—the finance houses seem to make little effort to publicise this aspect of their services among small firms—but it also reflects a slight tendency to regard small firms as marginal business, no doubt due to the higher relative cost of marketing the service to them. There are many types of leasing, and it is dangerous to generalise about them, but some at least are eminently suited to small firms urgently needing capital. One of the most interesting is manufacturer's leasing, whereby a manufacturer's products are offered automatically for leasing by customers under a guarantee provided by himself. In such cases the manufacturer's guarantee may obviate the need for investigation of the lessee and the manufacturer will assume responsibility for final disposal of the goods: amounts of £200 or even less may be available in these circumstances. Where equipment has a high resale value (typewriters are a good example) advances of £100 or even less are common without a manufacturer's guarantee. Otherwise, the minimum size of transactions tends to be dictated by the cost of the equipment in question and the overhead cost of the transaction: £1,000 is often quoted as a normal minimum. Most leasing companies apply no minimum limit to the size of the customer, though one requires net assets of at least £10,000. The essential criterion, again, is creditworthiness, and the normal test of this is a good profit record over at least three years, backed up by accounts, always assuming that the requirement is in reasonable scale with the size of the customer's business.

Long term finance

12.44 In this section of the chapter we are concerned with equity capital and long term borrowings. There are two important forms of fixed-charge borrowing at long term; mortgage finance and the facility known as sale and leaseback.

Mortgage finance

12.45 Mortgage loans are principally available from insurance companies and pension funds. These are very important providers of long term capital to industry in general; indeed, the insurance companies are collectively the largest single source of long term finance, and pension funds collectively are next in importance. However, neither is a significant source of capital for small firms other than by the provision of mortgage loans, which are the only facility they offer which is readily available to the small firm; only the insurance companies do a significant volume of business of this kind. Even so, the standard of security and the quality of trading results required by the insurance companies before they will lend are such that comparatively few small firms can meet them. In general, moreover, most companies observe a minimum loan size of £25,000 to £50,000.

12.46 We are glad to learn that one insurance company has recently instituted a small mortgage loan scheme, which began to operate on a national basis in October 1970. This scheme differs from the typical mortgage loan facility in that

One of these is the growth of the stock exchange as a channel through which individual and corporate savings may be invested in industry. This is a comparatively recent development: the number of UK industrial companies with shares quoted on the London Stock Exchange in 1885 was barely a hundred, and at that time a stock exchange purchase would have been regarded by many people as a highly speculative venture. It is possible that those with capital to invest might more often have looked for opportunities among local firms of which they had some knowledge, which would frequently mean small firms. The position today has been completely transformed. There are now some 4,000 companies quoted on the stock exchange in the UK and they account for a large proportion of the income and capital expenditure of the company sector. Safeguarding legislation and stringent stock exchange regulations have made investment in quoted securities comparatively safe to make, because risks can be spread, and investments are relatively easy to realise; nowadays an investment in an unquoted company is likely to be regarded as speculative, and for the private individual it is very much more difficult to make. Furthermore, the stock exchanges are well adapted to make use of the small savings of the average modern investor, whereas an individual outside investment in an unquoted company must be of some size to be worthwhile from the company's point of view.

12.51 The second major development which has channelled funds into major quoted companies is their greatly increased attractiveness to the institutional investors who are now responsible for the most important investment decisions. The great bulk of personal savings are now vested in life insurance companies, pension funds, investment trusts and unit trusts. (The tax system offers a strong incentive to save by means of an insurance policy or through a pension fund.) These institutions handle very large sums and make investments in relatively large lumps: the proportion of their total investment passing into the equity of small companies is very small.

12.52 Very few private individuals are now able to invest substantial sums, in the region of £10,000, say. High and progressive rates of taxation have seen to that. Of those who can, very few again are willing or capable of making the considerable effort that is necessary to find and invest in a promising small company; investment decisions will normally be taken on the recommendation of stockbrokers who will normally recommend investments in quoted companies. This is the cause of the phenomenon referred to by many witnesses as the disappearance of the "rich uncle". This is not to say that the role of the private investor is unimportant. Capital is still very often raised from friends and relatives of small firm proprietors. Many solicitors and accountants are ready to put clients with funds to invest in contact with a good small firm needing to raise capital, and there is an important, though small-scale, activity by certain issuing houses and stockbrokers who will make private placings of unquoted shares.

12.53 If we leave aside the approach to a private individual, there are two ways in which equity capital can be raised. A company may apply for quotation on a stock exchange and then issue shares to the public, or it may seek institutional participation.

outstanding growth prospects. The second and third types of investment are normally referred to indiscriminately as "venture capital", but we prefer to reserve this phrase for the third—the most difficult and hazardous—type and we therefore refer to the second as "equity participation". The important differences between these three situations arise from the motivation and expectations of the participants on both sides.

12.56 *Nursery finance.* Some institutions, including the merchant banks, venture capital houses and some stock exchange firms, will take equity in companies not yet able to go public but showing good promise of doing so in the near future. Most stockbrokers do not invest their own funds in these situations but a few will place their clients' funds in promising unquoted securities if asked to do so. The greatest importance is attached to prospects of "going public"—probably within two or three years—and the conditions looked for are those necessary for a successful public issue: prospective earnings of about £150,000 before tax (occasionally less) and outstanding growth prospects. Finance is normally provided in the form of a mixture of equity and convertible loan stock. Only a select few of those who seek nursery finance are accepted, and a good proportion of these will never reach the stage of public issue. The number of unquoted companies with any prospect of going public within, say, five years is of course very small.

12.57 *Long term equity participation.* We use this phrase to mean the investment of risk capital in established companies whose prospects of going public are a good deal more remote and uncertain than in a typical "nursery" situation —and whose owners may have no intention of going public. Whether the finance provided is equity, a long term debenture or loan stock with an option to convert into equity, or, perhaps most commonly, a mixture of the two, for the recipient it has all the advantages of a permanent addition to his capital. It also has one disadvantage which is regarded by most private companies as very serious: it involves surrendering to an outsider some part of the control of the business and parting with a share of the future growth of the business. Because most small businessmen have strong misgivings about parting with equity, they will usually accept such participation only if no other means of raising the long term capital they need is open to them.

12.58 There are a number of institutions in the UK which will on occasion make investments of this kind. They include some of the issuing houses and specialist venture capital houses. Of all these sources, ICFC is by far the most important provider of equity capital to small businesses. Most of the institutions impose minimum size requirements which exclude nearly all small firms as we have defined them. It is easy to see why this is so if one examines the nature of the operation. To invest at long term, and especially to take equity, in a small unquoted business, is to tie up capital for many years and perhaps permanently, for there is no ready market in unquoted securities and therefore no guarantee that capital invested in them can be realised. Furthermore, both administrative costs and risks are inversely related to the size of the investment. Investment of this kind cannot normally be recompensed adequately by a fixed-interest charge alone, for the rate needed would be beyond the power of most small firms to pay.

management charge to cover overheads but none is able to offset in this way all the costs of investigating small customers. These costs also must be met out of the proceeds of the occasional highly successful investment.

12.62 Equity capital is often sought for purposes other than expansion. One such purpose is to provide capital for payment of death duties without breaking up the firm or making a public issue. Certain institutions, of which the best known is the Estate Duties Investment Trust, a quoted company managed by ICFC, will in these circumstances buy a minority interest in the equity and so provide cash to meet estate duty when it arises. The Estate Duties Investment Trust was set up in 1952 specifically to meet this need. Since it is not normally prepared to invest less than £20,000 in any company and will never hold more than a minority interest, the Trust's investments are effectively restricted to companies earning profits before tax in the range upwards of £15,000 per annum. Equity holdings of this kind must be attractive investments in their own right, and the Trust therefore examines very critically the future prospects and past trading record of applicant companies, paying particular regard to the provision for management succession. ICFC can normally provide the same services for companies below the Trust's preferred minimum size. The demand for these services has remained much more static over the years than that for ICFC's other services, but the number of companies with estate duty problems which are amenable to this kind of solution is naturally limited.

12.63 Many institutional investors make it their policy never intentionally to acquire a controlling interest in any of the companies in which they invest. They are both unwilling and unable to assume responsibility for the day to day management of their client companies, and to do so would be illogical, since above all they are investing on the strength of their estimate of the capability of the existing managers. The size of the equity holding demanded by investors varies considerably: one merchant bank tries to ensure that its holding does not exceed 15 per cent, but 25–30 per cent may be a more typical figure. The proportion of equity to loan capital in the average financing is also very variable, since it is normally the outcome of complex negotiations with the borrower. It is relatively common for investors to require the appointment of a member of their own staff to the board of the borrowing company, partly to watch their own interests but mainly to strengthen the board by providing financial and banking expertise. Where this is not done, it is normal for the appropriate director or executive of the investing company to be permanently "on call" as a source of advice and to attend board meetings when asked. Institutional investors lay great emphasis on the need to back up financial help with management services. ICFC, for example, puts the services of its consultancy division, employing some 70 industrial consultants specialising in such fields as production control, marketing, data processing and executive recruitment, at the disposal of its portfolio companies. Such companies as Charterhouse Industrial Development and other institutions backed by the resources of a merchant bank, are also highly skilled in nursing client companies through the very difficult period of transition from complete proprietorial control to public quotation.

12.64 A distinction can be drawn between those investors who look essentially for capital growth in the short to medium term and those prepared to hold

would be accepted. In 1969, we were told, the number of financings might rise to 8 out of 300, due to increased involvement with the computer-based industries, but the company's investment criteria would remain very stringent. Even so, in their first 20 years the company made twenty winning and twenty losing investments. In money terms, gains greatly outweighed losses, because the rewards of a successful equity investment can be very great and because they were able to get out of losing situations, but the impossibility of combining high returns with safe investments, even for experts, is well illustrated.

12.66 Experience so far in this country suggests that suitable opportunities are at least as difficult to find as in the United States. We are told that on average, out of every ten investments by the venturing institutions, two are "winners", six are "plodders", and two "losers". Given the small proportion of winners, rewards from them must be correspondingly high; this is only possible if the investor has a significant share of the equity. The number of institutions which are active in this field is small, though most of the major financial institutions are associated with the field in one way or another. Though this number may be expected to increase, particularly if renewed growth in the economy leads to rising business confidence, the sheer difficulty of the operation will limit the rate of increase. So also will the relative dearth of young men with some initial capital and the skills and self-confidence needed to set up their own companies in the fields with the greatest potential for growth: our tax system and the mores of our society regrettably are not highly conducive to enterprise of this sort.

12.67 We cannot anticipate any significant improvement in the provision of equity capital for small businesses; it will remain available only to the most promising and successful. To attempt to alter this situation by artificially increasing the attractions of investing in the equity of small firms could be very hazardous In the early 1960s the US Government made a major effort to reduce the risk and increase the attractions of investment in small firms by providing cheap funds and tax advantages for the Small Business Investment Corporations set up under the Small Business Investment Act of 1958. This policy, coinciding with a spontaneous growth of interest in the commercial exploitation of new technologies, resulted in the establishment of some 700 SBICs by 1965. Equity investment in small firms increased—though by less than had been hoped—but the overall experience of the SBICs themselves was very disappointing. In 1967 it was found that most of the smaller SBICs had very poor profit records—only in 1967 did the industry as a whole begin to show a profit, and then it was only 2·4 per cent on capital employed—and 64 per cent of the total net income of the industry had been earned by the top 13 per cent by number, of the SBICs. These tended to be the larger and best-established companies, which had not allowed the availability of cheap capital to corrupt their normally cautious standards of judgement. We were told that the SBICs have been inadequate—except in a few isolated instances or, by and large, in cases of bank-affiliated companies—mainly because of the obvious difficulties of control by the SBA. A number, for instance, have been set up by individuals solely to finance their own companies; many have been inadequately capitalised and, having acquired a few equity investments which they have no hope of selling, have been unable to make further commitments. Even some of the bank-affiliated SBICs have tended to make loans

which they will take the stock into their own portfolio. This "obligation" is entirely unofficial, but it helps to account for the great reluctance of the institutions to issue or place securities in which they believe there will be no effective market. All the costs of share dealings bear proportionately more heavily on low-volume and infrequent dealings; many of them are in any case fixed costs. The consensus of expert opinion is that the level of demand for unquoted securities, and consequently the rate of turnover in them, would be so low as to render an effective market impossible.

12.72 We share this view, and we are not persuaded by the often quoted example of the American "over the counter" market that a more formalised market in unquoted shares in this country would improve matters. It is well known that in the United States such shares are sold "over the counter" by many jobbers and brokers to the general public, who invest heavily in them. The great majority of American stocks are marketed in this way; indeed, in 1968 only about 1,300 of the 55,000 company stocks in which the public held equity were quoted on the New York Exchange. It would be quite wrong, however, to compare American "over the counter" stocks with the average unquoted share in Britain. Many companies quoted in this way are very large indeed by our standards; few of our quoted securities would qualify for quotation on the major Exchanges in America. Certainly, the "over the counter" market is not much concerned with the securities of very small companies. Of the 550,000 corporations in the USA, only some 10 per cent had stocks in public hands in 1968. Even so, the level of dealings in some publicly held stocks is very low. A study carried out in 1963 revealed that in 433 out of a sample of 1,618 stocks there were fewer than 25 transactions during 1961. These unprofitable lines were being carried on the strength of dealings in the remainder. It appears that the market for really small issues is not significantly better in the United States than in Britain. The existence of an organised market does not in itself therefore ensure the marketability of stocks carried on it. American dealers compensate for low turnover in some stocks by charging commissions that by British standards are very high indeed. This would of course be possible on a British secondary market, but we think it very unlikely that sufficient jobbers or brokers would be prepared to make a market on such terms; at the same time, existing margins and rates of commission are such that, if all the shares in a £250,000 issue were turned over once in a year, the gross profit accruing to all the jobbers, brokers and issuing houses involved could not on the most favourable assumptions amount to more than £6,000, ignoring any possible profits or losses arising from price variations—hardly enough to cover their overheads.

12.73 We do not believe, therefore, that the institutions most concerned would be prepared to operate an "over the counter" type of market on American lines dealing in the stocks of unquoted companies. What is more, we do not believe that there would be significant interest in such a service, if it were provided, on the part of the general public. The number of individuals who now invest directly on the stock exchange, though higher than before the war, is very small. The general public, so far as it participates at all, does so indirectly, through investment in life insurance policies and, to a much smaller extent, investment and unit trusts. The idea that the British public might be brought to exercise its

but it is certain that only considerable effort could ever bring success.

Trade credit

12.76 Trade credit is an extremely important source of working capital, though sometimes a very expensive one, for firms of all sizes. The standard of credit management in much of British industry—not just among small firms—is very poor. This was the unanimous view of the trade protection and credit rating agencies which gave evidence to us. On the one hand, many firms are haphazard in granting credit and slow and irregular in the collection of debts, on occasion even neglecting for weeks on end to submit bills for work done or goods delivered; on the other, many firms fail to take advantage of discounts for prompt payment of accounts, having failed to appreciate that they may thus in effect be paying a very high rate of interest for the credit they are taking. As we have seen in Chapter 2, small firms as a whole both give and receive much more trade credit, in relation to their sales and their total short term financing, than quoted companies. To a large extent, however, this is due to the preponderance of small firms in certain trades where long credit is traditional, such as the building trade, with its multitude of small firms. As between small and large firms in similar trades it appears that there is no great difference in the use of trade credit: manufacturers, small or large, are net givers of trade credit and their ratios of debtors to turnover are not dissimilar; for non-manufacturers, a category dominated by the retail trades, debtors and creditors are more nearly equal.

12.77 These findings are based on our questionnaire survey, and relate to comparative data collected for the financial years 1963–4 and 1967–8. There is evidence that in 1969, the year of greatest financial stringency, small firms were obliged to advance credit to their customers on a much larger scale than in more normal times. We received dozens of well-substantiated complaints that powerful customers—large companies, nationalised industries, even local authorities—were deliberately delaying the payment of bills in order to improve their own liquidity. They themselves were under similar pressure from customers who could afford to keep them waiting: it appears that credit terms throughout industry lengthened in 1969. The Bristol and West of England Engineering Manufacturers Association, referring to the credit squeeze, said that it was "further aggravated by the larger firm which arbitrarily takes extended credit by delaying payment of its bills to the small firm". The Overall Manufacturers Association summed up the position as follows:

> The typical small manufacturer is now facing a situation in which his large customers are taking extended credit at a time when his own bank manager is compelled to refuse normal bank facilities.

The small firm thus found itself doubly squeezed; bank credit was scarce and its trade credit position had sharply deteriorated. It is probably inevitable that in such circumstances small firms will suffer most, particularly those that depend heavily on a small number of large customers. They are in no position to exact prompt payment by taking such customers to court, for the consequence of doing so could be to lose their future business. On the other hand, they cannot easily

the main contractor is required to observe the payment terms of any contracts with sub-contractors. The United States Government achieves this by stipulating that for certain contracts the main contractor will not be paid until he can demonstrate that all sub-contractors have been paid. This system might well be studied here.

12.81 The taking of trade credit by small firms gives rise to no such obvious problems. Indeed, most small firms appear unaware that it presents any problems at all. It should be remembered, however, that to pay 1 per cent or 2 per cent a month interest on outstanding accounts, or to forgo equivalent or larger discounts for prompt payment, is in effect to pay a very high rate per annum for short term working capital. It would usually be cheaper, questions of availability and of security or collateral apart, to borrow money on overdraft or term loan with which to pay off such debts.

Export finance

12.82 The majority of small firms are unable to export directly, because they are in trades which cater, more or less strictly, for local markets. It is well known that the bulk of our exports are contributed by a relatively small number of firms, most of them large; the Report of the Committee on Overseas Representation (Cmnd 4107, July 1969) quotes the CBI as saying that "68 per cent of our exports are sold by 500 companies". Nevertheless, direct exports of small firms are important, and the experience of Japan, a very high proportion of whose exports are manufactured by small firms and marketed through trading companies, suggests that they could be expanded significantly. In this field, as in many others, however, the very size of the small firm creates special problems. Although we have discovered no major problem, and certainly no discrimination against small firms in the field of export finance, it is clear that there are some difficulties here which contribute to the common feeling among small businesses that exporting is more trouble that it is worth.

12.83 The main problem appears to be, not the availability of export credit in the true sense, but an occasional shortage of pre-delivery finance. It is obviously difficult to distinguish between the working capital needed to finance the production of goods for export and ordinary working capital for the home market, and it is clearly right that the Clearing Banks, who are the main source of this kind of finance, should apply proper standards of creditworthiness in this field as elsewhere. However, it can be very difficult for a small firm to finance the extended periods which often elapse between receipt of an export order and delivery of the goods. This will have repercussions on the cash-flow of the exporting business which must reduce its ability to raise finance. It is not easy to see how, within the limitations of the General Agreement on Tariffs and Trade, more could be done in this country to give exporters privileged access to pre-delivery finance, and the technical problems are great. Certainly it would be difficult to justify special arrangements for small exporters unable to raise finance on their own merits; we should not wish to encourage marginal or unprofitable firms to go into exporting.

be done to improve the access of small firms to finance. First, as to the effects of credit restrictions, we find that small firms have indeed suffered differentially, for the reasons given in paragraph 12.17, from the official ceilings on bank lending. Although the full rigour of the credit squeeze was felt only in 1969, and although there are good grounds for hope that direct rationing of credit is unlikely to recur, it must be said that small firms, because of their heavy dependence on the Clearing Banks, will inevitably suffer most from restrictions on the banks' freedom to lend. Second, on the question of the "Macmillan Gap", we have found that the gap postulated by the Macmillan Committee has been filled by the development of institutions such as ICFC, Charterhouse and others, and by the rise of Finance Companies such as the United Dominions Trust. Nonetheless, the market facing the small firm is relatively constricted; there are certain financial facilities available to large firms which are not available to small ones, such as access to the inter-company loan market. Furthermore, for those facilities which are available, small borrowers must frequently pay rather more than large ones; this is true of overdrafts, of term loans, of hire purchase finance and even of equity raised by public flotation. Third, we find it is true that the great majority of small firms are unable to raise capital on the stock exchange: however, neither a "secondary market" nor any other of the remedies suggested would remove this disability.

12.87 Stated thus, these findings appear to constitute a powerful case for intervention to improve the small firm's ability to attract external finance, and many witnesses have urged upon us the necessity of such action. Three alternative courses of action were frequently commended to us:

i. the creation of a new institution with Government backing which would lend at cheap rates to deserving small firms;
ii. the provision of an official subsidy, or an official guarantee, for finance provided by the existing institutions;
iii. the provision of a subsidy to small firms themselves.

It will be noted that each of these proposals involves interference with or circumvention of the existing finance market and the provision of subsidised finance in one form or another. They thus implicitly recognise what we consider to be an important truth: that finance could not be provided on a commercial basis more cheaply than it is at present, (leaving aside the possibility of a general fall in interest rates) and that if cheaper funds are to be made available to small firms it will have to be done by means of a subsidy. Witnesses commonly quoted the examples of other countries whose Governments have found it necessary or desirable to make special provision for privileged access by small firms to external finance. In Appendix V we describe the measures taken for this purpose in the USA, Japan, France and Italy. It will be seen that such measures most commonly take the following forms:

i. the establishment of specialist institutions—with access to loans or grants from Government sources—which are able to co-operate with, and support, commercial banks in their lending operations;
ii. the provision of rediscount facilities to commercial banks by official

commercial basis—that the sector as a whole cannot be expected to pay the going rate for the finance available. We do not believe this. Apart from our general reluctance to recommend the subsidisation of small firms at the present time, the reasons for which are made clear in Chapter 8, there are strong arguments against doing so through the provision of loans on non-commercial terms.

12.90 The first argument is that we have failed to find a significant number of clearly deserving firms which were unable to raise finance on reasonable terms. We commissioned the Economists Advisory Group to carry out a sample survey of small firms which had made unsuccessful approaches to financial institutions and to identify the main reasons for failure. Their report[1] illustrates the extreme difficulty of pinning down genuine specimens of that all-important type—the small firm which needs finance, deserves it, has made serious efforts to raise it and has been turned down. The EAG found one or two firms which appeared to be in this category but we were in some doubt as to whether even these had been seriously misjudged. On the other hand they were surprised that some firms, in their view uncreditworthy, had been able to obtain outside finance. Such other "hard cases" as were brought directly to our notice and on which we were able to check appeared on investigation to be of doubtful validity. If this is the case the cost to the country of a subsidy would be incurred merely for the preservation of the inefficient. Though all small firms within the ambit of the subsidy would benefit from it, the efficient appear not to need it. We cannot improve on the EAG's summary in the Summary and conclusions to their Report, of the typical characteristics of the successful and unsuccessful applicants for external finance.

The following were the main characteristics of the firms investigated which were successful in their applications for finance during 1968 and 1969:

1. their profit/sales ratio and growth performance for the years 1965–69 were generally above the average for all the firms in the sample;
2. they required finance for "expansionary" reasons, and usually for clearly specified purposes;
3. they found it comparatively easy to know where to look for finance, and most denied they had experienced an "information gap";
4. they were generally well versed in, or advised on, financial matters, notwithstanding their claim that impartial advice was sometimes difficult to obtain;
5. they were not, in general, over ambitious in their requests for finance; on the other hand, they were persevering in their attempts to obtain the funds they needed on the most favourable terms;
6. though vocal about the additional pressures placed upon them by recent Government fiscal measures, and the credit restraints in general, they appear to have taken these in their stride.

By contrast, the firms unsuccessful in their applications for finance exhibited the following characteristics:

1. they were generally less profitable than the average firms in our sample;
2. a higher proportion of them required finance for defensive reasons; of the rest, few seemed to have any clear ideas of why they wanted funds;
3. they were inclined to complain about both an availability of funds gap and an information gap;
4. they were managerially and financially unsophisticated; nor did they always seem to get the best advice from their accountants or bank managers;
5. they seemed to be particularly adversely affected by recent Government fiscal measures and credit restraint;
6. they lacked perseverance in seeking for finance, sometimes giving up at the first attempt.

[1] *Problems of the Small Firm in Raising External Finance—the results of a sample survey.* Research Report No. 5 (forthcoming).

away from the existing institutions. This might put some of the independent operators out of business, thus reducing the number of "judgement centres" in the market, and we set great store on there being a substantial number of these. An official body lending solely to borrowers who were uncreditworthy by commercial standards would not have this effect but would put a premium on inefficiency. This would not, in our view, be a justifiable use of public funds. There are two other ways of injecting cheap finance into the small firm sector which would not distort the operation of the market so seriously: these are the provision of cheap money to the existing institutions for re-lending to small firms and the direct subsidy of small firms themselves. Either course would be difficult: the first because individual investors, as opposed to institutions, would presumably not qualify for cheap money and would thus suffer discrimination, the second because the definition and identification of eligible small firms would present severe administrative problems. It is greatly to be preferred, however, that these difficulties should be faced and overcome than that the superficially more straightforward expedient of an official agency should be adopted. Of the two we incline towards the provision of subsidised finance to the institutional lender. Nevertheless we are not in looking at these alternatives forced to make the choice because we believe that at present neither method should be adopted.

12.96 There are more serious weaknesses, in our view, on the demand side. It is clear both from our own investigations and from the EAG survey that many small firms are prevented by lack of information, by inexperience in presenting applications for finance and by a formidable barrier of prejudice against borrowing of all kinds from making use of the full range of facilities available to them. Though some of the institutions are now spending large sums on advertising their services, there is still, in fact, a serious "information gap". In their report on *Financial Facilities for Small Firms* (Research Report No. 4) the Economists Advisory Group wrote that "we have been impressed by the general inadequacy and fragmented nature of advice and information for small firms on financial and related matters". They recommended the creation of a "central agency" which would collect and disseminate information about the available sources of finance and would advise businessmen on techniques for evaluating their development proposals and presenting them to financial institutions. We do not support the creation of a special (and presumably official) agency for this purpose, and we consider that the advisory bureaux whose creation we recommend in Chapter 10 will serve as a source of basic information on this subject. The training of small businessmen in the evaluation of development projects and the presentation of applications for funds is a function more suited to their customary financial advisers. Suitable literature on the subject is also available from a variety of sources.

12.97 Finally we must repeat the essential point made in paragraph 12.4 that the role of institutional finance, or indeed any form of external finance, is necessarily limited. Unless owner's capital and retained profits are sufficient to provide an adequate equity base, it will not normally be possible to raise outside finance. Similarly unless individuals can be found to acquire existing businesses or to set up for themselves the sector must inevitably die. This again is a function

Introduction

13.1 In the first section of this chapter we consider the general effects of current tax levels on the small firm sector and the case for altering the balance of the fiscal system in their favour. This is discussed in highly generalised terms; the argument does not depend upon the detail of the tax system and its administration. The second section describes the tax treatment of small firms. Here detail is essential, though the description is as brief as it can be made. In the third section we discuss the effects of particular taxes under the heads of taxation of income, taxation of capital and taxation at death. It is in this section that we consider the proposals for reform put to us by witnesses and make such recommendations as we think necessary. Annexed to this chapter is a copy of a letter sent by the Chairman to the Minister for Industry in January 1971, which incorporates the recommendations on tax questions on which we had already reached agreement; some of these recommendations, which would otherwise have appeared in this chapter, are omitted because the 1971 Finance Act contained these or similar provisions. Three of the appendices also concern taxation: Appendix VI is a note on close trading companies and shortfalls in distributions: Appendix VII is a description of the tax treatment of the profits or income of small firms overseas; and Appendix VIII is a report by the Inland Revenue on a study on estate duty and family business which they carried out on our behalf.

13.2 A very high proportion of our witnesses referred to taxation, and all who did so emphasised the harm which the present burden of taxation inflicts on small firms. We are in no doubt that in the mind of the average small businessman and to a large extent in those of his professional advisers also, high taxation ranks as the most important single factor in the inhibition of enterprise and the decline of the small firm sector. We were repeatedly advised that only a radical reform of the system could improve the health of the sector, and were urged to recommend such a reform as a first priority. We had to recognise, however, that as a Committee we were not appointed, and not expected, to review the whole of the taxation system of the country and to recommend sweeping changes in, say, the general level of taxation or the balance between direct and indirect taxes. The general shape of the system had to be accepted as given, whatever our private views on the desirability of radical changes might be. As explained in Chapter 8, it soon became obvious to us that if positive discrimination in favour of small firms were thought necessary or desirable, changes in the tax system would be the easiest and most effective way of implementing it, though they would have to be very drastic to have a perceptible effect on the overall process of decline in the sector. However, for the reasons given in that chapter, we have decided that we cannot recommend, at the present time, any deliberate discrimination in favour of small firms, though in five or ten years' time the case for doing so might be more compelling than it is today. We are not therefore seeking means of conferring special advantages on small firms through the tax system, and in this chapter we concentrate on issues which relate to the equality or inequality of the tax burden as between small firms and large. Our task here, as elsewhere, is to identify cases where small firms or their proprietors are discriminated against, or for any reason suffer a differential disadvantage, and where possible to recom-

Fiscal year ending 5th April	Income tax and surtax: Income at which income tax and surtax takes: 50% of earned income	25% of investment income	Estate duty: Value of smallest estates on which average rate is 33%
	£	£	£
1920–21	43,835	4,031	2,928,000
1927–28	— (3)	16,954	4,350,000
1931–32	78,468	9,971	1,637,000
1935–36	103,950	13,250	1,691,000
1952–53	7,089	1,325	70,538
1957–58	9,196	1,344	59,255
1963–64	14,325	1,490	51,493
1965–66	11,815	1,317	47,635
1966–67	11,922	1,267	45,812
1970–71	9,944	1,088	37,982

Source: The British Economy: Key Statistics 1900–1970, with slight amendments.

Notes:

(1) A married couple with one child under 11 and with earnings of this amount wholly earned by the husband would be liable at the standard rate less the earned income relief fraction, i.e. at 32·01% ($\frac{9}{10}$ of 41·25% in 1970–71) on the next £1 earned.

(2) These figures relate to a married couple, wife not earning, with one child under 11. Surtax is that charged on the income of the year although it is not payable until the following year. Relief for National Insurance Contributions has not been taken into account.

(3) Income tax and surtax together did not reach 50% of income.

(4) Including the 10% surcharge on surtax for 1965–66.

(5) In these years legacy and succession duties at rates up to 10% were also chargeable. For example a free estate of little more than £1,000 could have suffered the full 10%. The point at which the death duties reached 10% of a free estate would therefore be somewhere between £1,000 and the amount shown above, depending on the way in which the estate was bequeathed and the relationship to the deceased of the beneficiaries.

(6) It should be remembered that from April 1965 to March 1971 estates may have been subject to additional charges to capital gains tax.

We are not here pursuing the widely-held belief that the tax burden in this country is relatively heavier than in other comparable countries. Though this is frequently advanced as an explanation for the disappointing performance of the economy, it is extremely difficult to compare international tax levels, and meaningless to do so without taking account, for example, of the related social security contributions, differences in the cost of living and other elements of the system. There is no question that by the standards of our own history we have been living under a regime of high direct taxation since 1939, and the change over the years is clearly shown in Table 13.I.

13.5 High taxation of profits and capital may affect all firms in the private sector, whether large or small, in two main ways:

i. it may erode incentives;

ii. it may reduce the availability of finance for the foundation, the maintenance and the expansion of businesses.

These effects are extremely hard to demonstrate and quantify, for two reasons. First, taxation is only one of many factors operating on the business climate, and its effects cannot always be distinguished with confidence. Second, the response of the economic structure, and especially the size-distribution of firms, to changes in taxation is subject to extremely long lags. The decision to

of entrepreneurial effort; the effect of the increasing incidence of estate duty has been to increase the difficulty of doing so and thus to weaken this important motivating force. Furthermore, a great deal of unproductive entrepreneurial effort is nowadays devoted to the avoidance of estate duty, and investment policy is frequently distorted by the desire to accumulate the liquid assets required for the eventual payment of the duty. None of these considerations need concern the management of a large company to the same extent and thus the small firm suffers a differential disadvantage. Capital gains tax is also said by many small businessmen to have a powerful disincentive effect, and there is no doubt of its intense unpopularity among them. But the small businessman can hardly be held to be at a disadvantage in this respect vis-a-vis the managers of big companies: the point is that it is more open to him to obtain capital gains —this is his greatest single advantage—and that these gains are taxed at a considerably lower rate than income.

13.8 As regards ii in paragraph 13.5, that is, the effect of taxation on the availability of finance—it is taxes on profits and income, not on capital, which fall under suspicion. It is true that the latter may fall heavily on the owners of equity, and may lead to enforced changes in the ownership of family businesses: but essentially most taxes on capital do not fall on the firm itself, and so can reduce the availability of finance to the firm only indirectly, for example by impoverishing persons who otherwise might be prepared to put money into it. Taxes on profits, however, unless they can be passed on to customers in the form of higher prices, may make it difficult or impossible to finance expansion out of retained profits and may even limit the ability to raise external finance. The basic issue therefore is: where does the incidence of such taxation ultimately rest—on the firm itself or on its customers? On this issue it is difficult to sustain a firm judgement either way; but common sense suggests that in the short run the cost of an increase in taxation falls on the firm and its proprietors, since it takes time in a competitive economy for business to adjust its pricing practices to the new situation. This suggests that in the post-war period profits after tax may well have been depressed by the sharp increase in tax rates which took place during and immediately after the war. There is no way of proving whether or not small firms were specially affected, but we suspect that this probably was so, since in all such matters small firms tend to be slower than big to adjust their pricing policies to new circumstances.

13.9 Nevertheless we believe that small firms would by now have adapted successfully to the high-tax regime if that were the only radical factor they had to contend with. It is the combination of high taxes with an accelerating rate of inflation (from zero pre-war to perhaps 10 per cent per annum at the present time) which has seriously depressed real profit levels as opposed to book profits. One of the well-known consequences of inflation is the over-statement of profit in real terms by a profit and loss account drawn up in accordance with current accounting conventions: this has a number of serious implications, of which perhaps the most important is that the true rate of taxation (calculated as the amount taken by taxation as a proportion of the true profit) is higher than the nominal tax rate. Consequently, the ability of a firm to grow in real terms in times of inflation is diminished. This is true for the whole of industry, though to

£1,150. This may not seem an overwhelming burden but, after allowing for taxation which—it will be remembered—is calculated on the accounting profit before making this deduction, and allowing for interest on loans and dividends, the net amount retained in the business out of the year's earnings after payment of dividends is reduced to £394, or less than one per cent of the nominal value of total net assets of £41,476 (£1,297, i.e., three per cent of the value of total net assets before dividends). Without providing for the effects of inflation, retentions would have been shown as £1,150 higher, at £1,544, or four per cent of total net assets. But this, of course, is only a notional calculation; had there been no inflation, accounting profit would have been correspondingly lower, but there would have been no requirement to plough back to cover inflationary increases. The correct question to ask is what would have happened if tax had not been charged on the notional inflationary element in accounting profits: at current corporation tax rates, the amount available for retention would have been increased by some £500, from the £394 at present shown as retained to, say, £900. This corresponds to some 2½ per cent of net assets at book values. Thus the effect of such an overstatement of the true profit is to step up the effective rate of taxation very drastically, and in a way which Parliament presumably did not intend. If the tax paid (£2,293) is seen not as a proportion of the accounting profit but as a proportion of "net economic profit less interest" (£3,590) the effective rate is 63 per cent instead of the then nominal rate of 45 per cent.[1] It will be remembered that these calculations relate to the average company in our sample, which, it must be concluded, was in 1969 barely able to finance any real expansion out of net earnings. Many firms, particularly those carrying large stocks, were in a worse position, and a large number were clearly failing to maintain intact the real value of their assets. It should also be remembered that these calculations are based on rates of inflation which by the standard of 1971 are comparatively modest: the present situation is certainly worse.[2]

13.11 It is possible, though difficult, for industry to adapt itself even to rapid inflation, but the most pernicious aspect of the current situation is that many firms are unaware of the extent of the problem: they are lulled into a false sense of security by the inflated profits shown in the annual Accounts. Once again, we suspect that big companies are more alive to this danger than most small firms; it hardly figured at all in the evidence we received from small firms. The destruction of small firms would be only one, and arguably not the most serious, of the consequences for the economy and society of continued inflation at the present rate, but it will certainly happen on a large scale if small firms fail to adjust to it. We return to this subject in more detail in paragraph 13.44 *et seq.*

13.12 The combination of high taxes and inflation cuts down retained profits, increasing the difficulty of self-financing, in the whole of industry. Large firms,

[1] We have disregarded the effects of accelerated depreciation allowances for tax purposes on plant and machinery: the relevant information is not available to allow such a computation, but we believe that this cannot account for a major part of the difference in tax rates noted above.

[2] It will be noted that the calculations above have been concerned with the rate of return on the firm's net assets, irrespective of whether they are financed by equity or loans. The transfer that takes place in an inflation to the equity holder at the expense of the loan holder has been ignored, and indeed is not relevant to the assessment of the required rate of return on total net assets.

13.14 We now proceed from generalised discussion to matters of detail. We have thought it right to include a factual account of the tax treatment of small firms, first because we hope that a short description will be of value to the small businessman, who understandably finds it difficult to keep up with rapidly changing tax law, and second because the discussion which follows will be simpler if unencumbered by descriptive matter. Our fiscal legislation makes no distinction between firms of different sizes, unlike that of certain other countries, notably the USA, where small firms benefit from a number of special concessions. However, the great majority of sole traders, partnerships and close companies are small, and we can therefore achieve our purpose by describing the way in which the tax system affects them.

A. Direct taxation

Individuals

13.15 The business profits of trades and professions carried on by individuals are assessed to income tax under Cases I and II of Schedule D. For an established business, the income tax assessment for any year will normally be based on the profits earned in the accounting year which ended in the preceding income tax year; but there are special rules which apply at the commencement or cessation of a business or on a permanent change of accounting date. Although, in general, the calculation of the taxable profits is on the same basis as that of the commercial profits, certain adjustments based on statutory rules and case law have to be made to the profits shown by the accounts to arrive at the figure assessable to income tax. The same rules apply in calculating allowable business losses, which can generally be relieved against future trading profits, or against other income of the tax year in which the loss was incurred, or the following year. Approximately 1·5 million Schedule D assessments under Cases I and II are made on individuals each year.

Partnerships

13.16 Where a trade or profession is carried on in partnership, the business profits are assessed on the partnership in one sum, although the tax due is calculated by reference to the individual partners' shares in the profit, and their personal circumstances. When there is a change in the members of the partnership, the business is treated for tax purposes as though it had ceased at the date of change, and as though a new business had started at that date, unless all the partners before and after the change elect for it to be treated as a continuing business. Apart from this, the main rules for computation and assessment of partnership profits are the same as for individuals. About 300,000 assessments are made annually on partnerships under Cases I and II of Schedule D.

Companies

13.17 Companies and unincorporated associations are liable to corporation tax on their profits (including capital gains). The current rate of corporation tax (September 1971) is 40 per cent. When a company pays a dividend from profits on which corporation tax has been paid, it has to deduct income tax at the standard rate from the dividend and account for it to the Inland Revenue; the income tax deducted from the dividend is treated as paid by the shareholder, and

also increase the general 60 per cent first-year allowance to 80 per cent for expenditure incurred between 19 July 1971 and 1 August 1973.

Close companies

13.19 *General.* Since 1922 there have been special rules for companies controlled by a small number of people; basically, the rules were designed to prevent avoidance of personal taxation, by forming a company to carry on the taxpayer's business or hold his investments and accumulating surplus profits in the company so that they did not form part of the shareholders' personal income for tax purposes. On the introduction of corporation tax in the Finance Act 1965 these rules were adapted to fit the new system. In their present form, they apply to "close companies": broadly, a close company is a United Kingdom resident company controlled by five or fewer persons or by its directors; but a company is not "close" if shares carrying at least 35 per cent of the voting power are held by the "public" (as defined in the legislation) and are quoted and dealt in on a recognised stock exchange. The main provisions relating to close companies are described in paragraphs 13.20–29 below. Of the 320,000 active companies within the charge to corporation tax, some 220,000, or 70 per cent, are close companies.

13.20 *Shortfall.* Under Section 289, Income and Corporation Taxes Act 1970, a close company whose distributions fall short of its "required standard" is liable to an assessment to income tax at the standard rate on the shortfall; and the shortfall may be apportioned to the participators in the company for surtax purposes and charged to surtax as part of their income. For a trading company, the maximum required standard of distributions is 60 per cent of the company's estate or trading income, plus 100 per cent of its investment income. However, this is the maximum standard, and the required standard can be reduced by so much of the company's income as it "shows could not be distributed without prejudice to the requirements of the company's business" (Section 290, Income and Corporation Taxes Act, 1970). Section 290 also provides that in arriving at the required standard "regard shall be had not only to the current requirements of the company's business but also to such other requirements as may be necessary or advisable for the maintenance and development of that business . . .".

13.21 For an investment company, the required distribution standard is 100 per cent of its investment income, plus so much of its estate or trading income (if any) as it could distribute without prejudice to the requirements of its business (up to a maximum of 60 per cent).

13.22 There is a special relief for small trading companies. If the company has no associated company and its estate or trading income (after corporation tax) is less than £5,000, the income is ignored in calculating the required standard. Small amounts of investment income, not exceeding £500 or 10 per cent of the estate or trading income, whichever is the smaller, are also ignored. This means that a trading company with net profits of £4,500 and net investment income of £450 will have no shortfall. If the estate or trading income is between £5,000 and £15,000 there is a tapering relief. If the company has one or more associated companies, the relief is in effect apportioned among the associated companies; extra relief cannot be obtained by splitting one company into two. As an

accounting period or (b) the nominal amount of the company's issued share capital and share premium account. A director has a "material interest" if he and his associates between them control more than five per cent of the company's ordinary share capital.

13.28 *Directors' remuneration.* The fixed limits imposed by the Finance Act 1965 on directors' remuneration allowable against corporation tax were abolished by the Finance Act, 1969. Directors' remuneration is now allowable in full, so long as it satisfies the ordinary tax rules for business expenses.

13.29 The proposed changes in corporation tax outlined in paragraph 13.17 will also apply to close companies and the Government will be consulting representative bodies to ensure that the administrative burden on close companies will be kept to the minimum. The Green Paper makes it clear that companies would continue to be required to make reasonable distributions, having regard to the requirements of the business, the maximum level of distributions being no higher than is required by law at present. However, the new system of corporation tax proposed in the Green Paper would have important implications for the present rules on the taxation of close companies. Under a two-rate system only the shareholder's surtax would be at issue, and the Revenue's concern with close companies would be to ensure that distributions were not kept down below a reasonable level in order to limit the surtax liability of shareholders.

Capital gains tax

13.30 In general the capital gains tax applies to small businesses in the same way as to larger enterprises; however, the rate at which tax is payable depends on whether or not the business is incorporated.

13.31 Capital gains tax is chargeable on gains accruing on the disposal of assets. Disposal includes sale, exchange and gift and also, generally, any other occasion when the owner of an asset derives a capital sum from it. Capital gains are computed as the difference between the cost of acquisition (or in certain circumstances the value at 5 April 1965) and the consideration received for the disposal less allowable expenses, but gains are only chargeable to the extent that they are attributable to the period from 6 April 1965.

13.32 Assets include all forms of property, or interests or rights in or over property. Thus freehold property and leases, plant and machinery (if sold for £1,000 or more), and goodwill are chargeable assets. Stock in trade is exempt.

13.33 Two reliefs are of special interest to small businessmen, although the first is also available to larger businesses. First, a trader, whether an individual or a company, may claim to defer payment of capital gains tax on gains accruing from the sale of certain classes of business assets if the proceeds of sale are spent on acquiring new assets for use exclusively in the business. Instead of paying tax on the gain the trader may have the cost of the gain deducted from the acquisition price of the new assets. Second, a person of retirement age is exempt from capital gains tax, subject to certain conditions being satisfied, on gains of up to £10,000 which accrue on the disposal by way of sale or gift of a family business or of shares or securities in a family trading company.

Selective employment tax

13.39 Since 5 September 1966 selective employment tax has been paid weekly by all employers in respect of each employee for whom they pay a Class 1 national insurance contribution. The Selective Employment Payments Act 1966 empowers the Secretary of State for Employment to refund the tax to employers whose establishments are engaged in manufacturing, in mining and quarrying, in agriculture and horticulture, the fishing and transport industries, in hotels in certain rural parts of Development Areas, and in charitable activities.

Employers in industries other than those listed above pay the tax and are not eligible for refund (except that two thirds refunds are paid in respect of employees aged 65 and over and part-time employees). The Government have announced their intention to abolish SET and on 5 July 1971 took the first step towards this by making a 50 per cent reduction in all rates of the tax. The weekly rates per employee are now, for men £1·20, for women and boys under 18, 60p, and for girls under 18, 40p. But for these changes the estimated net yield of the tax in 1971–72 would have been £509 million; it will now yield an estimated £219 million.

B. Indirect taxation

13.40 Net receipts in 1969–70 from the duties administered by HM Customs and Excise (including import deposits) amounted to £4,765 million. The yield of the various duties was as shown in Table 13.III.

TABLE 13.III

Yield of duties administered by HM Customs and Excise 1969/70

	£ million	*Per cent of total*
Hydrocarbon oils	1,309·5	27¼
Tobacco	1,141·5	24
Purchase tax	1,110·6	23¼
Alcoholic liquors	863·2	18
Protective duties	226·0	4¾
Betting and gaming	119·0	2½
Other	6·1	¼
	4,775·9	100
Less export rebates, ship-builders' relief etc.	11·2	
	4,764·7	

The only one of these with any special implications for small firms is purchase tax, about which we received many complaints, most of them directed at the cost to wholesalers and retailers of the administration involved in accounting for the tax, and at the anomalies and confusion which can arise from its four-rate structure. It has been announced that this tax and selective employment tax are to be replaced by a broadly based value added tax which will come into effect in April 1973. A Green Paper (Cmnd. 4621, published March 1971) sets out the basic principles of value-added taxation, the scope of a possible scheme

company;

iii. that there is unfair discrimination in taxation as between incorporated and unincorporated businesses, and between public and family companies.

13.43 It is very widely believed that the rates of tax on profits in this country are exceptionally high, and that they have grown higher in recent years. Neither is true, at least so far as companies are concerned. Corporation tax at 40 per cent (42·5 per cent before April 1971) is lower than the basic rates of 48 per cent in the USA, 51 per cent in Germany, 50 per cent in France and 46 per cent in Holland, for example, and the effect of the 1965 Finance Act, which introduced corporation tax, was to reduce substantially the burden of taxation on retained profits, which then stood at some 56 per cent. It may be true that, as the CBI said in their very valuable evidence on taxation, "Corporation tax at 45 per cent (the then rate) plus full personal taxation on dividends, adds up to an aggregate burden of taxation on shareholders which is unequalled elsewhere in Europe", but insofar as this is so, it is primarily a result of our personal taxation system. The great majority of small firms, being sole traders or partnerships, of course pay income tax rather than corporation tax on their profits. In general, because corporation tax is levied at a fixed rate and income tax plus surtax is progressive, it pays to be a sole trader or partnership at lower levels of profit and to be incorporated at higher levels. It is impossible to define the trade-off point exactly, because much depends on the circumstances of the individual business, but we may take it that proportionately very few small firms will pay more than 40 per cent tax on their profits and that the great majority will pay rather less.

13.44 However, as we pointed out in paragraphs 13.9–12, the effects of tax are greatly magnified in a period of rapid inflation. They then reduce real net profits to a level at which significant expansion is rarely possible without the use of external finance. The special difficulties of the small firm in doing this have been noted in Chapter 12. Even for an incorporated business the position may be critical, but for a successful unincorporated business such as a professional partnership it may be well nigh insupportable because of the effect of surtax at the higher rates. The situation has been improved by the changes introduced in the Budget of March 1971, particularly by the reduction in corporation tax and the raising of earned income relief for incomes above £4,005, but these are still only marginal in their impact on the financing problem of the small firm. We have accordingly considered a number of suggested ways of alleviating the burden of direct taxes on the small firm.

13.45 Three different methods of abating corporation tax for the benefit of small companies have been proposed. The first is that the tax should be made progressive by the introduction of graduated rates, as is done in Austria and Switzerland among other countries. The second is that a lower rate of tax should be applied to the first tranche of all company profits, as in the USA, where the first $25,000 of profit is taxed at 22 per cent, instead of the standard 48 per cent, thus benefiting the small company in particular. The third is that newly established companies should benefit from a "tax holiday", whereby they are either completely exempted or taxed at a lower rate for the first few years of their

TABLE 13.IV

Approximate effect of levying reduced rates of corporation tax on first tranche of taxable profit

Hypothetical profit maxima to qualify for exemption	*£20,000 pa*			*£10,000 pa*			*£5,000 pa*			*£2,000 pa*			*£1,000 pa*		
A. No. of companies exempt from 40% corp. tax level	241,000			230,000			217,000			194,000			178,000		
B. A as % of all companies	94%			90%			85%			75%			70%		
C. Total profit in companies below "cut-off"	£359m			£211m			£113m			£41m			£19m		
D. Profit below "cut-off" in "larger" companies	£296m			£260m			£195m			£124m			£78m		
E. Total profit affected	£655m			£471m			£308m			£165m			£97m		
Rebated Rate	*NIL*	20%	30%	*NIL*	20%	30%	*NIL*	20%	30%	*NIL*	20%	30%	*NIL*	20%	3
F. Amount of tax "saved" assuming 40% corp. tax	£262m	£131m	£66m	£188m	£94m	£47m	£123m	£61m	£31m	£66m	£33m	£16m	£39m	£19m	£
F(i) Corporation tax rate necessary to recoup tax "saved" in F.	50%	45%	42·5%	47%	44%	42%	45%	42%	41%	42·5%	41%	40·5%	41·5%	41%	40
G. Amount of tax "saved" if exemption applies only to companies with total taxable profit below "cut-off" level	£144m	£72m	£40m	£84m	£42m	£21m	£45m	£22m	£11m	£16m	£8m	£4m	£8m	£4m	£
G(i) Corporation tax rate necessary to recoup tax "saved" in G.	46%	43%	41·5%	43%	41·5%	41%	42%	41%	40·5%	41%	40·5%	40%	40·5%	40%	4

Source: Figures based on Year to 31.3.67 for UK Companies (Table 47 Inland Revenue Statistics 1970)

which would serve to inhibit the imposition—or at least cause serious consideration before the imposition—of tax rates of the order of 63 per cent (paragraph 13.10). These constraints would include both the attitudes of the public, management and politicians to such rates and more practical considerations of international comparisons and the effect on double taxation agreements. Thus it is probable that some of the tax burden would be transferred to indirect taxes, if total tax revenue were to remain unchanged;

iv. that assuming tax rates were adjusted to produce the same tax revenue in conditions of average inflation there would be some protection against erosion of capital in times of acute inflation.

It has also been pointed out that businesses are not the only sufferers from inflation and that tax on real income has risen perhaps even more steeply for individuals. This of course concerns us but it must remain a matter for Parliament—wage and salary earners do not have to maintain a stock of capital intact to remain in business. There is some analogy with the owner of fixed interest securities and we can see that if the proposal which we are suggesting for consideration were adopted it would be necessary for a view to be taken on capital gains tax. Nevertheless it is only the business which is compelled to realise trading assets—and under present circumstances pay tax on what in any economic sense must be a spurious profit—in order to carry on its affairs. Of course there would have to be an agreed basis on which accounts should be drawn up and the whole question of adapting accounting techniques to take account of inflation is now being studied by the Institute of Chartered Accountants in England and Wales in conjunction with the CBI and many other interested parties. This is not just a small firm problem, but its implications for small firms are so serious that we **feel justified in expressing the hope that these discussions will be pursued with urgency and speedily brought to a successful conclusion.** It is extremely difficult to determine the "replacement cost" of assets which in fact will never be replaced in the same form, and we are fully conscious of the severe accounting problems which will attend any solution. But if inflation is to become a permanent feature of our economic life it is essential that industry and the accounting profession should take proper account of it. At present the financing problems of small firms, as of the rest of industry, are being compounded by the taxation of purely notional profits. While present inflationary conditions persist, we must stress the importance of companies setting a target rate of return on capital employed which is significantly higher than has been customary, for failure to achieve higher returns is most likely to lead to the erosion of the real resources of the company and seriously affect its long term viability.

13.49 The major revision of the tax system brought about by the 1965 Finance Act completed the long transition from the basic assumptions of the old system, under which the company was treated as a pseudo-partnership, to the new doctrine of the complete separation of the company from its shareholders. The purpose of the special rules for close companies which were then introduced was to put them in the same position as other companies as regards the distribution of profits: it was felt that so long as retained profits were less heavily taxed than distributed profits, some means would be needed to ensure that close companies were prevented from avoiding tax by accumulating profit within the company,

for future needs (this is a more sophisticated version of ii above).

iv. The cost of the system to the company, in particular the cost of proving the need to retain more than 40 per cent of profits, is said to be excessive.

13.52 We accept that some watch has to be kept on the distribution policy of close companies. Given the fact that a close company is by definition under the control of a few individuals who are free from the pressures which compel public companies to maintain a reasonable level of distributions, and given the very large differential between the taxation of retained and distributed profits, there is obviously a strong temptation to make the distribution policy of the close company a mere reflection of the personal tax position of its proprietors. We do not dispute that tax avoidance by the creation of "money-box" companies is undesirable, or that in the case of investment or holding companies it might become a serious problem. The problem we are concerned with in this chapter, and on which we differ from the Inland Revenue, is whether the danger of avoidance by trading as distinct from investment companies is significant enough to justify the cost and complexity of the present system.

13.53 It must be said at the outset, however, that the cost and complexity of the system have been greatly inflated by misconceptions on the part of industry. In part these misconceptions account for the criticisms listed in paragraph 13.51. The complaint that the 60 per cent standard of distribution prevents the proper development of the company seems to imply ignorance on the part of the complainants of the very considerable scope that exists for negotiation with the Inland Revenue. It is in fact clear that very many small companies believe that 60 per cent distribution is an inflexible requirement, and that the standard of advice they have received on this matter has frequently been poor. (In an attempt to improve knowledge of these matters, we are publishing as an Appendix to this Report a full description of the shortfall provisions and their interpretation. This has been approved by the Inland Revenue and is, we believe, as accurate a statement of their practice as can be made.) The widespread belief that the Inland Revenue Inspectors invariably insist on 60 per cent distribution is, of course, quite mistaken. The Inspectors are required by law, when considering what should be the required standard of distribution for any company, to take into account the amount of the company's trading profits which could not be distributed without prejudice to the requirements of the company's business. In particular the Act lays down that "regard shall be had not only to the current requirements of the company's business but also to such other requirements as may be necessary or desirable for the maintenance and development of that business". Reasonable provision for the future must therefore be allowed. There is always room, of course, for disagreement about what is "necessary or desirable". The Inland Revenue claim to view sympathetically, and on a commercial basis, any claim for future requirements which is reasonably firm and roughly quantifiable. Some witnesses have complained that this is not enough, and that allowance should be made for unforeseen contingencies—such as possible changes in technology which may call for heavy investment if a firm is to remain competitive. The Revenue's reply is that wholly undefined and unquantified contingencies can hardly be provided for, but that they recognise the need to retain a

TABLE 13.V

Shortfall distributions in trading companies

(from the accounts of companies during the 12 months ended June 1970)

Amounts in £000 *(unless otherwise sta*

1 *Range of distributable income in £*	2 *Number of companies*	3 *Estate or trading income*	4 *Investment income*	5 *Maximum required standard*	6 *Distributions per accounts*	7 *Further distributions*	8 *Shortfall*	9 *Accepted busines requirem*
101—1,500	5,781	3,072	533	2,050	1,398	60	240	96
1,501—2,500	3,413	6,325	380	2,587	2,310	39	137	1,12
2,501—3,500	2,275	6,422	351	3,252	2,546	39	128	1,31
3,501—4,500	1,598	6,013	348	3,384	2,477	41	113	1,34
4,501—5,500	1,251	5,924	319	3,505	2,588	41	68	1,38
5,501—6,500	1,032	5,888	300	3,584	2,490	23	81	1,45
6,501—7,500	841	5,544	335	3,499	2,414	51	71	1,36
7,501—9,000	1,041	8,127	423	5,176	3,414	34	99	2,09
9,001—12,000	1,336	13,289	588	8,457	5,718	37	129	3,36
12,001—15,000	829	10,503	621	6,854	4,644	74	132	2,56
15,001—20,000	821	13,346	839	8,772	5,756	74	124	3,48
20,001—50,000	1,368	38,544	2,641	25,640	16,256	243	164	10,21
50,001—100,000	315	19,179	1,658	13,132	7,872	51	103	5,53
over 100,000	150	34,162	3,898	24,375	17,470	58	62	8,32
TOTALS	22,051	176,338	13,235	114,268	77,354	865	1,651	44,53

Note: The total of columns 6–9 exceeds column 5 because in many cases the distributions shown in the accounts exceed the maximum required standard. The distributions include directors' remuneration paid in excess of the limit permitted by the legislation (which was repealed in 1969) and this excess remuneration accounts for the greater part of the "over-distribution".

13.57 A further consequence of the introduction of corporation tax, unconnected with shortfall, is the inequality of treatment as between different forms of business organisation to which it gave rise. We have suggested that the great majority of small unincorporated businesses pay income tax on their profits at rates substantially below the fixed rate of corporation tax. In other circumstances an individual or partnership may be heavily disadvantaged by comparison with an incorporated business. The tax system thus has an important bearing on the choice of status in the carrying on of a business. We think this unfortunate; there are many reasons for the choice of business status, but the tax consequences should not be among them. Some of the major differences in treatment, apart from the difference in rates already referred to, are the following:

i. An individual or partnership cannot retain profits in a business or professional partnership without paying surtax on total profits—an incorporated business can.

ii. An individual trader can set losses in his business against other personal income, but the same man carrying on a trade as a one-man company cannot do so.

iii. The individual trader or partner has relatively beneficial treatment in the early years of his business or partnership if he is well advised as to the date to which he should draw his accounts, but this is not available to the same business carried on through a company.

13.58 One effect of the differential between corporation tax and the lower rates of income tax is to deter some small businessmen from incorporation, and thus from enjoying the security of limited liability. This is undesirable, not because incorporation is always advantageous, but because when it is advantageous a firm should not be deterred from it by marginal tax considerations. The Inland Revenue have pointed out to us that this problem has largely disappeared as a result of the 1969 Finance Act, which permitted close companies, if they wished to avoid the liability to corporation tax, to take out all profits in the form of directors' remuneration, and face assessment to income tax on that basis. We accept that this disposes of the problem for a profitable company where there is identity of interest between shareholders and directors, but where this is not so, it is not to be expected that outside shareholders would be prepared to countenance such a solution, and present law does not provide a method by which relief for losses incurred by a company can be offset against other personal income. We have been impressed by the advantages of a different and more radical proposal, which is that close companies should be allowed to opt to be taxed as though they were partnerships, the shareholders being taxed on their earnings from the company as though they were partners in an unincorporated business. In the United States this option is granted under sub-chapter S of the Internal Revenue Code to "Small Business Corporations", which are specially defined for the purpose of this sub-chapter. We feel that this possible disadvantage of incorporation in the United Kingdom should be removed, and to do so by this means would help to attract private capital into the small business sector, since outside shareholders would be enabled to offset their "share" of the trading losses of the company against tax on their other income. The view of the Inland

but only marginally. We can only note this in passing. The remedy would appear to lie in a large-scale transfer from direct to indirect taxation, but we have regarded any discussion of this as outside our remit.

13.61 *Pension provisions.* There are further differences between the tax treatment of a self-employed man or the owner-manager of a private company and that of an employee, however senior; we take as examples the position of the owner-manager and that of a senior executive in a large company. Until the present year the tax provisions which favour the creation of pension funds for employees have been markedly less generous in the case of the self-employed. Whereas the scheme covering pensions for employees offered tax relief on payments of 15 per cent or more of annual salary, with no specific ceiling, the self-employed were permitted tax relief on payments towards a retirement annuity of only 10 per cent of annual earned income or £750, whichever was less. Furthermore the self-employed man was not permitted, as were employees, to commute part of the annuity and convert it into a lump sum. These discrepancies will to a large extent be corrected by two proposals made in the Finance Act: first, to increase the amounts permitted for tax relief for a self-employed person to 15 per cent of his annual earned income or £1,500, whichever is less; and secondly to allow part of the annuity to be taken as a tax-free lump sum, the amount to be approximately equal to that allowed in occupational pension schemes. We commend this decision, but feel that it does not go far enough and would express the hope that in future pension provisions for the self-employed will not be allowed to fall so seriously out of line with those available to others. **We recommend that as a general rule the tax reliefs which are available for pension schemes set up for employees including non-controlling directors should be extended to similar funds for proprietors of unincorporated businesses and controlling directors of close companies.**

13.62 It may be objected that the average working proprietor would be unable to take advantage of this concession; many businessmen find it impossible to put by substantial sums towards a pension in the early years of the business, when all available cash reserves must be directed into productive investment. This means that by the time payment into a pension fund becomes possible, the flat-rate ceiling on contributions renders the creation of a worthwhile annuity impossible. It appears illogical in any case that proprietors of unincorporated businesses or controlling directors of close companies should be obliged to "lend" the premiums on their personal pension funds to insurance companies, then having to borrow from an institution at much higher rates of interest in order to finance the business. We see force in this and **therefore recommend that such pension funds should have complete freedom as to the choice of investment including the freedom to plough back into the business.** We fully accept that it would be imprudent for employee's pension funds to be invested inside the business, but we do not feel that the same arguments apply to the proprietor.

13.63 *Disallowance of interest.* The Finance Act 1969 abolished the general income tax reliefs for loan interest paid by individuals, and replaced them by special reliefs depending on the purpose for which the loan was used. Interest on loans to buy shares in close companies was allowed but only where the borrower

arise, deemed disposals are likely to be particularly onerous for small firms, because their proprietors are very unlikely either to have adequate liquid reserves to pay the tax or (in the case of unquoted companies) to be able to raise money by selling shares at a fair price. Where the assets consist of unquoted shares, two serious problems arise. First, the valuation of unquoted shares is a very difficult and uncertain matter, so that the proprietor or his Trustees may be unable to forecast the chargeable gain arising from the deemed disposal. Secondly, the shares may be the only source of funds with which to pay the tax and finding a buyer for unquoted shares, particularly a minority interest, is exceedingly difficult, even if the other shareholders agree to their sale to outside parties. In order to mitigate these problems we favour a measure of relief from the tax for unrealised gains. We would not propose 100 per cent relief, though a case could be made for doing so, because such a concession would present too great a temptation to avoidance. Instead we have taken as a precedent the 45 per cent relief from estate duty now applied to agricultural property and industrial buildings, plant and machinery. We welcome the relief given in the Finance Act 1971 in respect of "deemed disposals" by trusts and on death, and **we recommend that unrealised capital gains, on all assets other than qnoted securities, should be taxed on only part (say half) of the gain, the tax paid on such to be credited towards the tax payable on any subsequent realised gain on the sale of the asset concerned.**

13.66 *Capital gains tax on retirement.* Because capital gains tax is no longer to be levied on the death of a business proprietor, there is now a very strong incentive for such people to retain at least nominal control of their businesses until death; otherwise the capital gains tax liability which would arise on their retirement would substantially damage the interests of the business or their families. Since it is clearly undesirable to encourage businessmen to retain control after the end of their effective working lives there is a strong case for generous provision to be made for relief on retirement. (Such provision could also be justified as a form of provisional relief during the period that must elapse before our recommendation in paragraph 13.61, if accepted, could be implemented. We understand that this must depend in part on the progress towards a revised occupational pension scheme, which is likely to be neither easy nor rapid.) Section 34 of the Finance Act 1965 allows exemption to working proprietors at the age of 65 on the first £10,000 of capital gains, reducing by £2,000 for every year to the age of 60. This concession is in recognition of the fact that the working proprietor's opportunities to save for retirement are limited and that the only effective form of provision may be to build up the capital value of the business. The amount of the retirement exemption is a matter for debate, but we agree with the CBI that the present limit is too low. **We recommend as a transitional measure that retirement relief from capital gains tax should be raised from £10,000 to £20,000.**

13.67 *The attraction of private investment.* The discouraging effect of capital gains tax on the potential private investor could have unfortunate consequences for the small firm sector: institutional investors cannot wholly replace the private source of venture capital for two reasons. First, their very professionalism obliges them to view all propositions with caution. Second, the suspicion with which they are regarded by most small businessmen ensures that the institutions

It clearly presents the gravest obstacles to the continuation of the family business from one generation to another; it involves the taking of precautions against the future inevitable tax demands which are heavy in their incidence and may be crucial in their effect. It may, notwithstanding the measures taken, involve the disposal of the assets of the company in whole or in part on highly disadvantageous terms and is a major disincentive to the consolidation and expansion of a business built up in earlier years by the founders when they approach retirement.

These difficulties have been somewhat mitigated by changes introduced in the 1971 Finance Act, that is the introduction of payment of estate duty by instalments over eight years and the raising of the starting point for liability from £10,000 to £12,500, but they are still important. We shall discuss them under the heads of problems of succession (that is, threats to the continuation of the firm) problems of payment and problems of valuation.

13.69 *Problems of succession.* Estate duty obviously increases the difficulty of passing on a family business to one's children. It may undermine the entrepreneur's motivation to invest and develop the business, particularly as he becomes older and is forced to calculate the risks of new development against the certainty that an increasing proportion of any profit he makes will go to the Estate Duty Office. Many entrepreneurs are very largely motivated by the wish to leave a thriving business and a secure future for their families; our research into motivation reveals that the desire for independence is usually at least as powerful as the desire for wealth, and the ability to provide for one's family is a most important measure of independence. Estate duty could have a serious impact on morale precisely because it impinges on this sensitive area. For this reason, as we mentioned in paragraph 13.13 the CBI have urged very strongly that our estate duty rules should be brought into line with those in certain foreign countries, where generous tax allowances are made for bequests between members of a family: in France, for example, the maximum rate of duty on legacies to the wife or children of the deceased is 20 per cent, as opposed to a duty of 60 per cent in the case of bequests outside the family, and in other Common Market countries a similar concession for intra-family bequests is made. A concession which depends on the status of the legatee would not of course be compatible with our present system of estate duty: it is only appropriate to a system of inheritance taxes. The CBI have suggested, first, that if the United Kingdom enters the Common Market we shall be obliged to harmonise our law on this subject with that obtaining inside the Market, and secondly that in any case, in order to preserve the family business, it is desirable to discriminate in favour of such legacies. On the first point we are not competent to pronounce, though it is not obvious that membership of the Common Market necessitates abandonment of our present estate duty system. It is possible that the adoption of a system of legacy duties would benefit the small firm sector by causing capital to be more widely dispersed in smaller units and thus giving more people the means of starting their own business. This would be so, however, only if the overall burden of the duty were reduced. Any reduction in duty would be beneficial to small firms, and a change to an inheritance duty may be an acceptable way of achieving this, but the implications of this proposal are complex and would need to be considered in a far wider context than that of the small

13.71 Notwithstanding the relatively small size of the sample, these figures lend strong support to the many representations that have been made to us of the serious implications of estate duty for the continued survival of all privately-owned firms other than those with less than, say, £20,000 of trade assets. Even if the duty can be met out of non-trade assets the proprietors may thus be drained of external capital, and will face real difficulty if a second death should occur or a capital gains tax liability arise. Such considerations may well act as a disincentive to a comparatively young man who is offered a directorship or partnership in a private business, but who can foresee the break up or forced sale of the business on the death of the major shareholder or older partner.

13.72 Even where disposal of part of the assets of the firm is an acceptable means of providing for the duty, it may be difficult for the small firm to make such a sale on acceptable terms, particularly when the assets in question are the equity of an unquoted company. As we have explained in Chapter 12 it is possible for successful or promising private companies to raise finance to meet estate duty by selling part of their equity to an institution. Such provision needs to be made in good time, however, and not all private companies will be regarded by the institutions as desirable investments. If no provision has been made, and their external assets are inadequate, the proprietors are likely to find it very difficult to find buyers for minority interests in unquoted companies on acceptable terms. However, a considerable measure of relief has now been afforded by Section 62 of the 1971 Finance Act, which permits the payment of estate duty by instalments in the circumstances described in paragraph 13.35. This clause effectively meets the points we wished to raise on this subject and we have therefore withdrawn our recommendation about it.

13.73 *Loans to pay estate duty.* When a close company makes a loan to a participator in the company (or to one of his associates) income tax is charged on the loan as though it were a net dividend; if the loan is later repaid the income tax is refunded. Trading companies, however, benefit from an extra-statutory concession whereby, if they make such loans for estate duty purposes, the income tax charge is temporarily suspended. The concession is made subject to certain conditions: (a) that one-third or more of the ordinary share capital of the company forms part of the property chargeable for estate duty; (b) that the loan does not exceed the estate duty which the executors show could not be paid without realising some or all of the shares on which duty is chargeable and (c) that estate duty up to the amount of the loan is paid within a short interval after the loan is made. If the loan is not repaid within five years the income tax charge is enforced. We considered asking that this concession should be made statutory, but were persuaded by the Inland Revenue that it is more beneficial as an extra-statutory concession. **We therefore recommend that the extra-statutory concession for loans made by close companies to pay estate duty should be continued, expressing the hope that it will be made as widely known as possible.**

[1] Assuming £1,000 of capital per employee, which corresponds with the findings of our postal survey.

than commercial hereditaments, as otherwise the benefit might all go to the relatively profitable sector of office and shop developments (although a free market ought to adjust to a new rent scale over the whole, after a transitional period). **We therefore recommend that a similar concession to that given for agricultural land should be given for ownership of industrial land and buildings whether or not the landlord uses them for a trade.**

13.76 *Problems of valuation.* Valuing the equity of an unquoted company is a long, difficult and uncertain process. It is also expensive, requiring professional advice if the assets are at all complicated, and this expense may often deter legatees from disputing as seriously as they otherwise would what they regard as an unfair valuation by the Estate Duty Office. This can result in an additional disability for the small company forced to dispose of shares in order to pay estate duty. The Inland Revenue have argued that to deduct from the value of the estate all or part of the cost of valuing the unquoted equity, as the CBI and others have proposed, would be improper because the duty is based on the value of the assets at the time of death, not on what the beneficiary receives, and because valuation of the property is often necessary for purposes unconnected with estate duty. We take the view, however, that in many cases the need for valuation can be wholly attributed to the estate duty provisions and that it would be right to make an allowance for this. **We therefore recommend that a proportion (say half) of the cost, including the cost of associated litigation, of valuing assets other than quoted securities should be deducted from the estate for purposes of the duty.**

Recommendations

13.77 We wish to emphasise again that what is needed is a taxation policy which will restore initiative, encourage entrepreneurial activity and improve the liquidity position of small businesses. We believe that continued reduction in taxation of personal incomes and of estates would be most likely to achieve this result. This point is not specific to small firms, however, and we therefore merely state our view for the record. Our recommendations are as follows:

1. We hope that the current discussions between the Institute of Chartered Accountants, the Confederation of British Industry, and other interested parties on the question of adapting accounting techniques to take account of inflation, will be pursued with urgency and will be speedily brought to a successful conclusion. (Paragraph 13.48.)

2. We hope that when the rate for the new-style corporation tax is finally determined, account will be taken of the fact that the 50 per cent rate suggested in the Green Paper would involve an additional burden on the small company, which because of its dependence on self-financing makes a lower average distribution than the larger company. (Paragraph 13.49.)

3. Shortfall assessment on the trading income of close companies should be abolished, and no parallel provisions should be included in the forthcoming revision of corporation tax. (Paragraph 13.56.)

Committee of Inquiry on
Small Firms
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From The Chairman

15 January 1971.

Sir John Eden Bt, MP
Minister for Industry
Department of Trade and Industry
1 Victoria Street
LONDON SW1

Dear Minister

On 21 September last I wrote to the then President of the Board of Trade, Mr Michael Noble, about this Committee's belief that the Government should take an early opportunity to improve the morale of small businessmen and that the most effective way to do this would be some concession in the field of taxation. Mr Noble was kind enough to pass on these general views to the Chancellor in a letter of 6 October. At the same time I promised to inform the Government, as soon as we were in a position to do so, of the recommendations on tax matters which we propose to make in our Report, bearing in mind that the full Report will reach Ministers too late to be taken into consideration during the framing of the Budget.

My Committee wish to emphasise again that what is needed is a taxation policy which will restore initiative, encourage entrepreneurial activity and improve the liquidity position of small businesses. We believe that continued reduction in taxation of personal incomes and of estates would be most likely to achieve this result.

These matters would affect all equally and not small businesses preferentially. There are certain areas in which we believe that small businesses suffer inequities or unnecessary disabilities as a result of the present tax system, and we have a number of recommendations to make on them. We are not proposing radical discrimination in favour of small firms, since we do not believe that a case could be made out for this at the present time.

In the attached paper we have listed the more straightforward recommendations, with a very brief indication, in each case, of our reasons for favouring them; to argue each case in detail, as we shall in our Report, would entail far too long a document for present purposes. We have however discussed these recommendations at length with Inland Revenue officials, for whose help we are very grateful.

This is not a complete list of the recommendations on taxation which will appear in our Report. Of the remainder some are too complex for consideration in a Budget submission, and there are others on which we are not yet finally agreed. We are anxious however that such proposals as we have agreed on should be available for consideration during the preparation of the next Budget. We hope that you will think it right to pass on these recommendations to the Chancellor.

Yours sincerely,
J E BOLTON.

from the ownership of a controlling interest in an unquoted business has been recognised by Parliament, and the Finance Act 1965 provides that payment in such cases may be spread over a period of eight years. The same spread may be allowed, at the discretion of the Inland Revenue, in the case of minority interests where immediate payment would cause undue hardship. There is no reason in principle why these arrangements should not also be available for estate duty. *We accordingly recommend that similar facilities should be provided for payment of estate duty by instalments and that the facilities should extend also to estate duty on interests in unincorporated businesses.*

Estate Duty Relief

6. Estate duty relief of 45 per cent which now applies to agricultural property and industrial buildings, plant and machinery, these concessions dating from 1925 and 1954 respectively, reflects the emphasis placed on "productive" industry as opposed to "services". We feel that this sort of discrimination is no longer justifiable and that to generalise this relief would be both consistent with the recent trend of official thinking and particularly helpful to small businesses, which are heavily concentrated in the service sector. *We therefore recommend that the estate duty relief of 45 per cent now allowed to agricultural property and industrial buildings, plant and machinery should be extended to net trading assets (including any amount in the "assets valuation" of the concern which arises in respect of "goodwill") and to controlling interests in unquoted companies to the extent that their value represents net trading assets (including "goodwill") of the company.* We exclude minority holdings of unquoted shares since they are not valued on an "assets" basis and to give relief for all unquoted shares would discriminate against shares in quoted companies.

Retirement Provisions

7. We believe that the working proprietor or self-employed man is in a disadvantageous position in respect of the provisions that may be made for his retirement. The restrictions for relief on payments towards a retirement annuity are stricter than for an employee and the self-employed man is not permitted to commute part of the annuity. *We therefore recommend that the tax reliefs which are available for insurance-based pension schemes set up for non-controlling directors should be extended to similar schemes for proprietors of unincorporated businesses and controlling directors of close companies. There should be equivalent relief for pension funds to provide for the retirement of such proprietors and controlling directors.*

Retirement Relief from Capital Gains Tax

8. As a measure of transitional relief until such a revised occupational pension scheme can be implemented *we recommend that retirement relief from capital gains tax should be raised from* £10,000 *to* £15,000 *as soon as possible.*

Introduction

14.1 The Industrial Training Act of 1964 established a basic framework within which training was to be carried out in the greater part of industry and commerce. The Act had three main objectives:

—to ensure an adequate supply of properly trained men and women at all levels in industry;
—to ensure an improvement in the quality and efficiency of industrial training;
—to share the cost of training more evenly between firms.[1]

The Act provided for the creation by statutory instrument of industrial training boards (ITBs) to cover individual sectors of industry or commerce. It also required the Secretary of State for Employment to establish a Central Training Council to advise him on the exercise of his functions under the Act. Since 1964, 28 boards have been set up with responsibility for some 16 million workers. The boards are listed in Table 14.I. During most of 1971 the system has been under intensive review in the Department of Employment, with a view to the publication of a "consultative document" outlining the Government's plans for the future of the training board system. We sent our interim conclusions to the Department and our final views are put forward as a contribution to this process of re-thinking.

The composition and functions of an industrial training board

14.2 Members of industrial training boards are appointed by the Secretary of State for Employment. The Act stipulates that the Chairman must have "industrial or commercial experience" and that employers' organisations and trade unions must be equally represented. An industrial training board has the duty of ensuring that sufficient training is provided in its industry, and of publishing recommendations on such matters as the nature, content and length of training for occupations in the industry, and on associated further education. Boards must exercise their functions in accordance with proposals submitted to the Secretary of State and approved by him. They are required to impose a levy on firms in their industries under the authority of a statutory instrument (referred to in the Act as a "levy order") made by the Secretary of State. The order may exempt certain classes of firms from payment of all or part of the levy. Levies collected by the boards in the financial year 1969/70 amounted to just over £175 million, and investment income was £1 million. Grants paid in the same period amounted to £175·5 million to employers and £2 million to other organisations. Administrative expenses were £5 million and the cost of training advisory services amounted to nearly £7·5 million. Under the Act the Secretary of State may make grants and loans to boards up to an aggregate of £50 million, after which sanction for further expenditure would be required from Parliament. Grants totalling £9 million have been made to the boards since 1964, including £3·5 million towards their administrative costs, which are met entirely by the Government in the first year of a board's existence.

14.3 The Industrial Training Act was introduced at a time of widespread concern that shortages of skilled labour would put the United Kingdom at a competitive disadvantage with other nations. The White Paper[2] setting out the

[1] *Industrial Training Act: General Guide*. Ministry of Labour, revised edition 1965.
[2] *Industrial Training: Government Proposals*. Cmnd. 1892, December 1962.

a considerable improvement in the standard of apprentice training in certain industries, where the Government's hope that the standards of the best firms would be more widely emulated has to some extent been achieved. In engineering, for example, a scheme of first year training "off the job", followed by specialised training under the "module" system, has permitted a reduction in the period of craft training for apprentices. Some training boards, moreover, have in recent years encouraged forms of training specially adapted to the needs of small firms.

14.5 Notwithstanding these benefits of training under the Act, this legislation has aroused violent controversy almost from the start. In industry generally it has found far more detractors than supporters, and small businessmen in particular have been prominent among the critics of the Act and the training boards. The evidence we received leaves us in no doubt that the balance of opinion among small firms on this subject is heavily unfavourable to the system as it has evolved. The strength of feeling expressed on what might be thought a subject of fairly minor importance has been surprising. Our purpose in this chapter is to examine these complaints and suggest remedies for those we find to be justified. However, both the Government and the training boards are fully alive to the view of industry, and much has already been done to remedy the worst features of the system. The difficulties experienced by small firms, and hence the complaints we have received, may be classified under three heads:

i. the administrative cost of the system;
ii. the unsuitability to small firms of board-sponsored training;
iii. the financial drain imposed by the levy (whether recovered or not).

The administrative cost of the system

14.6 Most of the complaints we received about the working of the Act concerned the administration and form-filling involved in claiming grants. The following selection of quotations from our evidence is typical:

> . . . . small firms often complain to me about the length and complexity of the forms that are required to be completed by the training boards.
>
> (An Industrial Liaison Officer)

> . . . . and if it is to be effective, industrial and commercial training requires the enthusiastic support of the employer and this will not be achieved if he is swamped with a deluge of forms and paper work and faced with a bureaucracy apparently insensitive to his particular needs. This may be an exaggeration of the existing position, but the evidence from the survey (of small firm members) gives serious grounds for concern.
>
> (London Chamber of Commerce)

> The burden of additional paperwork is a major point of criticism, particularly as this is essential to success in claiming grants.
>
> (Engineering Industries Association)

> No-one denies that for many years there has been a need for more training in industry and commerce but the Industrial Training Act has taken the situation from one extreme to another. The organisation is over-elaborate and expensive, and could be greatly simplified and considerable economy in administration effected. There should be some regard for the smallness of the undertaking and the unduly detailed returns dispensed with in appropriate cases.
>
> (Western Counties Association of Chambers of Commerce)

One member of the Engineering Employers Federation, indeed, told us that "it often appears that skill in filling in forms offers a better return than improved training". A survey by the Furniture and Timber Industry Training Board of

secure a high proportion of the contribution made by them in levies. A few firms find the administrative problems of form-filling for grant further aggravated because their activities overlap industries covered by more than one training board. A chairman of a group training scheme complained of the "severe embarrassment" of his firm's having to deal with three boards, each of which had a very different policy.

Unsuitability of board-sponsored training

14.8 Complaints about the way in which small firms have been affected by the Act were not directed solely at the administration involved in claiming grant. One point which was emphasised forcefully by many witnesses was that in the field of training, as elsewhere, the small firm has important characteristics which differentiate it from the large and which greatly increase the small firm's difficulty in deriving full benefit from the services of the training boards. Small size in itself creates problems: it often means that there is no intermediate level of supervisory staff between management and employees and almost invariably means that specialist training officers cannot be employed. Responsibility for training therefore falls directly on the boss, and among all his other, more urgent, preoccupations it inevitably has low priority. If the total staff of the business is very small, it will be particularly difficult to send employees on day release or other courses of further education, since their absence will leave a gap that cannot be filled. Furthermore, as is shown in Chapter 2, labour turnover in small firms is considerably lower than in large. Employees stay longer in their jobs, instead of moving frequently in response to offers of better pay, apparently because they derive a special satisfaction from working in a smaller group. Thus the need to provide basic training will arise rather infrequently. Changes among management and supervisory staff are particularly rare, since they are frequently linked by family ties. Nevertheless, under the present system levy usually has to be paid every year on all employees covered by the Act. Since the opportunity to claim grant is intermittent, in many years there is an unavoidable net loss to the firm. This has now been recognised by several boards which pay grant for the establishment of suitable training programmes rather than for numbers of trainees.

14.9 Perhaps more serious still is the contention that the types of training favoured or provided by the boards are fundamentally unsuitable for many small firms, either because small firms work in highly specialised fields where the training boards have no competence or because the types of training programmes recommended by the boards are designed, whether consciously or not, with the needs of large firms in mind. Whatever the reasons, it is clear that many small firms do not find the boards' activities relevant to their needs. The following quotations from our evidence are typical:

> It seems clear also that the specialist small company, which may be the leader in its own field, has cause for complaint if its own industrial training schemes, geared to its special needs, are not acceptable to the board, or at least are acceptable only after considerable expenditure of time and effort. Problems also arise when training boards attempt to devise clerical training schemes which are based solely on the experience of the bigger companies: often these are totally inapplicable to the small business.
>
> (London Chamber of Commerce)

boards themselves. Overall, therefore, industry as a whole fails to recover its levy payments. The important question for us is whether small firms do worse than large in this respect, and we have no doubt that in general they do. There is evidence for this in some of the boards' annual reports, which display concern at the failure of many small firms to claim grants, and in the special schemes certain boards have adopted to improve the recovery rate of small firms. In any case it is hard to believe that a situation in which 65 per cent of large firms failed to recover their levy payments would have been tolerated. The levy/grant system thus imposes a net drain on the financial resources of the sector. The sums involved should not be under-estimated: though the levy is normally only a small proportion of a firm's payroll, it may represent a substantial proportion of its profits. We have received a great deal of evidence that in times of inflation and credit restriction small firms find it difficult to maintain an adequate level of working capital, and in some cases the training levy may significantly increase this difficulty. It is not difficult to find reasons why most small firms are in this position. As we have seen, some of them deliberately choose not to claim the grant because the businessman cannot spare the time needed to fill in the form. Others are genuinely unable to undertake sufficient training of the sort that attracts grants, either because of low staff turnover, or because a small staff or geographical isolation makes it impossible to release employees or send them on training courses.

14.11 Even those firms which get back in grant more than they pay in levy will suffer a drain on their finances if there is delay between the payment of levy and receipt of grant. Firms in this situation are in effect providing a "forced loan" to the training boards. This causes great resentment, but it is mitigated where boards allow payment of levy in two half-yearly instalments, and, far more important, when boards "net" levy and grant by paying the grant at the same time as the levy is assessed, so that only the net difference between the two changes hands. When we began our Inquiry this procedure was uncommon, but it is now becoming general, partly as a result of pressure from the Government. The Secretary of State for Employment stated in a written Parliamentary Answer on the proposals he hoped training boards would submit for his approval: "A proposal to increase the rate of levy will not normally be approved. Arrangements for netting levy payments against grant should be introduced generally".[1] There are now seventeen boards which "net" levies and grants in this way.[2] Some boards take up the levy in two instalments, the first a small instalment for the purpose of their own cash flow, and the second netted against grant. We hope that "netting" will become the universal practice of the boards.

Research by the training boards

14.12 All of the problems outlined above have long been evident to the people who are active in this field: it was clear to the training boards themselves after

[1] See *House of Commons Hansard* Vol. 812 No. 90 of 23 February 1971 (Col. 118).

[2] The boards now "netting" levy and grant are: Air Transport and Travel; Ceramics, Glass and Mineral Products; Chemical and Allied Products; Clothing and Allied Products; Cotton and Allied Textiles; Distributive; Engineering; Food, Drink and Tobacco; Footwear, Leather and Fur Skin; Foundry Industry Training Committee (EITB); Furniture and Timber; Gas; Iron and Steel; Paper and Paper Products; Petroleum; Printing and Publishing; Water Supply.

that the procedure for claiming grant should be simplified where possible by producing claim forms specifically designed for the smaller firm.

Current training board practices

14.13 All of these recommendations have to some extent been acted upon. Since the Chief Officers' Committee reported there have been significant modifications to training board practices. These have followed two main lines:

—exempting small firms from levy;

—sponsoring special forms of training for small firms under the levy/grant system.

However, the Committee did not see its function as being to assess the suitability to small firms of the levy/grant machinery as such. Instead it concentrated on particular areas of difficulty with a view to making the existing system work better. We discuss below the improvements in training board practices which have taken place since it reported.

Exempting small firms from levy

14.14 Section 4 of the Industrial Training Act enables the training boards to make different arrangements for different classes or descriptions of employers. Since the first levy and grant schemes were introduced in 1965, the boards have increasingly exempted small firms at the lower end of the scale from the levy/grant system because they have recognised the extreme difficulty of meeting their very specialised needs within their normal machinery and because they have judged that the cost and administrative complication of including the smallest firms outweigh the advantages to be gained. The Engineering Industry Training Board, for example, recently proposed not to charge levy on the first £35,000 of total payroll (instead of exempting the first £7,500 as before) effectively exempting some 11,000 firms (i.e. about 40 per cent of the total), but is also proposing to make certain grants available to firms below the exemption level. Some boards (e.g. the Food, Drink and Tobacco, and the Paper and Paper Products ITBs) allow firms exempted from levy on these grounds to "opt in" to the system nevertheless, paying levy voluntarily and claiming grant. Brief details of exemption limits below which boards do not collect levy are given in Table 14.I. In some sectors the number of firms exempted by individual boards has been very large. For example 59 per cent of those manufacturing firms employing under 25 who replied to our postal questionnaire said that they did not have to pay a levy. In the non-manufacturing sectors, 90 per cent of our respondents in catering, 78 per cent in retail distribution and 74 per cent in wholesale distribution were similarly exempted from levy/grant. In construction, however, only 9 per cent of our respondents were exempt from levy. We have of course defined small firms differently in different sectors, so this might have contributed towards these apparent differences. It is clear nevertheless that training boards are following somewhat different policies. We are pleased to see that the Government has now recognised the need for still higher exemption limits. In his written Parliamentary Answer of 23 February 1971 (referred to in paragraph 14.11) the Secretary of State for Employment said that he will "look for a significantly greater exemption of small firms from levy schemes" in future.

schemes by providing training officers and equipment. The Department of Employment estimate that by the end of 1970 there were over 650 group training schemes covering more than 800,000 employees. Two-thirds of all group training schemes are estimated to be covered by the Construction, Engineering and Road Transport Industry Training Boards. Many of these schemes are now developing a momentum of their own. It is difficult, however, to start groups without an injection of outside funds. The training boards have provided this initial finance and thereby helped increase the number of group schemes. In this respect the machinery set up by the Industrial Training Act has, we believe, benefited the small firm.

14.17 Two types of group are in existence at the present time. The first is the self-administered group (sometimes called independent groups) where the member firms form an association which finances the employment of a training officer, recruited and employed by the association. The alternative arrangement is one where a group of firms uses an outside organisation, such as the Industrial Training Foundation or their training board, which accepts responsibility for providing the training officer and servicing the group. There are certain problems that arise, however the group is organised:

i. In many areas there are not enough firms in one industry to form a viable group. This could sometimes be overcome by forming multi-industry groups where firms from a number of industries would join a group. Although a variety of technologies might be represented in such a group this is not necessarily a serious difficulty since the training officer is not usually an industrial technologist, but has an expertise in job analysis and the planning and organisation of training. A difficulty could arise from the variety of grant arrangements by different boards, which might make the financing of a multi-industry group complicated. This need not be an insuperable difficulty, and there have been discussions on the problems of multi-industry groups. In this type of group, servicing by an outside organisation might be particularly appropriate.

ii. Some small firms believe that they have "industrial secrets" which might become known to competitors through joining a group. Their fears are probably often exaggerated but this attitude does affect willingness to join a group.

iii. The training officer servicing a group of small firms may have to spend a considerable amount of his time in travelling and the cost per hour of effective training officer time must in such cases be greater than that of a larger firm which can employ a full-time training officer in one set of premises or at least in a relatively concentrated area. Therefore, if the small firm were to be put on a footing of equality with larger firms in regard to its training costs it would need some kind of subsidy. This can readily be provided through the machinery of the training board.

It is not always essential for a small firm to join a group in order to enjoy the part-time services of a qualified training officer. The firm can use an established independent training organisation to provide the amount of training officer's time it needs. An example is the Training Officer and Advisory Service provided

of the very large number of small firms, visits by training advisers cannot cover the whole field. At present the administrative costs of the training boards absorb some £5 million (i.e. over 3 per cent) of their levy income. If they were to increase their services to small firms significantly this cost would rise quite steeply and the proportion of levy available for paying grants would be further reduced. The Engineering Industry Training Board had this difficulty in mind when it stated in its Information Paper 25 on *Future Grant Policy* (published in July 1970) that:

> Neither the industry nor the Board's staff is yet fully equipped to move into a situation whereby an equitable grant award may be based on an identification of a firm's individual training needs.

This difficulty has weighed heavily with us in assessing the suitability for small firms of the training board system.

14.21 *Paying grant for in-company training.* A small firm will usually find it easier to carry out training on the job. "On the job" training carried out in accordance with certain minimum conditions is now recognised for grant by 15 boards with small firms within their scope. We have, nevertheless, been told by many bodies and small firms submitting evidence, both written and in oral session, that it is often extremely difficult to get grants for "on the job" training and that boards have been obsessed with external courses. This criticism has been levelled particularly at the Engineering Industry Training Board which is, of course, the largest. On the other hand, the Furniture and Timber Board told us that most of their training has had to be "on the job" because of the heavy preponderance of small and medium-sized firms in their industry.

Future policy

14.22 Notwithstanding the marked improvements that have taken place in the standard of provision for small firms, we are forced to conclude that because of the difficulties described in paragraphs 14.6–11 above, most such firms will continue to be unable to derive benefits from the training board system commensurate with its cost to them. The cost of claiming grants, the drain imposed by the levy on the small firm's finances, the inappropriateness of board requirements, and the lack of need for continuous training are in our view fundamental difficulties which, despite the good intentions and hard work of the training boards, will always prevent them from making a worthwhile and economic impact on the needs of small firms under the levy/grant system. We are also impressed by the evidence that the boards do not have, and could not in most cases possibly have, the resources needed to do a proper job for the very large number of small firms. We accept that the Industrial Training Act has increased training in small firms, as elsewhere. We believe, however, that this benefit has been of a "once for all" nature and is unlikely to be significantly improved by continuing the present cumbersome system. Some might propose that the boards should continue their attempts to meet the special difficulties of small firms but that they should do it more efficiently. **We believe, however, that the machinery set up under the Industrial Training Act is fundamentally inappropriate to the**

Transport Industry Training Board would lose £1,100,000 gross and save £600,000 on grants, thus losing £500,000, again before administrative savings. The effects on boards with a higher proportion of small firms would however be more drastic, and they might be obliged to curtail their activities. If this were thought serious, however, it would be possible to give support to such boards under Section 5 of the Industrial Training Act, which permits the Department of Employment to pay grants to training boards. Indeed, when the Bill which became the Industrial Training Act was passing through Parliament it was stated by the then Government that substantial grants would be paid from public funds towards the cost of the training boards. In fact the grants paid have been far below the expectations which were raised at the time. *If the exemption of small firms causes particular financial difficulty for some boards, the Government should be prepared to give short term financial assistance under Section 5 of the Industrial Training Act.*

Recommendations

14.25 We believe that the machinery set up under the Industrial Training Act is fundamentally inappropriate to the needs of most small firms and we therefore recommend that they should be exempted from the levy/grant system. Each training board, in consultation with the industry and the Department of Employment, should formulate an appropriate definition of the small firm in its industry and should establish an exemption limit designed to exempt them all from levy. Firms below these limits should be permitted to "opt in" to the levy/grant system if they wish. Training boards should consider the possibility of providing training services for small firms on a fee-paying basis.

Chemical and Allied Products (October 1967)	3,593 (1,185 employ under 200)	455,000 (10%)	1·5% of total emoluments, Levy is "netted" against grants.	£8,701,917 (0·7%)	Firms with a payroll under £25,000 are exempt from paying levy. Firms below this size can join grant scheme on payment of £40. Small Comp Advisory Panel established with whose help th board has prepared a series of booklets to help smaller firm appreciate the value of training. F group training schemes are in operation.
Clothing and Allied Products (October 1969)	About 15,000 firms. No breakdown by size.	N/A	0·25% of total emoluments reduced by £10,000 before assessment. After autumn 1971 it will be raised to 1%. Netting of levy and grant is permitted.	No levy income in 1969/70. D.Em. grant of £16,031 received.	Firms with total emoluments under £14,000 ar exempt from levy. In the autumn of 1971 this exemption will be raised to £25,000. The Boar formed a small firms and group training comm and there is one group training scheme in oper
Construction (July 1965)	86,310 plus 1,300 builders and plumbers	1,266,537 (27%)	9 per capita rates from £4 to £50 with lower rates for trainees, according to category.	£12,644,000 (6·5%)	Exemption for payrolls below £6,000 and payr between £6,000 and £14,999 reduced by 25%. Special department to deal with the manageme problems of small firms. In 1969/70 15 courses mounted at 7 centres on management apprecia for small firms. Group training is actively encouraged; and there are 215 schemes in ope
Cotton and Allied Textiles (July 1966)	1,700 ests. (1,004 employing under 250)	222,891 (NA)	0·85% of total emoluments. Levy payments are offset against grant.	£1,549,843	Exemption from levy when emoluments are un £15,000. Where levy is less than £10 it is not collected. Has a Small Firms Advisory Commi The Board runs seminars on "improving mana ment efficiency" specifically geared to the need the smaller firm. There are 8 group training sch operating.
Distributive (July 1968)	95,707 ests. (70%)	1,407,348 (60%)	0·7% of total emoluments which are reduced by £2,500 before assessment. Netting of levy and grant is permitted.	£4,733,357 (5·8%)	Exemption from levy when total emoluments a under £6,000. There are 10 group training sche in operation. New opt-in scheme for firms with under £60,000 annual payrolls.

Foundry Industry Training Committee (March 1965; responsible to the Engineering Board)	1,540 ests. (1,333 employing under 200)	152,765 (31·6%)	2·5% of total emoluments. Netting of levy and grant is permitted.	£4,100,199 (1·7%)	Firms with emoluments under £25,000 are exe The Committee has established a Management Development Unit at Aston University for assi small firms, whose advisers visited 140 establis ments in 1969/70, ran 20 seminars and produce over 200 management job descriptions. There a 15 group training schemes in operation.
Furniture and Timber (December 1965)	4,319 of which 3,375 are "leviable units" (95% employ under 200)	205,074 (13·5% in firms employing under 25)	0·75% up to £10,000 emoluments, 1% on next £10,000. 1.25% in excess of £20,000. Opting in is permitted for payrolls between £3,000 and £5,000. Netting of levy and grant is permitted.	£2,771,894 (10·2%)	Exemption from levy under £7,500. There are group training schemes in operation.
Gas (June 1965)	13 (No small firms)	199,475 (None)	1·05% of total emoluments proposed. Netting of levy and grant is permitted.	£1,331,427 (1·8%)	No small firms in scope.
Hotel and Catering (November 1966)	106,500 ests. (59%)	664,000 (NA)	1·25% of total emoluments.	£2,554,000 (18·5%)	Firms with a payroll under £6,000 are exempte Payrolls reduced by £2,400 before assessment. There are 52 group training schemes in operatio
Iron and Steel (July 1964)	160 ests.	309,700 (NA)	There is a levy of £6 per head, and £3 per head for first 20 employees. Firms employing under 11 are exempt.	£7,167,281 (0·6%)	Firms employing under 11 are exempt. Chair of group training schemes and small firms' repre sentatives meet for regular discussions. There a group training schemes in operation.
Knitting, Lace and Net (March 1966)	1,087 firms (920 are small firms)	154,118 (30·7%)	0·75% of total emoluments.	£1,108,056 (11·4%)	Exemption from levy for firms with payrolls of under £7,500. Where assessment is £10 or less it not collected. The Board runs seminars on "Imp ing Management Performance", which cater for small firms. There are 11 group training scheme operation.

Road Transport (September 1966)	50,972 ests.	891,000 (47·3%)	Earnings between £5,000— £19,999: 1·5%. Over £20,000: 2·2%	£16,914,796 (2·2%)	Firms with payrolls below £5,000 are exempt. There is a Training Assistance for Small Comp Department. Plans to introduce mobile trainin units outside London. There are 116 group trai schemes in operation.
Rubber and Plastics Processing (August 1967)	2,461 ests. covering 1,612 firms (1,409 employing under 250). (Uses under 75 employees as a working definition of a small firm)	269,372 (22·8% in firms employing under 250)	0·75% of total emoluments.	£2,032,091 (4·7%)	Firms employing under 10 are exempt from lev Has sponsored week-end courses on "Manager in the Smaller Businesses" after research by the Aston Small Business Centre and the Board's training advisers. There is a small firms Sub-Committee. Pays grants for in-company trainin provided by those employing under 75. Grants available towards the cost of employing trainin consultants by small firms. There is one group training scheme in operation.
Shipbuilding (November 1964)	1,166 firms (1,079 employing under 250). (Board's small firm definition is 25 employees)	120,196 (33%)	1·75% of total emoluments	£2,111,495 (3·8%)	A Small Firms Sub-Committee has studied the problems. There are 6 group training schemes i operation. Firms with payrolls below £5,000 ar exempt.
Water Supply (June 1965)	250 (No small firms)	43,000 (None)	1·6% of total emoluments. Levy may be "netted" against grants.	£770,581 (3·7%)	No small firms in scope.
Wool, Jute and Flax (June 1964)	2,111 ests. (1,579 are small)	172,700 (52·4%)	13 rates of levy for different occupations between nil and 1·5%.	£1,504,406 (4·8%)	Firms with emoluments below £5,000 will be exempt. 10% of remaining emoluments up to £50,000 are also exempt from assessment. Oper a Training Consultancy Service on a commercia basis. There is a sliding scale concession to smal firms regarding cut-off of grant, i.e. spread over period of 5 years and a simplified grant applicat form for small firms. There is one group trainin scheme in operation.

Sources: Department of Employment evidence.
Training Board submissions.
Annual Reports for the year ending 31 March 1970.
"Levy Orders".
Censuses of Production and Distribution (for estimates of firms in scope where there is no ITB data).

remotest chance of these being completed within the next 6 months.

We calculate that irrespective of PAYE and National Insurance, we already spend the equivalent of 2 months' working time for one man working on Government and semi-Government records, forms and statistics. We regret that these forms can only be completed by the Chief Accountant or myself personally. No member of staff is capable or has access to information to enable them to complete such statistics.

We are driven crazy by all this bureaucracy. You may need the information. We physically cannot give it. These forms will take the equivalent of one full day's work to complete and right now, we wish we could create one full day for ourselves to do the work we have.

Industry is dying under the weight of paper.

Yours faithfully.

The increasing involvement of Government

15.3 Since most of the burden of form-filling in the small firm falls on the proprietor, there must clearly come a point at which the cost of collecting better statistics or of new administrative procedures, desirable though they may be, outweighs their value. This would be recognised in principle in all the departments and in particular by the Central Statistical Office. We do not believe, however, that Government understands the true cost of completion of its questionnaires in terms of diversion of effort by the proprietor of a small firm on whom the burden directly falls. Yet the burden is liable to continue to grow because of the increasing demand for statistics, on the part of industry as well as Government, and the increasing complexity of life in a modern economy. Our tax law, for example, has become more complicated year by year, although some attempt at simplification is now being made, and Government finds it necessary to be better informed on innumerable issues affecting industry and commerce, from labour relations to the control of pollution. It would therefore be vain to hope for a dramatic reduction in paperwork; the best we can hope for is to contain it within tolerable bounds.

The need for co-ordination

15.4 We have made a distinction between statistical and administrative forms because it is a convenient way of breaking down a large subject and because it is observed in a very important practical way within Government. Nevertheless we recognise that no such distinction is made by most small firms. From their point of view as respondents, the different types of official paperwork are all of a piece; they are all burdensome, in greater or lesser degree, and they all require strict justification in terms of their benefits outweighing their cost to industry as well as Government. We sympathise with this point of view. The collection of information from, and maintenance of records about, industry by Government, for whatever purpose or by whatever department, must in our view be treated as an integrated whole. In the long term it will appear ridiculous that businessmen should be required to submit to the Inland Revenue, to Companies House, to the Business Statistics Office and to any number of official agencies very similar information about their businesses in so many different permutations. Businessmen have complained to us that they are repeatedly called upon to supply the same information to different agencies and they question why data cannot be transferred within the public sector.[1] Still worse, they complain that two agencies

[1] The Committee are of course aware of the fears of other businessmen about the loss of confidentiality if a data bank system were adopted. This is considered later in the chapter.

ii. inquiries are excessively detailed or complicated, and require the production of information in a form that is unfamiliar to the firm, and therefore expensive to produce;

iii. the statistics produced are of dubious accuracy because many respondents make little attempt to ensure the accuracy of the information returned;

iv. the published statistics, which are normally national aggregates, are of no use to small firms, which typically operate in a localised area rather than the national market;

v. statistics are collected for their own sake, without proper consideration of the need for them or their cost to industry.

We accept that not all of these complaints are valid, but the fact that these views are strongly held by small businessmen is nonetheless significant, since it indicates that the statistical burden makes an important contribution to the estrangement between business and Government which is so marked a feature of small firm psychology.

15.6 We should say at once that we do not share the view of some witnesses that the Government is already more than adequately informed about business and about small businesses in particular. Indeed, we believe that one important reason for the absence or inadequacy of official concern about small firms is the lack of any satisfactory statistical assessment of their position. We were astonished, on starting our Inquiry, by the paucity of knowledge about small business, and in particular by the lack of suitably analysed statistical information in the Government machine, which necessitated our adding to the burden by our own inquiries. We are confident that this deficiency could be made good to some extent by a more thorough analysis of statistics already returned on existing statistical and administrative forms, and by suitable amendments to these forms, while still reducing the overall burden on the reporting firms. There can, however, be no question of exempting small firms from the obligation to provide a minimum of statistical information. Even taking the narrowest view of the small firms' interests it is desirable for the Government to be much better informed about them than it now is. If, as we hope, future Governments are to take proper account of the interests of small firms in formulating policies, they must have adequate information about them. The Government must also collect such information to produce accurate statistics about the United Kingdom economy as a whole. In certain areas of manufacturing and in all services, small firms make a significant contribution to the total, so that without information from them global statistics would be seriously inadequate. Small firms must therefore provide sufficient information for those purposes, but they have a right to expect that the demands on them will be kept to a minimum by efficient organisation in Government.

The present statistical burden

15.7 The Central Statistical Office have provided us with information on the relative incidence of statistical inquiries on small firms (as defined by the Committee) and on large. This is reproduced at the end of this chapter as Table 15.I. It shows that a number of statistical inquiries are completed only by large firms, because it is accepted that many of these are too onerous for small busi-

firms' 1·5 million—a ratio of 4:1. The number of "white collar" workers in each sector is a still better indication of resources for this purpose. A large firm can employ specialists, such as accountants or statisticians, who can more easily turn to form-filling than the small firm manager whose regular job is of a very different nature. A small firm manager moreover may deal with form-filling himself because he is unwilling to delegate. Using this measure of "white collar" workers would tip the balance further in favour of the large firms—especially if we remember that in the small firm the burden usually falls on the principal decision maker. The proportion of resources taken up in statistical form-filling, using this crude measure of the number of forms, is therefore at least four times as great in the small firm sector as in the large firm sector. This conclusion however is subject to qualifications. First, the ratio only applies to the small firm and large firm sectors taken as a whole. It cannot be used to compare individual, or even average, firms because there is known to be considerable variation in the form-filling burden within each sector. For instance, firms with 150–200 employees may typically receive about 30–40 forms each year, while those with ten employees or less (which account for about half of all small firms in manufacturing) may receive none. Secondly, it must be emphasised that *these calculations have been confined to manufacturing*, where the form-filling burden, particularly on small firms, is greatest. In the service trades the number of inquiries received per firm is much lower. Thirdly, since no allowance has been made for the complexity of different forms, the argument rests on the supposition that forms sent to small firms are at least as complex as those sent to large firms. Nevertheless, despite these reservations we believe that form-filling constitutes a real and disproportionate problem. **We therefore recommend that the effect on small firms of all statistical surveys be carefully considered and every effort made to extend the present practices of sampling and of exemption of smaller firms wherever possible.**

The controlling function of the CSO

15.10 At present it is the responsibility of each department collecting statistics from business to ensure that this is done as efficiently as possible and at the least possible cost to industry. Some of our witnesses believe that co-operation between departments is at present inadequate. The Institute of Statisticians expressed sympathy for the idea of a single statistical agency which would collect all information, "first, because series covering different topics are likely to be more comparable if they are collected by the same agency than if they have nothing in common; secondly, because in general there are few less rewarding tasks than trying to reconcile two different series collected by different authorities, ostensibly relating to the same aggregates." However, no department has formal powers to take an overall view of the statistical burden. The closest approximation we now have to a single agency is the Central Statistical Office which is responsible for ensuring that the collection of necessary data by the Government's statistical service is conducted in an orderly manner as regards phasing and frequency of enquiries, use of definitions and classifications, elimination of unnecessary overlap among inquiries and in general for critical examination of all new and existing inquiries from the viewpoint of the supplier. This responsibility is discharged through the recently established Survey Control Unit of the CSO. This unit has no statutory authority. Its power derives from the central

regularly reviewed and justified. **We recommend therefore that the use of statutory powers for the collection of statistics should be strictly controlled and in all cases explicity justified.**

15.13 It is not generally known that completion of the majority of statistical enquiry forms issued by the Government is not a statutory requirement: for example, we suspect that the quarterly steel return, though not a statutory requirement, is often thought to be so. When the completion of a questionnaire is not a statutory obligation, we think this should be made clear to the respondent. A substantial part of the complaint really arises from what is considered to be the enforced burden. Much benefit might be obtained by disclosing the true position. It is possible that the response rate would not be seriously affected, but even if it were to be reduced we think it preferable for the respondent to be in no doubt about his legal rights and obligations. **We therefore recommend that it should be clearly stated on every statistical enquiry whether or not its completion is obligatory.**

15.14 A controlling authority could also do much to improve the design of forms, which we believe has hitherto not received sufficient attention. In particular we had misgivings about the old Census of Production form, which was exceedingly long and which asked in some cases for input and output figures to be entered against 100 or more product headings. Although on average small firms completed only three of these headings, merely to receive a form of this length provoked an unfavourable reaction which we believe accounts for the fact that the Census of Production has attracted more criticism from our witnesses than all other statistical inquiries combined. (The current census form is much shorter—some twelve pages and thirty headings only.) We accept that the issuing department will not know beforehand which headings the respondent will complete and that it may be easier for the respondent to classify his sales under a narrowly defined list of products, but we suspect that these advantages are outweighed by forms which give rise to the kind of resentment expressed in this letter from a witness:

> I find that there is an attitude of mind of Government departments that they demand all sorts of information from companies regardless of the trouble, inconvenience and cost a small company can be put to in providing the same. Personally I always resist on principle as a protest and frequently supply inaccurate information or incomplete returns just to put them to more trouble.

We do not of course support this attitude, which is incorrect in that the Government do pay some regard to the cost to industry of providing statistics, and also foolish, in that the return of false information not only diminishes the value of that provided by other respondents but will often be detected and give rise to an additional burden on the firm in responding to requests for clarification. Nevertheless we can understand the frustration which finds expression in this way. A more powerful CSO should be able to ensure that more attention is paid to the psychological aspects of form-filling. We are pleased to note that large-scale Censuses of Production are now being discontinued. In the new system there will be a series of quarterly, industry-based inquiries about the goods which firms produce: this will cover all except the smallest firms, i.e. those with

out a full survey of firms in all trades, and we know that this matter has been looked at from time to time. It may be that the recently instituted system of annual Censuses of Employment will provide some further information since these are rather more comprehensive than other censuses. But information from this source would not include statistics of sales or turnover, for instance, nor would it provide information on business demography. Apart from the question of comprehensive coverage there is also a disadvantage in the present methods which is of special importance for an assessment of trends in industrial structure: it is that a business organisation which has interests in several industries appears separately in each of the inquiries, without its total size (in terms of employment or turnover) appearing anywhere. For example, a holding company with subsidiaries in manufacturing and distribution appears once in the Census of Manufacturing and then again in the *Census of Distribution*. The result is that the degree of concentration of the economy is inevitably understated, and the number of independent firms of a given size is overstated. We appreciate that the Central Register of Businesses, towards which the Government Statistical Service is working, may help in this direction since it is an essential feature of the register that it records the links between the various businesses on the register. However it is not certain that this development would necessarily provide the information on the small firm sector of the economy which we have in mind and **we therefore recommend that the Central Statistical Office should reconsider the question of the preparation and publication of an enterprise census, which would provide comprehensive coverage of all firms, as soon as possible as part of its plans for the development of business statistics.**

Business Statistics Office

15.17 An important recent development is the formation of a Business Statistics Office, which is charged with the responsibility for collecting industrial statistics, making available the results, and for building and maintaining the Central Register. Its policy is directed by a small inter-departmental management committee under the chairmanship of the Director of the Central Statistical Office. The BSO will provide a common service to industry and to the Government Statistical Service alike, and the collection and dissemination of industrial statistics will become much more centralised than hitherto. We welcome this development, as we do all activities directed at obtaining greater value for the cost of the collection of statistics.

Costing statistical enquiries

15.18 A suggestion made by the Timber Trades Federation, among others, is that industry should be compensated for the labour of form-filling. This idea has many attractions, not least that of economy, in that the true cost of a statistical inquiry would be brought home to the sponsoring department. Regretfully, however, we cannot support it, largely because the cost of administration would be excessive if payment were to be in line with the actual cost to the respondent. **Nevertheless it is of the utmost importance that the true cost of any statistical exercise, and not merely the often comparatively small proportion of the cost falling on Government estimates, should be fully taken into account before starting an enquiry, and methods chosen which involve the least total cost rather than least**

future, even when the evidence of decline has been available for them to read: equally, firms in this position could frequently learn from published statistics which are the growth markets in their area. The CSO are putting considerable effort into persuading small and medium sized businesses to make use of the published statistics: their very helpful booklet *Profit from Facts* describes the statistics, suggests ways in which they might be used and gives case-histories of firms which have done so profitably. The fact that the CSO report a growth in the demand from smaller businesses for various statistical publications suggests that they are having some effect. The value of statistics is also much affected by their availability. We do not believe that the average small firm, however willing, would find its way to what is valuable in the statistics because there is no index to which it can refer. We are glad to find that the CSO is proposing to issue an Index of Statistical Sources which will help to overcome this problem. Such an index would also be of great benefit to trade associations. It should, of course, be one of the main functions of trade associations to interpret relevant statistics and other information to their members, but all too few of them are doing this at present. However, when all has been said about the possible value of statistics to small firms, it still in our view remains true that small business because of its very nature will obtain little direct benefit from central statistical effort.

15.21 We strongly approve the intention of the Central Statistical Office to improve co-operation and understanding between industry and the statistical service. It is already common practice for departments to consult representatives of the industries to be affected, usually the relevant trade associations, when planning and designing new surveys, but it is very difficult for them to establish effective contact with individual firms, especially small ones, because of the large number involved. In this matter the interests of trade associations and their members are not necessarily identical. If the small firm has no use for statistics, the trade association has; and we know of trade associations which, having urged a department to include in a survey additional questions of interest to themselves, have not only not informed their members of their part in expanding the enquiry, but have afterwards faithfully transmitted their members' complaints at the length of the form. (One enquiry on which trade associations were recently consulted, and which would have served the Government's purposes with 8 questions, would have had to be expanded to over 30 questions if all the additions suggested had been accepted.) It would seem necessary to create more direct links between the statisticians and small firms if "consultation" is to be a reality. This is a difficult public relations problem and we welcome the statisticians' increased recognition of its importance.

The likely effect of forthcoming changes

15.22 In spite of our satisfaction at the progress, both actual and projected, described in the preceding paragraphs, we were disturbed to find that some forthcoming "improvements" in business statistics are likely to increase rather than reduce the form-filling burden on industry, including small firms. For example, it is probable that the compilation of comprehensive employment statistics from National Insurance cards will be discontinued, being replaced by an annual Census of Employment. This change, though it will economise

difficulty about administrative forms is that to question whether a certain form is needed at all is to question the value of the policy it serves. In other words complaints of the kind quoted above are in effect pleas that the burden of paperwork should be given due weight, along with other considerations, in deciding whether some particular policy of Government is on balance advantageous to the nation, or whether on the other hand it should be abandoned or modified in some way.[1] Our impression is that the burden of paperwork is in general not given due weight and that administrative reforms are needed to correct this state of affairs.

Vetting of administrative forms

15.25 We were very disturbed to find that nobody in Government is able to estimate the cost to industry of administrative form-filling or has the responsibility to take an overall view of the question. As we said earlier it has been suggested that statistical forms, for which the CSO accept general responsibility, account for only about 15 per cent in man-hours of the total burden of official paperwork: for the remaining 85 per cent there is no focus of responsibility. It is of course impossible entirely to divorce responsibility for paperwork from responsibility for the policy giving rise to it, but there is an urgent need for the Government both to take account of the total cost of form-filling to industry—which at present it does not know—and to assure itself that all the information collected by means of administrative forms is necessary, is collected in as economic a way as possible from the suppliers' viewpoint, and is put to the fullest possible use as a source of statistical information, for only thus can the burden of statistical form-filling be reduced. It does no good to Government–business relations if costs to industry are apparently ignored when, for example, only the Government's costs of collection are published by the Inland Revenue or Customs and Excise (see paragraph 15.18).

15.26 We thus return to the fundamental question raised in paragraph 15.4. The present decentralised system of communication with industry makes it impossible either to measure the form-filling burden or to make proper use of the information the completed forms provide. Table 15.II lists five different statistical enquiries into numbers employed which are sent to varying samples of manufacturers; yet a businessman who has completed one or all of these will still have to state the number of his employees when applying for a training grant or an Industrial Development Certificate, because there is no mechanism by which data collected for one purpose can be processed for other uses. Worst of all, the enormous volume of information collected by departments for their own purposes is under-exploited, so that a statistical source of great potential value is largely wasted. We can support this from our own experience: our efforts to make use of administrative returns for statistical purposes were very largely in vain, even though the data which firms had fed into the Government machine were certainly relevant to many aspects of our Inquiry. To take one example only, the Inland Revenue, who have been exceedingly helpful to us in every respect, were unable to provide a cross-classification of firms by size of employ-

[1] For example, by the exemption of small firms, as we propose in the case of the Industrial Training Act (See Chapter 14).

approved federal administrative and statistical reports had increased by more than 30 per cent and that the Bureau had been unable to affect significantly the number of administrative forms distributed. This was not merely due to lack of resources—the Bureau were in fact opposed in principle to expansion of the Office of Statistical Policy to the size that would be needed to cope with the burden: it is rather, as we understand it, that the task was found to be beyond the powers of a statistical agency.

15.28 If we accept that there are reasons of principle why a statistical agency cannot successfully monitor administrative forms (and the experience of the Bureau of the Budget, in spite of the powerful commitment of the Senate and the Executive, suggests that we are unlikely to do better here) we cannot look to the Central Statistical Office to take the lead in this matter. What then, in the context of the United Kingdom, is the job that has to be tackled, and what, in the United Kingdom administration, would be the best machinery for tackling it? In answer to this question, we are putting forward two separate sets of proposals, one relevant to the short term and the other to the long term.

15.29 *The short term.* In the short term action must be taken to rationalise administrative form-filling, and at present this, in our view, can be done only within the issuing departments. **We therefore recommend that all departments should review all existing and proposed forms with an eye to their cost to industry—this review to extend to a reconsideration of the policies and administrative procedures giving rise to the need for these forms. Departments should also accumulate the total costs to indnstry of the forms for which they are responsible and review them annually.** We think it vital that professional statisticians should be closely involved in this for three reasons: first, because they are best qualified to judge the technical merits of the design of forms; second, because they should be more alive than other civil servants to the effect of a new return on the total burden of form-filling and to the possibility of duplication between forms; and third because they alone are competent to exploit administrative returns for statistical purposes. Moreover they also maintain liaison with the CSO and are most likely to be able to perform an informal co-ordinating function between departments of Government and develop a common approach to administrative enquiries. We should therefore like to see the Director of Statistics in every department charged, first, with initiating a grand review of all existing forms issued by his department, with the specific instruction to challenge, if need be, established policies and procedures in the interest of reducing the burden of paperwork, and, second, with participating *ab initio* in the detailed consideration of any new administrative arrangements liable to impose additional paperwork on industry. In this he will have a dual responsibility, first to his Permanent Secretary and second to the Director of the CSO, but this is the effective position already, so that from our point of view the present organisation of the Government Statistical Service is ideally suited for carrying out the function with which we think it should be entrusted. It may be objected that these functions are already in principle carried out by departmental statisticians but if so we believe that the control they exercise needs to be considerably tightened up: we are not satisfied that the total burden of form-filling is adequately taken into account when new policies are adopted, nor that the advantages of simplicity and sampling are given due weight, nor again

15.32 For these purposes we think it essential that a powerful and authoritative body within Government should begin the study of these matters at once, in consultation with industry (and in particular with small firms), and that it should have freedom to survey the entire field of Government paperwork. The problem remains to decide where this authority should be located. Since there is at present no authority in the Government competent to plan the administrative and information system of the 1990s, it follows that a new authority will have to be created if this job is to be done. **We therefore recommend that the Government should quickly establish within a central department a powerful and expert secretariat, whose function would be to plan, in collaboration with the CSO, an integrated system of administrative and statistical returns, based on a data bank, to form the basis for a single and comprehensive system of business records.** As its experience grew, it would be possible for the secretariat to assume certain executive powers which would be used to ensure that new departmental surveys were designed consistently with the overall plan.

15.33 We suspect that the main recommendations which we make in this chapter, both for immediate action (paragraph 15.29) and for the longer term (paragraphs 15.30–32) may call for a reversal of what appears to have been hitherto the official attitude to the role of statisticians in the Civil Service. This attitude, as we understand it, has made a virtue of the greatest possible segregation of the statistician from the administrator, presumably lest the latter's preoccupation with policy should corrupt the scientific objectivity of the former. For our part we are prepared to trust the professional integrity of members of the Statistical Service: on the other hand we are greatly concerned about the grave disadvantages which in our view inevitably result from any attempt to segregate the Statistical Service from the rest of the governmental machine. For whatever may have been the case in the past, the Statistical Service now has to be an integral part of Government. A large part of the process of present-day government consists of the collection, processing and analysis of quantitative information: these operations impose such a massive burden on the citizen and on industry and form such an intimate part of the daily work of the administrative machine that the guidance of statistical experts should surely be sought all the time, both for the improvement of existing administrative processes and in the consideration of new policies which, if adopted, would generate new administrative tasks. Moreover, almost all policy making, at any rate in the economic field, needs to be continuously informed by a quantitative assessment of the issues involved, which surely requires the closest association between policy makers and statisticians. For example, we have no doubt that our own proposal that a Division responsible for small firms and reporting to a specially designated junior Minister should be set up in the Department of Trade and Industry (Chapter 9) would be frustrated in its purpose unless the Minister himself and his senior officials were supported by statisticians expert at monitoring the course of events in the small firm sector, and at assessing the implications of new policies under consideration by the Minister. **We therefore recommend that statisticians should be more closely associated with policy makers, so that existing administrative processes can be improved, and in order that new policies can be based more firmly on a quantitative assessment of the issues involved.**

15. Statisticians should be more closely associated with policy makers, so that existing administrative processes can be improved, and in order that new policies can be based more firmly on a quantitative assessment of the issues involved (paragraph 15.33).

Manufacturing

This is defined as firms classified in Standard Industrial Classification Orders III to XVI (1958 SIC).

Small firms defined as those with less than 200 persons—in 1963, about 93% of all firms in manufacturing.

Statistical inquiries sent to Manufacturing Firms

A. INQUIRIES COMPLETED ONLY BY LARGE FIRMS

1. Fuel return (weekly and monthly).
2. Survey of company liquidity (quarterly).
3. Trend of profits enquiry (quarterly).
4. Inquiries into superannuation and pension funds (quarterly and annual).
5. Investment intentions inquiry (three times a year).
6. Inter-quinquennial Census of Production.

B. INQUIRIES COMPLETED BY SMALL FIRMS AS WELL AS LARGE. ESTIMATED PERCENTAGE OF SMALL FIRMS AFFECTED BY EACH INQUIRY

Under 1%

1. Continuing survey of road goods transport.
2. Fuel return (monthly).
3. Price quotation card for wholesale prices (monthly).
4. Inquiries into manufacturers' stocks (monthly and quarterly).
5. Return of PAYE numbers, pay and tax deducted (quarterly).
6. Quarterly inquiry into capital expenditure.
7. Consumers' receipts, use and stocks of steel (quarterly).
8. Inquiries into overseas financial transactions (quarterly annual and three-yearly).
9. Inquiry into expenditure on scientific research and development (annual).
10. Survey of goods vehicles (five-yearly).
11. Survey of transport from manufacturing establishments (*ad hoc*).
12. Transport costs survey (*ad hoc*).

1–5%

1. Monthly return of total wages and salaries—reference WS.
2. Earnings and hours by occupation—reference EO (six monthly).
3. (New) earnings survey (annual).
4. Analysis by occupation of numbers employed—reference L7/L8 (annual).
5. "Production" inquiries—annual and frequencies other than monthly or quarterly.*

small firms are exempted include a large number of the onerous and more frequent inquiries—such as, for example, the short term inquiries into stocks, capital expenditure, profits, investment intentions, liquidity, overseas financial transactions and use and stocks of fuel and steel, none of which go to more than 1% of small firms. The inquiries which are sent to a higher proportion of small firms tend to be undertaken either annually or even less frequently.

1. Exchange of group B National Insurance cards—number of insurance cards held (annual).

90% plus

1. Full Census of Distribution: [less than 10% of small firms were required to provide the full range of information; the remainder provide turnover and employment details only] (approximately ten-yearly).

Source: Evidence of the Central Statistical Office (CSO).

N.B. The CSO submitted similar information on the position in: Mining and Quarrying; Construction; Road Transport; Wholesaling; the Motor Trades; and Miscellaneous services. This information is not reproduced here for the sake of brevity. The position in other trades and industries does not differ materially from that in Manufacturing and Retailing, though of course different industries are in general subject to different enquiries.

16.3 It may be well to restate here our general position on the issue of competition: competition is the stimulus to firms to produce and sell their products skilfully and efficiently and is the mechanism for ensuring that resources are transferred from the less to the more efficient suppliers. As we saw in Chapter 4 small firms play an important role in the preservation of competition: new entrants to an industry present a fresh challenge to established market positions and the existence of small efficient firms widens the range of consumer choice and promotes the innovative process. Although we are in sympathy with the general philosophy underlying the legislation there is some reason to believe, however, that small firms have benefited less than might have been hoped from the monopolies and mergers legislation, and that from the Restrictive Trade Practices Acts they have suffered certain needless disabilities.

Monopolies and mergers legislation

16.4 The main purpose of the 1948 Act was to make it possible to institute inquiries into industries where monopoly conditions were thought to exist and to make judgements as to whether such conditions were contrary to the public interest. The Monopolies Commission was set up as an independent tribunal to report on industries referred to it by the Board of Trade. The Government was and is not bound to accept or to act on the Commission's recommendations. The Act laid down criteria for the investigation of monopoly power—a referral was in order when at least one-third of the goods under reference was supplied by a single firm or by two or more firms with arrangements between themselves which had the effect of restricting competition. The Commission's terms of reference thus extended to restrictive practices even in circumstances where no single firm exercised great market power. The definition of the "public interest" contained in the Act is of necessity imprecise, but it is made clear that the Commission was expected to concern itself with the structure and performance of industry as well as with the abuse of monopoly powers. Section 14(b) of the Act referred to the need to encourage new enterprise, and Section 14(d) to the importance of "technical improvements and the expansion of existing markets and the opening up of new markets".

16.5 Although the 1948 Act appeared to be a radical departure from earlier policies, as noted in Chapter 7 the concentration of market power in relatively few hands has continued, and the rate of disappearance of small firms from the economy has accelerated. This is no doubt due in part to the working of economic forces which are not primarily affected by the absence of effective policies for the promotion of competition, but in our view the results of the monopolies legislation have been disappointing. The Act did not, of course, contain a presumption that monopoly *per se* is against the public interest: monopoly situations were to be judged by their effects, actual and potential. Nevertheless it appears that the policy was operated, especially in the early years, with great and perhaps excessive caution; there was certainly no determined or sustained attack on the abuses of monopoly power. In the first five years of the Commission's existence

closing of growth prospects for small firms. **We recommend that in making future references to the Monopolies Commission greater emphasis should be placed on the effect of the monopoly or merger in question on the maintenance of a balanced industrial structure.**

The Restrictive Trade Practices Acts

16.8 The early reports of the Monopolies Commission, culminating in the Report on Collective Discrimination, revealed that certain types of business behaviour could with advantage be made subject to consideration by a court, rather than by an administrative body. This was followed through in the 1956 Act, which represented a significant development in competition policy, and inaugurated important changes in procedure. The Act removed from the Monopolies Commission its responsibility for restrictive trade practices and created a new body, the Restrictive Practices Court, with powers and responsibilities which ensured that the prosecution of the policy would be far more vigorous than hitherto. The Act contained the presumption that certain types of restrictive trading agreements should only be allowed to continue if the parties could satisfy the court that they were not contrary to the public interest. The effects of the Act were dramatic; by June 1969, out of 2,660 restrictive agreements registered only 290 were still current. Some 2,000 were brought to an end by the parties without proceedings before the court. How far this has increased competition and efficiency is not clear. The impact of legislation on certain activities (by no means all of them desirable in the public interest) of trade associations, the majority of whose members are of course small firms, has been profound. On the other hand in some industries abandonment of an agreement has led, after a period of price competition, to a series of takeovers and mergers, as happened in the glass bottle and in the bakery industries, or to the emergence of a dominant price leader, as in the market for electric cables. The legislation is also complex, and if we may judge from the evidence we have seen, has been widely misunderstood: this accounts for much of the concern which has been expressed to us.

16.9 The principle underlying the restrictive trade practices legislation is that the separate firms in each industry should act in competition, not in collusion. Early investigations by the Monopolies Commission, between 1949 and 1956, revealed that restrictive trading agreements prevailed in very many industries and trades. The practices operated included price-fixing between suppliers to keep prices up; exclusive dealing arrangements to keep newcomers out of an industry or trade; market sharing arrangements to prevent firms from gaining a larger share of the market; and collective boycotts by suppliers to squeeze out firms who did not observe the rules. Such agreements benefited the participants, at the expense of the public, by, for example, stabilising market shares and keeping prices high. Some participants, however, benefited more than others, and inefficient firms, which might otherwise have gone out of business, survived: efficient firms found their opportunities for improving their market position diminished and the inefficient were sheltered; there was a positive premium on not "rocking the boat". The prevalence of restrictive agreements thus tended to fossilise existing market structures at a considerable cost in terms of general

counteracting restrictive measures taken by a powerful single firm, enabling the parties to negotiate fair terms with a preponderant buyer or seller, preventing unemployment, and protecting exports. In the 1968 Act a further "gateway" was added, namely that the restriction does not restrict or discourage competition to any material degree in any relevant trade or industry and is not likely to do so.

16.12 Restrictions which are found to be against the public interest become void. The Registrar of Restrictive Practices may also apply to the court for an Order restraining the parties from giving effect to the agreement or making another agreement to the like effect. Parties disobeying such an Order are open to contempt of court proceedings which can involve heavy fines or even imprisonment. The court is thus very powerful. Unlike the Monopolies Commission, which can only investigate cases referred to them and make recommendations, the Restrictive Practices Court makes decisions and Orders. Prolonged proceedings before the court can be very expensive whether or not the agreement investigated is found to be against the public interest.

16.13 Although all registered agreements may be referred to the court, the Registrar has an important discretion under Section 9(2) of the 1968 Act whereby he may make a representation to the Department of Trade and Industry that the relevant restrictions are not of such significance as to call for investigation by the court. The Department may then direct him not to refer them to the court. The Registrar considers all agreements for treatment in this way, whether or not he is asked to do so. In many cases he is able to suggest to the parties that if certain objectionable restrictions were dropped the remainder of the agreement might be suitable for Section 9(2) treatment. He will also give on request an informal indication of the likelihood that any proposed agreement would qualify for such treatment, though this cannot be a binding commitment. The Registrar has stated publicly[1] that if the agreement appeared capable of causing detriment, whether to purchasers or to other traders, of which the court would be likely to take account if the agreement came before them, he would not be prepared to make a representation under Section 9(2). A primary consideration is whether the agreement is likely to reduce competition between those affected in any respect in which such competition is to the advantage of consumers, whether by affording them a useful choice or by acting as a spur to the efficiency of those engaged in the trade or industry. The Registrar also considers whether the agreement has, or is likely to produce, discriminatory results. As a result of representations made by him to the Department since the 1968 Act came into force in November 1968, the Registrar has received directions not to refer 81 cases.

The impact of the legislation on small firms

16.14 It is very difficult to judge the impact of these Acts on small firms, either in terms of the number of firms involved in restrictive agreements or in terms of the balance of costs and benefits arising from the Acts. We are therefore very grateful to the Department of Trade and Industry for attempting to see whether any quantitative assessment could be made of the degree of involvement of small

[1] *Report of the Registrar of Restrictive Trading Agreements July 1966–June 1969* (Cmnd 4303).

because of its adverse effects on small firms, it must be on the grounds that it is based on a narrow or short term view of the public interest which does not take sufficient account of the long term effects of a reduction in the ability of small firms to compete effectively with large.

16.18 There are two grounds on which it is argued that the competitive situation of small firms has been weakened by the restrictive practices legislation. First, it is claimed that small firms have found it necessary to take collective action of various sorts far more often than big firms. Only in combination can small firms exert any control over their environment, whereas a big company, even one far short of being in a monopoly position, is to a much greater extent the master of its own fate. By prohibiting collusive activities which were of central importance to the small firm but marginal to the large (leaving aside for the present the question of the desirability of these activities) the Acts can therefore be said to have altered the competitive balance between large and small. Second, the Acts have affected the powers and functions of trade associations, particularly by preventing their giving certain types of recommendations and advice to their members. Again leaving aside for the moment the merits of these activities, it can be said that since small firms, for obvious reasons, rely on trade association services to a greater extent than large firms (who maintain their own internal services) reduction of these services is a more serious loss to them. These two arguments, and the less fundamental point that the cost of defending a restrictive agreement may be a deterrent to small firms in particular, are now considered separately.

The competitive weakness of the small firm

16.19 The Restrictive Trade Practices Acts are concerned only with restrictive agreements between firms, and not with the internal practices, however restrictive, of individual firms. The latter may be referred to the Monopolies Commission—but only if the firm in question supplies one-third or more of the national market in the class of goods in question. There is no minimum size qualification in the case of restrictive agreements. This has consequences which appear somewhat anomalous. The first is that restrictive agreements whose economic effects are comparatively trivial may be prohibited while the trading practices of a single firm, which may be far more restrictive and damaging in their effects, are not subject to scrutiny and cannot be controlled. The second is that whereas for example a common pricing agreement between a number of firms would be registrable (and would certainly be disallowed) a merger between the firms concerned, or their takeover by a larger company, would make it possible to pursue the same policy, or a much more restrictive one, with impunity. This places some premium on mergers as against other forms of combination and contributes to the competitive advantage of the large firm over the small.

16.20 The usual defence of this apparent double standard is that while economic benefits, in the form of economies of scale, may flow from mergers, no such benefits are derived from restrictive practices. It is also said that while the purpose of a merger is not necessarily to restrict competition, this is always the purpose and the effect of a restrictive agreement. We find these arguments unconvincing. In

merger might produce, but within which they could retain their independent status. It is difficult to see any greater menace, for example, in a common pricing agreement between a number of independent retailers than in the common pricing policy of all the branches of a large multiple shop, since the latter will have far greater market power than a thousand small retailers. If competition is thought to require the existence of the greatest possible number of independent competing units, the creation of collusive groups of small firms would be anti-competitive, but so would the extension of chain stores: if one believes, as we do, that effective competition requires reasonable parity of market power between the competing units, a case can be made out for creating countervailing power among the small firms in an industry by permitting a degree of collusion among them. In general terms we see no reason to believe that any greater public mischief is caused by a combination of small units than by a single firm of corresponding size or market power. Thus if the monopolies legislation cannot be invoked unless one-third of the market in question is held by one company, and if a merger does not have to be reported for examination by the DTI unless assets worth at least £5 million are to be taken over we can see no reason in equity why combinations of small firms within these limits should be subject to any greater restrictions. We have formed this view and still hold it despite the undoubted belief of officials of the DTI and the Registrar's Office to the contrary. It may well be that the present monopoly legislation is too lenient—we tend to believe that it is—but we cannot see that this justifies unequal treatment of the small firm because it is caught in the meshes of a different Act. We repeat that we can see no reason on any grounds, economic or otherwise, for not permitting a group of small firms to combine in any way which they think desirable, subject of course to full disclosure to customers and others, to carry out any objective which would be permissible to a large firm or to the same small firms if they were merged.

16.21 To formulate a recommendation for legislation based on this proposition, in such a way that the real benefits of the present law would not be lost, presents very great difficulty. However, we cannot believe it would be found impossible if there were appreciation in Government of the desirability of reinforcing the competitive strength of small firms. **The whole subject of competition policy as it affects small firms clearly requires further study, and we recommend that this should be pursued by the Small Firms Division which we wish to see established within the DTI. In the meantime, that is, until such studies are made, we can only recommend that a broad view should be taken by the Registrar and the DTI whenever an agreement involving small firms is under consideration.** The Registrar has informed us that in considering whether to make representations to the Department that an agreement should not be referred to the Court, he regards the number and size of the participants as a very relevant factor. In some cases it is decisive. This is clearly right, and it would be very helpful if substantial publicity could be given to the possibility of obtaining exemption for minor agreements. **However, we feel that the view taken should extend to the long term, and to the likely effects of the agreements under consideration in preserving in being the smaller firms which our industrial structure requires if it is to function efficiently.** It is not enough to take account simply of what appears to be the immediate public interest.

by grocery chains, an attempt was made by legislation to put an end to price discrimination. The Robinson–Patman Act of that year prohibited all price discrimination which could not be strictly justified in terms of savings in costs. It thus became illegal for food manufacturers, for example, to offer large customers discounts greater than the savings in delivery costs, etc. made possible by bulk purchasing. The usual justification previously offered for discriminatory pricing was that a large order could be added to a factory's production without adding proportionately to costs, so that the marginal cost of supplying it was low. However, we have been told that studies by the Federal Trade Commission of the cost of supplying different customers revealed that the true savings of supplying large orders were much smaller than those claimed to be due to marginal costing, and the legislation disallowed price discrimination based on this argument. The Robinson–Patman Act has had dramatic effects, partly because of strong built-in incentives for aggrieved parties to take suspected offenders to court. The first of these is that under United States law an unsuccessful plaintiff is not required to meet any of the costs of the defence, so that an ill-advised suit is much less expensive than it would be in Britain. (This has incidentally led to considerable abuse.) Second, a successful plaintiff is entitled under the Act's "triple damages" clause to damages three times as large as those he is actually proved to have suffered. Academic and business opinion in the United States is deeply divided on the efficacy of the Act. Its administration is costly and difficult, necessitating frequent investigations of company books by the Federal Trade Commission, as well as many law-suits, and it has given rise to some undoubted absurdities, as when genuine cost savings have been "disallowed" on the grounds that they could not be shared equally between all customers.

16.24 Our knowledge of this very complex subject is much too slight to permit us to recommend the adoption of similar legislation in this country, even if there were wider agreement on the success of the Robinson–Patman Act. Moreover, very few of our witnesses have proposed this course and among those who opposed it, one, the former Consumer Council, did so specifically on the grounds that the price-cutting which the use of buying power makes possible has been of benefit to the public. However, we believe that the possibility of the abuse of buying power, and particularly of discrimination against small firms, is serious enough to warrant close study. We agree that so far price discrimination has often worked to the benefit of the consumer, but we fear that in the long term, by inducing further concentration of market power, it could have serious adverse effects. **We therefore recommend that the Department of Trade and Industry should consider referring to the Monopolies Commission the question of the market power exercised by large firms through their buying policies, and the possible damage to the competitive structure of industry, through discrimination against small firms, which results from it.**

Restraints on trade associations

16.25 We have seen that about three-quarters of all the registered agreements in which small firms were involved were organised by trade associations. Indeed, the only sense in which most small firms were ever party to restrictive agreements (apart from oral agreements, which may have been numerous) was that they

[illegible] of our evidence has dealt with recommendations and advice by trade associations, the position of which is much more complex. We must accept that "recommendations" could not simply be exempted from the legislation on the grounds that nobody is obliged to follow them, for that would open wide the door to wholesale evasion of the Acts: restrictive agreements would simply be replaced by "recommendations" with precisely the same effects. An agreement is not the less restrictive because those who participate in it do so voluntarily. Clearly, a great deal depends on the terms and content of the recommendation: some of those we have seen would clearly operate against the public interest if widely followed; others to the layman seemed to be legitimate attempts to give advice to members. To illustrate the difference we may take three examples from a number submitted to us by trade associations. In the first, the Chairman of a Local Division of the Motor Agents' Association wrote to seven members who were known to be selling petrol below recommended prices, "recommending" them not to do so and asking them to advise the Divisional Secretary within three days of their willingness to co-operate, in which case it would not be necessary to take the matter further. This was clearly unacceptable, and the recommendation was withdrawn by the Motor Agents' Association at the insistence of the Registrar.

16.28 In the second case, the same association were required to register a recommendation to their members not to use trading stamps. The association claim that they were merely seeking to inform their members of the fact that a substantial increase in turnover is required if the use of trading stamps is to be profitable, but we are in no doubt that they were engaged in a deliberate campaign against stamps. Their recommendations were quite unequivocal in their terms and their intentions. The association did not attempt to defend this recommendation before the Restrictive Practices Court, which in the absence of a defence was bound to find it contrary to the public interest. The National Shoe Retailers' Council were in a similar position regarding advice given to their members on the respective merits of various bank credit cards. Their document concluded that one particular scheme was not in the interests of retailers because of its cost to them and recommended their members not to participate in it. This was held to be a registrable agreement and was not defended before the court. If the concluding sentence which contained the recommendation had been omitted, the document, which otherwise simply listed the credit cards and their costs, would not have been registrable.

16.29 Our purpose in quoting these examples is not to express disagreement with the Registrar or the court (which in the absence of a defence had no option to decide otherwise than it did) but to question whether it is in fact clearly against the public interest that trade associations should make recommendations to their members on questions of genuine financial significance such as these. The use of trading stamps and credit cards was very vigorously promoted by their sponsors and it seems reasonable to us that the contrary case should have been advanced by trade associations, if they were convinced that the balance of advantage, for their members, was against the use of these methods of sales promotion. Who else would be sufficiently interested to put this across to small businesses? An enforced boycott of these forms of competition would of course have been objectionable, but the associations were not capable of that, even if

judged by their outcome, though they are necessarily defined by reference to their content. "Thus for example, when in an industry some factors of cost have changed or are expected to change, circulation of a statement by a trade association that those changes are estimated in general to increase costs by X per cent may well result in a general price increase of X per cent in that industry. Such estimates often take little or no account of possible cost savings but may he taken by some firms as relieving them from the need to ascertain their own unit costs, thus contributing to cost inflation. On the other hand, cost information schemes designed to demonstrate the range of divergence between firms in the various elements which together constitute costs of production have been an important spur to efficiency". Cost information agreements of the latter kind would not therefore be referred to the court even if they were to be called up.

16.32 There is no simple remedy for these difficulties encountered by trade associations. Experience shows that continued vigilance is required against the inevitable inclination of trade associations to fix prices and regulate trade in the interests of their members, without reference to the public interest. It is clear from examples given to us by trade associations of what they feel to be harmful consequences of the Acts that many of the things they wish to be able to do would restrict competition. We can therefore see no prospect of defining a class of agreement organised by trade associations which could be taken as being invariably in the public interest and therefore exempted in advance from reference to the court. We nevertheless believe that the uncertainty of trade associations as to what may constitute a recommendation or agreement and as to the likelihood of particular agreements heing referred to the court is a real problem. We have therefore considered the possibility of extending the existing arrangements under which the Registrar will give an informal indication to the parties to an agreement of its chances of exemption under Section 9(2). From the point of view of trade associations, the present procedure is open to three ohjections. First, the Registrar's advice is not definitive; he cannot promise either that he will, on mature reflection, recommend the exemption of an agreement, or that the Department of Trade and Industry will accept his recommendation. Second, the right of access to the Registrar for this purpose is not widely known; some firms and associations appear to receive poor advice on this from their solicitors. Thirdly, some are deterred from approaching the Registrar by the fear that if they expose their affairs to him, practices or agreements other than the one in question will be found to he registrahle and will he proceeded against.

16.33 In his report for the period July 1966–June 1969 (Cmnd 4303) the Registrar indicated the principles on which he decides whether to recommend exemption under Section 9(2). This is quoted in paragraph 16.13. It is, however, a short and inevitably a generalised statement. Further guidance can be derived from study of the brief descriptions published in the reports of agreements against which Orders have been made and of those in respect of which Directions have been given under Section 9(2). The agreements themselves and any variations made to them are also open to the public. There appears however to be a genuine need for fuller and more detailed guidance, since both trade associations and their legal advisers seem badly informed about the legislation in general and this section in particular. We have discussed this problem with the Registrar and

"minor importance", where the total market share of the companies concerned is too small to cause any appreciable restraint on competition, are not banned under Article 85(1). Agreements are deemed to be of minor importance when they cover not more than 5 per cent of the market for the product in question in the countries covered by the agreement and when the total turnover of the companies participating in it does not exceed $15 million in the industrial sector or $20 million in the commercial sector. There is nothing in the Treaty, however, to preclude member States from maintaining their own regulations for purely domestic agreements. Article 85(1) therefore has no necessary implications for policy towards agreements of the kind we have been discussing, but does suggest a line of thought when considering the problem which we discussed in paragraph 16.21.

16.36 The European Commission has stated that it welcomes co-operation between small and medium-sized firms if this enables them to increase their productivity and competitiveness in the larger market, and this is the reason for the concession under Article 85(1). We have no means of estimating the impact on smaller British firms of competition within the Common Market, and so far as we can ascertain, the Government also has no information which would permit such an estimate to be made. The presumption must be, however, that many smaller businesses will find it extremely difficult to withstand heavy competition from Continental firms which are likely to invade the British market, and we suggest that a lenient view should be taken of agreements made between smaller firms to enable them to meet foreign competition, since this will be the effect of the present policy of the Community. Co-operation in selling to EEC countries will be facilitated by the existing exemption for export agreements.

16.37 **Recommendations**

1. In making future references to the Monopolies Commission greater emphasis should be placed on the effect of the monopoly or merger in question on the maintenance of a balanced industrial structure (paragraph 16.7).

2. The whole subject of competition policy as it affects small firms clearly requires further study, and we recommend that this should be pursued by the Small Firms Division which we wish to see established within the Department of Trade and Industry. In the meantime, that is, until such studies are made, we can only recommend that a broad view should be taken by the Registrar and the DTI whenever an agreement involving small firms is under consideration (paragraph 16.21).

3. We feel that the view taken of agreements involving small firms should extend to the long term, and to the likely effects of the agreements under consideration in preserving in being the smaller firms which our industrial structure requires if it is to function efficiently (paragraph 16.21).

4. The Department of Trade and Industry should give consideration to the possibility of referring to the Monopolies Commission the question of the market power exercised by large firms through their buying policies, and the possible damage to the competitive structure of industry, through discrimination against small firms, which results from it (paragraph 16.24).

The effects of the 1967 Act

17.1 The Companies Act of 1967 brought about a number of changes in the legal status and obligations of private companies. Among these changes were the abolition of the status of the exempt private company and a number of additions to the matters about which information is required in the report and accounts which all limited companies must now supply to the Registrar of Companies. In this chapter we shall describe the provisions of the Act which affect small firms and attempt to assess their impact. The latter is a difficult thing to do, in view of the short time for which the Act has been in operation, but it is necessary if we are to do justice to the many complaints we have received to the effect that the 1967 Act has serious detrimental consequences for small companies.

17.2 The main requirements relating to disclosure by non-exempt companies in accounts and reports before the enactment of the Companies Act 1967 were that:

i. a company should prepare annual accounts which gave "a true and fair view" of the state of its affairs and of its profit or loss, contained information on the matters set out in Schedule 8 to the Companies Act, 1948, and gave the information about the aggregate of directors' emoluments required by Section 196 of that Act;
ii. the accounts should be audited by an independent and qualified auditor;
iii. the directors should prepare annually a report with respect to the state of the company's affairs, the amount which they recommended should be paid as dividend, and the amount which they recommended should be carried to reserves;
iv. the accounts, auditors' report and directors' report should be laid by the directors before the company in general meeting;
v. the company should make an annual return to the Registrar of Companies;
vi. there should be annexed to the annual return copies of all reports and accounts which were laid before the company in general meeting in the year to which the return related.

As the Registrar makes available for inspection by the public the returns filed with him, the effect of (vi) was that companies published their accounts and reports by filing them with the Registrar even if they published them in no other way.

17.3 However, certain of the above provisions did not apply to so-called exempt private companies, which were, in broad terms, companies with not more than 50 shareholders or debenture-holders, none of the shares of which were held by nominees or corporate bodies, and none of the directors of which were corporate bodies. The great majority of companies, and practically all small companies, were in this category. An exempt private company was exempt from (vi); that is, it was not required to publish its accounts. It was also exempt from part of (ii); a person who was a partner of or in the employment of an officer or servant of the company could be an auditor of an exempt private company, and the auditor of such a company was not required to be qualified.

requirement to file its accounts and reports, and it provides a procedure by which a limited company may re-register as unlimited.

17.8 The Jenkins Committee recommended that if, in accordance with their recommendation, all limited companies were required to publish their accounts by filing them with the Registrar, companies of the kind which would have been exempt private companies should be permitted to withold from their accounts filed with the Registrar, but not from the accounts circulated to members and debenture holders, the information required by Section 196 of the 1948 Act about directors' emoluments and the information which the Committee recommended should be given about turnover.

17.9 The Government of the day did not accept this recommendation. They thought that the information about the aggregate emoluments of a company's directors required by Section 196 was of value to those who extend credit to a company and should therefore be published, and that the additional information about emoluments required by Section 6 of the 1967 Act was relevant to incomes policy and so should also be published. As regards turnover, the Government's view was that information about a company's turnover could be as useful to a creditor as to an investor and should therefore be disclosed by a company even though it was not a company in which the public were interested as investors. It was also the Government's view that fears expressed about the harmful effect on certain companies of disclosing turnover were exaggerated.

17.10 The 1967 Act, however, does contain certain provisions which were included to take account of representations made on behalf of small companies;

i. Paragraph 13A(5) of Schedule 2 exempts from the requirement to state its turnover in its accounts, a company which is neither a holding company nor a subsidiary, and which has a turnover not exceeding £50,000. Such a company is also exempt from the requirement to show in its directors' report the turnover and profit attributable to each of its substantially different activities.

ii. Section 6(6) of the 1967 Act exempts from the requirement to show details of the emoluments of directors a company which is neither a holding company nor a subsidiary and which shows in its accounts under Section 196 of the 1948 Act an amount for the aggregate emoluments of its directors which does not exceed £7,500.

iii. Section 18(5) exempts from the requirement to state the number of employees and the aggregate of their remuneration a company which, with its subsidiaries, employs less than 100 persons or which is a wholly owned subsidiary of a company incorporated in the UK.

iv. A company with a turnover not exceeding £50,000, whether or not its turnover has to be disclosed under paragraph 13A of Schedule 2, is exempt from the requirement imposed by Section 20 of the 1967 Act to state in the directors' report the value of its exports.

whose securities have been neither quoted nor offered to the public should be allowed to withhold turnover and directors' remuneration from their published accounts, on the grounds that this information was not of prime importance to creditors and that its publication could embarrass some small companies. The then Government, however, decided not to accept these recommendations but to substitute for them the exemptions described in paragraph 17.10 above. The difference between the Government and Jenkins was one of degree: whereas Jenkins wished to exempt all unquoted companies, the Government interposed a set of size criteria which had the effect of exempting the great majority (over 70 per cent of all companies have an annual turnover below £50,000) but left the remainder subject to these controversial requirements. Few of our witnesses have questioned the justification for demanding some degree of information from even the smallest limited companies (though see paragraph 17.16) but most of them fear the practical consequences for the small company of these particular requirements. Our basic problem, therefore, is to decide whether the disclosure of these items by some 30 per cent of private limited companies confers benefits on those who do business with them and on the public generally which can be shown to outweigh the costs of the procedure and the alleged risks for the companies themselves. An important point to bear in mind is that small firms have interests on both sides of this question: one of the major purposes of the legislation is to protect the creditors of limited companies and all those who do business with them from losses caused by fraud and incompetence. Very often these creditors will themselves be small firms and it would therefore be wrong to assume that the small firm stands to gain nothing from the 1967 Act.

17.15 The points made to us by witnesses on this subject, though they vary greatly in detail, can be summarised in the five general statements which follow:

i. the disclosure provisions are an invasion of privacy;

ii. they are in practice more onerous and exacting for small companies than for large;

iii. partly as a result of (ii) they put the small company at a serious competitive disadvantage;

iv. compliance with the requirements is costly and time consuming;

v. disclosure by small companies serves no useful purpose.

We do not question the point made by the then President of the Board of Trade in 1967 (see paragraph 17.6) that Parliament has a right, indeed probably a duty, to ensure that the advantage of the common wealth should prevail over individual interest. This is particularly the case where, as with a limited liability company, there has been an advantage given by statute. Nevertheless, we believe that Parliament should not impose unnecessary burdens even on creatures of its own statutes. When an obligation is resented by a large proportion of those having to comply with it we suggest that the public advantage needs to be demonstrated to justify the imposition. It is therefore in the spirit of asking whether the common good requires whatever protection is offered by the revision of the Companies Act that we discuss the various matters in the succeeding paragraphs.

17.19 Schedule 8 of the 1967 Act lays down that limited companies must state in the directors' report filed with the Registrar the turnover and profit attributable to "each substantially different class of the company's business". The typical small company is likely to be engaged in only one class of business; some will manufacture or sell only one basic product or a very small range. In such cases this requirement is likely to mean that the directors' report may give a complete picture of the company's turnover and therefore the profitability of its limited range of products. On the other hand, we are told that similar disclosure by large companies, which tend to be very much more diversified, does not reveal sensitive information of this kind about particular areas of their business. The result of this is that while a large company may be able to learn from the published accounts of its small competitors information of real value in the determination of its trading policies, its own accounts will afford them no such insights. The most obvious example is that of the single-product company in competition with a larger diversified company: the amount of relevant information that each can derive from the other's report is clearly very different.

Effects on the competitive position of the small company

17.20 There are several ways in which the disclosure provisions can plausibly be said to damage the competitive strength of small companies, and even to endanger their continued existence. All of them turn on the possibility that information published in the report and accounts may be used to the small firm's detriment by larger competitors, by customers and suppliers or by such other interested parties as landlords. Of these relationships the most controversial is that already mentioned above, between a small company and a larger competitor.

17.21 Many witnesses, including the CBI, have suggested that large firms may make use of information derived from small competitors' accounts to drive them out of business. The CBI speak of "the fear which small firms entertain that the disclosure requirements . . . will reveal such information regarding their business to other larger competitors that the latter will thereby be inspired and encouraged to drive them out of business either outright or by takeover". It is certainly conceivable that, having learned the profit margins of a competitor from his accounts, a large company could undercut his prices for a period and thus force his closure. To undercut prices without risk (since the duration is limited and the outcome certain) and without fear of retaliation would seem an unfair, though not illegal, form of competition. We have to report, however, that no single case of this kind has been brought to our notice, in spite of the number of expressions of fear we have seen.

17.22 An equally effective way of removing a small competitor is by takeover. One witness wrote as follows:

> My affairs are open to the battalion of large competitors; but theirs are NOT open to me. This is because their branches are my competitors, not their whole company. Having had three takeover bids in the past I know perfectly well that they will now be looking at our figures so as to decide how to proceed further.

Others have told us of takeover bids (in each case unsuccessful) whose purpose appeared to be the extinction of competition and which followed the publication

tors and in relation to major customers there is some possibility that they have been placed in a disadvantageous position, but there is very little evidence that this had led to genuine detriment. In the nature of things, however, such evidence is hard to obtain; small firms who have lost orders or otherwise suffered through disclosure may not know how or why this has happened. We were indeed told by the Chairman of a large company which makes a practice of scrutinising competitors' accounts that the small firms concerned would normally know nothing of the matter, or of the subsequent action taken by his company.

The financial and administrative cost of disclosure

17.26 The cost of disclosure, both financially and in terms of extra administration, was the subject of a number of complaints. The Smaller Businesses Association made the financial point as follows:

> The compilation of the necessary information for filing with the Registrar of Companies involves a small company in additional professional costs annually, which is yet another unproductive annual cost, albeit small.

This, however, is likely to be significant only for the very smallest businesses. We have received rather more complaints about the administrative cost of the procedure, which is said to demand the attention of senior management and the maintenance of otherwise unnecessary records by skilled clerical staff. This is difficult to understand. If the report and accounts filed with the Registrar are merely duplicates of those prepared for submission to shareholders, their marginal cost must be very slight. In general the information required in the report and accounts is no more than is needed for the proper control of a business, and it is to be hoped that any companies which are now collecting this information for the first time will make proper use of it. We do not therefore accept that the administrative costs of disclosure are serious.

17.27 A small number of companies—less than 10 per cent of the total—do face a possible additional cost as a result of the 1967 Act's stipulation that the auditing of Accounts should henceforth be carried out by properly qualified persons, except in certain strictly defined cases, but this has no connection with disclosure.

The value of disclosure by small firms

17.28 The alleged advantages of disclosure by small companies as advanced by Government spokesmen when the Companies Act was debated were the following:

i. that the published information, including turnover and directors' remuneration, would be of value to those who extend credit to private limited companies;
ii. that it was necessary to protect the public interest;
iii. that the information on directors' remuneration was relevant to incomes policy;

accelerated, but we can find no evidence as to whether the files of formerly exempt private companies constitute a significant proportion of the number searched; no analysis of searches on these lines has been carried out.

17.31 The credit agencies are unanimous in maintaining that by facilitating better informed and more effective credit management the 1967 Act has considerably increased the readiness of suppliers to extend credit. Their argument is that access to accounts enables the supplier to gauge the degree of risk more accurately and to go nearer the limit, whereas previously ignorance forced him to take a cautious line. The agents suggested—and we agree—that an efficient system of credit reporting is in the interest both of the supplier and of the company reported on, if the latter is a good risk. If it is a bad risk, the supplier has the right to know it. It was further suggested that some companies are saved by credit reporting from assuming an excessive load of debt. In moving towards more professional standards of credit management we are following a trend that is very familiar in the USA and, to a smaller extent, in certain EEC countries. It has been put to us that the US has no equivalent of our disclosure provisions for unquoted companies, but the same purpose is served by an extremely comprehensive and sophisticated system of credit reporting which ensures that suppliers of credit are well informed about prospective customers. The system is based on direct approaches to the companies under investigation, supplemented where necessary by private inquiries. Since it is accepted that a good credit rating is essential, most US businessmen are very ready to supply information about their companies. The scale of this activity is indicated by the fact that Dun and Bradstreet issued 15 million credit reports on 3 million businesses in the USA in 1969. Although the US system of informal and private investigation works very well, the credit protection agencies took the view that it is in some respects less satisfactory than having access to accounts, whose authenticity is unquestioned. This enables the credit agency to express a firm opinion on a company's creditworthiness, whereas in the US they will more often prefer to make only a factual report, leaving it to the client to form his own opinion as to whether credit should be granted.

17.32 Though the credit agencies agreed that disclosure had on the whole promoted trade credit, there were differences of emphasis between the credit agencies on the extent to which all the information now published is essential for their purposes. Dun and Bradstreet, for example, expressed the view that it might be possible to raise the exemption limit for disclosure of turnover to £200,000 without greatly affecting the provision of credit, and Trade Indemnity would be prepared to see this figure raised to £500,000 provided that accounts and balance sheet were available. However, this view was not shared by the National Association of Trade Protection Societies, whose members are much more heavily involved in reporting on small firms. They told us that even the present exemption limits were an inconvenience and resisted the suggestion that the turnover limit should be substantially raised. All agreed, however, that the emoluments of individual directors were of little interest to creditors, though it is important to know the total directors' emoluments before a reasoned judgement can be made.

been discontinued on the ground that disclosure of the accounts has made it unnecessary. The last analysis which was done (*Economic Trends*, No. 136 of February 1965) was of high quality. If there is some reason why a similar sample analysis cannot be based on the material at Companies House, we believe the former practice of analysing accounts supplied to the Inland Revenue should be resumed.

Proposed changes in the law

17.36 We find it difficult to persuade ourselves that the 1967 Act has been on balance either harmful or beneficial to the vast majority of small private companies. However, the Act has provoked great disquiet among small companies and in some circumstances could have harmful effects on them. If the causes of disquiet and potential harm could be removed without significantly reducing the value of disclosure to creditors, shareholders and the public, we should wish to see this done. In the next few paragraphs we shall consider three methods of reducing the burden which their authors believe should have no undesirable consequences.

17.37 Three basic suggestions for amendment of the law on disclosure have been put to us. They are:

i. That the category of exempt private company as defined in the 1948 Act should be restored;

ii. that, as the professional accounting bodies have recommended, the present legal concepts of public and private companies should be replaced by new categories to be known as "stewardship" and "proprietary" companies, with appropriate rights and obligations;

iii. that the present size limit for exemption from certain requirements, particularly the publication of turnover, directors' remuneration, be raised substantially.

17.38 As regards the restoration of the status of exempt private company, the Smaller Businesses Association recommended that all unquoted companies should be treated exactly as they were under the 1948 Act, thus re-creating the exempt private company in its old form. The Midland Bank Finance Corporation proposed that unquoted companies with annual turnover below £100,000 should be treated in this way. Whether limited by size or not, however, the old definition, which was never satisfactory, would need modification to bring it in line with the real intention of exempting companies owned by a small number of individuals who do not call on the general public for finance. The Jenkins Committee remarked of the exempt private company that "the present definition is so complex that there is little doubt that many companies which at present claim and obtain exemption are not entitled to do so. The very complexity of the definition makes its application uncertain and produces unfair and capricious distinction in the treatment of very similar companies". We do not wish to suggest reversion to this state of affairs, and any revised definition is likely to give rise to the same or similar problems.

opinion. We believe that there are sound arguments, based mainly on the need to protect creditors, for maintaining the disclosure requirements in something like their present form, but that those elements of the requirements which are not necessary for this purpose should be swept away. The present Act concedes the point that the arguments for full disclosure become weaker as the size of the company concerned declines. We believe that the present exemption limits are too low—they were criticised as such at the time by many people who were generally in sympathy with the Bill—and as a result of inflation they have become still less realistic in the intervening years. There is very wide support for raising the exemption limits: the CBI and the Engineering Industries Association, for example, have proposed that the turnover limit should be raised to £500,000, while the Institute of Directors suggest £250,000. Either of these figures, but especially the former, would have dramatic effects on the number of private companies required to state their turnover; well over 90 per cent of private companies have an annual turnover of less than £500,000. In our view the limit could safely be raised to £500,000 and **we therefore recommend that private companies be exempted from the requirement to disclose turnover when this is below £500,000 per annum.**

Summary and recommendations

17.41 In our view the provisions for disclosing directors' remuneration and turnover should be eased. We believe that the disclosure of total directors' remuneration is necessary if the profit and loss account is to be meaningful. On the other hand we are not convinced that disclosure by private companies of the remuneration of individual directors serves any useful purpose. We therefore recommend the exemption of private limited companies with annual turnovers below £500,000 from the requirement to disclose the individual emoluments of directors, though firms should continue to show the total amount in the profit and loss account. (Paragraph 17.18.)

17.42 The evidence of the credit agencies leaves us in no doubt that disclosure of turnover in the directors' report is of value in establishing the creditworthiness of firms. However, two of the three agencies who gave evidence said that the present exemption limit of £50,000 annual turnover could be raised substantially without greatly affecting the provision of credit. In our view the limit could safely be raised to £500,000. We recommend therefore that private companies be exempted from the requirement to disclose turnover when this is below £500,000 per annum. (Paragraph 17.40.)

(Section 19 of the 1967 Act)

xiii. If the company supplies goods and its turnover exceeds £50,000, the value of goods exported by the company during the year, or a statement that no goods were exported.

(Section 20 of the 1967 Act)

impact on the small firm of these delays and frustrations. In doing so we shall have to retrace some of the ground covered by Sir Joseph Hunt's Committee in their report on *The Intermediate Areas* (April 1969, Cmnd. 3998) but the points of view from which we and they approach the matter are of course somewhat different.

18.4 Until recently any application for planning permission that would lead to the creation of new industrial floor space exceeding 5,000 square feet (or, in the Midlands and South-East, 3,000 square feet) had to be supported by an IDC issued by the appropriate Regional Office of the Department of Trade and Industry. The procedure for submitting applications is uniform over the whole country. It applies to extensions of existing buildings as well as to entirely new ones, and to applications for re-classification as industrial premises of existing buildings whose planning classification is non-industrial. The purposes of the IDC procedure as stated to us by the Department of Trade and Industry are:

i. To provide an opportunity to influence firms to undertake projects in those areas, especially the Development and Intermediate Areas, where resources are available;
ii. To assist in limiting the demand on resources, especially labour resources, in those areas of the country where, particularly in times of rapid expansion, resources tend to become overstrained.

The 5,000 and 3,000 square feet limits were in force through the greater part of our Inquiry. All the complaints we received about the way in which small firms were affected by the IDC procedure relate to the control as then operated, as do all the statistics in this chapter. On 7 December 1970, however, the Department of Trade and Industry raised the exemption limits to 10,000 square feet generally and 5,000 square feet in the Midlands and South East. This was a very substantial relaxation of the control which has, we believe, gone some way towards meeting the objections of many of our witnesses. Whether it went far enough is a matter we have to consider, but the change is too recent for there to be any quantitative information on its effects.

18.5 The Department of Trade and Industry see at a very early stage every proposed factory development larger than the "free allowance" (see paragraph 18.18). In 1969 approvals and refusals of IDCs totalled 6,840. When considering an application the Department must decide whether the project will impose an excessive burden on the resources of the locality and whether it might appropriately be steered elsewhere—to a Development or Intermediate Area or perhaps to a new or expanding town where labour or land is available. When such a move appears feasible, the opportunity will be taken to describe the advantages of the assisted areas and the various incentives to go there, and perhaps to show businessmen the factories or sites available. In the Development and Intermediate Areas, of course, these questions do not arise; the Department's main function there is to attract new industry, so IDCs are freely available, refusals are very rare, and certificates are issued without delay. "Elsewhere", according to the Department, "the control is operated with varying degrees of flexibility to take account of local needs". In the London and Birmingham areas, for example, the

i. Some developments by small firms are frustrated because an IDC is refused;
ii. Decisions on IDC applications are unreasonably delayed, and developments are thereby held up;
iii. The application procedure makes excessive demands on the businessman's time;
iv. For most small firms the objects of the policy are quite irrelevant because it is not possible for them to contemplate removal or fragmentation of the business.

We shall consider each of these complaints in turn.

Refusal of applications

18.7 It is of the essence of this policy that some applications will be refused; the whole procedure would be pointless if they were not. However, this is no comfort to those who suffer the refusals, and some believe, as we have seen, that small firms suffer disproportionately. There are plausible reasons why this might be so. First, the small businessman is unlikely to be skilled in dealing with Government. Second, most small businessmen are chronically short of time, and disputed IDC applications may take a long time to negotiate. The small man is therefore much more likely to give up in disgust or despair than the large company. For these reasons we have tried to discover how well or ill the small firm's application fares. The Department of Trade and Industry have kindly carried out on our behalf a size-analysis of approvals and refusals in 1969. The results of this survey are shown in Table 18.I. These results showed that in those regions where there were any refusals at all (there were none in the Scottish, Welsh, Northern and Yorkshire and Humberside regions) there were only 203 refusals out of 5,332 cases decided. Firms employing under 200 suffered a higher proportion of refusals than larger firms, and those employing between 100 and 200 appeared to fare worst of all. The figures must be treated with caution, however. The number of cases decided within each size-band has been estimated on the basis of a 10 per cent sample, though the refusal figures are accurate. Thus, owing to sampling errors the discrepancy between small and large firms may well be larger or smaller than shown in the Table. Nevertheless we are able to draw the conclusion that small firms suffer a higher proportion of refusals. This does not mean that the Department of Trade and Industry discriminate against the applications of small firms. There is no evidence of such discrimination and there are other factors which might explain why small firm applications fare worse than those of large firms. Large firms will undoubtedly be more familiar than small with the aims and working of IDC control. They are more skilled at dealing with Government and often enjoy better professional advice than is normally available to a small firm. They are therefore more likely to ensure that only projects with a high probability of success reach the formal IDC application stage.

18.8 The department also analysed applications which were refused by the size of the projects concerned and found that applications for large projects are much more likely to be turned down than small applications: although nearly 60 per cent of all IDCs issued were for projects of 10,000 square feet or below,

taken by the department to decide on applications. Some witnesses have said that negotiations may take several months or even a year, and there is a widespread belief that delays are inordinate. The department, however, have provided figures which demonstrate that this is untrue in the great majority of cases. The average time taken to decide on applications over the whole country is four to six weeks, although there is some variation around this figure according to local conditions. In the Development Areas, as we have said, applications are nearly always granted, usually well within a week of receipt. In the most congested area, the London and South East Region, more applications are refused or disputed and the average time taken to deal with them is six to eight weeks. These average periods include the time spent in protracted negotiations over the most difficult cases, which though few in number may often take up to six months, or even more. The issue of certificates in normal cases, therefore, takes less than six to eight weeks even in the London area. We well understand, however, that a delay even of this length could be exasperating for an applicant currently engaged in complex and inter-related negotiations with landowners, planning authorities, builders, machine manufacturers, banks, and finance houses. Unfortunately, however, the department could not undertake to operate much more quickly given the very large number of applications handled and the need to give applicants a reasonable time to provide further information. We have considered whether special arrangements could be made to minimise delay for small firms. We shall come to this when considering the rationale for applying the policy to them at all.

Complexity of the procedure

18.11 The IDC procedure is not exacting in terms of form-filling, but subsequent negotiations with officials are likely to place a heavy burden on the small businessman and may represent a serious diversion from his normal work. From the point of view of the department these discussions are the essential part of the procedure: they provide the opportunity to interest the new or developing firm in the advantages of the assisted areas at the crucial state of decision. Also, to be fair, such a meeting is probably the best and quickest way to assess a firm's needs and capabilities. Sympathetic administration is only possible if all the relevant facts are known.

Relevance of the policy to small firms

18.12 The first and proper responsibility of the Department of Trade and Industry's regional officers when considering an IDC application is to ask whether the development in question could not take place in a Development or Intermediate Area, since the creation of new jobs in those areas is a major purpose of the policy. The typical manager of an established small firm will find this question irritating because it appears inapplicable to his own business. He is likely to depend heavily on close and perhaps long-standing relationships with local customers and suppliers, and is not likely to have a national market, or the financial or managerial resources needed to carve out a wholly new market in a different area. To shift his entire production is therefore out of the question. It would be equally impossible for most small firms to set up additional premises in a Development Area away from the main establishment. We have already

may not be too serious a brake on the economy as a whole, but there is no question that unnecessary costs are incurred, both for Government and industry, in processing small applications which would never yield new employment in the assisted areas. Some of those who favour retention of the control have argued that it can work to the benefit of small firms in two ways: first, in certain cases where large companies have been prevented from expanding by the control, they have been obliged to put out more of their work on sub-contract to small firms; secondly, the restriction of development by larger competitors may create opportunities for small firms to flourish. We are not convinced by these arguments, which anyway do not require the retention of the control for small firms. Since we are particularly concerned in this context with the dynamic small firms, we would also consider any such incidental advantages well lost in return for greater freedom to expand. Perhaps the most serious, though unquantifiable, cost of the control is the uncertainty it creates among industrialists as to whether their plans will be allowed to go ahead, especially in view of the widespread misunderstanding of the purpose of the control and the severity of its application. It is widely, though wrongly, believed that the control is rigidly applied, and many misconceptions exist as to its purposes; at least one of our witnesses believed the control to be operated by planning authorities, and we have no doubt that many complaints about delay in the procedure stem from failure to distinguish between this and local authority planning procedures.

The Hunt Report on the Intermediate Areas

18.14 The difficulties of small firms in complying with IDC policy were discussed in the Hunt report on *The Intermediate Areas* (April 1969, Cmnd 3998) which recommended that some relaxation of the control was desirable in their case on three grounds: the relative immobility of small firms owing to their dependence on a close network of local relationships, their greater difficulty in coping with the procedure, and the need to encourage infant industries. A fourth ground, not exclusively related to small business, was that the Committee wished to minimise the loss of growth to the economy caused by the control, marginal though this appeared to be. They therefore recommended (with two dissentients) that a single minimum exemption limit of 10,000 square feet over the whole country should replace the limits then in force (3,000 square feet in the Midlands and South East and 5,000 square feet elsewhere). Their report stated that their recommendation would "do much to alleviate the problems we have outlined. At the same time we do not think that such a relatively modest change would be likely to deprive the Development Areas of the major industrial investment which they badly need". The Government of the time did not act on this recommendation, because fears remained that the change would harm the interests of the assisted areas. The present Government has, however, accepted the case for higher exemption limits and in December 1970 it raised the 5,000 and 3,000 square feet limits to 10,000 and 5,000 square feet respectively.

18.15 We are strongly attracted by the Hunt Committee's proposal, which on the 1969 figures would have reduced the total number of applications by nearly 60 per cent. The effect of such a change on the area of industrial floor space approved would not have been very great: though projects below 10,000 square

may be) every IDC issued carries with it the right to make additional extensions up to the exemption limit without a second application. The effective limits therefore are 10,000 square feet in the Midlands and South East and 20,000 square feet elsewhere. When firms have used up their "free allowance" they are advised by their local authority that planning permission for any further extension must be supported by a new IDC, even if these further extensions would create less than 10,000 square feet of industrial floor space. The purpose of the "free allowance" is to deliver both industry and the Department from the deluge of paperwork that would ensue if every trivial development—the enlargement of a machine bay, for example,—were subject to the control. This is very desirable, but the Scottish Council were concerned that a nation-wide exemption limit of 10,000 square feet would imply an effective limit on new developments of almost 20,000 square feet because of the free allowance. We are not convinced that raising the exemption limit in the Midlands and South East would pose a serious threat to regional development policy. The Scottish Council's concern is, however, understandable. At one stage we considered whether this anxiety could be relieved by stipulating that no premises for which an IDC has been issued should be enlarged by more than, say, 5,000 square feet in the following five years without another IDC. A lower free allowance would, we thought, provide adequately for minor improvements and we hoped that it could be policed by the local planning authorities with no more difficulty than the present IDC requirements. The Department of Trade and Industry, however, said that such a solution would be so complex to legislate for and difficult to enforce that they doubt whether it would be practicable, and we must accept this view.

Office development permits

18.19 Under the Control of Offices and Industrial Development Act 1965, and the Orders made under the Act, planning permission may not be given by a local authority in certain parts of the country for the erection or extension of an office building above a prescribed limit, without an office development permit from the Department of the Environment. Until recently the office control applied to developments exceeding 10,000 square feet (which the Department of the Environment estimates as equivalent to accommodation for about 70 people) in the South East Economic Planning Region (outside Greater London) and the East and West Midlands Economic Planning Regions. In Greater London the limit was 3,000 square feet, which is equivalent to accommodation for about 20 people. In December 1970 the control was lifted from all regions except the South East and the limit in Greater London was raised to 10,000 square feet. We have had few complaints that the system of office development permits places an unfair burden on small firms. However, as applied at present, the control might conceivably harm small firms in two main ways:

i. The Department of the Environment has stated that the limitation on office space probably contributes towards higher rents generally.

ii. It is not always easy for developers to get a permit for new office space which they propose to let in small units.

The first difficulty is, of course, experienced by the whole business community.

will be exercised by a single level of authority. The eight proposed regional authorities and the separate authorities for Orkney and Shetland will be responsible for strategic planning. In the three outlying regions and in Orkney and Shetland the strategic planning authorities will also draw up local plans and control development. In the five regions in the central belt, local planning and development control will be dealt with by the 31 district authorities.

18.21 Town and Country planning controls are exercised within the framework of a development plan. Local authorities in England are required to survey their area at least once every five years and to submit a plan to the Secretary of State for the Environment showing proposed land use over the next 20 years. Welsh and Scottish local authorities must similarly submit their plans to the Welsh or Scottish Office, as appropriate. These plans, which are produced in map form, show the sites of proposed roads, public and other buildings and works, airfields, parks, pleasure grounds, nature reserves and other open spaces, and they allocate areas of land for agricultural, residential, industrial or other purposes including shopping and business. Development plans may also set aside areas which in the opinion of the local authority should be developed or redeveloped for one of a number of purposes, including the relocation of population or industry. Great importance is attached by planners to the latter aspect, commonly known as "zoning". Some of the difficulties we describe later arise because planning authorities allocate separate areas for residential, commercial or industrial use and are reluctant to see property for different uses built in the same area.

18.22 Plans have until recently been drawn up according to the procedure laid down in the Town and Country Planning (Development Plans) Regulations 1965. Notice of submission for Ministerial approval has to be published in the London Gazette and in at least one local newspaper. This notice must state where the plan may be inspected. A period of six weeks is allowed for objections. Objectors have the right to be heard by a person appointed by the Secretary of State, and in practically all such cases a public inquiry is held. When he has considered the plan and all objections the Secretary of State may grant approval with or without modifications. Notice of approval is publicised in the same way as submission to the Minister. The plan becomes operative on the date on which approval is first advertised.

18.23 The Town and Country Planning Act 1968 provides for a new development plan system, which is being introduced gradually. This consists of two main elements—structure plans setting out the main proposals for the area looking as far ahead as possible and including consideration of the use of land and transport planning; and local plans within the framework of the local planning authority's structure plan once the latter has been approved. The structure plan will identify "action areas" for major changes within the next ten years. A local plan must be drawn up for each "action area". Local plans can also be drawn up in the form of district plans (which deal with the whole range of planning problems for the areas they cover) and subject plans (which set out the details of an authority's proposals for a particular type of development or other use of land throughout the area, for example its policy for village settlement or mineral working). Different local plans may be in force simultaneously in the

18.25 Businessmen may seek to build because they want to set up in business, because they have to vacate existing premises, because they need to accommodate growth or because technical progress has made their existing premises unsuitable. Our evidence shows that difficulties can arise when the small firm is in one of three situations:

i. when its premises (probably pre-dating the Town and Country Planning Acts) do not conform to the development plan for the area in which they are located;
ii. when, for financial reasons, they seek a site in an area where planning policy is strongly against development of the kind proposed; for example a cheap site might be available in a green belt or residential area;
iii. when the firm wishes to move to another nearby area but the development plan has made insufficient provision of land for industrial use.

18.26 Planning permission for an extension to existing premises may be refused because the business is located in an area which has been scheduled for residential use. This normally affects manufacturing firms although other businesses could also experience difficulties. The firm can appeal but this can take as long as nine months. About 75 per cent of appeals are, moreover, unsuccessful. If the businessman fails in his appeal he will face a choice: he can move either partly or wholly to another area where his proposed building is permitted or he can remain in his inadequate premises, his firm's growth and efficiency being impaired. Much depends on how the local authority exercises its powers. The Town and Country Planning (Development Plans) Direction 1965 makes special provision for allowing development which is not in accord with the development plan. Local planning authorities are free to grant planning permission where the proposed development "would, in their opinion, neither involve a substantial departure from the plan nor affect the whole of the neighbourhood" (*Development Control Policy Note—General Principles*, HMSO 1969). More substantial departures from the development plan may be allowed if the Minister is informed and if interested parties are given the chance to make representations.

18.27 The value which each community places on preserving its amenities, and the extent to which local authorities stick to the development plan, varies from place to place. It would, indeed, be surprising if practice were uniform throughout the country. One borough told the Association of Municipal Corporations that "zoning of land has been given a too strict interpretation in some parts of the country" and we agree. The same borough added that they "would always discourage firms from expanding on their present sites if the use carried on did not conform with the development plan. This seems to be the whole idea of having a development plan". We appreciate this point too. We do, however, think that local authorities should always weigh the likely economic gains (in the output of goods and services) resulting from such proposals against any detraction from local residential amenities. The 1965 Direction gives them considerable discretion in these matters.

18.28 Financial considerations may sometimes lead a small firm to seek a site in an area in which planning policy is strongly against development of the kind proposed, if, for example, a cheap site is available in a green belt or residential

who are willing to comply with the planning requirements, an opportunity of obtaining accommodation. Many small firms do not need sophisticated accommodation; often they have survived for years in old and perhaps sub-standard property. But any new accommodation available is likely to be of a much higher standard and will therefore command an appreciably higher rent. In some large towns the problem may be alleviated by the availability of older property but where redevelopment has taken a heavier toll of this older property, the problem is likely to be much worse. The Department of the Environment stated that "elderly proprietors and weak firms" often prefer total extinction of their businesses when their properties are demolished, because they are unable to contemplate paying a much higher rent.

18.32 Another serious difficulty is that small firms displaced by redevelopment are sometimes offered premises which are too large. Local authority practice in this respect varies greatly; but at least some local authorities make a real and effective effort to provide premises designed to meet the needs of small firms. Aldershot, for example, provides accommodation in small units for small firms on an industrial estate built for the relocation of "non-conforming" users. The firms concerned are offered sites on a 99-year lease with provision for rent revision every 14 years. The borough told the Association of Municipal Corporations that "it has always been the council's policy to try to offer alternative accommodation to firms displaced by the council's various schemes. Some firms are offered temporary accommodation in the first instance in other property which the council have acquired in advance of a redevelopment scheme being carried out. Some of this property is also let temporarily to small firms who are just starting". Liverpool also offers a very wide range of accommodation to small firms displaced by redevelopment. During the two years up to January 1969 over 120 firms were relocated in specially designed premises of convenient sizes on sites close to the central area. We have been told that other boroughs also exert themselves a good deal to re-accommodate displaced firms and in the Annex to this chapter we give a few examples of provision made by a number of authorities. There are undoubtedly many other authorities tackling this problem equally conscientiously.

18.33 One type of business which experiences particular difficulty as a result of redevelopment and zoning is the waste trade. This trade arouses hostility from local residents, and as a result only a very limited amount of land is set aside for it, often in "special" zoning areas, which are frequently isolated from the greater part of the town. This problem is not universal; the borough of Edmonton, for example, has built an estate specifically to accommodate the waste trades. We are nevertheless concerned at the large number of cases brought to our attention by the Federation of Reclamation Industries where local authorities have not catered for the legitimate needs of these traders and have instead preferred to compensate displaced dealers on the basis of total extinction of the business. We deplore such inadequate provision.

18.34 The problems of displaced small firms are numerous and intractable; we cannot expect to eliminate all hardships. We are satisfied that the Department of the Environment and its Scottish and Welsh counterparts are alive to the

exercise of their discretion on the grounds that, if they were to make an allowance in any particular case, they would have to do so in many more. In the Minister's view this is to misconceive the purpose for which these discretionary powers were given". In 1963 the Circular 36/63 asked that "reasons directed to the circumstances of the individual case" be given where discretionary compensation had been considered but in the event withheld. Finally, compensation may be paid to businesses which are not being demolished but which suffer loss of trade through nearby redevelopment under Section 63(2) of the Housing Act 1957, which provides that local authorities may, subject to certain conditions, pay allowances to meet losses involving personal hardship suffered by shopkeepers who are not themselves in a clearance area, but whose business is "seriously diminished" by slum clearance operations in the locality.

18.37 Our evidence suggests that small businesses are not always adequately compensated by local authorities. Those firms whose premises have been acquired in the course of redevelopment may suffer because:

i. The Landlord and Tenant Act 1954 provides that the amount of compensation paid on compulsory acquisition of a tenancy shall exclude the value of the likelihood of the tenancy being renewed.
ii. Compensation is assessed not in respect of the level of trade when notice to treat is served on the business, but, instead, on the level of trade at the date when the acquiring authority takes possession or when the value is agreed, whichever is the earlier.
iii. Businesses whose property has not been acquired may suffer because there is no adequate provision for compensating loss of trade caused by nearby redevelopment.
iv. Capital gains tax may be charged on the proceeds of compulsory purchase.

We discuss these difficulties below.

18.38 *Compensation for short term tenancies.* Section 31(1) of the Landlord and Tenant Act 1954 provides that the amount of compensation paid on the acquisition of a tenancy shall exclude the value of the likelihood of the tenancy being renewed. Since businesses may be carried on in premises on a weekly or monthly tenancy but where there is little likelihood of the tenancy being terminated, the payment of compensation on the basis provided by the Act may be inadequate where a well-established business is brought to an end or seriously impaired. We believe that where this situation arises additional compensation should be paid to the businessman. The Department of the Environment have said that there are two alternative ways of dealing with this problem. The first is for the Lord Chancellor's Department (who are responsible for the Landlord and Tenant Act) to amend the Act. The Department of the Environment told us that this would be a major undertaking which would affect the whole basis on which premises are let and which might lead to higher rents. The alternative way is for local authorities to use their discretionary powers under the Land Compensation Act 1961 and other statutes and pay additional compensation. This is to a large extent done already. The Department of the Environment told us at oral evidence:

under Part III of the Housing Act 1957, there is no such provision for compensation where redevelopment takes-place under powers conferred by other Acts. This will not in practice entail many cases of hardship but they do occur. In our view the fact that compensation is available only when redevelopment affecting businesses in this way is carried out under Housing Act powers is an anomaly. In practice, this situation is probably in many cases remedied by discretionary compensation. It is, nevertheless, an unsatisfactory situation which should be rectified in the Department of the Environment's current review of the Compensation Code. **We recommend that all businesses should have a legal right to compensation for loss of trade resulting from nearby redevelopment.**

18.41 *Assessment for capital gains tax on compulsory purchase.* Generally speaking capital gains tax is payable on any gain on the disposal of a chargeable asset. There is no general exemption for involuntary disposals nor is there any particular exemption for property disposed of under a compulsory purchase order. However the Finance Act 1965 provides that where the proceeds of the compulsory purchase are spent on acquiring new assets of a similar type, provided they too are to be used for purposes of the trade (e.g. a new shop to replace one which has been demolished) tax may be deferred until these new assets are disposed of and the proceeds not themselves reinvested in assets of the same type. In this case the deferment is achieved by valuing the old asset for tax purposes as if it had been sold at its cost price and then deducting the excess of the disposal proceeds over the cost price from the cost of the new assets. When a business is able to continue trading after its former premises have been demolished, therefore, there should be no problem on account of capital gains tax. However, we have seen that there are many small businesses which are unable to carry on in new premises. When this happens it may not be possible to escape payment of tax if a capital gain is realised on compulsory purchase. If the owner has reached retirement age there will often be little difficulty, since working proprietors who retire at the age of 65 are allowed exemption on the first £10,000 of capital gains, reducing by £2,500 for every year from the age of 65 down to 60.[1] When this retirement relief cannot be claimed or when capital gains are in excess of the amount for which relief is available, however, capital gains tax can reduce the net amount that an owner will get when his business is put out of commission. When a limited company is put out of business capital gains tax is moreover leviable at two stages. In the first place the firm must pay the tax on any gains realised from the compulsory purchase of its premises, if it is unable to reinvest the proceeds in similar assets. Secondly, if the business has to be wound up shareholders are assessed, subject to any retirement relief, for capital gains tax on the excess of what is distributed over the cost of the shares after the company has paid its own tax.

18.42 There is, of course, nothing unusual about charging capital gains tax on the proceeds of a compulsory sale; this would also occur in the event of the nationalisation of a business. Nevertheless we think that it is regrettable if it affects small businesses which provide the only means of livelihood of their owners, who are in effect forced to retire, although we recognise that cases of

[1] We are recommending that this figure should be increased to £20,000 (Chapter 13).

ment of the Environment and the Scottish and Welsh Offices should do more to encourage unhelpful local authorities to cater for the needs of small firms as effectively as other more enlightened authorities (paragraph 18.34).

5. The Landlord and Tenant Act 1954 should be changed so as to require local authorities to pay compensation for compulsory purchase which includes the value of the likelihood of a tenancy being renewed (paragraph 18.38).

6. Legislation should provide for compensation on compulsory purchase to be assessed at the level of trade when notice to treat is served on a business (paragraph 18.39).

7. All businesses should have a legal right to compensation for loss of trade resulting from nearby redevelopment (paragraph 18.40).

This site provides a location to which new industries, including those affected by redevelopment, can transfer.

WORTHING stated that it is able to rehouse many small "one or two man" industrial firms in the Corporation's unit factories. "If the firm expands as we hope it will do then the next logical step in the expansion of the firm will be for them to be offered a site on which to build their own bigger and purposely designed factory with mortgage from the local authority". (AMC evidence.)

[illegible] to survive as entrepreneurs this social contribution would be greatly missed, and thought would have to be given to means whereby it could be preserved or replaced. The difficulty here would be that the spirit of sturdy independence which is the special quality of the small businessman would not survive dependence on Government patronage. Happily, we believe that the sector is economically viable, so that this dilemma does not arise.

19.5 The sector is viable, in our view, because the small firm is in many ways a highly efficient organism, better adapted to the exploitation of certain kinds of economic opportunity than larger units and having some special advantages which derive from the intense commitment of the owner-manager. In Chapter 8 we have distinguished eight important economic functions performed by small firms, which comprise their special contribution to the health of the economy. They are as follows:

i. the small firm provides a productive outlet for the energies of that large group of enterprising and independent people who set great store by economic independence and many of whom are antipathetic or less suited to employment in a large organisation but who have much to contribute to the vitality of the economy.

ii. In industries where the optimum size of the production unit or the sales outlet is small, often the most efficient form of business organisation is a small firm. For this reason many important trades and industries consist mainly of small firms.

iii. Many small firms act as specialist suppliers to large companies of parts, sub-assemblies or components, produced at lower cost than the large companies could achieve.

iv. Small firms add greatly to the variety of products and services offered to the consumer because they can flourish in a limited or specialised market which it would not be worthwhile or economic for a large firm to enter.

v. In an economy in which ever larger multi-product firms are emerging, small firms provide competition, both actual and potential, and provide some check on monopoly profits, and on the inefficiency which monopoly breeds. In this way they contribute to the efficient working of the economic system as a whole.

vi. Small firms, in spite of relatively low expenditure on research and development by the sector as a whole, are an important source of innovation in products, techniques and services.

vii. The small firm sector is the traditional breeding ground for new industries —that is for innovation writ large.

viii. Perhaps most important, small firms provide the means of entry into business for new entrepreneurial talent and the seedbed from which new large companies will grow to challenge and stimulate the established leaders of industry.

19.6 Of these functions the first six are self-rewarding: that is, their performance ought to be reflected in the efficiency and profitability of the firms performing them; the private and public interests, although not necessarily identical,

[illegible] is a general point, but we have no doubt that the small firm sector would respond to fiscal incentives at least as positively as any other contributors to the economy.

iii. The encouragement of more effective and fair competition throughout the economy. Although we have commented adversely on some aspects of competition policy as it affects small firms, we are convinced that in the last analysis the sector must benefit from any measures taken to promote opportunities as nearly equal and markets as nearly perfect as can be achieved.

iv. Effective equality of treatment in every aspect of legislation and Government policy.

19.9 With regard to the question of equal treatment by Government, we are quite clear that Government is not and never has been consciously prejudiced against small business. On the contrary, Governments of all political complexions have taken great pains to preserve equity as between one sector and another. In this we are at odds with many statements made to us in evidence, which suggested that Westminster and Whitehall were on the lookout for every opportunity to destroy some element of small business. Our complaint against Government is simply that the interests of small firms are neglected because it is nobody's job to consider them. Policies which are wholly neutral in intention and in their administration may be far from neutral in their effects because of the different circumstances of large and small firms. Too often this is not appreciated, so that small firms suffer unintended disadvantages. The great majority of our recommendations concern matters in which we believe the small firm sector or part of it has been put at a disadvantage in this way, and the fact that we have made so many recommendations shows that in our view this absence of effective concern and true understanding is widespread in Government.

19.10 We think it is vital that this failing in Government should be rectified, and that this will not be achieved under a system in which no Minister or department has a special responsibility for small business as such. The way to get anything done is to make someone responsible for it—and if possible for him to have no other responsibility. For this reason our major recommendation is that a Division should be created within the Department of Trade and Industry to sponsor small firms throughout industry. The main responsibility of such a Division would be to ensure that the interests of the small firm sector and the maintenance of its ability to fulfil its proper role in the industrial structure are never again allowed to go by default. We recommended in Chapter 9 that:

1. A Small Firms Division should be created within the Department of Trade and Industry, responsible for the development, interdepartmental co-ordination and implementation of policy towards small firms and for the administration of such official services as are provided for them (paragraph 9.27).

2. A Minister of the Department of Trade and Industry should be expressly designated as the Minister responsible for small firms and to oversee the work of the Division (paragraph 9.27).

[illegible] are not restricted to small firms and are not management services in the normal sense. However, we saw a need for a new localised information service aimed specifically at the small firm which we believe should be provided by Government and could not be put on a commercial basis. We suggest that all other services should at least be required to break even, though we recognise a possible case for supporting rural industries and the crafts, on social rather than economic grounds. We also recognised that in some exceptional cases "pump-priming" assistance might be justified, and saw no objection to this provided that progress towards self-financing is strictly required and a time-limit for subsidy fixed at the outset. In this we shall undoubtedly have disappointed many who enthusiastically argued the case for Government provision of a great range of services and facilities for small firms. However, we are fortified by the knowledge that small businessmen themselves did not ask for subsidies or special assistance: they wanted the maximum degree of freedom in making their own decisions and were prepared to accept the consequences. Our recommendations in Chapter 10 are as follows:

1. the provision of free or subsidised services is only justifiable if the four criteria we have identified are met, and wherever possible those services which continue to be provided should be put on a competitive fee-charging basis (paragraphs 10.40 and 10.44).

2. Among the management advisory services we have considered we recognise none which meets our criteria for continuing subsidy. There is however a need for a pure "signposting" or referral service which could not, we believe, be made to pay for itself, and this the Government should provide. This could best be done by setting up a network of Small Firms Advisory Bureaux in important industrial centres (paragraph 10.47).

3. The functions of the Small Firms Advisory Bureaux should be to provide information in response to queries, and assistance on technical, financial and management problems by providing introductions to the appropriate sources of professional, commercial or official advice. These services should be available to firms in all industries (paragraph 10.48).

4. The Advisory Bureaux should report directly to the Small Firms Division of the Department of Trade and Industry (whose creation we recommend in Chapter 9) and provide a source of first hand information about the progress and problems of the small firm sector (paragraph 10.51).

5. Since small firms are most in need of a service of this kind, and since most of the approaches to the Advisory Bureaux will be made by them, it is desirable that the Bureaux should be widely publicised as Small Firms Advisory Bureaux. However, it is not necessary that their activities should be strictly confined to small firms as defined in this Report (paragraphs 10.51 and 10.53).

6. Consideration should be given by the Small Firms Division, in consultation with other interested organisations, to methods by which the knowledge and experience of retired executives could be used to promote the efficiency and productivity of small businesses (paragraph 10.55).

19.12 Chapter 11 deals with the crafts. It contains no recommendations, though we would be prepared to countenance some modest support for the crafts, on social rather than economic grounds. We welcome the assumption of responsibility for the crafts by the Department of Education and Science.

abolished, and no parallel provisions should be included in the forthcoming revision of corporation tax (paragraph 13.56).

4. Close companies should be allowed to elect, by unanimous decision of the shareholders, to be taxed as partnerships (paragraph 13.58).

5. As a general rule the tax reliefs which are available for pension schemes set up for employees, including non-controlling directors, should be extended to similar funds for proprietors of unincorporated businesses and controlling directors of close companies (paragraph 13.61).

6. Such pension funds should have complete freedom as to the choice of investment, including the freedom to plough back into the business (paragraph 13.62).

7. Section 20 of the Finance Act 1969, disallowing interest on loans for the purchase of interests in closed companies as a deduction from income for tax purposes, should be repealed (paragraph 13.63).

8. Unrealised capital gains, on all assets other than quoted securities, should be taxed on only part (say half) of the gain, the tax paid on such to be credited towards the tax payable on any subsequent realised gain on the sale of the asset concerned (paragraph 13.65).

9. As a transitional measure retirement relief from capital gains tax should be raised from £10,000 to £20,000 (paragraph 13.66).

10. The extra-statutory concession for loans made by close companies to pay estate duty should be continued and made as widely known as possible (paragraph 13.73).

11. The estate duty relief of 45 per cent now allowed to agricultural property and industrial buildings, plant and machinery should be extended to net trading assets, including any amount in the assets valuation of the concern which arises in respect of goodwill, and to controlling interests in unquoted companies to the extent that their value represents net trading assets, including goodwill, of the company (paragraph 13.74).

12. A similar concession to that given for agricultural land should be given for ownership of industrial land and buildings whether or not the landlord uses them for a trade (paragraph 13.75).

13. A proportion (say half) of the cost, including the cost of associated litigation, of valuing assets other than quoted securities should be deducted from the estate for purposes of the duty (paragraph 13.76).

However, we wish to emphasise again that what is needed is a taxation policy which will restore initiative, encourage entrepreneurial activity and improve the liquidity position of small businesses. We believe that continued reduction in taxation of personal incomes and of estates would be most likely to achieve this result. This point is not specific to small firms, however, and we therefore merely state our view for the record.

19.15 We examine training in the sector, in Chapter 14, solely with reference to the Industrial Training Act. Although we recognise the valuable work that has been done under the Act we were forced to the conclusion that the present system

11. The Director of Statistics of every department or agency should be charged with more specific responsibility for all administrative forms issued by his department, and should be represented in all departmental deliberations about any policy or procedure with form-filling implications (paragraph 15.29).

12. Administrative forms should be designed wherever possible to serve statistical purposes, especially where this will permit the suppression or simplification of a statistical form (paragraph 15.31).

13. All statutory barriers to the passage of statistics between different departments should be stringently examined and demolished wherever possible. We regard this as of particular importance in the case of statistics collected by the Inland Revenue (paragraph 15.31).

14. The Government should quickly establish within a central department a powerful and expert secretariat whose function would be to plan, in collaboration with the CSO, an integrated system of administrative and statistical returns based on a data bank to form the basis for a single and comprehensive system of business records (paragraph 15.32).

15. Statisticians should be more closely associated with policy makers, so that existing administrative processes can be improved, and in order that new policies can be based more firmly on a quantitative assessment of the issues involved (paragraph 15.33).

19.17 We believe that an effective competition policy is of the greatest importance to the future of the small firm sector. We are not satisfied that our present policies give sufficient weight to the relative power of the competing units, or to the possibility that maximising the number of competing units alone may not always lead to maximum effective competition. We also think that insufficient attention has been given to the actual and potential abuse of buying power. Our recommendations in Chapter 16 are:

1. in making future references to the Monopolies Commission greater emphasis should be placed on the effect of the monopoly or merger in question on the maintenance of a balanced industrial structure (paragraph 16.7).

2. The whole subject of competition policy as it affects small firms clearly requires further study, and we recommend that this should be pursued by the Small Firms Division which we wish to see established within the Department of Trade and Industry. In the meantime, that is, until such studies are made, we can only recommend that a broad view should be taken by the Registrar and the DTI whenever an agreement involving small firms is under consideration (paragraph 16.21).

3. We feel that the view taken of agreements involving small firms should extend to the long term, and to the likely effects of the agreements under consideration in preserving in being the small firms which our industrial structure requires if it is to function efficiently (paragraph 16.21).

4. The Department of Trade and Industry should give consideration to the possibility of referring to the Monopolies Commission the question of the market power exercised by large firms through their buying policies and the possible damage to the competitive structure of industry, through discrimination against small firms which results from it (paragraph 16.24).

small firm sector. Many other problems on which we should have made recommendations if we had been reporting two years or even a year ago have since been dealt with by action of Government or change of circumstances. However, as we know from our experience of the past two years, new problems and difficulties arise almost as fast as the old ones are solved. It is for this reason that we place so much weight on the creation of a Small Firms Division within the DTI and the appointment of a responsible Minister to keep the sector under constant review. Benign neglect is no substitute for a policy.

19.21 We trust that this Report will generate further interest in the sector, not only in Government and among trade associations and others directly concerned with small business but also among academics and, not least, the general public. The field offers enormous scope for further research: our own work and that of our commissioned researchers has suggested many avenues that could be fruitfully pursued and which lack of time alone has prevented us from attempting.

19.22 For the general public we would only say again that what we have been studying is not merely a collection of statistics but something highly personal—their friends, bosses, trades people, local councillors, fellow members of golf or tennis clubs—a great part of the fabric of all our daily lives. There is no doubt that the quality of life would suffer severely and in ways we cannot now foresee if the small firm were to disappear. Fortunately, the sector has shown its resilience in adverse conditions and its ability to survive neglect and disinterest. We believe it will continue to do so whatever problems may arise, but we trust that in future it will be with the greatest possible encouragement from public opinion and understanding from Government.

a. The importance of small firms in the economy:
   i. Statistical description of the small firm "population" in terms of their number and size (output, employment, capital, etc.) with an analysis of recent trends and changes in this "population".
   ii. The economic advantages and disadvantages of small firms, and especially their role as innovators and specialist suppliers.
   iii. Their profitability and efficiency in the use of resources, including manpower, finance, capital equipment and materials.

b. The services available to small firms from Government, Government-sponsored agencies and other sources, and in particular:
   i. Technical, commercial and statistical information.
   ii. Expert advice—from consultants, bankers, accountants, etc.
   iii. Educational and training facilities.
   iv. The need for co-ordination of the services available and the extent to which they are currently used by small firms.

c. Special implications for the management and development of small firms of:
   i. Sources of development finance and working capital.
   ii. Taxation, including estate duty.
   iii. Investment grants.
   iv. The operation of the Industrial Training Act, 1964.
   v. The requirements of the Factories Acts.
   vi. The disclosure provisions of the Companies Acts.
   vii. The requirements of industrial development and planning controls.
   viii. The statistical and other returns required by the Government.

d. The experience of small firms, and attitudes towards them, in other countries.

e. Practical proposals which can be put to Government for improving the efficiency of small firms.

f. Any other matters of relevance.

6. It would be extremely helpful to us to have your views on each of these topics broadly under the headings set out above. Where possible, statements about, for example, the effect of particular legal requirements or economic policies on small firms, should be supported by concrete examples or such quantitative evidence as is available; generalised statements are of limited value. Our aim is to assess the economic cost of the various pressures affecting small firms—that is, the extent to which growth and efficiency have been inhibited by them—but without some quantitative assessment of these factors it would be difficult to justify remedial action. In addition to the written and oral evidence we shall receive, the Committee is commissioning detailed studies, on the basis of statistical samples, of a number of problems of special importance.

Questionnaires used by the Committee in their postal survey

(referred to in the Preface, paragraph 7)

COMMITTEE OF INQUIRY ON SMALL FIRMS

INQUIRY INTO SMALL FIRMS IN MANUFACTURING

SFI	

SECTION A

PLEASE COMPLETE AND RETURN BY DECEMBER 5th, 1969

Telephone enquiries:
Newport 52277
Extension 92
STD Code 0633

In reply please quote

If the name and address shown above is incorrect please correct it.

NOTE:

If your firm forms part of a wider organisation please give the name and address of this organisation in the space below and return this questionnaire, uncompleted, to the Business Statistics Office, Chartist Tower, Dock Street, Newport, Mon., NPT 1XG

Except where figures are specifically asked for in the questions below, please put a tick in the appropriate box.

(1) GENERAL

1. Have you recently completed, or are you in process of completing:

		Yes	No
(a) a questionnaire from the Association of British Chambers of Commerce entitled 'Small Firms Enquiry; Chamber of Commerce Questionnaire'?	1		
(b) a questionnaire from the Confederation of British Industry entitled 'Bolton Committee of Enquiry into Small Firms'?	2		

		Day	Month
2. On what date does your accounting year end?	3		

3. What was the approximate average number of persons employed:

(a) during your last accounting year?	4	
(b) during your accounting year which ended during the year ended 31st March, 1965?	5	

10. Is the chief executive of the firm the founder or a member of the founder's family? . . . . . .

	Yes	No
24		

If NO, was the chief executive:

(a) appointed from within the firm?	25	
(b) recruited from outside?	26	

11. How old is the chief executive?

	Under 30	30 - 39	40 - 49	50 - 59	60 or over
27					

12. What percentage of your total sales last year was accounted for by the customer who took the largest share?

	Less than 10%	10 - 25%	25 - 50%	50 - 75%	Over 75%
28					

13. Has your firm been successful in introducing any relatively MAJOR innovations during the last five years:

	Yes	No
(a) of produce? 29		
(b) in manufacturing processes? 30		

If YES please give brief details:

.....

.....

.....

.....

.....

.....

14. Do you regard the main competition to your business as coming from:

(a) imports?	31	
(b) production in the United Kingdom by other small firms? . . .	32	
(c) production in the United Kingdom by large firms?	33	

15. How many other firms manufacturing in the United Kingdom do you regard as serious competitors?

	1	2	3 - 5	6 - 15	Over 15
34					

22. In the last two years, has your output been adversely affected by strikes or other industrial disputes, either in your firm or in other firms? 58

	Yes	No
58		

If YES please estimate how much of your output was lost (even if the loss was later made up):

Lost output as % of Total output -		Industrial disputes in - (a) Your firm	(b) Other firms
Less than 2%	59		
2 - 5%	60		
5 - 10%	61		
More than 10%	62		

(4) FACTORS AFFECTING EXPANSION AND EFFICIENCY

23. During the last five years, has your firm taken over any other firm or firms, or been formed as a result of a merger? 63

	Yes	No
63		

24. Do you have overdraft facilities? 64

	Yes	No
64		

If YES, has your overdraft limit in the last twelve months been:

(a) reduced?	65	
(b) maintained?	66	
(c) increased?	67	

25. (a) Have you made attempts to obtain additional finance during the last two years? 68

(b) If YES, were you successful? 69

	Yes	No
68		
69		

(c) If you have obtained additional finance during the last two years, please indicate (by ticking below as appropriate) from what source (or sources) additional finance was obtained:

Source		Equity	Long-term loan capital (5 years or more)	Other
FINANCIAL INSTITUTIONS				
Banks	70			
Insurance companies	71			
Hire purchase and leasing companies .	72			
Factoring companies	73			
Other (please specify)	74			
OTHER SOURCES				
Trade customers/suppliers	75			
Private individual/existing shareholders	76			
Other (please specify)	77			

32. Has your dividend distribution policy been conditioned by the provisions of the Finance Act, 1965 relating to retained profits? .

	Yes	No
95		

If YES, have you:

(a) assumed that the Act requires you to distribute 60% of profits, or pay tax on it, or	96	
(b) have you taken professional advice to this effect, or . . .	97	
(c) have you been advised to this effect by a Tax Inspector? . .	98	

33. The Committee would like to know of any proposals you may have for improving the conditions of small firms and, in particular, whether there are any aspects of Inland Revenue taxation of income, profits or capital which you have found a serious obstacle to the functioning and development of your business.

YOUR COMMENTS:

Signature .....

Date .....

4. What is the MAIN activity of your firm?.

(a) Catering	6	
(b) Construction	7	
(c) Motor trades	8	
(d) Retail distribution	9	
(e) Road transport	10	
(f) Wholesale distribution	11	
(g) Other (please specify)	12	

(2) STRUCTURE AND COMPETITIVE SITUATION

5. Is your firm:

(a) a quoted public company?	13	
(b) a non-quoted limited company?	14	
(c) an unlimited company?	15	
(d) a partnership?	16	
(e) a sole proprietorship?	17	

		Yes	No
6. If your firm is a limited company, are any of the shareholders themselves limited companies?	18		

7. What is the smallest number of partners or shareholders which may or does form a controlling interest (i.e. holding more than 50% of the shares or voting power?)

	1	2	3 - 5	6 - 10	More than 10
19					

8. What is the number of working partners or shareholders?

	1	2	3 - 5	6 - 10	More than 10
20					

		Yes	No
9. Is the chief executive of the firm the founder or a member of the founder's family?	21		
If NO, was the chief executive:			
(a) appointed from within the firm?	22		
(b) recruited from outside?	23		

10. How old is the chief executive?

	Under 30	30 - 39	40 - 49	50 - 59	60 or over
24					

18. In the last two years, has your output been adversely affected by strikes or other industrial disputes, either in your firm or in other firms? . . . . . .

	Yes	No
44		

If YES, please estimate how much lower your turnover was over the two years than it would have been in the absence of any strikes or disputes:

Actual turnover lower by:		Industrial disputes in: (a) Your firm	(b) Other firms
Less than 2%	45		
2 - 5%	46		
5 - 10%	47		
More than 10%	48		

(4) FACTORS AFFECTING EXPANSION AND EFFECIENCY

19. During the last five years, has your firm taken over any other firm or firms, or been formed as a result of a merger? . . . . . .

	Yes	No
49		

20. Do you have overdraft facilities? . . . . . .

	Yes	No
50		

If YES, has your overdraft limit in the last twelve months been:

(a) reduced?	51	
(b) maintained?	52	
(c) increased?	53	

21. (a) Have you made attempts to obtain additional finance during the last two years? . . . . . .

	Yes	No
54		

(b) If YES, were you successful? . . . . . .

	Yes	No
55		

(c) If you have obtained additional finance during the last two years, please indicate (by ticking below as appropriate) from what source (or sources) additional finance was obtained:

Source		Equity	Long-term loan capital (5 years or more)	Other
FINANCIAL INSTITUTIONS				
Banks	56			
Insurance companies	57			
Hire purchase and leasing companies .	58			
Factoring companies	59			
Other (please specify)	60			
OTHER SOURCES				
Trade customers/suppliers . . .	61			
Private individual/existing shareholders	62			
Other (please specify)	63			

29. In your last accounting year, what percentage did Selective Employment Tax represent of your firm's:

(a) turnover?	82	%
(b) total labour costs?	83	%

		Yes	No
30. Has Selective Employment Tax caused you to economise in the use of labour?	84		

		Yes	No
31. Has your firm reorganised its business or reallocated any of its employees to make any of its establishments eligible for refund of the tax?	85		

32. The Committee would like to know of any proposals you may have for improving the conditions of small firms and, in particular, whether there are any aspects of Inland Revenue taxation of income, profits or capital which you have found a serious obstacle to the functioning and development of your business.

YOUR COMMENTS:

Signature .....

Date .....

1. TRADING AND PROFIT AND LOSS

(Please give figures to nearest £)

		Accounting year ended within the 12 months 1st April, 1964 – 31st March, 1965 OR First full year of business (a)	Most recent accounting year
1. Date when accounting year ended . .	1		
2. Total sales (b)	2	£	£
3. Wages and salaries paid (c) . . .	3		
4. Employer's national insurance and pension contributions; Selective Employment Tax (net); training levies (gross); and redundancy payments (in total)	4		
5. Directors' salaries, pensions and other salary costs (d)	5		
6. Rent of properties leased . . .	6		
7. Rent of plant and machinery, office equipment or transport leased (e) .	7		
8. Bank interest paid	8		
9. Other interest paid (including hire purchase interest charges) . . .	9		
10. Gross trading profit	10		
11. Depreciation	11		
12. Net profit before tax	12		
13. Net profit after tax	13		
14. Dividends (f)	14		
15. Proprietor's/Partners' drawings (including salaries) (g) . . .	15		

(a) If your firm started business less than five years ago.

(b) Net of trade discounts, but before cash discounts.

(c) Excluding directors' salaries (heading 5) and proprietor's or partners' salaries (heading 15).

(d) This does not cover proprietor's or partners' salaries, which are to be included at heading 15.

(e) Exclude short term plant or other hire.

(f) Companies only.

(g) Unincorporated businesses only.

2. ASSETS, LIABILITIES AND CAPITAL (continued)

(Please give figures to nearest £)

		Accounting year ended within the 12 months 1st April, 1964 – 31st March 1965 OR First full year of business (a)	Most recent accounting year
		£	£
18. Hire purchase balances outstanding with suppliers (b)	33		
19. Mortgages, debentures and other term loans	34		
20. Preference shares	35		
21. Ordinary shares and share premium account	36		
Other reserves and profit and loss balances:			
22. PLUS	37		
23. MINUS	38		

During the period between the first and last accounting periods shown above, have you:

		Yes	No
Made a bonus issue of shares?	39		
Revalued a substantial part of your assets?	40		

(a) If your firm started business less than five years ago.

(b) Include all hire purchase balances outstanding, wherever they appear in your accounts.

Signature .....

Date .....

4

List of Persons and Organisations who gave written or oral evidence to the Committee.

(Referred to in the Preface, paragraph 9)

1. *Trade Associations*

British Precast Concrete Federation
Dry Lining and Partition Association Ltd
Federation of Master Builders
National Building and Allied Hardware Manufacturers Federation
National Federation of Builders' and Plumbers' Merchants
(b) National Federation of Building Trades Employers

(b) British Hotels and Restaurants Association
National Association of Master Bakers, Confectioners and Caterers
National Federation of Master Painters and Decorators of England and Wales
National Hairdressers' Federation
Road Haulage Association Limited

Bakery Allied Traders' Association
British Antique Dealers Association
Co-operative Productive Federation Ltd of Leicester
Federation of London Wholesale Newspaper Distributors
(a) Federation of Wholesale Organisations
Independent Food Services Ltd
London Fruit and Vegetable Trades Federation Ltd
(b) Motor Agents Association
National Association of Corn and Agricultural Merchants
(b) National Chamber of Trade
National Dairymen's Association (Inc)
National Federation of Fruit and Potato Trades Ltd
National Federation of Retail Newsagents, Booksellers and Stationers
National Federation of Wholesale Grocers and Provision Merchants
National Federation of Wholesale Poultry Merchants
National Grocers Federation
Pottery and Glass Wholesalers' Association
(b) Retail Alliance
Retail Credit Federation
Retail Distributors' Association Inc
Scottish Federation of Meat Traders' Associations
Spar (Britain) Ltd
Wholesale Confectioners' Alliance Ltd
Wholesale Grocers' Association of Scotland

(a) Oral evidence only.
(b) Written and oral evidence.

Textile Machinery and Accessory Manufacturers Association
Toilet Preparations Federation
Truck and Ladder Manufacturers Association
Tufted Carpet Manufacturers Association
Wool Textile Delegation

2. *General Trade Organisations*

Aims of Industry
(b) Association of British Chambers of Commerce
Association of British Travel Agents
Aycliffe and District Traders Association
Birmingham Chamber of Commerce and Industry
(b) British Export Houses Association
(b) British National Export Council
(b) Confederation of British Industry
(b) Confederation of British Industry, Tax Committee
(b) Confederation of British Industry, Smaller Firms Council
Engineering and Building Centre, Birmingham
Furniture Development Council
Green Shield Trading Stamp Co Ltd
London Chamber of Commerce
Medway Chamber of Commerce
Merseyside and District Chamber of Commerce and Industry
Photographic Importers Association
Publishers Association
Sand and Gravel Association of Great Britain
(b) Scottish Council (Development and Industry)
Slough and District Chamber of Commerce and Industry
(b) Smaller Businesses Association
Timber Trade Federation of the United Kingdom
Well Drillers' Association
Western Counties Association of Chambers of Commerce

3. *Professional, Advisory and Consultative Organisations*

Association of Municipal Corporations
ASLIB
(b) Birmingham Productivity Association
(b) British Institute of Management
British Insurance Association
British Productivity Council
British Standards Institution
(b) British Tourist Authority
Central Middlesex Hospital Occupational Health Unit
Central Production Information Registers Ltd
Centre for Interfirm Comparison Ltd
(b) Consumer Council
Council of Industrial Design
(b) Council for Small Industries in Rural Areas
(b) Craft Centre of Great Britain

Croydon Industrial Liaison Centre
Durham University Business School
Hendon College of Technology, Industrial Liaison Centre
Heriot-Watt University
University of Keele
Kingston Polytechnic, Industrial Liaison Centre
University of Lancaster
University of Liverpool
(a) London Business School
(b) Manchester Business School
Medway and Maidstone College of Technology, Industrial Liaison Centre for Kent
Percival Whitley College of Further Education
Slough College of Technology, Industrial Liaison Centre for Buckinghamshire
(b) University of Strathclyde
University of Strathclyde, Centre for Industrial Innovation

5. *Financial Organisations*
(b) Bank of England
(a) Bank of Scotland
Barclays Bank Ltd
Chartered Bank
(b) Charterhouse Group Ltd
(b) Committee of London Clearing Banks
Copleys Bank Ltd
(a) Council of Associated Stock Exchanges
County Bank Ltd
Coutts and Co
(a) Dun and Bradstreet Ltd
Export Finance Consultants Ltd
(b) Finance Houses Association
First National Finance Corporation Ltd
Firth Cleveland Ltd
Gresham Trust Ltd
Hambros Bank Ltd
(b) Industrial and Commercial Finance Corporation Ltd
(b) Issuing and Accepting Houses Association
Keyser Ullman Industries Ltd
Lloyds Bank Ltd
Merrill, Lynch, Pierce, Fenner and Smith Ltd
Midland Bank Ltd
Midland Bank Finance Corporation Ltd
Morgan Grenfell and Co Ltd
(a) National Association of Trade Protection Societies
National Westminster Bank Ltd
(a) Noble Grossart Ltd
Portland Group Factors Ltd

Rubber and Plastics Processing Industry Training Board
Shipbuilding Industry Training Board
Training and Evaluation Associates
Wool, Jute and Flax Industry Training Board

(a) Chairman of Six Group Training Schemes

8. *Research Associations*

Furniture Industry Research Association
National Research Development Corporation
Scientific Instruments Research Association

9. *Economic Planning Councils*

East Anglia Economic Planning Council
East Midlands Economic Planning Council
Northern Region Economic Planning Council
North West Region Economic Planning Council
Scottish Economic Planning Council
South East Economic Planning Council
West Midlands Economic Planning Council

10. *Individual Firms*

BCA Travel Ltd
British Aircraft Corporation (Holdings) Ltd
Courtaulds Ltd
Delta Metal Co Ltd
Dunlop Group
Ford Motor Co Ltd
Imperial Chemical Industries Ltd
Kalamazoo Ltd
Lansing Bagnall Ltd
John Lewis Partnerships Ltd
Joseph Lucas (Industries) Ltd
Massey Ferguson Ltd
Owen Organisation
Pilkington Brothers Ltd
Rolls Royce Ltd
Rootes Motors Ltd
Smiths Industries
Swan Hunter Group
Unilever Ltd
Unquoted Companies Group
Vickers Ltd
Wiggins Teape Ltd

A I Welders Ltd
Ray Adlam Motors
William Agnew and Associates

L E Management Consultants Ltd
Lloyds Pharmaceuticals Ltd
Manchester Metal Works Ltd
Miles Roman Ltd
Mitchell Goldie & Co Ltd
Morning Foods Ltd
G D Mountfield Ltd
Naylor Buildings
Nichols Ltd
The Normal Press
G H Norton & Co Ltd
Odell Leather Co Ltd
PDI Ltd
Perrey Dugmore Ltd
Perkins Builders Ltd
Pilamec
C J Priday
H E Reed
Rockweld Ltd
R A Rooney & Sons
Rothesay Sea Foods Ltd
J W Ruddock & Sons Ltd
Scama Ltd
W G Sharp & Son Ltd
Sherborne Pouffes Ltd
Siddal & Hilton Ltd
V Siviter Smith & Co Ltd
David Smith & Co Ltd
Sparex Ltd
Stafford-Miller Ltd
Stanhope-SETA Ltd
Sterling-Winthrop Group Ltd
Stephens Belting Co Ltd
John A Stott Ltd
Symington & Co
A S Toone Ltd (Harris & Sheldon Group Ltd)
Triplan Ltd
Trylon Ltd
United States Metallic Packing Co Ltd
H Upchurch & Co Ltd
Wade and Suggitt
Walker Caledon Ltd
Wandex Plastics Ltd
Warner & Sons Ltd
West Hyde Developments Ltd

11. *Individuals*

D Andrew, Dundee College of Technology
Clifford H Barclay Esq

12. *Overseas Organisations*

United States of America

Bank of America
Boston Capital Corporation
Commercial Department, British Embassy, Washington
Continental Communications Corporation
First National City Bank
Graduate School of Business Administration, Harvard University
J H Whitney & Co Ltd
School of Business Administration, University of Washington
National Association of Small Business Investment Companies
National Federation of Independent Business
Small Business Administration, Washington
Small Business Association, Los Angeles
Small Business Association of New England
(b) United States Department of Commerce

Canada

Bank of Canada
British High Commission, Ottawa
Department of Finance
Department of Industry, Trade and Commerce
Industrial Development Bank

Japan

Commercial Department, British Embassy, Tokyo
Professor S Kato, St Paul's University
Ministry of International Trade and Industry
Small Business Credit Insurance Corporation
Small Business Finance Corporation

France

Confédération Générale des Petites et Moyennes Entreprises
Economic and Commercial Departments, British Embassy, Paris
Ministry of Finance
Ministry of Industry and Scientific Development
M Arnaud de Vitry, European Enterprises Development Company

Germany

Bundesverband der Deutsche Industrie
Commercial Department, British Embassy, Bonn
Deutscher Industrie und Handelstag
Federal Ministry of Economics

13. The Committee also attended a Seminar on Small Businesses and Growth organised on their behalf by the Society of Business Economists.

e. the establishment of, or financial support for, institutions and co-operatives which guarantee the credit standing of small businesses seeking term finance;

f. subsidisation of interest rates charged by institutions lending to small businesses.

Apart from official financial support and finance from commercial banks in the form of the provision of capital, loans and lines of credit, the specialist institutions seem to have been able, in a number of instances, to raise additional financial resources on their own account. Their ability to do so is undoubtedly limited by the nature of their business but co-operative institutions, in particular, seem to have obtained deposits from, or issued bonds to, their members.

The specialist lending institutions have, in a number of instances, been set up on a regional basis and have been restricted to lending within the confines of their own regions. In addition, where limits on the amount of credit obtainable by individual borrowers, the terms of loans and the rates of interest chargeable are fixed by the authorities, the conditions may vary from one region to another—thus again making term lending an instrument of regional development.

There are a number of potential difficulties and disadvantages in official support of schemes for lending to small businesses. It is clear, for instance, that such schemes could be used for political ends, bad as well as good. Dealing with small businesses—the definition of which in itself presents considerable difficulty—frequently involves complex procedures to try to provide adequate security and hence lengthy delays. The cost of subsidies, e.g. on interest rates on loans to small concerns when market rates are rising, may be hard to quantify. Nevertheless, both the specialist institutions and the commercial banks in the countries studied, seem to have included a sizeable proportion of term loans to small businesses in their portfolios. The success of schemes for encouraging term lending in their own political and economic environment does not, however, necessarily mean that they would achieve equal success if transplanted.

c. *Equipment loans to farmers:*
   i. Local Agricultural Credit Institutions
   ii. Caisse Nationale de Crédit Agricole
   iii. Bank of France

Special arrangements exist for small and medium sized enterprises unable to provide the security necessary for a loan through these normal channels. Loans are available to such firms if they are members of a Mutual Guarantee Society[1]; this condition fulfilled, they can obtain 2–7 year "professional credits" for equipment and light construction from banks at rates of interest believed to be a little below those normally charged for such loans (see Annex). In addition to the Society's guarantee, the bills representing these credits require the "aval" (equivalent to endorsement, normally unconditional) of the Caisse Nationale des Marchés de l'état (CNME) before they are eligible for rediscounting at the Crédit National and then at the Bank of France.

There are also some medium term credits available to small enterprises which are not mobilisable at the Bank of France. These include loans made by the Banques Populaires (co-operative credit societies) for purchase or improvement of a business, loans made by the Caisse Centrale de Crédit Coopératif to small business co-operatives for equipment or real estate investments, and loans for equipment and enlargement programmes by the Caisse Centrale de Crédit Hôtelier, Commercial et Industriel (see below).

B. *Long term credit*

Long term loans are granted direct by specialised institutions for periods between 5 and 20 years, and in some cases for as long as 30 years.

The Crédit National makes equipment or building loans (which are rarely for less than Fcs.100,000) to industrial and commercial enterprises for a maximum period of 20 years; it is unusual, however, for the duration of these loans to exceed 15 years and the average duration is 7–12 years. Loans of similar duration are made by the Caisse Central de Crédit Hôtelier, Commercial et Industriel (CCCHCI) to hotel-owners wishing to enlarge or modernise their property and to prospective hotel purchasers. These two institutions also have special procedures by which small and medium sized enterprises lacking adequate security can obtain equipment and building loans (see below). The Caisse Nationale de Crédit Agricole grants equipment credits to farmers for up to 15 years and also lends for a maximum of 30 years for land and house purchase. The Crédit Foncier is active in the field of loans, normally up to 15 years, for real estate, agricultural and equipment investment and also participates in a special 20–30 year scheme for the financing of low-cost house building. Under this last-mentioned scheme, which is not much used by small and medium sized firms, loans for approved projects initially take the form of medium term credits[2]

[1] These undertake, for a small commission, to guarantee loans granted to their members. There are numerous different societies covering the various sectors of industry, but one (SOCOMID—PME) exists specifically for small and medium sized enterprises generally.

[2] The reason loans take this form is that the Crédit Foncier's statutes and the laws governing mortgages prevent the institution from lending direct on a property which has not yet been built.

c. Non-mobilisable medium term and total long term credit (all non-mobilisable)		170·1
of which granted by:		
Commercial banks	18·2	
Crédit National	9·4	
FDES	5·1	
Co-operative Credit Institutions	3·9	
	36·6	

N.B. The bulk of the total of 170·1 comprises credit for housing finance and agriculture which is of no particular relevance to small and medium sized firms. However, small and medium sized firms can be expected to have benefited to the extent of at least one-quarter of the sub-total of 36·6.

Crédit Foncier	Special construction	4·75%–5·50%
Crédit National	Small and medium sized enterprises	8·75%
CCCHCI	Small and medium sized enterprises	8·50% (some lending at 5·0% and 6·75%)
Caisse Centrale de Crédit Coopératif, Crédit Populaire	Government funds via FDES → Co-operatives, Craft business	?6·50%, N/A

credit institutions to lend at below-market rates to small businesses. These subsidies are paid one year in arrears and are calculated from the difference between the payments of principal and interest due using the normal rates of interest applied by the credit institutions[1] and the payments which would be due using the fixed terms for medium sized and small industrial borrowers. Mediocredito acts as agent for the Government in dealing with transactions covered by interest subsidies, and for this purpose an endowment fund is allocated by the Treasury, annual contributions to which are included in the budget. In addition, since 1967 Mediocredito has raised funds by bond issues. The decision to subsidise a particular investment is made by an Interministerial Committee acting on behalf of the Government, whose criteria give favourable consideration to firms operating in depressed areas, those making use of local resources, those providing the most jobs or those whose ratio of productivity to capital invested is high, or those operating in conjunction with state enterprises.

In addition to the financial bodies already mentioned, there are 11 regional institutions established for the specific purpose of financing small and medium-sized firms in the regions of Northern and Central Italy (the South and islands being served by ISVEIMER, IRFIS and CIS). These regional organisations were founded in the 1950s, mostly by the banks, and they obtained their funds through bond issues, from lines of credit with the concerns which set them up, and through rediscounting with Mediocredito and collecting savings deposits. Lastly, the Banca Nazionale del Lavoro has a special section for credit to small and medium sized industries. This section has its own capital and reserves[2] and is administered separately from the main bank, although it avails itself of the offices and branches of the BNL and of the savings banks. It obtains its remaining funds through bond issues and through rediscounting with Mediocredito.

Small and medium sized industries are defined as those, in the South and the islands, whose capital does not exceed Lire 6 md., (£4 m.), and those elsewhere whose capital does not exceed Lire 3 md. (£2 m.) and which employ up to 500 people. Except for very small firms (see below), the terms of the loans to small and medium sized firms from whatever source are as follows: up to 15 years at 3% to a maximum of Lire 1½ md. (£1 m.) in the South and the islands, and up to 10 years at 5% to a maximum of Lire 1 md. (£667,000) elsewhere.[3] Loans granted may not exceed 70% of the cost of the project, including not more than 30% of the total to cover expenditure on inventory accumulation. For very small firms the maximum loan is Lire 50 m. (£33,000) and loans are made at 3% for 10 years in the South and the islands and at 5% for 7 years elsewhere. These rates of interest, which remain fixed throughout the life of the loan, compare favourably with normal market rates, which are currently in the region of 9%. In addition to special rates of interest there are several fiscal reliefs for small and medium sized firms: exemption from stamp duty and Government licence taxes and from any other indirect tax or charge on business (including the general turnover tax in respect of the interest payable); a fixed rate of stamp duty (Lire 100 per million Lire or fraction thereof) on bills of exchange and promissory notes, whatever their duration; a reduction by half of legal fees in connection with the loans.

[1] Making allowance for the special terms and subsidies they already enjoy.

[2] Subscribed by the BNL itself, by the Government, by Italcasse (the organisation of Italian savings banks), by the National Insurance Institution and by the Social Insurance Institution.

[3] The interest rate is reduced to 4 or 4·5% for loans to small and medium sized industries located in the depressed areas of Northern and Central Italy.

Industrial Credit Institutions

Mediocredito Centrale	Istituto Centrale per il credito a medio termine; established in 1952 for the purpose of refinancing (through rediscounting facilities and interest subsidies) credit institutions.
IMI	Istituto Mobiliare Italiano, which lends to State and private enterprises.
Crediop	Consorzio di Credito per le Opere Pubbliche, which lends for public works.
ICIPU	Istituto di Credito per le Impresi di Pubblica Utilita, which lends exclusively to public enterprises and only for industrial purposes.
ISVEIMER	Istituto per lo Sviluppo Economico dell'Italia Meridionale.
IRFIS	Istituto Regionale per il Finanziamento alle Industrie in Sicilia.
CIS	Credito Industriale Sardo.

deposits only from members. Their lending is also restricted to members, but membership is fairly easy to acquire.

(d) *Commercial banks*

Commercial bank lending usually takes the form of term loans. The bulk of this is to large firms but the banks also devote a significant part—about one-third at present—of their loans to small firms. Commercial bank lending to small firms is not exempted from general restrictions on credit.

II. In Mixed Ownership

The Central Bank for Commercial and Industrial Co-operatives

The Bank's deposit and loan transactions are confined to member organisations (co-operatives which have subscribed to the capital of the Bank and are organised under the Law for Co-operatives of Small Business) and their constituent members; and, as far as deposit taking is concerned, to public bodies, non-profit entities and financial institutions approved by the Government. The Bank's operations are supervised by the Ministers of Finance and of International Trade and Industry who are also authorised to appoint its officers. The Government intervenes more extensively in the business of the Bank than it does with other financial institutions and also provides financial assistance, partly through taking up bonds. Government funds account for about a quarter of the Bank's resources and deposits for between 20 per cent and 30 per cent.

The Bank extends credit to its member organisations in the form of 5 to 20 year term loans, as well as by overdrafts and discounting bills. It may also make short term loans to holders of its debentures on the security of those debentures. A loan limit per borrower is fixed for each business year.

III. Publicly Owned

(a) *The Small Business Finance Corporation*

This financial agency of the Government was set up in 1953 to supply funds to small businesses which would have difficulty in raising them through other financial institutions.

Apart from capital subscribed by the Government, the Corporation's funds derive from bond issues, limited to twenty times its capital; it is not permitted to receive deposits. The Corporation conducts its business on a nationwide basis through its head office in Tokyo, 35 branches and numerous agencies appointed from among banks and credit associations.

Loans to single borrowers are limited in amount with the intention that the Corporation's resources may be made available to a large number of small enterprises. The Corporation's term and instalment loans are for periods of one to five years.

(b) *The People's Finance Corporation*

The People's Finance Corporation is also a Government agency, the successor of the pre-war People's Bank and Pension Bank. It lends, for business purposes,

The climate

The general climate in the USA towards the encouragement of small businesses is historically very favourable. This attitude is reflected particularly in the US Congress, both Houses having powerful Committees on Small Business. In the 1957 hearings of the US Senate Committee on Finance entitled "Investigation of the Financial Condition of the United States" a considerable time was spent discussing the plight of small businesses, and from the subsequent report the Committee appears to have accepted that "upon the success of small business firms to prosper and grow depends much of our production and our survival as a free competitive society". There was also much Congressional concern about the harmful effects which tight monetary policies in 1966 and 1969 had on small businesses and the way in which these policies allegedly encouraged the tendency to corporate mergers. Another facet of the same attitude is the extensive Anti-Trust legislation of the USA.

Two cautionary notes should, however, be sounded about the limited relevance of US experience to the UK:

a. An important constitutional difference is marked by the political change-over at the top of the Small Business Administration of the Federal Government each time the political character of the Administration changes. Past switches of direction in SBA policies may thus reflect not so much their success or failure but rather the different ideological preferences of the new Administrator and his deputy.

b. More and more of the SBA's activities are being directed to the creation of middle classes among the minority groups—the negroes in particular. Apart from doubts about the validity of this approach—and there are many prominent negroes who reject it—it and the problem that it is intended to solve may well make many of the SBA's procedures inapplicable to the UK.

Instruments of policy

The political interest in fostering small business has taken effect in two particular areas—direct assistance (both financial and educational) and tax policy.

I. Direct assistance

(a) *Small Business Administration*

This Administration was set up by an Act of 1953 and is an independent US Government Agency with the purpose of helping in all ways the setting up, continuance, management education and growth of small business. The Agency relies for its finance on a large appropriation from the Federal Budget and includes a Disaster Loan Fund. Under the aegis of the Agency, Small Business Investment Companies were set up by an Act of 1958 and act as a means of attracting finance specifically for small business ventures; several hundred exist, and make funds available to small firms in the form of equity or 5 to 20-year loans. Financial assistance is granted by the SBA at advantageous rates and both SBICs and investors therein gain tax concessions when they sell their securities. There are,

i. Investment credits.
ii. Medical plans.
iii. Contribtion of Inventory to Charitable, Scientific or Religious Organisations.
iv. Pension, Profit Sharing and Deferred Compensation Plans.

Assessment

The Small Business Administration has no funds left for direct lending and so has been forced to concentrate on guaranteeing bank loans to small businesses. According to the SBA, this programme has been reasonably successful in overcoming the difficulties of small firms in raising term loans from SBICs. But, according to other sources, there is a much larger small business need for longer-term funds which, insofar as the SBA guarantee programme is concerned, could only be met by the insurance companies. The SBA prefers to rely on the—admittedly inadequate—SBICs and is proposing to Congress that it should be permitted also to guarantee the SBICs' equity investments in small firms.

The SBICs have been inadequate—except in a few isolated instances or, by and large, in cases of bank-affiliated companies—mainly because of lax control by the SBA. A number, for instance, have been set up by individuals solely to finance their own companies; many have been inadequately capitalised and, having acquired a few equity investments which they have no hope of selling, have been unable to make further commitments. A successful Investment Company operation is thus the exception rather than the rule. Even some of the bank-affiliated SBICs have tended to make loans—often those which the bank itself will not entertain—rather than take equity participations. Although the companies associated with large city banks have done well, further progress down this road will depend on how successful the SBA is in overcoming populist prejudices in Congress.

Another important function of the SBA—and to some extent of the SBICs—can broadly be called educational; that is to say, teaching small businessmen how to deal with banks, how to keep accounts, how to control stocks, etc. For this purpose the SBA hires outside consultants but, on their own admission, this programme has a long way to go.

31.3.1971 are £50,000 and it has dividends from other UK companies of £2,000. Its corporation tax assessment is as follows:

	£	£
Trading income		50,000
Corporation Tax @ 45% (assumed rate)		22,500
"Estate or trading income" (Appendix, para. 3)		27,500
Income other than "estate or trading income"		2,000
"Distributable income" (Appendix, para. 2)		29,500
"Distributable investment income" (Appendix, para. 4):		
Income other than "estate or trading income"	2,000	
Deduct 10% of £27,500 or £200, whichever is the less	200	
"Distributable investment income"	1,800	
60% of "estate or trading income" = 60% × £27,500	16,500	
"Maximum required standard of distributions"	18,300	

B Ltd pays dividends of £18,300 and there is, therefore, no shortfall liability.

(Two points not illustrated by the example are worth noting. First, capital gains are not included in distributable income (Appendix (2)). Second, the legislation provides for some mitigation of the maximum required standard of distributions for certain trading companies with estate or trading income of less than £9,000.)

4. As will be seen from the example, the maximum required standard of distributions allows the company to retain automatically part of its estate or trading income for any accounting period. But the company may not wish to distribute up to this standard—it may want to retain more of its income. How does it go about measuring its required standard of distributions ((b) above) in order to show if possible that this is less than its maximum required standard of distributions?

5. The words quoted in (b)—which define the required standard of distributions for the trading company—are worth looking at a little more closely. In effect they say that certain income (broadly the company's income less the corporation tax charged on it—see Appendix (2)) is distributable but that some of that income need not be distributed. The amount which need not be distributed is the amount which "could not be distributed without prejudice to the requirements of the company's business" (and that amount may be equal to the whole of the company's income—in other words the required standard may be Nil and the company may be able to retain the whole of its income). In measuring the required standard of distributions therefore the company has first to quantify "the requirements" of its business and then to show how much of its income it cannot distribute without prejudice to those "requirements".

distributions, the company can distribute up to that standard "without prejudice to the requirements of its business" (i.e. without using resources that are needed to provide for requirements). If that balance is less than the maximum required standard of distributions, the company can distribute that balance (and that balance only) without prejudice to requirements. In other words the required standard of distributions will be less than the maximum and if the company distributes up to that required standard there will be no shortfall assessment. Where, however, all the accumulated resources that would otherwise be available to provide funds for distribution are needed to provide for requirements, then the company cannot make any distributions without prejudice to the requirements of its business and it will not be liable to a shortfall assessment.

9. So far only the main statement regarding requirements has been considered. There is, however, one further statement the Act makes which may not affect all trading companies but is of importance to many of them and it must be taken into account by both the company and the Inspector. Section 293(1) provides that certain items are not to be taken into account as requirements of the company's business. The provisions are fairly lengthy and a detailed review of the whole of them would be beyond the scope of this Appendix. The part of those provisions which affects close trading companies most often provides broadly that if the company uses income to repay money borrowed (including money obtained from the issue of share capital) in order to acquire its business or to repay the amount outstanding for the purchase of that business, the income so used is not to be treated as having been applied to the requirements of its business and is to be regarded as available for distribution. It follows that if income has been used for this purpose the required standard of distributions will not be less than the smaller of (i) the amount of income so used or (ii) the maximum required standard of distributions—whatever the requirements of the company's business or the resources available for distribution may be.

10. The Inspector has to examine claims for requirements and, as he is bound by the legislation, he looks at the problem of requirements on the lines indicated in the preceding paragraphs. First and foremost he has to get to know "the company's business". To assist him in acquiring this knowledge, he has the accounts of the company for a number of years, the directors' reports and the correspondence he has had with the company or its representatives on numerous matters. In many cases, this information will enable him to get a picture of the company as a trading enterprise but he may well have to ask questions to enable him to complete it. In the light of this knowledge he then has to consider three matters: the resources of the company that appear to be available for distribution, the claims on those resources made by the requirements of the company's business and the effect of Section 293(1) referred to above. In trying to assess the resources that appear to be available for distribution, the Inspector has normally to start with the Balance Sheet at the end of the accounting period he is dealing with. From this he makes his preliminary assessment of resources. This is not merely a matter of arithmetic—a large measure of judgment has to be used. Clearly investments and current assets are the most likely sources of funds for the payment of dividends. But not all investments and current assets are available for distribution. Some investments may be trade investments

solution for either the company or the Inspector. Both the company and the Inspector must realise that there is room for differences of opinion about what are "requirements of the company's business" and the resources that are available for distribution after providing for those requirements and must try to assess fairly each other's point of view. Only by doing this can a reasonable solution be found. In most cases such a solution will be found but there will always be cases in which one side will not be able to accept the other side's views. In such cases the Act provides for the matter to be taken before an independent body of Commissioners and, if necessary, to the courts.

14. The possibility that the Inspector may not share the company's view on requirements will, of course, worry some directors and they may want the Inspector to declare his position early. The Act, therefore, provides that the company may send its accounts (and the directors' report, if any) to the Inspector and ask him to say whether or not he is going to make a shortfall assessment and the Inspector is given by the Act a certain time within which he must reply. This action by the company cannot, however, be taken before the accounts have been approved in general meeting. Some directors may think that this is too late—the dividends will by then have been declared—and they may want to know how the company stands before they meet the shareholders. If this is the case, the directors, after they have agreed the draft accounts, should ask the Inspector to consider those accounts and, if possible, agree with the company's representatives what dividend, if any, should be proposed in order to satisfy the provisions regarding shortfalls in distributions.

Definitions

1. "*Distributions*" are defined in Sections 233, 284 and 285 ICTA 1970. They include mainly, as far as the close company is concerned:

a. dividends, including capital dividends;
b. any other distribution out of the company's assets in respect of shares, except a repayment of capital or a distribution in exchange for new consideration;
c. loan, interest above certain limits paid to a director of a company who has a material interest in that company or to an associate of such a director;
d. annual payments (other than interest) and certain rents and royalties paid to a participator or an associate of a participator.

Section 291(1) defines "distributions for an accounting period" generally.

2. "*Distributable income*" is defined in Section 291(2) ICTA 1970. It is broadly the total of the following amounts:

a. the amount on which the company has to pay corporation tax less the corporation tax on that amount, reduced by the amount of any chargeable gains liable to corporation tax less the corporation tax attributable to those gains.

Memorandum by the Board of Inland Revenue

(Referred to in Chapter 13, paragraphs 13.43 and 13.45)

1. This memorandum briefly describes the extent to which certain overseas countries give favourable tax treatment to small firms in respect of their profits or income. For the purpose of the memorandum "small firms" means, broadly, firms having 200 or less employees. The memorandum restricts itself to the taxation rules in force in the United States of America and in the countries of the European Free Trade Area and the European Economic Community. Sterling equivalents of abatement levels etc are shown at the official exchange rate for the country concerned.

I EUROPEAN ECONOMIC COMMUNITY

France

2. There are two systems which allow certain taxpayers to be assessed on a basis which is different from real profits and real turnover (for TVA)—the "forfait" system and the "simplified" system. The eligible businesses are:

> "Forfait": Businesses of individuals or partners (other than partners in limited share partnerships) where the annual turnover is F.500,000 (£37,500) or less for trading concerns, or F.125,000 (£9,500) or less for businesses providing services.
>
> "Simplified"—any business (including that of a company) where the annual turnover is F.1,000,000 (£75,000) or less for a trading concern, or F.250,000 (£18,500) for a business providing services.

Those businesses which are eligible for the simplified system may opt to be assessed by reference to actual profits and turnover (income tax/company tax: VAT): businesses eligible for the "forfait" system may opt only for the "simplified" system, and not any more for assessment by reference to actual profit and turnover.

3. In the *simplified system* the simplification consists in the business not having to make such detailed returns as those which are assessed on real profit and turnover. Instead of ten attachments to the return three only need to be supplied: a summary account of profits and losses, a summary balance sheet and a note showing what adjustments should be made to the accounting profit to arrive at the tax profit, and, in whatever form the business considers appropriate, a schedule of depreciations and reserves. The simplified system is "still, in principle, a system of taxation in accordance with actual profit".

4. The broad effect of the *"forfait" system* is that every four years the amount of the normal income of the business is agreed between the tax authorities and the taxpaying business: this amount is used as the basis for the income tax assessment on the business for that year and the next three. The "forfait" system also applies for the VAT. The "forfait" regime entails an abbreviated annual return by the business, which, for the calendar year 1969 for example, would include the following:

i. Total purchases, less goods for own consumption, analysed into purchases at the various rates of TVA (which is always shown, by law, on the

undistributed profits is computed by reducing the taxable income by a pro-portionate part of the distributed profits.

According to World Tax Series "Germany" (12/2.1.b), the comparatively high tax rate on the distributed profits reflects the expectation that only a very low portion of the earnings would be distributed: this expectation was not realised, hence the option to be taxed at normal rates.

Belgium

7. i. Where the undistributed profits of a company are less than F.1,250,000 (about £10,000), they are taxed at a lower rate than normal. The rates are (excluding surcharges):

UNDISTRIBUTED PROFITS

F. million	*£ equivalent*	*Rate*
1	8,300	25%
1—1·25	8,300–10,400	F.¼ million + 50% of the difference between F.1 million and the undistributed profits
1·25—5	10,400–41,500	30%
5	41,500	F.1·5 million + 35% of the excess over F.5 million

ii. A Belgian private limited company may opt for its profits to be assessed to the tax on individuals in the names of its members. The option may not be exercised if there are more than ten members, if one of the members is a legal entity, or if the invested capital exceeds F.3,000,000 (about £25,000). Belgian tax rates for individuals begin at about 17 per cent.

Netherlands

8. In the Netherlands company income of FL40,000 (about £4,600) or less is taxed at 43 per cent; when the company's income exceeds FL50,000 (about £5,800) the whole of it is taxed at 46 per cent.

Luxembourg

9. There is a graduated scale of company tax rates. The top rate of 40 per cent applies only where the taxable income exceeds F.1,312,000 (£11,000): lower rates are 20 per cent and 30 per cent.

Italy

10. Italy has a schedular income tax system under which differing rates of tax apply to different kinds of income; in addition a surtax at progressive rates applies to the total income less the amount of the schedular taxes. Business income is normally taxed to the Movable Wealth Tax Category B at rates of 18 to 25 per cent, but certain very small businesses (broadly, those employing less

and may be of not more than 20 per cent of the employee's net salary or wages, are to be used for the setting up of an "independent economic activity"; the eligible deposits in these accounts are deductible at the time they are made, in arriving at the taxable employment income. The deposits remain in a blocked account. They may be released when assets costing more than Kr30,000 (£1,675) have been purchased. Of the releases, one-third, up to a maximum of Kr5,000 (£280), bears no tax on release, but the remainder is set off against the cost of the assets acquired for the setting up of the "independent economic activity", and so reduces the normal tax depreciation allowances.

Norway Sweden

16. There are no special tax reliefs for small businesses.

Switzerland

17. The rates of company tax of the Federal Government, and of many of the cantons (and hence the local authorities in those cantons) are graduated. The graduation is based, wholly or partly, on the ratio between taxable income and taxable capital (net worth). For example, the Federal rates are:

i. basic tax of 2·7 per cent;
ii. in addition an additional tax of 2·7 per cent on all taxable income which exceeds a yield of 4 per cent on taxable capital, or if the taxable capital is less than Sfr50,000 (£5,000), the additional tax applies to all taxable income in excess of Sfr2,000 (£200);
iii. further, a second additional tax of 3·6 per cent on all taxable income which exceeds a yield of 8 per cent on taxable capital, or if taxable capital is less than Sfr50,000 (£5,000), the second additional tax applies to all taxable income in excess of Sfr4,000 (£400).

III UNITED STATES OF AMERICA

18. In America small businesses may benefit from four provisions of the tax law. First, the rate of tax on the first $25,000 (about £10,400) of company profits is 22 per cent as compared with 48 per cent on profits in excess of that amount.

19. Second, "small business corporations", broadly, corporations with 10 or fewer shareholders, may opt for treatment as partnerships so that, in principle, shareholders are taxed on the whole profit, whether distributed or not, as if they were partners in a partnership. Other conditions for the exercise of the option are that the corporation should not be a member of a group and should have no corporation or non-resident shareholders. The option was granted, we understand, in order to minimise the effect of Federal income taxes on businessmen's choices of the form of organisation through which they conduct their business. It may nevertheless be effectively a concession to small companies with low profits because the lowest tax rate on individuals is 14 per cent whereas that for corporations is 22 per cent.

Report by the Board of Inland Revenue on the investigation undertaken for the Committee in respect of 1967/68

(Referred to in Chapter 13, paragraph 13.70)

1. The effect of estate duty on private businesses has previously been studied by the Board of Inland Revenue in two special investigations covering England and Wales. Their function was to ascertain to what extent on the death of the owner of a private business the non-trade assets were insufficient to pay the duty, so that some recourse had to be had to the business assets. The first of these investigations was undertaken at the instance of the Colwyn Committee on National Debt and Taxation which reported in 1927. It related to estates paying duty in England and Wales in 1922 and the results were published as Appendix XX to the Colwyn Committee's Report (Cmd 2800). The second related to 1948 but at the rate of estate duty for 1950 and the results were published in 1951 in Cmd 8295.

2. Both these investigations were based on a sample of cases for which the net capital value of the estate exceeded £10,000 and from these samples cases were selected for further investigation in which trade assets exceeded £1,000. Trade assets were defined to include shares in private companies, the net value of any interest in a partnership and trade assets held as such by an individual trader. Cases where the estate was below £10,000 net capital value were excluded as the duty would have been too small to have an adverse effect on the business and those where trade assets did not exceed £1,000 were eliminated as non-trade assets would then have been sufficient to pay the duty.

3. At the request of the Committee a similar investigation has been conducted in respect of 1967/68. The Committee suggested a sample of about 500 cases from estates with net capital value exceeding £20,000. A main sample of 445 such cases stratified by range of net capital value was taken and from this cases were studied for which trade assets exceeded £5,000.

4. Trade assets as defined above include shares in non-trading companies such as private estate and investment companies which should more properly be grouped with non-trade assets. In the 1922 investigation no separation of these shares was made. In the exercise based on 1948 figures were presented both with these shares included in trade assets (for comparability with the 1922 exercise) and excluding them (to give a better indication of "hardship"—see paragraph 6 below)[1]. In the present exercise it is not necessary to include these shares in trade assets in order to obtain comparability with 1948 but similar data are nevertheless shown in order to compare better the samples in the two years and to determine whether any differences between these samples are the result of bias in the way the sample emerged. Table VI suggests that for estates with net capital value of £20,000 and over there are very few "hardship" cases unless trade assets exceed £20,000. It therefore seems unlikely that any serious bias is

[1] The 1951 investigation also excluded minority holdings of unquoted shares and certain partnership interests. These have not been excluded in the present investigation.

compare this situation with 1948. This table shows a small number of estates with less than £5,000 business assets including non-quoted shares. The appearance of these cases in the sample is the result of the more refined analysis applied to the "hardship" cases leading to some small reclassification of estates.

12. Table II compares the distribution of estates by ratio of trade assets to net free estate. The higher proportions that trade assets bear to total net capital in 1967/68 than in 1948 are almost entirely due to the higher cut off point of £5,000 used in the later year. For this reason the percentages shown under the tables of numbers are misleading.

13. Table IV examines "hardship" cases according to alternative criteria. Table V expresses the "hardship" cases so defined as percentages of total estates covered for various ranges of net capital value. As for 1948 the percentage of "hardship" cases increases with size of estate and it does so whichever criterion is used for trade assets. Table VI gives the 1967/68 data by range of trade assets and again "hardship" tends to increase with size of trade assets.

14. Table VII compares encroachment of duty on trade assets assuming that *all* non-trade assets will be applied to paying off duty and unallocated debts. In 1967/68 there was a smaller number of cases of greater "hardship" where the encroachment was over 50% of the trade assets.

Conclusion

15. The present investigation indicates very little change from the position found in 1948 (but see Table VI). In particular the number of cases of "hardship", judged by any of the criteria used, remains a very small proportion of all estates with a significant amount of business assets. The number of sampled estates upon which Table VII is based is perhaps too small for any firm conclusion to be drawn from it but it does suggest that estate duty encroached upon the trade assets somewhat less in 1967/68 than in 1948. This may be mainly the result of the introduction in 1954 of the reduced rates of duty on certain business assets.

Hardship cases

Range of net capital value	Total number of estates	Estates with trade assets over £1,000	Numbers of "hardship" cases		
			Trade assets including investment companies etc. Debts set against non-trade assets	Trade assets excluding investment companies etc. Debts set against non-trade assets	Trade assets excluding investment companies etc. Debts set against all assets pro rata
1948					
10– 20	6,900	1,500	—	—	—
20– 50	4,230	1,080	70	30	20
50–100	1,245	460	90	40	40
100–250	476	180	30	10	4
250 and over	135	70	14	6	6
Total	12,986	3,290	204	86	70
Per cent	100	25	1·6	0·7	0·5
		Estates with trade assets over £5,000			
1967–68					
20– 35	7,412	889	52	—	—
35– 75	4,818	794	65	65	65
75–150	1,379	261	33	33	33
150–300	405	123	15	9	9
300 and over	124	72	20	10	10
Total	14,138	2,139	185	117	117
Per cent	100	15	1·3	0·8	0·8

TABLE V

Percentage distribution of "hardship" cases by range of net capital value

Range of net capital value	Total number of estates	Estates with trade assets over £1,000	"Hardship" cases		
			Trade assets including investment companies etc. Debts set against non-trade assets	Trade assets excluding investment companies etc. Debts set against non-trade assets	Trade assets excluding investment companies etc. Debts set against all assets pro rata
1948					
10– 20	100	22	—	—	—
20– 50	100	26	2	1	0·5
50–100	100	37	7	3	3
100–250	100	38	6	2	1
250 and over	100	52	10	4	4
Total	100	25	1·6	0·7	0·5
		Estates with trade assets over £5,000			
1967–68					
20– 35	100	12	0·7	—	—
35– 75	100	16	1·3	1·3	1·3
75–150	100	19	2·4	2·4	2·4
150–300	100	30	3·7	2·2	2·2
300 and over	100	58	16·1	8·1	8·1
Total	100	15	1·3	0·8	0·8

Accepting houses, 12.24, 12.25
Accountants
source of advice for small firms, 10.11–10.12
Acquisitions, 2.9, 2.11
Administrative returns
burden on firms, 15.23–15.26
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TABLE VI

"Hardship" cases in 1967/68 by range of trade assets

Range of trade assets (including investment companies etc.) £'000	*Estates with trade assets (including investment companies etc.) over £5,000*	*Numbers of "hardship" cases*		
		Trade assets including investment companies etc. Debts set against non-trade assets	*Trade assets excluding investment companies etc.*	
			Debts set against non-trade assets	*Debts set against all assets pro rata*
Less than 5	22	—	—	—
5– 10	585	1	1	1
10– 20	871	2	2	2
20– 30	428	117	65	65
30– 50	160	15	13	13
50–100	28	14	6	6
100 and over	45	36	30	30
Total	2,139	185	117	117
		Percentages of estates with trade assets over £5,000		
Less than 5	100	—	—	—
5– 10	100	—	—	—
10– 20	100	—	—	—
20– 30	100	27	15	15
30– 50	100	9	8	8
50–100	100	50	21	21
100 and over	100	80	67	67
Total	100	8·6	5·5	5·5

TABLE VII

Encroachment of duty on trade assets

Range of net capital value £'000	*Numbers where percentage of trade assets (excluding investment companies etc.)[1] required to meet duty is (per cent):*				
	0–25	*25–50*	*50–75*	*75–100*	*Total*
1948					
10– 20	—	—	—	—	—
20– 50	30	—	—	—	30
50–100	15	15	10	—	40
100–250	6	2	2	—	10
250 and over	—	3	2	1	6
Total	51	20	14	1	86
Percentage	59	23	16	1	100
1967/68					
20– 35	—	—	—	—	—
35– 75	65	—	—	—	65
75–150	13	20	—	—	33
150–300	7	—	2	—	9
300 and above	8	2	—	—	10
Total	93	22	2	—	117
Percentage	79	19	2	—	100

[1] Assuming all non-trade assets have been applied to paying off duty and debts and remaining duty is to be paid from trade assets.

TABLE I

Distribution of estates by net capital value in 1948 and 1967/68 studies

Range of net capital value £'000	*Total number of estates*	*% distribution of number of estates*	*Estates with trade assets over £1,000* *Number*	*% of Nos. in range*
1948				
10– 20	6,900	53	1,500	22
20– 50	4,230	33	1,080	26
50–100	1,245	10	460	37
100–250	476	4	180	38
250 and over	135	1	70	52
Total	12,986	100	3,290	25
			Estates with trade assets over £5,000	
1967–68				
20– 35	7,412	52	889	12
35– 75	4,818	34	794	16
75–150	1,379	10	261	19
150–300	405	3	123	30
300 and over	124	1	72	58
Total	14,138	100	2,139	15

TABLE II

Estates with trade assets over £5,000 in 1967/68 by range of trade assets
(with non-quoted shares (a) included and (b) excluded)

Range of trade assets £'000	*Number of estates* (a)	(b)	*Percentages* (a)	(b)
Less than 5	22	1,450	1	68
5– 10	585	195	27	9
10– 20	871	346	41	16
20– 30	428	111	20	5
30– 50	160	17	8	1
50–100	28	5	1	—
100 and over	45	15	2	1
Total	2,139	2,139	100	100

TABLE III

Numbers where ratio of trade assets to net free estate is

Range of estate £'000	*0% 10%*	*10% 20%*	*20% 30%*	*30% 40%*	*40% 50%*	*50% 60%*	*60% 70%*	*70% 80%*	*80% 90%*	*90% 100%*	*Over 100%*	*Total*
1948												
10–20	50	450	350	200	150	50	150	—	50	50	—	1,500
20– 50	300	240	150	110	80	80	40	10	30	40	—	1,080
50–100	135	55	55	70	45	10	25	30	10	10	15	460
100–250	72	26	18	10	14	16	4	6	2	10	2	180
250 and over	40	9	3	5	3	2	2	1	3	1	1	70
Total	597	780	576	395	292	158	221	47	95	111	18	3,290
Per cent	18	24	17	12	9	5	7	1	3	3	1	100
		42	59	71	80	85	92	93	96	99	100	
1967–68												
20– 35	—	—	117	52	175	—	52	311	117	65	—	889
35– 75	—	175	280	117	117	70	35	—	—	—	—	794
75–150	52	144	—	—	26	—	13	26	—	—	—	261
150–300	69	28	10	10	3	—	—	—	—	—	3	123
300 and over	40	12	4	2	4	4	2	—	2	—	2	72
Total	161	359	411	181	325	74	102	337	119	65	5	2,139
Per cent	8	17	19	8	15	3	5	16	6	3	—	100
		25	44	52	67	70	75	91	97	100		

introduced by the adoption of higher "starting points" than in the previous exercise.

5. As in the 1951 investigation unallocated debts have been charged alternatively against non-trade assets including investment companies etc. and *pro rata* against trade assets and non-trade assets and in addition against non-trade assets excluding investment companies.

6. "Hardship" cases have been defined as for the 1951 exercise i.e., as those cases in which the estate duty exceeded three-quarters of non-trade assets. This crude criterion makes allowance both for the fact that not all non-trade assets will be disposed of to pay the estate duty and for a small element of costs which have to be paid as well as estate duty.

7. The results of the present investigation are shown in the following Table together with a comparison with 1948, and further details are shown in Tables I to VII.

	1948		1967/68	
	Number of cases	*Percentage of cases*	*Number of cases*	*Percentage of cases*
Field covered (estates exceeding £10,000 in 1948, £20,000 in 1967/68):				
Cases in sample	1,183		445	
Cases represented by sample	12,986	100	14,138	100
of which				
Cases with trade assets exceeding £1,000 in 1948, £5,000 in 1967/68	3,290	25	2,139	15
"*Hardship*" *cases*				
i. 1922 definition, all debts against non-trade asset	204	1·6	185	1·3
ii. excluding investment companies etc., debts against non-trade assets	86	0·7	117	0·8
iii. ditto, debts *pro rata*	70	0·5	117	0·8

8. It is probably more use to compare the numbers of cases of "hardship" in the two years than the percentage these represent because the percentages are influenced by the level chosen for the size of estates to be excluded from the study. This level had to be fixed arbitrarily.

9. However the percentage of cases of hardship, excluding unquoted shares in investment and estate companies from trade assets rose from 0·7 to 0·8 between the two years if unallocated debts are set against non-trade assets and from 0·5 to 0·8 if they are "allocated" *pro rata*.

10. In order to compare the incidence of "hardship" in 1967/68 with that in 1948, some allowance had to be made for changing prices. Groups were therefore chosen for the later period to give a similar percentage distribution of estates by net capital value as in the earlier (see Table I). These ranges have been adopted in later tables (e.g. Table V) for this comparison.

11. Table II shows the distribution of estates with business assets over £5,000 (including non-quoted shares) by range of business assets both including and excluding non-quoted shares, some of which will relate to investment and estate companies, as business assets. It will be seen that if they are excluded only a small

20. Third, shareholders in small business corporations with equity and shareholders–loan capital of $1,000,000 (£417,000) or less may have any losses on disposals of their ordinary shares treated as "ordinary losses" rather than "capital losses". This means that the losses may be immediately set off against other income and thus relieved at income tax rates instead of being available for relief only against any future capital gains. This treatment extends only to losses up to a maximum of $25,000 (about £10,400), ($50,000 (about £20,800) when husband and wife put in a joint return).

21. There is an "additional first year depreciation allowance for small business". This is 20 per cent of the cost of business assets, given for the year of acquisition. It is not quite like the United Kingdom initial allowance: it reduces the cost available for annual allowances not only for years after the year of acquisition, but for the year of acquisition also. The allowance is limited to 20 per cent of $10,000 (about £4,200) ($20,000 (£8,400) in the case of a joint return). Although in law this allowance is not restricted to small businesses, the commentary on it and, indeed, the section rubric in the law, suggests that it is for their benefit.

Japan

22. Lower rates of corporation tax are payable by companies with a capital of 100 million yen (£117,650), or less. The lower rates apply both to distributed and to undistributed income but only up to 3 million yen (£3,500).

than 10 people) are taxed under Category C1 at rates of 8 to 15 per cent. This is only of limited advantage, since the surtax (for individuals, the complementary tax) falls at the same rates on all income, while the taxable income for the complementary tax is increased by the smaller deduction for the schedular (C1 tax).

II EUROPEAN FREE TRADE AREA

Portugal

11. Two main concessions are in operation for the benefit of small concerns. First, businesses run by individuals, which employ a very small number of people, use no more than two vehicles, keep only rudimentary accounts or none at all, and have very small premises, do not have to support their returns with detailed statements. Their income is assessed on an estimated basis by local commissioners. Once an assessment is made on this basis, it remains unchanged year after year unless the commissioners have reason to believe that the income of the business has increased or decreased by more than 25 per cent. Second, somewhat larger (although still quite small) businesses whose average taxable income is 300,000 escudos (£4,500 approximately) or less, do not have to produce detailed statements (unless they happen to keep adequate accounts); instead local commissioners make tax assessments on them on the basis of their rough returns of income and expenses. In both cases the businesses avoid the need to keep full accounts.

12. These concessions do not apply to companies (there are, we believe, few very small companies in Portugal). Companies are liable to the industrial and complementary taxes. The rate of companies' complementary tax is, however, graduated so that the top rate of 8 per cent does not begin to operate until the taxable income exceeds 5,000,000 escudos (£73,500).

Austria

13. In Austria very small businesses owned by individuals (including partnerships) which have 3 employees or less (excluding spouses and apprentices) are taxed on an estimated basis if their turnover or annual profits do not much exceed a prescribed amount which varies with the locality, plant employed, inflow of raw material and "other circumstances which influence profits". The maximum annual profit for which this concession is granted is S75,000 (about £1,250), so that it is a concession only for the smallest of businesses. It applies only where no proper accounts are kept.

14. In addition small companies benefit from the structure of the company tax which is levied at graduated rates. The top rate of 44 per cent (57·64 per cent including surcharges) applies only where the taxable income exceeds S111,100 (£18,000). The lowest rate is 24 per cent (31·44 per cent including surcharges). Rates are halved for distributed profits.

Denmark

15. In Denmark there are no special tax concessions for small businesses but there are special tax reliefs for young people who are saving to set up in business.

purchase invoices), purchases exempted from TVA and purchases not liable to TVA;

ii. stock at 31 December 1969;

iii. turnover, in the following categories:

a. resales of products and merchandise purchased;
b. sales of products manufactured by the business;
c. sales for consumption on the premises;
d. services;
e. letting of rooms;
f. building work;
g. other.

iv. General expenses (in totals), in the following categories:

a. employees' remuneration (not partners);
b. employees' benefits-in-kind (not partners);
c. Social Security contributions (including the partners' own), pension payments;
d. rents for business premises;
e. other general expenses (giving details of TVA suffered).

v. Details of fixed assets acquired in 1969.

The return would also include personal details of the proprietors, a note of the number of employees, and a list of the motor vehicles used by the business and the proprietors personally.

5. This limited information enables the tax authorities to compute the "agreed annual income" of the business for the year in question; once this is agreed with the proprietors, it will be continued for a maximum of three years following that for which it is first agreed. Either party to the agreement may denounce it in a future year. The advantage of the "forfait" system is that it absolves small businesses from keeping full accounts. In 1967 over 85 per cent of individuals in business used the "forfait" system (*Statistiques et Etudes Financières*, June 1970 Supplément, p. 40).

Germany

6. The normal rates (excluding temporary surcharge) of tax payable by a German company are 51 per cent on undistributed profits and 15 per cent on distributed profits. However, a company with a net worth of 5,000,000 DM (about £600,000) or less, 76 per cent or more of whose shares (which must be registered, and not traded) are owned by individuals, will pay tax at the following rates (excluding temporary surcharge) unless it opts to be taxed normally:

Undistributed profits	First	10,000 DM:	39%	(up to about £1,200)
	Next	10,000 DM:	44%	(£1,200—£2,400)
	Next	10,000 DM:	49%	(£2,400—£3,600)
	Next	10,000 DM:	54%	(£3,600—£4,800)
	Next	10,000 DM:	59%	(£4,800—£6,000)
	Balance		49%	(over £6,000)

Undistributed profits 26·5%

b. The company's franked investment income less any relief given against it for losses, management expenses, etc.

c. The company's group income.

3. "*Estate or trading income*" is defined in Section 291(4) and (5) ICTA 1970. It is broadly income which would be earned income if the company were an individual (and this, of course, includes the company's trading profits), income chargeable under Schedule A or Schedule B, and income chargeable under Schedule D (other than interest) which arises from the ownership, occupation or other rights over, land or buildings (including rent for furnished letting).

The "estate or trading income" to be taken into account in arriving at the required standard of distributions is the amount included in respect of it in distributable income (i.e. the estate or trading income less the amount of corporation Tax charged on it—Section 290(3)(b) ICTA 1970).

4. "*Distributable investment income*" is defined in Section 291(3) ICTA 1970. It is broadly that part of the company's "distributable income" which is not estate or trading income, plus the gain on certain insurance policies (S.399(1)(b) ICTA 1970) and less whichever is the smaller of:

a. 10 per cent of the estate or trading income less the corporation tax thereon, and

b. £200, or a proportionately reduced amount if the accounting period is shorter than a year.

essential for the protection of the company's business. Most companies need a certain level of stock-in-trade to maintain the business. Most companies need to give credit to customers to retain their custom and must have resources to do this. Further, current liabilities represent calls on current assets and these calls must be met; although here the Inspector has to take into account that most companies in the normal course of trade receive credit from suppliers and if he is taking into account the need of the company to give credit he takes into account also the normal credit facilities it receives from suppliers. So in endeavouring to assess the resources that can be considered as available for distribution, the Inspector brings into play all the knowledge he has acquired about the company and its method of carrying on its business.

11. This preliminary assessment of the company's available resources may indicate that, although the company has made profits, it has no resources out of which to pay a dividend. An analysis of the Balance Sheet may show that any available resources the company had at the beginning of its accounting period and the resources that have flowed in during the accounting period in the shape of profits, etc., have in fact been ploughed back into the business—for example, by purchasing additional plant and machinery or premises—and are not now available for distribution. If this is the case, then the required standard of distributions is Nil and the Inspector will not need to seek further information from the company to establish that there is no shortfall in distributions. But this lack of resources may not always indicate a Nil required standard. Some of the company's resources may have been used for items which, at least on the face of it, are not requirements of the company's business and the Inspector may need to seek further information about these items since the Act provides that only the requirements of the company's business can be taken into account.

12. If, on the other hand, the Inspector comes to the conclusion that apparently the company has resources out of which it can distribute and either it has not distributed or it has not distributed up to its maximum required standard, then he must seek the company's reasons for claiming that it cannot distribute or cannot distribute more than it has done. Here again the knowledge he has gained about the company's business comes into play (and he may well add to that knowledge as he asks questions and considers the replies he is given about the company's need to retain resources to meet requirements). He must, however, always bear in mind that the past spending must have been, and future needs must be, for the company's business if they are to be taken into account as requirements. Where the company is not contractually committed to certain expenditure, he must endeavour to judge whether the plans, etc. of the company are so far advanced and so supported by what he has learnt about the company's business that they are more than mere "vague adumbrations" (to quote a judgement of the courts). Moreover, if the funds the company needs in order to carry out its plans for the maintenance and development of its business will not have to be spent for some time, he must assess to what extent the company needs to retain present resources to meet that expenditure since during the intervening period further funds will flow into the company, for example, from future profits and it may not be reasonable to load on to current resources the whole of the cost of future development, etc.

6. What are "the requirements of the company's business"? The Act does not list them but Section 290(3)(a) says:

> (3) In arriving at the required standard for any accounting period—
>
> (a) regard shall be had not only to the current requirements of the company's business but also to such other requirements as may be necessary or advisable for the maintenance and development of that business . . .

This is the main statement the Act makes about requirements and it merits careful consideration. First note the emphasis on "the company's business". These words crop up three times—Section 290(1) refers to "the requirements of *the company's business*" and Section 290(3)(a) to "the current requirements of *the company's business*" and "the maintenance and development of *that business*". It follows that it is essential (for both the company and the Inspector) to view requirements in the light of the company's business and it can be said, therefore, that the first step in deciding whether something is a "requirement" is to identify the company's business for this is what that "something" must be for. It is because of the Act's emphasis on "the company's business" that no comprehensive list of "requirements" is possible. Businesses are not produced from one mould or even from a limited set of moulds. They differ from one another as much as individuals do. And because they are different, their requirements are different.

7. Secondly, note that the statement covers the three needs of all businesses: the need for resources to meet current requirements, the need for resources to maintain the business and the need for resources to develop the business. Clearly a company wants funds to meet its current commitments and its day-to-day needs. But even after its current requirements have been taken into account, the company may need further resources to maintain its business. For example, major items of plant and machinery may be wearing out and need replacement or the directors may know that unless the plant and machinery is modernised, the company's competitors by using more up to date plant and machinery will be able to undercut its prices and it will lose its share of the market. Therefore the directors will enter into commitments or plan for replacement or modernisation and will also plan to provide the funds needed to meet the cost. Or to take another example, the source (e.g. quarry, sand pit, gravel workings) of the raw materials the company uses (or extracts and sells) may be almost worked out and a new source of supply will be needed. Clearly funds will be necessary to purchase this new source. Finally, most directors want to develop the company's business. They may, for example, wish to go more extensively into the export trade and need funds for acquiring additional premises abroad or to enable them to give extended terms of credit to foreign buyers. Or they may find that sales are increasing and the company's premises and machinery are inadequate to produce all the goods that can be sold and additional premises and plant are needed. All such plans and needs have eventually to be paid for and the company will need to have the resources to meet the bills as and when they come in.

8. But the fact that a company needs to provide resources for its current requirements, to maintain its business and to develop that business does not of course necessarily mean that it cannot pay a dividend. That need will tie up part (maybe the whole) of the accumulated resources that would otherwise be available to provide funds for distribution. But if it ties up only part of those resources,

Appendix VI

Close trading companies and shortfalls in distributions

(Referred to in Chapter 13, paragraph 13.53)

1. From time to time directors of trading companies which are close companies have expressed doubts about the effect of the corporation tax system and its provisions regarding the payment of dividends. These doubts take various forms. Some directors assume that, unless their company pays out all its profits as dividends, it will suffer an income tax bill on those profits in addition to a corporation tax bill; others that the company must pay out as dividends sixty per cent of its profits or be similarly taxed; whilst others, although they have heard that there is a rule that allows the company to retain profits, fear that the possibility of this rule applying to their company is so remote that they had better reckon on having to pay a dividend of at least sixty per cent of the profits. The object of this Appendix is to allay some of these doubts. It does not purport to be a comprehensive survey of the whole of the close company legislation. It is an attempt to present the bare bones of the subject as simply as possible so that the director who has no time to consider the detailed legislation may get a general idea of its effect on the close trading company.

2. Broadly a close company is one which is controlled by five or fewer persons or by its directors. It has long been recognised (in the taxing Acts since the early twenties) that the dividend policy of such a company could be unduly influenced by thoughts of saving personal tax for its few controllers. Chapter III of Part XI Income and Corporation Taxes Act 1970 therefore provides that, where the distributions of a close company fall short of a standard prescribed by the legislation, the company is liable to be assessed to income tax (and, possibly, surtax) on the amount of that shortfall. (Such an assessment may be referred to as a shortfall assessment.)

3. The provisions regarding shortfall assessments in relation to the close company whose main activity is, and will continue to be, the carrying on of a trade in effect say this:

a. If, for any accounting period, the company distributes its distributable investment income plus 60 per cent of its estate or trading income (this can be called the company's maximum required standard of distributions) it will not suffer a shortfall assessment.

b. If, for any accounting period, the company can demonstrate that its required standard of distributions (that is, its "distributable income less so much of that income as the company shows cannot be distributed without prejudice to the requirements of the company's business") is less than the maximum required standard of distribution, then it will suffer a shortfall assessment only if its distributions are not up to that required standard.

"Distributions", "distributable investment income", "estate or trading income", and "distribution income", have precise meanings defined in the legislation. An abbreviated account of these meanings is attached, with references to the appropriate legislation where the full definitions can be found. A simple example will illustrate broadly how (a) works and give some indication of the meaning of the phrases used.

of course, considerable restrictions and regulations covering assistance by these organisations to individual businesses and limitations on the extent to which banks may acquire direct or indirect ownership or control of an SBIC; nevertheless, complaints of misconduct are not infrequent.

(b) *Commercial banks*

Term loans (i.e. for more than one year) bulk large in US banking practice and account for some 40 per cent of the total commercial and industrial loans of the large commercial banks. The banks lend to small businesses either direct or through participation in and ownership of Small Business Investment Companies. The First National City Bank have recently set up their own subsidiary to specialise in this type of business. To an appreciable extent the SBICs need to supplement the funds they obtain from the SBA—which are limited to $250,000 for a single business loan and to maximum term of ten years—from bank sources.

II. Taxation

In spite of the acknowledged importance of small businesses to the US industrial system, the institutional arrangements to provide term finance to such firms seem a little sparse and lacking in depth when compared with the arrangements in other industrial countries aiming at fostering the growth of small concerns. This apparent deficiency is perhaps made good by the favourable tax treatment offered in the USA to small firms.

The US Internal Revenue Code and its Regulations offer many opportunities to new and established small businesses to choose the tax structure most beneficial to them; they are briefly:

(a) *Differential between corporate and individual/partnership structure*

i. *Corporate*, with a ceiling tax rate of 48 per cent on net profits when they reach $25,000 (22 per cent below that) and advantages such as division of business to minimise inheritance taxes, relief on fringe benefits, and multiple corporations giving more than one surtax exemption. Even though a tax of 6 per cent must be paid on the first $25,000 of taxable income if multiple surtax exemptions are chosen, this only produces a rate of 28 per cent on the first $25,000 of profit, coupled with the possibility of an exemption if the estimated tax of each corporation is not in excess of $100,000.

Partnership, where taxation rises as high as 70 per cent but starts at a low of 14 per cent; this form may have several advantages over the corporate as it offers easier movement of capital between the owners and the business itself, and offset of business losses directly against personal income; distribution of initial investment is not subject to a double tax, whereas it would normally be considered a dividend in the corporate form and therefore liable at corporate and recipient level.

ii. *Choice of a fiscal year* may be very important for corporations but there is substantially less latitude for partnerships.

(b) *Choice of an overall method of accounting*

The cash receipts and disbursements method (cash basis) or the accrual method are available options.

to private individuals who encounter difficulties in borrowing from ordinary financial institutions. The Corporation's resources consist of the capital subscription of and borrowings from the Government.

The last two institutions are supervised by the Ministry of Finance which also regulates the activities of the mutual loans and savings banks and the credit associations. The credit co-operatives come under the control of prefectural offices.

System for augmenting credit standing

A system of credit guarantee associations guarantees the obligations of small enterprises seeking credit from ordinary financial institutions. The associations derive their funds from local public authorities and from the Small Business Credit Insurance Corporation.

The latter corporation is a financial agency of the Government and derives its funds from Government sources. Its purpose is to insure the debts guaranteed by the credit guarantee associations and to supply funds to them in the form of two-year loans for operating capital and six-month loans for meeting their obligations under guarantees.

Scale of operations

The role of the various orgainsations in extending loans to small businesses may be judged from the following table of loans outstanding at the end of 1969. (Yen 360=$1).

	Yen md.	*Per cent of total*
Mutual loans and savings banks, credit associations, and credit co-operatives	10,788	43·1
Commercial banks	10,438	41·7
The Central Bank for Commercial and Industrial Co-operatives, the Small Business Finance Corporation and the People's Finance Corporation	2,353	9·4
Other financial institutions	1,452	5·8
	25,031	100·0

Japan

The climate

Since 1945, Japanese industry—both large and small—has been heavily dependent upon funds borrowed from the banking system and from specialised institutions, although in the last ten years the proportion of equity finance has increased and some firms (mainly of larger size) have been able to build up their own resources. However, borrowing still accounts for over half the total and practically all of this is in the form of term loans. The situation in Japan is, therefore, very different from that in the UK and the following account of institutional arrangements may not be of direct relevance to UK problems.

Instruments of policy

The Japanese have augmented the supply of loanable funds to industry by setting up a whole series of specialist institutions which confine their lending to small business. These institutions can be divided into three types, privately owned, of mixed ownership and publicly owned. Apart from the commercial banks, there are three categories within the private sector—mutual loans and savings banks, credit associations and credit co-operatives—each supplying term loans within particular limits. The institutions in mixed and public ownership also provide term loans and comprise the Central Bank for Commercial and Industrial Co-operatives (mixed ownership), the Small Business Finance Corporation (publicly owned) and the People's Finance Corporation (also publicly owned). The latter institutions supplement the private concerns and, being less vulnerable during periods of credit restriction, act as valuable sources of funds to small firms.

I. Privately owned

(a) *Mutual loans and savings banks*

Mutual loans and savings banks receive deposits and savings by instalments, make loans and discount bills, conduct domestic remittance business and accept securities and other valuables for safe keeping in the same manner as commercial banks. They are, however, subject to certain restrictions in their lending. Initially the opening of business establishments was permitted only on a regional basis so that funds collected could be employed within the same region but in 1968 this stipulation was abolished. The authorities may vary interest rate ceilings on the different types of lending in which these organisations are involved but, within the ceilings, the Mutual Loans and Savings Banks Association fixes, by agreement, voluntary maximum rates according to size of loan.

At the end of 1970 there were 72 mutual loans and savings banks, some of the larger institutions having reached a size comparable with city banks.

(b) *Credit associations*

Credit associations are non-profit-making co-operative organisations. The areas within which they may conduct business are limited, they may lend only to their members (though deposits may be drawn from the general public) and the funds they lend may be utilised only within their respective regions. Otherwise the business of the credit associations, of which 502 were in existence at the end of 1970 is similar to that of commercial banks.

Assessment

The relative importance of credits to smaller firms in the Italian economy can only be broadly estimated. The total of subsidised credits made under Law No. 623 of July 1959 by special industrial credit institutions to small and medium sized businesses outstanding at end 1970 was Lire 1,350 md. (£900 m.), which represented 8 per cent of all credits granted by the special industrial credit institutions and 5 per cent of total credit given by the commercial banks. The total of subsidised credits received by small and medium sized industries is, however, somewhat higher than this, as there are other laws which also enable them to benefit from such facilities.

Italy

The climate

The official rationale behind the provision of state-subsidised credit to smaller firms appears to be closely linked to the policy of stimulating industry in underdeveloped areas. Since smaller firms may well be, in many cases, the most appropriate way of doing this, the provision of adequate and cheap credit to such firms is regarded as important. There seems to be little intention that the provision of such credits should help to produce bigger units, though it may, of course, incidentally do so.

The firms, for their part, are enabled to finance investments without recourse to the capital market, the cost of which could well be prohibitive to them, and, since these are all term loans with an unvarying rate of interest, the firms can plan their investment without having to make allowance for fluctuations in market rates. The Italian authorities seem to recognise, however, that there are some unsatisfactory aspects to the scheme; the demand for such loans and the complexity of the procedures cause delays; also, since the rates of interest do not vary over the term of the loan, there is an additional subsidy burden on the state if market interest rates rise in the interim.

Institutional arrangements

The main sources of medium and long term credit available, with particular reference to small and medium sized firms, are summarised below; the principal lending institutions are listed in an annex.

In Italy medium and long term loan finance for private industry as a whole comes very largely from specialised credit institutions, rather than from borrowing direct on the capital market. These credit institutions, whose capital is subscribed either by the Treasury or by the banks or other financial bodies, raise their operating funds through savings deposits, issues of securities or debentures, or through rediscounting with Mediocredito Centrale.[1] The institutions may be divided into two groups: those which operate over the whole territory, and those whose interest is regional. Of the first group, IMI,[1] Crediop[1] and ICIPU[1] are Government-controlled, while Mediobanca, Efibanca, Centrobanca and Interbanca were set up with capital subscribed by various groups of banks. The regional institutions are the three bodies ISVEIMER,[1] IRFIS[1] and CIS,[1] set up by the Cassa per il Mezzogiorno for the development of the South and the islands, and industrial credit sections of the Banco di Napoli and the Banco di Sicilia. Almost all commercial banks act as intermediaries for the above special credit institutions, and a firm wishing to borrow would most naturally in the first instance approach its bankers.

Within this general system for medium and long term lending special provision is made for credit to small and medium sized industries. In the early 1950s small businesses were enabled to obtain credit on favourable terms (through the setting up of Mediocredito), and in 1959 the system was formalised in a law authorising the granting of loans on fixed terms to small firms for the purpose of constructing new industrial plant or for the conversion or extension of existing plant. Subsequent laws extended the terms to cover equipment and initial stock formation.

[1] See Annex.

Rates charged to borrowers

The rates shown below are those applicable in January 1970, a time of exceptionally high interest rates. In the 15 years prior to the May 1968 "events" and their aftermath interest rates in France remained extremely stable; e.g., the Bank of France's rediscount rate fluctuated within the narrow range of 3½–5%. This stability applied equally to the rates for medium and long term credit, many of which were stated to be "fixed". However, following the increase in the Bank of France's rediscount rate, in stages, from 3½% in July 1968 to 8% in October 1969, rates were raised over the whole spectrum: in the case of medium term credits, this applied not only to credits first granted after the increase but also to *existing* credits. The actual increases for *mobilisable* credits were 1% on existing loans and 1½% on new loans (except those granted through Crédit National/CNME to small and medium sized industries, whose cost went up by 1%): for *non-mobilisable* credits, both new and existing, the increase was 1½%. Since January 1970, the Bank of France's rediscount rate has been reduced by 1¼ but it is not known to what extent the rates shown below have been correspondingly reduced.

Medium term[1]

Channel	*Purpose of Loan*	*Rates (for new credits)*
Mobilisable Credits		
Crédit National Banques Populaires	Equipment	5 years: 10% 6 years: 10·4% 7 years: 10·65%
Crédit Foncier	Construction	9·5%–10·25%
Crédit Agricole	Agricultural investment	8·5%
Crédit National/CNME	Small and medium sized industries	5 years: 9·05% 6 years: 9·55% 7 years: 10·05%
Non-mobilisable Credits		
Banques Populaires Caisse Centrale de Crédit Coopératif	Equipment, real estate	5 years: 10·75% 6 years: 11% 7 years: 11·25%
Long term (all non-mobilisable)		
Crédit National	Equipment/construction	8·75%
CCCHCI	Hotels	8·50% (some lending at 5·0% and 6·75%)
Crédit Agricole	Agricultural investment	4·5% (7% between Fcs. 150,000–300,000)

[1] The rates for medium term credits are minimum rates; higher rates may be charged where the nature of the business or the risks demand it.

granted for 2½ years for an individual building and 4½ years for a larger development by the Comptoir des Entrepreneurs. These credits are rediscountable at the Crédit Foncier and the Bank of France, and, at the end of their initial term, are consolidated by the Crédit Foncier for the remainder of their life.

As is the case for medium term credit, small and medium sized enterprises unable to give the necessary guarantees (such as a first mortgage) can borrow at long term subject to certain conditions. The Credit National lends for a maximum of 15 years against security equal to 50% of the loan, plus a guarantee from one of the professional associations set up with the specific purpose of guaranteeing their members' long term loans. Loans are also available from the CCCHCI, an important source of finance for small and medium sized firms for building and enlargement of premises or for purchasing equipment. These loans are normally granted for between 8 and 15 years, although the maximum duration is 20 years.

In addition, Government money is made available through the Fonds de Développement Economique et Social (FDES) to the Crédit Populaire and the Caisse Centrale de Crédit Coopératif which grant loans of up to 15 years for financing, respectively, craft businesses and co-operatives.

It is also possible for firms which are too small to raise a loan directly on the capital market to raise one collectively through a professional association or to borrow from their appropriate "Société de Développement Régional", which institutions do raise money on the capital market.

Assessment

It is extremely difficult to assess the effects that the available facilities have had on smaller firms, particularly because there is a lack of adequate statistics and also because of problems of definition of the size of firms. However, the indications are that smaller firms have been able to make use of credit facilities to improve their productivity and often to increase their scale of operations.

An idea of the scale of medium and long term lending to small and medium sized firms may be gained from the following table.

Total medium and long term credit to the private sector at end 1969 (excluding export credit)

		Fcs. mds.
a. Mobilisable medium term credit	48·69	
of which:		
credit to small and medium sized industries with the "aval" of the CNME.	3·2	= 6·6% of total

N.B. We are not aware how much credit small and medium sized industries may have obtained through normal channels.

France

The Climate

In France, medium and long term loan finance for private industry as a whole comes very largely from the banks or from specialised credit institutions which either discount bills for the banks or lend direct to firms. The attitude to small and medium sized firms seems to be that, while the rationalisation of the economy necessitates mergers in certain sectors of industry, it should not be allowed to result in the disappearance of smaller firms in other sectors, where their continued existence remains indispensable. Thus, it is necessary to encourage not only the survival but also the modernisation and the development of smaller firms, within reasonable limits of size. From there it follows, in the French philosophy, that because the smaller firms are often not able to offer sufficient security to raise a loan under the normal system, they should be given special credit facilities.

The main sources of medium and long term credit to the private sector in France, with special reference to the channels open to small and medium sized industries, are summarised below. Of necessity the description is highly simplified, especially as regards long term credit. What information there is on rates charged is included in an Annex.

Institutional arrangements

A. *Medium term credit*

Medium term loans are granted for 2–7 years by the ordinary banks and by the Banques Populaires; these latter lend particularly to small and medium sized firms. Such credits are usually rediscountable (subject to prior approval), in the first instance at institutions such as the Crédit National and Crédit Foncier, who in turn can rediscount approved paper at the Bank of France. The technique employed is that once the loan has been approved by the bank and the rediscounting institution, the primary bills representing the credit, which are not directly rediscountable, are used as backing for mobilisation paper drawn by the lending bank on the rediscounting institution; this mobilisation paper gives rise to drawing rights which can be used by the banks according to need. There are, however, certain restrictions on the mobilisation of medium term credits. At present only the first two annual instalments falling due (compared with the first three instalments under the system operating until 8 October 1969) are eligible for rediscounting at the Bank of France; there is also a "coefficient de retenue", which requires that banks retain in their portfolios, without recourse to rediscounting, a proportion of their immediately rediscountable medium term credits equivalent to 16% of current liabilities.

The normal channels for granting and rediscounting mobilisable medium term credit are thus as follows:

a. *Equipment loans to commercial and industrial enterprises:*
   i. Banks
   ii. Crédit National
   iii. Bank of France

b. *Construction, agricultural investment and shipbuilding loans:*
   i. Banks

Appendix V

Term loans for small businesses in France, Italy, Japan and the USA

(Referred to in Chapter 12, paragraph 12.87)

The accompanying studies of term loans for small businesses in France, Italy, Japan and the USA, which began as investigations into term lending by banks, underlined differences in banking techniques between the UK and other industrialised countries. In both the USA and Japan, it was found that term loans form a considerable proportion of bank lending to industry. It was also confirmed that term loans or equity participations by banks on the Continent are not uncommon, whereas they are much less a feature of UK banking practice. But while it became clear that there is a strong demand for term loans whenever these have been made available to small businesses, it proved difficult to arrive at an appraisal of the effectiveness of lending of this sort without the benefit of specific studies in particular lines of activity in the countries concerned.

Early in the investigations it became evident, in view of the differing institutional arrangements in other countries and the involvement of banks with specialist institutions, that a description of the operations of banks alone told only a limited part of the story and would not in itself be of sufficient help. The scope of the investigations was therefore broadened to take in most forms of medium and long term credit to which small firms have access.

In all four countries the need to provide or augment facilities for small businesses to obtain term loans has been recognised by the authorities. In France, the preservation of small scale enterprises in certain sectors of the economy by assisting their modernisation and development, has been regarded as indispensable. In Italy, assistance to small businesses has been seen largely as a means of stimulating industry in underdeveloped regions, whereas in the USA, although the encouragement of small concerns has in part reflected an innate suspicion of concentrations of financial power, such encouragement has been increasingly directed towards the creation of a middle class among racial minorities. The Japanese authorities, on the other hand, seem simply to have been reinforcing existing financing facilities.

The authorities in each of the four countries appear to have been abundantly aware of the difficulties encountered in raising capital, even when commercial banks make a practice of lending at medium term to small enterprises. They have accordingly resorted to a wide range of institutions and devices to increase the availability of term credit to small concerns, the main forms of which are:

a. the establishment of specialist institutions—with access to loans or grants from government sources—which are able to co-operate with, and support, commercial banks in their lending operations;
b. the provision of rediscount facilities to commercial banks—by official institutions, including, ultimately, the central bank—for at least a proportion of their term loans;
c. official financial support and encouragement for the establishment by commercial banks, of affiliate financial institutions specialising in term loans to small and medium-sized concerns;
d. official financial support and encouragement for the formation of trade

(a) Professor J A Bates, Queen's University, Belfast
A C Blackburn Esq
P E Brandenburger Esq
(a) The Rt Hon Lord Brown MBE, former Minister of State, Board of Trade
(a) Sir Max Brown KCB CMG, Secretary (Trade), Department of Trade and Industry
(a) Professor Sir Alec Cairncross, formerly Head of the Government Economic Service and Chief Economic Adviser to the Treasury
H C Collins Esq
J M Cox Esq
(b) A Godfrey Cruft Esq
(b) Dr A Earle, London Business School
A G Elliot Esq
Professor David Flint, University of Glasgow
Nicholas J Flower Esq
B Hadden Esq, Queen's University, Belfast
D Harper Esq, University of Reading
A C Hazel Esq
(a) Rt Hon Sir Keith Joseph MP, Secretary of State for Health and Social Security
(b) E Kaye Esq, CBE, Unquoted Companies Group
Alexander Kennaway Esq
(a) Professor G H Lawson, Manchester Business School
The Hon Christopher Layton, Centre for European Industrial Studies
T Lucas Esq
B J Morgan Esq
(a) The Rt Hon Michael Noble MP, Minister for Trade, Department of Trade and Industry
R G Opie Esq, University of Oxford
A H Pearson Esq
E T Pearson Esq
(a) Professor M M Postan, University of Cambridge
(a) The Rt Hon J Enoch Powell, MBE, MP
(a) Professor B Reddaway, University of Cambridge
H Reynolds Esq
(a) The Hon Nicholas Ridley MP, Parliamentary Under Secretary of State for Industry, Department of Trade and Industry
Martin Rudd Esq, University of Salford
Sir Gordon Russell, CBE, MC
C J Saunders Esq
C Shaw Esq
(a) Z A Silberston Esq, University of Cambridge
M Siva Esq
J W Snaith Esq, Dunchurch Industrial Staff College
L M Spalton Esq
William Storie Esq
F Colin Swallow Esq
C H Trimby Esq
M E L Weir Esq
(a) Bernard Weatherill Esq, MP
(a) Dr Harold Whitehead

Alba Furniture
Allied Electronics Ltd
R G Baker & Co Ltd
Beaver & Tapley Ltd
Max Bernstein & Son Ltd
Clive Bingley Ltd
Bomford & Evershed Ltd
J Bradbury & Co
Wm Briggs & Co Ltd
Broughton Moor Green Slate Quarries Ltd
BSA Guns Ltd
Burlington Fabrics (Holdings) Ltd
Cairncross (Goldsmiths)
Carnation of Cumberland
Carter-Parratt Ltd
The Castleton Oil and General Trading Co Ltd
Chilham Plastics Ltd
Clifton & Baird
Conquers Transport Ltd
Cosmic G T (Overseas) Ltd
Courtin & Warner Ltd
G T Culpitt & Sons Ltd
A L Curtis (Onx) Ltd
Dale Electric of Great Britain Ltd
English Drilling Equipment Co Ltd
David Dowling Ltd
G Earnshaw Ltd
Elastic Rail Spike Co Ltd
The Enfield Foundry Co Ltd
Evans, Adlard & Co Ltd
W Fernehough Ltd
Filton Ltd
F & R Engineering Co Ltd
Frank Fehr & Co Ltd
W H Foster & Sons Ltd
Fullerton, Hadgart & Barclay Ltd
Fyne Machinery and Engineering Ltd
Gilmans Ltd
Goonvean & Rostowrack China Clay Co Ltd
R D Gordon Ltd
William Grant & Sons Ltd
Halse of Honiton
David Huntley Associates
Helmets Ltd
Hughes (Blyth) Ltd
Isopad Ltd
Jarvis (Harpenden) Ltd
R A Jones & Sons Ltd
Kine Engineering Co Ltd
Kinloch Anderson Ltd
Alfred Knight Ltd

Reserve Bank of Australia
(a) Royal Bank of Scotland
(b) Trade Indemnity Co Ltd
Williams Deacon's Bank Ltd
Yorkshire Bank Ltd

6. *Government Departments*

(b) Board of Inland Revenue
(b) Board of Trade (before amalgamation into the Department of Trade and Industry)
(b) Central Statistical Office
Crown Agents
HM Customs and Excise
Department of Education and Science
(b) Department of Employment
Department of Health and Social Security
(b) Department of Trade and Industry
Development Commission
Land Commission
(a) Ministry of Agriculture Fisheries and Food
Ministry of Defence (Navy)
(b) Ministry of Housing and Local Government (now Department of the Environment)
(b) Ministry of Public Building and Works (now Department of the Environment)
(b) Ministry of Technology (before amalgamation into the Department of Trade and Industry)
(b) Office of the Registrar of Restrictive Trading Agreements
Scottish Development Department (Scottish Office)
Scottish Home and Health Department
(b) HM Treasury
Welsh Office

7. *Industrial Training Organisations*

Carpet Industry Training Board
Ceramics, Glass and Mineral Products Industry Training Board
Chemical and Allied Products Industry Training Board
Civil Air Transport Industry Training Board
Construction Industry Training Board
Cotton and Allied Textiles Industry Training Board
(b) Distributive Industry Training Board
(b) Engineering Industry Training Board
(b) Food, Drink and Tobacco Industry Training Board
Footwear, Leather and Fur Skin Industry Training Board
(b) Furniture and Timber Industry Training Board
Hotel and Catering Industry Training Board
Industrial Training Committee for Trades Allied to Agriculture
Industrial Training Foundation
Industrial Training Service
Paper and Paper Products Industry Training Board

(b) Crafts Council
(b) Economic Development Committee for the Distributive Trades
GLC Department of Planning and Transportation
GLC Industrial Centre Valuation and Estates Department
(b) Glasgow Productivity Association
Gravesend Public Library
Herefordshire Industrial Association
(b) Highlands and Islands Development Board
(b) Hire Purchase Trade Association
Industrial Society
Industrial Co-partnership Association
(b) Institute of Chartered Accountants in England and Wales
(b) Institute of Chartered Accountants in Scotland
Institute of Cost and Works Accountants
(b) Institute of Directors
Institute of Manpower Studies
(b) Institute of Patentees and Inventors
Institute of Personnel Management
Institute of Practitioners in Advertising
Institute of Statisticians
Institute of Work Study Practitioners
Institute of Engineering Inspection
Library Association
Leicestershire Technical Information Service
(b) Management Consultants Association
Management Services Centre
Management Technology Ltd
Manchester Public Libraries
(a) Merseyside Productivity Association
(b) Metrication Board
NUMAS (Management Services) Ltd
National Computing Centre Ltd
National Council for Quality and Reliability
National Economic Development Office
National Heating Centre
Negotiations Ltd
(b) North Hertfordshire Productivity Association
The Personal Rights Association
Sheffield Central Library
(b) Small Industries Council for Rural Areas in Scotland
Society of Designer Craftsmen
Society for Long Range Planning Ltd

(b) Trades Union Congress

4. *Universities and Technical Colleges*

Ashridge Management College
(b) University of Aston, Birmingham
Bristol Polytechnic (Small Business Centre)
University of Cambridge

Aberdeen Fish Curers and Merchants Association Ltd
Amalgamated Society of Woodworkers
Association of Bronze and Brass Founders
Association of Electrical Machinery Trades
Association of Master Upholsterers
Bristol and West of England Engineering Manufacturers Association
British Brush Manufacturers Association
British Button Manufacturers Association
British Closure Makers Association
British Federation of Master Printers
British Footwear Manufacturers Federation
British Furniture Manufacturers Federated Associations
British Independent Steel Producers Association
British Laboratory Ware Association
British Lead Manufacturers Association (Management) Ltd
British Leather Federation
British Lubricants Federation
British Polish Manufacturers Association
British Rubber Manufacturers Association Ltd
British Stone Federation
British Tin Box Manufacturers Association
Business Equipment Trade Association
Cattle Food Trade Association
Chemical Industries Association Ltd
Compound Animal Feeding Stuffs Manufacturers National Association Ltd
Decorative Lighting Manufacturers and Distributors Association
Electrical Contractors Association
Engineering Employers Federation
(b) Engineering Industries Association
Federation of British Manufacturers of Sports and Games Ltd
Federation of Merchant Tailors of Great Britain
Federation of Oils, Seeds and Fats Association Ltd
Federation of Reclamation Industries
Food Manufacturers Federation Incorporated
Fur Breeders Association
Gifts and Fancy Goods Association
Hairdressing Manufacturers and Wholesalers Association Ltd
Macclesfield Textile Manufacturers Association
Maltsters Association of Great Britain
National Association of Glove Manufacturers
National Association of Goldsmiths of Great Britain and Ireland
National Association of Scottish Woollen Manufacturers
National Association of Soft Drinks Manufacturers Ltd
National Childrenswear Association
National Federation of Beer Bottlers
National Hosiery Manufacturers Federation
Overall Manufacturers Association of Great Britain
Rubber and Plastics Reclamation Association
School Furniture Manufacturers Association Ltd
Ship and Boatbuilders National Federation

Appendix III

List of Research Reports Commissioned by the Committee

(referred to in Chapter 1, paragraph 1.2)

1. The Small Firm in the Road Haulage Industry. B Bayliss.
2. Scientific and Engineering Manpower and Research in Small Firms. J G Cox.
3. Small Firms in the Manufacturing Sector. J R Davies and M Kelly.
4. Financial Facilities for Small Firms. Economists Advisory Group.
5. Problems of the Small Firm in Raising External Finance—The Results of a Sample Survey. Economists Advisory Group.
6. The Role of Small Firms in Innovation in the UK since 1945. C Freeman.
7. Attitude and Motivation. C W Golby and G Johns.
8. The Small Unit in the Distributive Trades. Margaret Hall.
9. The Small Firm in the Motor Vehicle Distribution and Repair Industry. J Hebden and R V F Robinson.
10. Small Firms in the Construction Industry. P Hillebrandt.
11. Three Studies on Small Firms. P Lund and D Miner.
    i. Previous Surveys of Small Firms.
    ii. Comparison between Firms of Different Size using the CBI's Industrial Trends Surveys.
    iii. The Investment Behaviour of Small Firms.
12. Dynamics of Small Firms. Merrett Cyriax Associates.
13. Aspects of Monopoly and Restrictive Practices Legislation in Relation to Small Firms. S Moos.
14. The Small Firm in the Hotel and Catering Industry. J F Pickering.
15. Small Retailers: Prospects and Policies. A D Smith.
16. A Postal Questionnaire Survey of Small Firms: an Analysis of Financial Data. M Tamari.
17. A Postal Questionnaire Survey of Small Firms: Non-Financial Data, Tables, Definitions and Notes. Research Unit.
18. The Relative Efficiency of Small and Large Firms. D Todd.

These Reports have been published separately and are obtainable from Her Majesty's Stationery Office.

2. ASSETS, LIABILITIES AND CAPITAL

(Please give figures to nearest £)

		Accounting year ended within the 12 months 1st April, 1964 – 31st March, 1965 OR First full year of business (a)	Most recent accounting year
		£	£
CURRENT ASSETS			
1. Cash and bank balances	16		
2. Stocks and work in progress . . .	17		
3. Debtors	18		
4. Other current assets	19		
5. TOTAL CURRENT ASSETS	20		
CURRENT LIABILITIES			
6. Bank overdrafts and loans . . .	21		
7. Current tax liabilities	22		
8. Acceptance credits and bills payable	23		
9. Other creditors	24		
10. TOTAL CURRENT LIABILITIES . . .	25		
FIXED ASSETS, NET OF DEPRECIATION			
11. Land and buildings	26		
12. Plant and machinery	27		
13. Furniture and fittings	28		
14. Cars, lorries and other transport equipment	29		
15. Goodwill, patents, trademarks and other intangible assets	30		
16. Other fixed assets	31		
17. TOTAL FIXED ASSETS, NET OF DEPRECIATION	32		

COMMITTEE OF INQUIRY ON SMALL FIRMS

SF3

SECTION B

PLEASE COMPLETE AND RETURN BY DECEMBER 31st, 1969

Telephone enquiries:
Newport 52277
Extension 92
STD Code 0633

In reply please quote

If the name and address shown above is incorrect please correct it.

ACCOUNTING INFORMATION

In this section, you are asked to give information from your latest annual accounts, with corresponding figures for an earlier year. The Committee need this information in order to obtain a full picture of the financial problems of small firms.

If your business is not incorporated as a company, please give all the information you can, with corresponding information for the earlier accounting year.

22. Would it have been an important advantage to you if term loans, with a fixed duration of up to, say, five years, had been available from your Bank? . . . . . .

		Yes	No
64			

23. Please give the information below in respect of each of the last five accounting years. If your firm was started less than five years ago please give the information for as many years as possible:

		Accounting year which ended during the year ended March 31st.				
		1965	1966	1967	1968	1969
Total sales . . .	65					
Net profit before tax	66					

24. During the last twelve months has the ratio of debtors to total sales, on average:

(a) increased?	67	
(b) remained much the same?	68	
(c) fallen?	69	

25. During the last twelve months has the ratio of debtors to creditors, on average:

(a) increased?	70	
(b) remained much the same?	71	
(c) fallen?	72	

26. During the past twelve months has pressure been put on your liquid assets by (please tick as appropriate):

(a) larger suppliers exacting prompt payment? (Yes/No)	73	
(b) larger customers delaying payment of debts?	74	
(c) payment of training levy?	75	
(d) Selective Employment Tax?	76	

27. Has your expansion or efficiency been impaired during the last 5 years by the operation of the Town and Country Planning Acts? . . . .

	Yes	No
77		

If YES please give brief details:

.....

.....

.....

28. Has your dividend distribution policy been conditioned by the provisions of the Finance Act, 1965 relating to retained profits? .

	Yes	No
78		

If YES, have you:

(a) assumed that the Act requires you to distribute 60% of profits, or pay tax on it, or	79	
(b) have you taken professional advice to this effect, or . . .	80	
(c) have you been advised to this effect by a Tax Inspector? . . .	81	

11. **(This question does not apply to firms in retail distribution.)** What percentage of your total sales last year was accounted for by the customer who took the largest share?

	Less than 10%	10 - 25%	25 - 50%	50 - 75%	Over 75%
25					

12. Do you regard the main competition to your business as coming from:

(a) other small firms?	26	
(b) large firms?	27	

(3) INDUSTRIAL TRAINING AND LABOUR RELATIONS

13. Please indicate what type of training (if any) is provided for each of the following categories of staff (tick the boxes in the table below as appropriate):

Category of staff		No training schemes in operation	Training is provided 'on the job'	Training is carried out as a separate programme
Clerical staff	28			
Other staff	29			
Management	30			

		Yes	No
14. Are you exempt from Industrial Training Levy?	31		

If not:-

In your last accounting year, was the amount which you paid in levy under the Industrial Training Act, 1964:

(a) less than the amount you received in grant?	32	
(b) about the same as the amount you received in grant?	33	
(c) more than the amount you received in grant?	34	

15. Are your staff other than clerical and managerial:

(a) entirely unionised?	35	
(b) mainly unionised?	36	
(c) partly unionised?	37	
(d) non-unionised?	38	

		Yes	No
16. Are you a member of an Employers' Federation/Association	39		

17. How do your wage rates (for the same skills) compare with those paid by larger firms in your area?:

(a) your rates are lower	40	
(b) your rates are about the same	41	
(c) your rates are higher	42	
(d) you do not know	43	

SF2

COMMITTEE OF INQUIRY ON SMALL FIRMS

INQUIRY INTO SMALL NON-MANUFACTURING FIRMS

SECTION A

PLEASE COMPLETE AND RETURN BY DECEMBER 5th, 1969

Telephone enquiries:
Newport 52277
extension 92
STD Code 0633

In reply please quote

If the name and address shown above is incorrect please correct it.

NOTE:

If your firm forms part of a wider organisation please give the name and address of this organisation in the space below and return this questionnaire, uncompleted, to the Business Statistics Office, Chartist Tower, Dock Street, Newport, Mon., NPT IXG.

Except where figures are specifically asked for in the questions below, please put a tick in the appropriate box.

(1) GENERAL

1. Have you recently completed, or are you in process of completing:

		Yes	No
(a) a questionnaire from the Association of British Chambers of Commerce entitled 'Small Firms Enquiry; Chamber of Commerce Questionnaire'?	1		
(b) a questionnaire from the Confederation of British Industry entitled 'Bolton Committee of Enquiry into Small Firms'? . .	2		

		Day	Month
2. On what date does your accounting year end?	3	:	

3. What was the approximate average number of persons employed:

(a) during your last accounting year?	4	
(b) during your accounting year which ended during the year ended 31st March, 1965?	5	

26. Would it have been an important advantage to you if term loans, with a fixed duration of up to, say, five years, had been available from your Bank?

	Yes	No
78		

27. Please give the information below in respect of each of the last five accounting years. If your firm was started less than five years ago please give the information for as many years as possible:

		Accounting year which ended during the year ended March 31st.				
		1965	1966	1967	1968	1969
Total sales . . .	79					
Net profit before tax	80					

28. During the last twelve months has the ratio of debtors to total sales, on average:

(a) increased?	81	
(b) remained much the same?	82	
(c) fallen?	83	

29. During the last twelve months has the ratio of debtors to creditors, on average:

(a) increased?	84	
(b) remained much the same?	85	
(c) fallen?	86	

30. During the past twelve months has pressure been put on your liquid assets by (please tick as appropriate):

(a) larger suppliers exacting prompt payment? (Yes/No)	87	
(b) larger customers delaying payment of debts?	88	
(c) payment of training levy?	89	
(d) import deposits	90	
(e) delay in obtaining refund of Selective Employment Tax? . . .	91	
(f) delay in obtaining Investment Grants?	92	
(g) ~~import deposits~~	93	

31. Has your expansion or efficiency been impaired during the last 5 years by the operation of the Town and Country Planning Acts? . . . .

	Yes	No
94		

If YES please give brief details:

.....

.....

.....

.....

.....

.....

16. In which area do you consider your main competitive advantage lies? (Please tick one box only):

(a) price	35	
(b) design and/or quality	36	
(c) prompt delivery	37	
(d) flexibility in meeting customer's specifications	38	
(e) service	39	

(3) INDUSTRIAL TRAINING AND LABOUR RELATIONS

17. Please indicate what type of training (if any) is provided for each of the following categories of staff (tick the boxes in the table below as appropriate):

Category of staff		No training schemes in operation	Training is provided on the job	Training is carried out as a separate programme
Apprentices	40			
Operatives	41			
Clerical staff	42			
Supervisory staff	43			
Management	44			

		Yes	No
18. Are you exempt from Industrial Training Levy?	45		

If not -
In your last accounting year, was the amount which you paid in levy under the Industrial Training Act, 1964:

(a) less than the amount you received in grant?	46	
(b) about the same as the amount you received in grant?	47	
(c) more than the amount you received in grant?	48	

19. Are your operatives:

(a) entirely unionised?	49	
(b) mainly unionised?	50	
(c) partly unionised?	51	
(d) non-unionised?	52	

		Yes	No
20. Are you a member of an Employers' Federation/Association?	53		

21. How do your wage rates (for the same skills) compare with those paid by larger firms in your area?:

(a) your rates are lower	54	
(b) your rates are about the same	55	
(c) your rates are higher	56	
(d) you do not know	57	

4. Do you receive Regional Employment Premium for operations in a Development Area? . . . . . .

	Yes	No
6		

5. What is the MAIN activity of your firm? (Standard Industrial Classification Orders are given for your assistance):

(a) Manufacturing or processing of food, drink and tobacco (S.I.C. Order III)	7	
(b) Chemicals and allied industries (S.I.C. Order V)	8	
(c) Metal manufacture and miscellaneous (S.I.C. Orders VI, XII) . .	9	
(d) Mechanical and marine engineering (S.I.C. Orders VII, VIII, X) .	10	
(e) Electrical engineering (S.I.C. Order IX)	11	
(f) Textile, leather, clothing, footwear (S.I.C. Orders XIII, XIV, XV)	12	
(g) Bricks, pottery, glass, etc. (S.I.C. Order XVI)	13	
(h) Other manufactured goods (S.I.C. Orders IV, XI, XVII, XVIII, XIX)	14	
(i) Non-manufacturing (please specify)	15	

(2) STRUCTURE AND COMPETITIVE SITUATION

6. Is your firm:

(a) a quoted public company?	16	
(b) a non-quoted limited company?	17	
(c) an unlimited company?	18	
(d) a partnership?	19	
(e) a sole proprietorship?	20	

7. If your firm is a limited company, are any of the shareholders themselves limited companies? . . . . . .

	Yes	No
21		

8. What is the smallest number of partners or shareholders which may or does form a controlling interest (i.e. holding more than 50% of the shares or voting power?)

	1	2	3 - 5	6 - 10	More than 10
22					

9. What is the number of working partners or shareholders?

	1	2	3 - 5	6 - 10	More than 10
23					

7. Since we are aiming to produce our Report within a year, and since there is a great deal of ground to cover, I have to ask that submissions should reach the Committee Secretary as early as possible, and in any case not later than 30 November. It will be our intention to make public a selection of the evidence received in order that we can benefit from a public dialogue on this important subject. Any evidence submitted is, therefore, liable to publication unless we receive specific instructions to the contrary. At a later stage we shall be hearing oral evidence from selected organisations, when we may seek amplification of statements made in written submissions.

8. It would be helpful if trade associations and other representative bodies could send us details of the numbers, classification and importance in their industry of the small firms which they represent and on which their evidence is based. It would also be much appreciated if all organisations could provide ten copies of their submissions, or as many as is reasonably possible, and if they could let us know, within the next few weeks, whether or not they intend to make a formal submission.

9. I am sorry that, because this letter is being sent to over 2,000 organisations, it has not been possible to address each one individually; I hope that we shall be forgiven for this.

Yours faithfully,

JOHN E BOLTON

(*Chairman*)

Appendix I

Chairman's letter inviting the submission of written evidence
(referred to in the Preface, paragraph 5)

Committee of Inquiry on Small Firms,
1 Victoria Street,
London SW1,
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20 August 1969.

Dear Sirs,

Submission of Evidence

1. On 23 July the President of the Board of Trade announced that he had appointed an independent Committee of Inquiry on the role of small firms in the national economy and the problems confronting them. The terms of reference of the Committee and its membership, with notes on the background and relevant experience of members, are set out in the attached note.

2. The Committee first met on the afternoon of 23 July and has held five further meetings, plus two meetings of a statistics sub-committee; we feel that our task is of great importance to the national economy and are approaching it with urgency. We are now ready to invite interested persons and organisations to submit written evidence and we should be grateful for the views of your organisation on the questions we shall be considering.

3. It may be helpful if I described our approach to this Inquiry, which in our view has three main functions: to assess the importance of small firms in the economy, to evaluate their problems and to recommend ways of helping them to improve efficiency and growth. First, it is clear that although small firms form an important sector of the economy, in terms of numbers, output, and use of resources, our knowledge of them is not adequate to permit us to say either how important they are, or whether, by and large, they could make more efficient use of their resources. The Committee's first task, therefore, will be to describe and analyse the field covered by the Inquiry in greater detail than has been attempted hitherto.

4. Our second and major task will be to estimate the value of the contribution of small firms to the national economy and to recommend any action necessary to increase the efficiency and productivity of this sector or to stimulate the rate of growth of the more dynamic enterprises within it. In this context the improvement of export performance and import substitution will be very important. For these purposes it will be necessary to define the special characteristics and functions of small firms and to identify the special problems facing them. The Committee will necessarily concentrate on problems of general significance; it will be impossible to consider in detail the position of particular firms, except as illustrations of general principles.

5. We hope that the CBI, or another authoritative source, will consider publishing further guidance, in consultation with the Registrar, on the treatment under the Acts of agreements, particularly trade association recommendations and information agreements, with special reference to the grounds for exemption from reference to the Court under Section 9(2) of the 1968 Act (paragraph 16.33).

19.18 We also received many complaints about the operation of the Companies Acts, though we found it difficult to identify any actual damage to small firms resulting from them. On the other hand it seems that some of the troublesome provisions have brought little advantage to anyone and if it is possible to remove a cause of friction at little cost we think it should be done. We therefore recommend in Chapter 17:

1. the exemption of private limited companies with annual turnovers below £500,000 from the requirement to disclose the individual emoluments of directors, though firms should continue to show the total amount in the profit and loss account (paragraph 17.18).

2. That private companies be exempted from the requirement to disclose turnover when this is below £500,000 per annum (paragraph 17.40).

19.19 Finally we considered the question of industrial development and planning controls, which give rise to a number of problems for small firms. Our recommendations are:

1. Small firms throughout the country should be relieved of the need to apply for an IDC when their plans involve the creation of less than 10,000 square feet of industrial floor space, in accordance with the Hunt Committee's proposals (paragraph 18.15).

2. If it is considered that this should not be extended to all undertakings, the 10,000 square feet exemption limit should be extended to established small firms (paragraph 18.16).

3. Local authorities should be prepared to use their powers under the Town and Country Planning (Development Plans) Direction 1965 to allow the establishment of small businesses in residential areas when this will not detract from those areas' amenities (paragraph 18.28).

4. The present legal obligation of local authorities to provide suitable alternative accommodation to displaced firms should be strengthened, and the Department of the Environment and the Scottish and Welsh Offices should do more to encourage unhelpful local authorities to cater for the needs of small firms as effectively as other more enlightened authorities (paragraph 18.34).

5. The Landlord and Tenant Act 1954 should be changed so as to require local authorities to pay compensation for compulsory purchase which includes the value of the likelihood of a tenancy being renewed (paragraph 18.38).

6. Legislation should provide for compensation on compulsory purchase to be assessed at the level of trade when notice to treat is served on a business (paragraph 18.39).

7. Legislation should provide for all businesses to be compensated for loss of trade resulting from nearby redevelopment (paragraph 18.40).

is expensive and inappropriate in its application to small firms. We concluded as follows:

> We believe that the machinery set up under the Industrial Training Act is fundamentally inappropriate to the needs of most small firms and we therefore recommend that they should be exempted from the levy/grant system. Each training board, in consultation with the industry and the Department of Employment, should formulate an appropriate definition of the small firm in its industry and should establish an exemption limit designed to exempt them all from levy. Firms below these limits should be permitted to "opt in" to the levy/grant system if they wish. Training boards should consider the possibility of providing training services for small firms on a fee-paying basis.

19.16 The burden of form-filling, which is dealt with in Chapter 15, is particularly onerous for the small firm. We suggest that the load of Government statistical requirements is very much heavier for small firms than for large, bearing in mind their respective resources. Our recommendations are intended to ensure that for the short term consideration is given to the full cost, and particularly the cost to industry, of every statistical or administrative requirement, and for the long term that work should begin immediately on the planning of an integrated system of official records about businesses. They are as follows:

1. the effect on small firms of all statistical surveys should be carefully considered and every effort made to extend the present practices of sampling and of exemption of smaller firms wherever possible (paragraph 15.9).

2. The Survey Control Unit of the CSO should be given power to amend or veto all statistical surveys not meeting with its approval on grounds of expense, necessity, coverage or design (paragraph 15.11).

3. This power should extend to all departments of Government and to those quasi-Government bodies which commonly issue statistical enquiries (paragraph 15.12).

4. The use of statutory powers for the collection of statistics should be strictly controlled and in all cases explicitly justified (paragraph 15.12).

5. It should be clearly stated on every statistical inquiry whether or not its completion is obligatory (paragraph 15.13).

6. The development of the Central Register of Businesses is strongly commended, and it is hoped that resources adequate to ensure rapid progress will be devoted to it (paragraph 15.15).

7. In this context the CSO should reconsider the question of the preparation of an enterprise census which would provide comprehensive coverage of all firms as soon as possible as part of its plans for the development of business statistics (paragraph 15.16).

8. The true cost of any statistical exercise, and not merely the often comparatively small proportion of cost falling on Government estimates, should be fully taken into account before starting an enquiry, and methods chosen which involve the least *total* cost rather than least Government expenditure (paragraph 15.18).

9. Any proposal for a new or revised statistical exercise should include an estimate in man-hours of the time required by respondents to complete the form (paragraph 15.18).

10. All departments should review all existing and proposed forms with an eye to their cost to industry—this review to extend to a reconsideration of the policies and administrative procedures giving rise to the need for these forms.

19.13 Chapter 12 deals with finance and the operation of the banking system. In view of the importance of this subject we thought it particularly desirable that our own work and the evidence we received should be supplemented by external research. We are very glad that our distinguished researchers—the Economists Advisory Group—reached conclusions broadly in accord with our own provisional views. These were that there was no institutional deficiency in the finance market, that while there are some differences in the bases on which small firms and large can raise money these are mostly functions of inherent cost and scale differences, and that many recent problems derived from rigidities in the system caused by controls and ceilings imposed on the financial institutions by the central authorities. It is also important to remember that the role of the institutions, however adaptable and sensitive to market needs they are, is necessarily limited; if the small firm sector is to be preserved, institutional finance can never take the place of personal wealth and ploughed-back profits. The role of the institutions is important, however, and it is unfortunate that small businessmen, and to some extent their professional advisers, have a lamentable ignorance of the sources available to meet specific financial needs. We have endeavoured to cover this information gap by the "sign posting" service referred to in paragraph 19.11 above. We also hope that this Report and those of the Economists Advisory Group will help to meet this need. In view of our findings as to the adequacy of the finance market to meet the needs for institutional finance we do not support the creation of a state owned body to provide finance to the small firm. Moreover we do not believe for reasons discussed in Chapter 12 that finance for the small firm should be made available at subsidised rates. However, if at some future date it was decided to provide subsidised funds we would wish to see the subsidy provided in such a way as to preserve the maximum number of institutional operators in the field rather than to provide the money directly through an official body.

19.14 Chapter 13 deals with taxation, on which we received a great volume of evidence, most of it very strongly expressed. Much of this merely added up to the statement that the sector is overtaxed, which is the common complaint of all taxpayers; sympathetic though we may be to this general proposition as taxpayers ourselves, it is of course far outside our remit. Moreover, during the past year the Government has dealt with a number of tax problems on which we should otherwise have made recommendations. Nevertheless there remain a great many tax changes that could usefully be made and which we thought it right to recommend. These are:

1. we hope that the current discussions between the Institute of Chartered Accountants, the Confederation of British Industry, and other interested parties on the question of adapting accounting techniques to take account of inflation, will be pursued with urgency and will be speedily brought to a successful conclusion (paragraph 13.48).

2. We hope that when the rate for the new-style corporation tax is finally determined, account will be taken of the fact that the 50 per cent rate suggested in the Green Paper would involve an additional burden on the small company, which because of its dependence on self-financing makes a lower average distribution than the larger company (paragraph 13.49).

3. So far as is possible the separate identity of the Small Firms Division should be stressed and publicised (paragraph 9.27).

4. All other departments with trade or industry sponsorship functions should designate an official with specific responsibility for liaison with the Small Firms Division of the Department of Trade and Industry, and for his department's policy towards small firms (paragraph 9.27).

5. The Small Firms Division should endeavour, in co-operation with sponsoring departments, to form a view of the present and future role of small firms in all industries in which they are important, and should collect the necessary statistical and other information needed to enable it to do so (paragraph 9.28).

In addition to this central question Chapter 9 also deals with two special questions which we believe should concern the Small Firms Division. The first is the effect of entry into the European Economic Community on small firms and the steps that might be taken to help them meet the new conditions. The second is the question of Government procurement, where we believe there is scope for increasing the share of small firms in Government contracts and purchases. On these we recommended as follows:

6. immediate attention should be given by the Department of Trade and Industry to the study of the impact of entry into the EEC on small firms, and this question should be an urgent priority of the Small Firms Division (paragraph 9.34).

7. Major purchasing departments should have regard to the effects of their buying policies on the structure of industry in general and particularly on the small firm sector, in addition to their overall concern with achieving value for money (paragraph 9.39).

8. The proposed Small Firms Division of the Department of Trade and Industry should give early attention to the effect of official procurement policies on small firms, and promote policies designed to maximise competitive participation by small firms in suitable Government contracts (paragraph 9.40).

19.11 In Chapter 10 we consider the adequacy of management advisory services, both private and Government-sponsored, for small firms. In conformity with our general approach we set our face not only against direct subsidy by Government but also against indirect subsidy in the shape of provision of Government services at less than their economic cost. Our reasoning is analogous to that underlying Gresham's Law—bad money drives out good. In almost every circumstance where a service can be profitably employed we believe the small firm sector will benefit from its provision in a competitive market, and it is impossible to have sufficient entrants into the field to provide such a market if Government provides "cut rate" facilities. We suggest in paragraph 10.40 that four criteria must be satisfied if a service is to be provided or subsidised by Government. These are:

i. that the service is needed;
ii. that private enterprise cannot or will not provide it;
iii. that the economic benefit to the nation deriving from the service is greater than its cost;
iv. that users of the service cannot or should not be expected to pay its full cost.

will coincide. Provided that reasonably free market conditions can be maintained, therefore, there is no case for intervention on behalf of small firms on the ground that they perform these functions. The last two functions are quite different, however, in that even in a free market circumstances could arise in which the individual entrepreneur lacked the incentive or the power to fulfil them. Moreover, in these cases the public benefit deriving from these functions may greatly exceed the return to the entrepreneur who performs them; their performance does not ensure an adequate return for the individual business. The preservation of dynamism in the economy, which we consider the most important of all the benefits arising from the existence of small firms, is not the primary result of their business activities, but an incidental one. We can think of no substitute for the dynamic influence of new firms in preventing the ossification of the economy. "If small firms did not exist it would be necessary to invent them." For this reason we regard the maintenance of effective freedom of entry for new industrial and commercial enterprises, and of conditions in which they can grow, as a most important concern of Government—important enough even to justify differential support for the small firm sector if that were necessary.

19.7 The most important question which faced us, therefore, is whether the economic climate has changed to such an extent that small firms can no longer survive and flourish in sufficient numbers as the seedbed for the industry of the future, bearing in mind that only a tiny and unidentifiable proportion of the small firm population will play this vital role. In considering this question we have found no help in published academic research and little in the statistics we have collected. The matter is not made easier by the fact that our answer, to be of any use as a guide to policy, must take account of the time lag before any action taken now could be effective, which requires forming a view of the situation ten or more years hence. Our judgement is necessarily largely subjective, especially in view of the absence of most of the statistical series needed to monitor the condition of the sector, but on balance we believe that the small firm sector is at present, and will remain for the foreseeable future, vigorous enough to fulfil the "seedbed function", given a fair crack of the whip, and is not therefore in need of special support. This is a finely balanced judgement which should be kept under constant review by Government, and we have suggested means by which this might be done. There is no cheap or easy way of insuring against an excessive decline in the sector; if there were, we should unhesitatingly have recommended it. Any action by Government would have to be on a massive scale to offset the enormous market forces which are bringing about the decline and would necessarily lead to inequities and distortions. Such action could only be justified if the sector were clearly unable to fulfil its proper role in the economy. This is not demonstrably so at present.

19.8 To reject discrimination in favour of small firms is not, of course, the end of the matter. It is still necessary for the ring to be held if they are to have a fair chance to compete effectively. For the small firm sector to flourish without subsidy requires that the following conditions be met:

i. a good general economic climate. It is impossible to isolate so wide a sector from general economic conditions and a real improvement in the growth rate of the national economy would probably contribute more than anything else to the health of the sector, and particularly of its livelier elements.

CHAPTER 19: Conclusion and Summary of Recommendations

19.1 We have thus reached the end of our wide-ranging review of the small firm sector in which we have set it against its economic and social background, and have considered all the most relevant areas of Government policy. To sum up in detail would be impossibly tedious and we do not propose to attempt it, but to put down our pen without endeavouring to bring the whole into focus would be a grave omission, since the lack of such a conspectus partly accounts for the public neglect to which small firms have been subject in the past. We therefore repeat our main findings and list our recommendations—with the warning that it is not possible to understand the reasoning which has led us to these conclusions without reading the Report itself.

19.2 Our researches have shown that the small firm sector remains one of substantial importance in the United Kingdom economy: its output is equivalent to about one-fifth of the GNP and it employs more people than the entire public sector. If the range of our Report were expanded to cover all owner-managed businesses, of which there are many much larger than the size limits we have accepted, the contribution of the small firm sector would be seen to be much larger still. We find also that small firms are not inefficient in the use of resources. Their output per person employed is on average lower than that of large companies, but this is in part explained by the labour-intensive nature of the trades in which small firms predominate, and by differences in the composition of the labour force—the employment of more part-time labour, for example. It is also counterbalanced by a better return on capital employed, so that there is no ground for asserting either that as a group large firms are more efficient than small in their use of total resources, or the reverse.

19.3 Despite this the small firm sector is in a state of long term decline, both in size and in its share of economic activity. The same is true in other developed countries throughout the world, but the process appears to have gone further in the United Kingdom than elsewhere. In itself this decline, though significant, does not constitute proof of fundamental weakness in the sector, or of a basic disequilibrium in the economic system. No work has ever been done which would enable us to determine the optimum size-distribution of firms in our industrial structure and it is therefore very difficult to say that at any time there are too few or too many small firms. Many unavoidable forces, most of them wholly desirable, have been operating to change the size of markets and the nature of production processes and distribution methods. It is therefore perfectly natural that the industrial population of today should differ from that of fifty, twenty or even five years ago; any attempt to freeze the existing or any other size distribution for all time would be futile and would inhibit the continuous adaptation of the economic system to changing circumstances which is one of the most valuable features of the free-enterprise system.

19.4 The contribution of small businessmen to the vitality of society is inestimable. The qualities of vigour, enterprise and ambition which characterise so many of them have made them natural community leaders and they have been benefactors to their localities, to the arts and in many other ways which help to make life meaningful and pleasant. Above all their spirit of independence is

Annex to Chapter 18 (see paragraph 18.32)

Provision by Certain Local Authorities of Accommodation for Small Firms Displaced by Redevelopment

Our evidence from the Association of Municipal Corporations, the Department of the Environment, the Scottish Office and the Welsh Office has included a few examples of local authority provision for small firms displaced by redevelopment. This Annex very briefly sets out the main forms which this provision has taken. These eight examples are nowhere near an exhaustive list of authorities catering for small firms: rather than a survey it is a random selection. The examples we have seen are:

ALDERSHOT has built an industrial estate for the relocation of non-conforming users which provides accommodation suitable for small firms on an industrial estate. The firms concerned are offered sites on a 99 year lease with provision for rent revision every 14 years. The borough told the AMC that "it has always been the council's policy to try to offer alternative accommodation to firms displaced by the council's various schemes. Some of the firms are offered temporary accommodation in the first instance in other property which the council have acquired in advance of a redevelopment scheme being carried out. Some of this property is also let temporarily to small firms who are just starting".

BIRMINGHAM Corporation makes information available to displaced firms on the availability and specifications (including rent) of alternative accommodation in the conurbation. From the information supplied by the Department of the Environment it seems that rents are upwards of three shillings per square foot.

BRISTOL has built a number of industrial and warehouse units for accommodating displaced traders. "In addition it has been the policy of the Planning Committee to encourage displaced traders to build new accommodation for nominated occupiers. In the case of the accommodation provided by the Corporation, the rents have been at an understanding level sufficient to meet the basic overheads". (Evidence of the AMC.)

ELLESMERE PORT (CHESHIRE) provides flatted factories suitable for displaced small firms on the Rossmore Trading Estate.

GLASGOW. The Scottish Development Department state that "the local authority have in recent years exerted themselves a good deal to re-accommodate displaced firms within the city".

LEEDS has recently started a pilot scheme of flatted factories to make available small units—1,200 to 2,700 square feet—where cost was kept to a minimum in an effort to produce suitable accommodation at modest rents (6 to 9 shillings per square foot).

LIVERPOOL offers a considerable range of accommodation to small firms affected by redevelopment. During the two years up to January 1969 over 120 firms were relocated on specially designed sites close to the central area. The acquisition and preparation of these areas is being undertaken by the Corporation and "involves a capital expenditure of several million pounds". (Evidence of the AMC.)

hardship are not very numerous. We sympathise with the National Chamber of Trade who spoke of the potentially "cruel" effects on the owner of a small business. Nevertheless we do not think that capital gains tax should be abated simply because there has been a forced disposal in view of the implications this would have in other contexts. If there is a real problem it lies in the inadequacy of compensation: the impact of capital gains tax may be a further reason for more generous compensation.

Excess provision of shopping accommodation

18.43 Despite the vetting of local development plans by the Department of the Environment there is no doubt that some local authorities have carried out town centre redevelopment schemes without regard to those undertaken by neighbouring authorities. In particular, rival shopping precincts for neighbouring towns have been built with each authority calculating on a catchment area which includes the whole or a large part of the other authority's catchment area. As a result the level of trade in each is too low to support the shops established, particularly at the high rents normally charged in these developments. The Department of the Environment told us that this was a common problem in the early 1960s. Indeed the Ministry sent a circular to local authorities in 1966 (MHLG Circular 50/66) which stated: "there are at present several hundred town centre redevelopment schemes at various stages of preparation and implementation. Moreover proposals of individual towns are prepared in isolation and often take little account of proposals being put forward by neighbouring authorities. In total the proposed provision of facilities in town centre schemes up and down the country greatly exceeds the need and possibility of execution. Over-optimistic redevelopment schemes which fail to be carried out result only in blight". The National Chamber of Trade told us that this problem still endures, if less acutely. We believe that this has the effect of hampering the growth of small firms—or what is worse, of encouraging businesses to establish themselves where they cannot survive. To some extent this problem has been caused by the large number of small local authorities; it should be less acute when the Government has reduced the number of authorities. They and the central Government, however, should continue to keep this problem under review. In the meantime, small traders would be well advised to look critically at proposals for comprehensive redevelopment of their towns.

Recommendations

18.44

1. Small firms throughout the country should be relieved of the need to apply for an IDC when their plans involve the creation of less than 10,000 square feet of industrial floor space, in accordance with the Hunt Committee's proposals (paragraph 18.15).

2. If it is considered that this should not be extended to all undertakings, the 10,000 square feet exemption limit should be extended to established small firms (paragraph 18.16).

3. Local authorities should be prepared to use their powers under the Town and Country Planning (Development Plans) Direction 1965 to allow the establishment of small businesses in residential areas when this will not detract from these areas' amenities (paragraph 18.28).

> We certainly know that many authorities, where they are acquiring a freehold and dispossessing the tenant by means of notice of entry so that he is entitled only to compensation under the Landlord and Tenant Act, do make an extra payment under the Land Compensation Act which brings the compensation up to what would have been payable had the tenant been dispossessed before the end of his term. The key factor that this brings in is the value of any business goodwill which is not taken account of in the Landlord and Tenant Act.

We are pleased to see this use of discretionary powers. In our view, however, the best solution is a change in the Landlord and Tenant Act 1954 despite any difficulties which this may cause. We are pleased to note that this matter is one of the points being looked at in the current review of the Compensation Code. While we accept that most local authorities probably use their discretionary powers to ensure fair compensation, we are unhappy about relying on administrative discretion. The main weakness of the present position is that a business has no right in law to additional compensation should an authority decide to base compensation on a strict interpretation of the Landlord and Tenant Act. We **recommend therefore that the Landlord and Tenant Act be changed so as to require local authorities to pay compensation which includes the value of the likelihood of a tenancy being renewed.**

18.39 *Compensation for loss of trade.* As a result of a recent decision of the House of Lords it has been established that assessment of compensation takes place not when notice to treat is served on the business but, instead, on the date when the acquiring authority takes possession of the property, or the date when the value is being agreed, whichever is the earlier. This can cause hardship because where an area is being comprehensively redeveloped small shops are often among the last buildings to be demolished. This will invariably reduce the level of their trade as their customers move away. The value of business goodwill will therefore be reduced. The Department of the Environment stated that:

> As a matter of valuation practice the actual losses are adjusted so as to eliminate the effect of a scheme on such matters as earnings and profits; thus if a small business is situated in the middle of an area being acquired compulsorily and by the date of actual disturbance a large number of properties have been demolished, thereby affecting the claimant's profits, then the decline in trade directly due to the scheme is ignored. Nonetheless a claimant has a duty to mitigate his loss and he is therefore expected to continue to run his bnsiness on sound commercial lines until the date of dispossession. If he were to close down or run down his business between the service of notice to treat and the date of valuation the resultant loss would be due to his own actions and it would seem unreasonable to expect the acquiring authority to compensate him for them.

We do not think that the amount of compensation should be affected by any action of the businessman after he is told that his business is to be demolished. We accept that in practice the effect of nearby redevelopment on earnings and profits is taken into account when compensation is assessed for a displaced firm. Nevertheless we believe that the right of a business to compensation based on the level of trade when notice to treat is served should be established in law rather than rest on practice. In the present situation businesses are unnecessarily reliant on administrative benevolence, and a businessman has no legal right to challenge what he considers an inadequate allowance for the run-down of his trade caused by nearby redevelopment. **This is an unsatisfactory situation and we therefore recommend that legislation should provide for compensation on compulsory purchase to be assessed at the level of trade when notice to treat is served on a business.**

issues at stake and that local authority administration at its best is sympathetic and helpful. We are nevertheless convinced that the provisions made by local authorities are not always in line with the best practices. The Department of the Environment have told us that they expect the pressures on local authorities to make adequate provision for displaced firms to grow with the new system of development plans and that the problem will become much less serious as a result. We think this is probably true. We nevertheless believe that there may remain a hard core of authorities where the needs of small businesses will be little heeded. We believe that local authorities should do more as they have been urged to do in the past, to provide premises of the right type for redeveloped small businesses. **We recommend that the present legal obligation of local authorities to provide suitable alternative accommodation be strengthened and that the Department of the Environment and the Scottish and Welsh Offices should do more to encourage unhelpful local authorities to cater for the needs of small firms as effectively as the authorities referred to above.**

Inadequate compensation

18.35 The third source of difficulty for small firms arises from the inadequacy of compensation for compulsory purchase. The basic principle of the Compensation Code is that a dispossessed person receives the market value of his interest together with compensation for disturbance and consequential loss. The latter may include loss of business goodwill, loss or enforced sale of stock, fittings, etc., removal expenses, and legal and professional charges. The present Compensation Code embodies all the principal recommendations of the Second Report in 1918 of the Scott Committee (Cd 9229), which reviewed the previous system of compensation for compulsory purchase. That Committee recommended that "the standard of value to be paid to the owner is to be market value as between a willing seller and a willing buyer, though . . . the owner should of course, in addition, receive fair compensation for consequential injury". The Committee also recommended that "no allowances for the compulsory acquisition of land be added to the market value". The latter recommendation marked a departure from the previous practice of paying more than the market value in order to take account of the compulsory nature of the purchase. The present Compensation Code is itself currently under review by the Department of the Environment.

18.36 Local authorities are empowered by Section 30 of the Land Compensation Act 1961 (and by similar powers in other legislation) to pay additional compensation to those displaced by compulsory purchase. In the case of business premises the local authority may pay what it considers to be a reasonable allowance towards the loss which the occupier will suffer because of the disturbance caused to his business. In estimating this loss the authority must have regard to the period for which the premises might reasonably have been expected to be available, had it not been for the compulsory purchase, and to the availability of other suitable premises. Payments under these discretionary powers may be made to people who have no entitlement to compensation under the Code (for example tenants dispossessed at the end of their term and who would otherwise be entitled only to compensation under the Landlord and Tenant Act). These powers have not always been used. The then Ministry of Housing and Local Government reminded local authorities in 1956, 1959 and 1963 of their discretionary powers. In particular its 1956 circular 43/56 stated (under the heading "Small Businesses") that "while a number of authorities make full use

area. This difficulty, like the first, is primarily experienced by manufacturers. It is clearly not desirable to allow the intrusion into residential areas of businesses likely to be a serious nuisance to the residents. There will, nevertheless, be instances when a small firm wishes to start up in, or to move into a residential district where there is a cheap site available and where it will not seriously disturb the residents or be an eyesore. Alternatively a firm may wish to change the use to which a building is put, for example to use a garage as a small electronic assembly establishment. **In all these cases we recommend that all local authorities be prepared to use their powers under the 1965 Direction to allow the establishment of small businesses in residential areas when this will not detract from those areas' amenities.** Some witnesses have noted that there has already been a change in planning philosophy and it seems that local planning authorities are now less intent on a drastic geographic separation of different kinds of land use.

18.29 The business may wish to move to a new site, perhaps because of the problems of seeking to expand on its present site or because it wishes to organise itself better than it can in its existing location. If the development plan has not provided enough land for industrial development this could hurt the small manufacturer, especially if the local authority concerned does not interpret its plan flexibly. We are, however, somewhat reassured to learn from the Department of the Environment that in allocating the use of land in their plans authorities "will invariably pay great attention to the need for employment in their areas and to ensuring that their planning policies provide for the needs of industrial firms". The Department said that it is indeed common for authorities to allocate too much land for industrial use. They also told us that while development plans drawn up under the former system did not always provide enough land for commercial development, this is unlikely to happen under the new system (see paragraphs 18.21 to 24). Some businesses, such as retailers, garages, launderettes etc. must be accessible to their customers. It is not enough for adequate commercial acreage to be provided if it is too far removed from residential areas. We believe it is wrong, therefore, to adopt an excessively clinical approach to zoning and we are reassured to learn that local authorities are now recognising this.

Displaced firms forced to seek new premises

18.30 The development plan of a locality can provide for comprehensive redevelopment. This is a common feature of development plans for the older conurbations because of the need to tackle slum conditions and obsolete development and to build roads. Much of the property in large areas of low-standard housing contains many small businesses: the Birmingham jewellery trade, for example, is heavily concentrated in areas of old and generally decaying residential property. Many, perhaps a majority of firms in such circumstances pay very low rents. When these areas are scheduled for redevelopment small firms may experience difficulty either because the cost of alternative sites is too high or because the sites that are offered are too large.

18.31 The Department of the Environment state that "rent increases on relocation vary considerably but the Department's impression is that in practice they are seldom less than double in terms of rent per square foot of floor space". Retailers are particularly affected by this difficulty although it is experienced by firms of all types. Section 78(7) of the Town and Country Planning Act 1962

same area. Structure plans are subject to similar procedures to those drawn up under the earlier system but local plans are normally decided by the local planning authority itself. The 1968 Act, however, makes an important innovation in providing that the local planning authority shall, in drawing up structure and local plans, take steps to ensure that:

i. adequate publicity is given both to the report of the survey that must be carried out when preparing the plan and to the proposals in the draft plan, and that
ii. those who may wish to make representations to the authority are made aware that they are entitled to do so and given adequate opportunity of doing so.

These safeguards should ensure that public opinion can make itself felt more effectively than hitherto. Although the granting of planning permission is considered in the context of a development plan, it is not obligatory for the local authority to follow the plan in every case. In considering applications the authority must have regard to the plan and to any other material considerations. Individual cases can be treated on their merits and exceptions to a plan may be allowed. The exercise of planning powers is, within statutory limits, not subject to central Government control. The Department of the Environment and its Scottish and Welsh counterparts do, however, provide advice at frequent intervals in their circulars to local authorities, and through their Regional Offices.

18.24 Development plans do not differentiate between large and small firms; the only distinction they make is between light and other industry. The Department of the Environment stated that "there is no reason to think that development control regulations in themselves bear more hardly on small firms than on others". They point out that the small firm might well enjoy a more advantageous position than the large because the Town and Country Planning General Development Order of 1963, as amended, exempts certain minor works from planning control procedure. Among the minor projects which the order allows are, for example, certain alterations to buildings, the erection of plant or machinery meeting certain conditions, and the rearrangement of private ways. The building projects of small firms are, moreover, less likely than those of a large firm to involve a substantial departure from the local development plan. It seems clear, however, that small firms think they are adversely affected by town and country planning processes. 18 per cent of the respondents to our postal questionnaire in non-manufacturing and 15 per cent in manufacturing stated that their expansion or efficiency had been impaired in the previous five years by the operation of the Town and Country Planning Acts. Difficulties arise for small businesses when:

i. they wish to build in areas set aside in the plan for residential purposes.
ii. Redevelopment forces them to find new premises.
iii. They are inadequately compensated for compulsory purchase or loss of trade.
iv. Local authorities provide too much shopping accommodation in new housing estates, or redeveloped town centres.

These difficulties are discussed below.

It is an inevitable consequence of any policy which attempts to restrict building in a region already suffering from a shortage of accommodation. The second difficulty probably affects small firms more than others. Although the exemption limits mean that the development of smaller areas of office floor space can be undertaken without the need for a permit, smaller firms who want new accommodation in practice rent space in large buildings subject to permits, rather than build themselves. When developers plan to provide office space to be let in small units it is often difficult to know at the planning stage who the eventual tenants will be, so that their need for accommodation in the area of control cannot easily be judged. This seemed to us to be a potential source of difficulty for small firms. The Department of the Environment have now informed us that changes in the administration of the control have recently been agreed by Ministers to ensure that adequate provision is made for essential local services. As a result, where there is a demonstrated need for small offices for local firms, the department have in certain cases issued permits subject to a condition limiting the amount of space which may be let to one firm or organisation. In our view the recent change in the administration of the control seems to have taken care of the potential difficulty.

Town and country planning

18.20 Under the Town and Country Planning Acts 1962 and 1968 the development of land—meaning the carrying out of building, engineering, mining or other operations or the making of any material change in the use of buildings on land—generally requires planning permission. The planning authorities in England and Wales outside London are the 58 county and 83 county borough councils and in addition the Peak District and Lake District National Park Joint Planning Boards. In London there are 34 planning authorities: the Greater London Council, the 32 London Boroughs and the City Corporation. Many development control functions are in practice delegated by the planning authorities to borough, urban district, and rural district councils. In Scotland planning control is the responsibility of the 33 counties, 21 burghs and the small burghs of St. Andrews and Thurso. The Government has announced in a recent White Paper (*Local Government in England: Government Proposals for Reorganisation*, Cmnd 4584 February 1971) that legislation will be introduced in the 1971–72 Parliamentary session to reorganise English local government outside London. Under the proposed new system of local government in England there are to be 44 counties, including six "metropolitan" counties. There will be a substantially reduced number of district councils. Both county and district councils are to have planning functions. Responsibility for broad planning decisions are to rest with the counties; the Government, however, intend that the new districts should as of right take by far the greater number of planning control decisions provided the professional advice they receive comes from officers who are part of a unified staff structure serving both county and district. The national parks will continue to have special arrangements. Broadly similar plans for reform in Wales and Scotland were also announced[1]. In Wales the planning authorities will be the councils of the seven proposed counties, while development control will largely be the responsibility of the 36 proposed district councils. Cardiff City Council, administering the most populous district, will

[1] *Reform of Local Government in Scotland* (Cmnd 4583, February 1971). *The Reform of Local Government in Wales: Consultative Document*, HMSO, 1971.

feet accounted for 59·6 per cent by number of all approvals in 1969, in terms of floor space they accounted for only 17·2 per cent. While the Government has now conceded the need for higher limits it has not implemented the Hunt Committee's recommendation in full. In the Midlands and South East the exemption limit is still only 5,000 square feet. There is no doubt that these are the regions where small firms have experienced the greatest difficulty. We believe that the new exemption limit in these regions has only partly eased their problems. **For the reasons we have already given we recommend that small firms throughout the country be relieved of the need to apply for an IDC when their plans involve the creation of less than 10,000 square feet of industrial floor space.**

18.16 Adopting the Hunt Committee's proposal in the Midlands and South East would benefit some large firms as well as small. We have considered whether it would be practicable to give differential treatment to the applications of small firms and have consulted the Department of Trade and Industry on the possibility of raising the limit in the Midlands and South East to 10,000 square feet for small firms only. They have advised us that this would be extremely difficult administratively. Since the greatest difficulties are experienced by small firms who are already established in a "congested" region we have considered whether, if the limit were not raised, some means of exempting *established* small firms only, or greatly simplifying the procedure in their case, could be devised: for example small businesses established in an area would receive favourable treatment, or automatic approval. We have to recognise, however, the difficulty of defining such cases in advance so as to prevent abuses: it would be very easy, for example, by buying a small existing factory, to establish a "right" to privileged status as a resident firm. Discriminatory policies inevitably breed evasion and we think therefore that the best remedy is for the Government simply to extend the 10,000 square feet exemption for IDCs to the Midlands and South East. **Nevertheless, if it is considered that the relaxation should not be extended to all undertakings, despite the administrative difficulties visualised by the Department of Trade and Industry we recommend that the 10,000 square feet exemption limit be extended to established small firms.**

18.17 Although the Hunt Committee considered that raising the IDC exemption limit to 10,000 square feet across the country would not seriously harm the interests of the assisted areas, it is proper to record that we have received evidence from the Scottish Council, the Highlands and Islands Development Board and other bodies concerned with the welfare of the Development Areas, which strongly opposed relaxation of the control. The Scottish Council stated that a large proportion of the firms setting up in Scotland for the first time do so in factories of 10,000 square feet or less. They said that in the smaller towns and on some industrial estates this is the typical and most favoured size for new factories, particularly for light industry with a high technological content such as electronic engineering. The Council agreed that if the relaxation were confined to those established small firms which clearly cannot move or undertake split management, little or nothing would be lost to the assisted areas, but they would prefer to allow such cases to be identified and catered for, as now, by administrative flexibility in the Department of Trade and Industry.

18.18 A major source of disquiet in the assisted areas is the potential effect of the "free allowance" as it is now operated, if the exemption limit were raised.

discussed the reliance of most small firms on the talent and energy of one or two men: such small management resources cannot be spread over two or more establishments separated by appreciable distances. In any case the overhead costs of running two small establishments are likely to be prohibitive. This is why attempts to persuade the established small firm to move are likely to be a waste of time and a source of irritation. The department have told us that they recognised the essential immobility of the very small firm, and that they would never require such a firm to move hundreds of miles to a Development Area. They are more likely to suggest a move, if expansion on the proposed site is undesirable, to a new or "overspill" town nearby—for example to Redditch, Daventry or Telford in the case of a Birmingham firm. (It has been suggested to us by officials that the management of separate establishments might then be little more difficult than if they were a few miles apart within Birmingham itself: nonetheless we do not entirely accept this as regards the very small firms). Firms which show promise of very substantial growth, on the other hand, may well be expected by the DTI to go to a Development Area.

18.13 The Department were not at first able to tell us how many established small firms, as distinct from new firms (including foreign companies new to this country) or subsidiaries of larger units, they have succeeded in inducing to move, largely because it is not possible to identify these categories of small firm from the statistics. They have, however, made a special study of the effect of IDC refusals on the expansion plans of firms affected in the Midlands between 1958 and 1963. During this period there were 143 sustained refusals, 48 affecting firms employing under 200. Information about the subsequent actions of all but 16 of these firms was obtained. Only two of the 48 small firms who were refused an IDC were induced to move to a Development or Intermediate Area. Furthermore, despite the fact that the Department had justified half the refusals to small firms on the grounds that the company concerned could be expected to move to an "overspill" town, in only two such cases did the firm do so. The survey thus showed that only four of the 48 small firms refused an IDC (i.e. eight per cent) subsequently set up production in an area preferred on distribution of industry grounds. On the other hand 18 per cent of refusals to large firms resulted in moves to a Development or Intermediate Area, with a further five per cent going to "overspill" towns. The department also carried out a similar study of the subsequent actions of firms refused IDCs in the South East of England in the same period. Out of 4,846 applications there were 278 sustained refusals. In 65 of the 278 refusals a move to an area preferred on distribution of industry grounds resulted. Unfortunately the second survey (which was not carried out on this Committee's behalf) did not analyse the size of the firms involved. In both the South East and Midlands Regions the majority of firms refused IDCs either erected new buildings not requiring IDCs, occupied existing premises in the same area or a nearby locality, or abandoned or deferred their projects. The survey of projects refused in the Midlands seems, in our view, to demonstrate that the Development and Intermediate Areas and "overspill" towns gain very little from the application of IDC controls to established small firms. We therefore feel that there is some validity in the contention that for most small firms the IDC procedure is a time-wasting charade. The figures show that if they persist with their applications they usually get their way in the end, but only after their plans have been delayed. Those who are refused an IDC of course suffer even more. Unfortunately those who must endure these frustrations are pre-

only 33 per cent of the refusals fell in this category. Conversely, though only about 17 per cent of approvals were for projects over 25,000 square feet, just over 30 per cent of refused applications were of this size. Larger projects thus fare worse than small—reasonably enough, since they are more likely to impose a heavy demand on resources. This does not conflict with the finding that small firms' applications are more likely to be refused, since a number of large applications are submitted by small firms and many small applications, for extensions and the like, are made by large firms; 28 per cent of applications for projects exceeding 10,000 square feet were made by small firms while large firms made 47 per cent of those for projects below this size.

18.9 The department themselves have pointed out, however, that the number of refusals is an inadequate measure of the deterrent effect of the control. It takes no account of those cases where, perhaps foolishly, firms decide not to apply on the basis of hearsay, without taking the department's opinion, nor of thoses cases where applications are withdrawn before a decision has been reached, either because the chance of success seems too slender to justify the trouble of proceeding further or because the applicant is persuaded by officials to adopt a different solution to his problem. We would expect small firms to figure more prominently among these cases first because they are less likely to have taken professional advice before consulting the department, and hence are more likely than large firms to be deterred by hearsay and second because they can less well afford the time and expense of proceeding with a doubtful case. This suggests that the small firm is at a greater disadvantage than the figures in Table 18.I imply.

TABLE 18.I

Industrial Development Certificates approved and refused in 1969 in regions where refusals occurred—analysed by employment size of firm

Numbers employed	*0–100*	*101–200*	*0–200*	*Over 200*	*All firms*
East and West Midlands, East Anglia and South East "congested" areas					
Cases decided	1,853	257	2,110	2,149	4,259
Of which refusals	103	17	120	74	194
Refusals as % of cases decided	*5·6*	*6·6*	*5·7*	*3·4*	*4·6*
North West and South West					
Cases decided	392	52	444	629	1,073
Of which refusals	2	2	4	5	9
Refusals as % of cases decided	*0·5*	*4·0*	*1·0*	*0·9*	*1·1*
Total for areas in which there were refusals					
Cases decided	2,245	309	2,554	2,778	5,332
Of which refusals	105	19	124	79	203
Refusals as % of cases decided	*4·7*	*6·1*	*4·9*	*2·8*	*3·8*

Source: Department of Trade and Industry Survey (See paragraph 18.7).

Note: There were no refusals in the Northern, Yorkshire and Humberside, Welsh and Scottish regions. This Table analyses IDC cases decided and refused in 1969 by size of enterprise in the remainder of the country. In the case of a subsidiary of another firm the size of the *whole* enterprise was examined. The enterprise was thus one or more firms under common ownership or control as defined in the Companies Act 1948. Because of the very small number of refusals in the North West and South West no statistically valid inferences can be drawn for these regions. If we aggregate the figures for all the regions where IDCs were refused it can be seen that 4·9 per cent of applications for IDCs for firms employing under 200 were refused compared with 2·8 per cent of the applications for larger firms. The Department of Trade and Industry stated that the size of the difference is not statistically significant but that it does imply that in 1969 small firms found it harder than large firms to obtain IDCs.

control is strict and projects which could reasonably be located in Development and Intermediate Areas are not approved, some applications being rejected on grounds of congestion alone. Nearly all refusals occur in the three "congested" regions, the Midlands, the Eastern Region and the London and South East Region, and it follows that here also occur most of the delays due to protracted negotiations. Unfortunately these areas also contain a high proportion of the liveliest small firms. Over most of the country's land area however the IDC policy presents no problem for small firms.

18.6 The procedure for obtaining an IDC is basically simple. The application form is as short and simple as it could be and the Department of Trade and Industry assure us that their internal procedures are as streamlined as regular reviews can make them. All applications are considered in the first instance by the appropriate Regional Office, to which they are addressed, and the great majority—about 95 per cent—are settled by the region without reference to headquarters. Where the application is very small—i.e. just above the exemption limit—it is normally dealt with on the strength of the information on the form, without detailed investigation, and if approved a certificate will usually be issued within a few days. Larger applications will normally necessitate a visit to the applicant firm to gather background material—on local circumstances and the feasibility of a move to an assisted area—before the case is considered by the Regional Office. In the London and South Eastern, and Eastern Regions every such application is considered by an informal interdepartmental committee but this procedure is not followed elsewhere. We are told by the department that such applications are normally decided within four to six weeks of receipt and that in special circumstances requiring a quick decision—for example when an IDC is needed to replace fire damaged buildings or for submission to an early meeting of a planning authority—a certificate may be issued within 24 hours. Only the largest applications, for 50,000 square feet or more, and the most difficult, are referred to Whitehall for decision. These comprise about five per cent of the total. Although this procedure appears simple and straightforward a number of witnesses have complained strongly about its injurious effects on small firms already established in the Midlands and South East. One firm stated that "application of these controls by the Board of Trade (then responsible for the control) to this company appears at best to be irrational and at worst, even vindictive". More temperately the Engineering Employers' Federation wrote that:

> Small firms do not appear to find it easy to obtain industrial development certificates, and in their case removal to a new area such as may be required can sometimes entail a capital outlay beyond the resources of the company.

The First National Finance Corporation stated:

> We believe that small firms are less likely than others to move away from their chosen locations. If their physical expansion is not permitted within a reasonably close distance to its desired location we believe that small firms are quite likely to forgo expansion, bearing in mind the effect that the incidence of taxation has on the incentive to take risks.

These are generalised complaints, and most of our evidence on the subject is of this kind. On examination, however, four specific charges against the policy recur

CHAPTER 18: The Effects of Development and Planning Controls

Introduction

18.1 Many witnesses have stated that small firms experience special difficulties as a result of control of industrial development through the issue of industrial development certificates (IDCs) and the machinery of town and country planning. Although we have received very little evidence about the control of office development, at the outset of our Inquiry this appeared to create certain problems for small firms and we therefore deal briefly with this subject also. We have dealt separately with industrial development certificates, office development permits (ODPs) and town and country planning; although they are seen by most businessmen as part of a single process, the purposes of the Department of Trade and Industry who issue IDCs, the Department of the Environment who issue ODPs and of the local authorities who grant planning permission are not merely different—they may sometimes be in conflict.

18.2 A manufacturer who seeks to extend his factory or build a new one has to submit his plans for official approval at two stages. First, any application for planning permission that will lead to the creation of industrial floor space above a prescribed limit needs to be supported by an industrial development certificate from the Department of Trade and Industry certifying that the proposed development can be carried out consistently with national policy on the distribution of industry. Second, having obtained an IDC the businessman must apply to his local authority for planning permission, which will be granted or refused on the strength of local considerations. Application for planning permission must be made whatever the size of development in question except in the limited circumstances described in paragraph 18.24. Applications for planning permission for the creation of office space exceeding 10,000 square feet in London and the South East must in addition be supported by an office development permit issued by the Department of the Environment.

Industrial Development Certificates

18.3 The Government has at its disposal a formidable array of powers designed to correct the imbalance between the levels of economic activity obtaining in the most prosperous areas of this country—broadly the Midlands and South East—and in the less prosperous areas of the North and West. In this chapter we are concerned with only one of these, the power of the Department of Trade and Industry, under the Town and Country Planning Act 1962 and subsequent statutes, to prevent all but tbe smallest of industrial developments by withholding the issue of an industrial development certificate, and we shall examine this mainly with an eye to its negative effect on small firms. We shall ignore the positive tools of distribution of industry policy—the Regional Employment Premium, building and removal grants, loan assistance, enhanced investment incentives and the provision of cheap factory space in the assisted areas—merely because they cause no major problems for small firms, not because we fail to appreciate their value. We are generally in sympathy with the purposes of distribution of industry policy. The evidence we have received on the subject, however, suggests that small firms face special difficulties in complying with the

Annex to Chapter 17

The contents of the Directors' Report

Section 157 of the Companies Act 1948 states that "there shall be attached to every balance sheet laid before a company in general meeting a report by the directors with respect to the state of the company's affairs" and sets out the information which this report must contain. Section 15–20 of the Companies Act 1967 added to the items on which information must be given. Broadly, the information now required in a directors' report is as follows:

i. The recommended dividend and the amount, if any, which they propose to carry to the company's reserves.

(Section 157 Companies Act 1948)

ii. The names of persons who have been directors during the financial year.

(Section 16(1) of the 1967 Act)

iii. The principal activities of the company and its subsidiaries during the year and any significant changes therein.

(Section 16(1) of the 1967 Act)

iv. Particulars of any significant changes in the fixed assets of the company or of any of its subsidiaries.

(Section 16(1) of the 1967 Act)

v. Details of shares and debentures issued during the year and the reasons for the issues.

(Section 16(1) of the 1967 Act)

vi. Certain particulars of any "contract with the company in which a director of the company has, or . . . had . . . an interest".

(Section 16(1) of the 1967 Act)

vii. A statement of any arrangements to which the company is a party under which directors of the company are or were during the year enabled to acquire shares or debentures in the company or any other body corporate.

(Section 16(1) of the 1967 Act)

viii. Information of directors' interests at the end of the year in shares or debentures of the company or its holding company or subsidiaries etc.

(Section 16(1) of the 1967 Act)

ix. Particulars of any other matters "material for the appreciation of the state of the company's affairs by its members, being matters the disclosure of which will not, in the opinion of the directors, be harmful to the business of the company or of any of its subsidiaries".

(Section 16(1) of the 1967 Act)

x. If turnover exceeds £50,000 in the year a division of turnover and profit (or loss) into classes of business undertaken.

(Section 17 of the 1967 Act)

xi. Average number employed if in excess of 100, and in addition their aggregate remuneration.

(Section 18 of the 1967 Act)

17.39 An attempt to deal with the problem by means of a more fundamental change in the law has been proposed by the four major accountancy institutes in their publication *Companies Legislation in the 1970s*. They point out that by abolishing the exempt private company, the 1967 Act obscured an essential distinction between public companies and the great majority of private ones, which is that the latter are effectively managed by their owners whereas public companies are managed on behalf of their owners, their shareholders, by outside appointees. They would refer to the owner-managed company as a "proprietary" company. They defined the latter as one:

a. which is managed and controlled by substantially the same persons;
b. which is not under the control of another company which is not itself a proprietary company;
c. which limits the right to transfer its shares;
d. which prohibits any offer of its shares to the public;
e. which limits the number of its members to 25;
f. whose average number of employees per week does not exceed 200;
g. which has an annual turnover not exceeding £500,000.[1]

Public companies and such large private companies as are not effectively managed by their owners, would be known as "stewardship" companies. "Proprietary" companies, by virtue of their small size and lesser importance to the public, would be exempted from the more onerous disclosure requirements and would be relieved of some of the burden of present accounting procedures. The obligations of "stewardship" companies would be similar to those of the present public companies, but their management would be made more clearly accountable for company policy, thus recognising where effective power lies. The advantage of the proposal is that it would significantly reduce work on the preparation of accounts for "proprietary" companies as well as solving the main problems arising from disclosure. We have no reason to quarrel with the concept but consider that similar problems of administration to those occasioned by the 1948 Act would arise. The very complexity of the proposed definition of the "proprietary" company supports this view. Nevertheless, we recognise the validity of the point made by representatives of the accountancy bodies that as the law is likely to be changed to provide for considerably more information to be given to the shareholders of public companies, some method of discrimination between them and the small private company must be found if the latter are not to be involved in increasingly tiresome and expensive requirements in the future. *We see the merits of this proposal and believe that the Department of Trade and Industry, who are at present considering the next major revision of company law, should give it their careful consideration.*

17.40 Whatever is the outcome of such consideration, we believe that raising the present limits for exemption from the requirements to publish the more sensitive items is open to no objections of principle. We have been informed by the Department of Trade and Industry that if we wish to propose the exemption of a larger number of private companies from some of the disclosure provisions, they would find it a great deal easier to administer a criterion based on size, whether of turnover or capital employed, than any legal criterion that might be devised. There is nothing sacrosanct about the present limits, which are the result

[1] "Companies Legislation in the 1970s", published in April 1969 as a supplement to *Accountancy* magazine.

The protection of the public

17.33 Shareholders in unquoted companies are of course entitled to protection against incompetence and fraud, but in any case, they will see the company's report and accounts as of right. The only problem to arise is on the possible interests of the public other than as shareholders. The Consumer Council, for example, favoured the retention of the existing disclosure provisions in relation to small companies and urged further measures to ensure that they are effectively enforced. They argued that the provisions:

> enable vital information to be available about companies whose solvency is uncertain and who set out to defraud the public, so enabling the Council to warn the public of their activities in good time. These are generally small companies with a nominal capital which, before the 1967 Act was passed, protected themselves from investigation by adopting exempt private company status. They seized the opportunity afforded by exempt private company status of enjoying the benefits of limited liability while avoiding the responsibilities of showing the public their true financial position. Firms with little capital behind them were thus able to obtain deposits from the public, often over the doorstep, for equipment such as central heating, immersion heaters, vending machines, etc. and to go into liquidation sometimes before the equipment was installed, leaving the unfortunate householders still with the obligation of paying for the equipment to Finance Houses. If the equipment was installed and subsequently proved faulty, as was often the case, householders were still obliged to go on paying for it while the Finance House had no legal obligation to put it right.

We are of course in complete sympathy with the Consumer Council's wish to stamp out practices of this sort. We do not believe, however, and the Council accepted this, that the publication of turnover and directors' remuneration has much value for this purpose. We are proposing no changes in those aspects of the law to which the Council attached special importance.

Relevance to incomes policy

17.34 The Government required disclosure of directors' emoluments from private companies, against the recommendations of the Jenkins Committee, on the ground that it was relevant to incomes policy. This could mean either simply that it was thought right in principle that the pay of directors should be known to their employees among others, or that the Government hoped disclosure would operate as a restraining influence. For our part, in the context of new policies on earnings or indeed even of the old we find it difficult to believe that any contribution is made by the disclosure of individual salaries.

Value as economic data

17.35 The argument that the records filed at Companies House will comprise a valuable body of basic data on which the Government can draw in framing its economic policies is not convincing. It is true that management of the economy is facilitated if information is available to the forecasters and policy makers and that records for perhaps 500,000 unquoted companies might conceivably be a source of such information, even though available only after a long time lag and in respect of different overlapping financial years. However, no official attempt has yet been made to analyse this material comprehensively and no plans exist for doing so, though there have been several small sample investigations. The extent to which these records will have value as statistical data is therefore unproven. It is the more unfortunate that a useful analysis of the accounts of

iv. that the formulation of national economic policy would be improved by using small companies' accounts as a source of statistical data;
v. that the efficiency of management and the forces of competition would similarly be strengthened by access to this material.

We have no quarrel with any of these as an aim of policy but we doubt whether disclosure by small companies goes far to serve these ends, except for the first. We shall examine the arguments relating to each.

The protection of creditors

17.29 The Government placed great emphasis on the protection of creditors as justification for demanding the publication of more information by unquoted companies, and it is, of course, of the utmost importance. There is, however, a clear divergence of opinion among witnesses on the question whether the disclosure provisions serve this purpose. Small businessmen and their representatives deny that published accounts are of any value to creditors since they are normally very much out of date; by the time accounts are prepared and filed, up to 18 months may have elapsed, so that they may give a very inaccurate picture of the current situation. Moreover, it is suggested, those who advance money on credit to private companies could if they wished demand from the company the accounts or any other necessary information, and many do so.

17.30 This view is, however, directly contradicted by the evidence of three "professional" users of the material filed at Companies House whom we consulted on the value to them of the material provided under the 1967 Act. These were Dun and Bradstreet Limited, who provide a credit rating and credit reporting service to their clients, the National Association of Trade Protection Societies, whose members provide similar services to, on the whole, customers of slightly smaller size, and Trade Indemnity Limited, who insure their clients against the risk of loss in extending credit to customers. One of the most important functions of these agencies is to establish the creditworthiness of firms and all three agreed that the publication of the Accounts and directors' reports of all limited companies has greatly assisted them in carrying out this function. Before the passage of the 1967 Act their position was a great deal more difficult. Useful information on the creditworthiness of exempt private companies could only be obtained either by making private enquiries, through customers and suppliers, for example, or by direct approach to the company. There are obvious difficulties in the first course and the second was often frustrated by the refusal of the company being investigated to co-operate, or by unwillingness on the part of the firm instigating the investigation to let the fact be known. Dun and Bradstreet told us that prior to 1967, when they wished to see the Accounts of exempt private companies, they were voluntarily made available in only ten per cent of cases. All three agencies accepted that late filing of accounts causes some difficulty, but not that this outweighs the value of disclosure: moreover, the difficulty is declining due to the energy with which the Companies Registry pursues late returns. Very extensive use is made of the published accounts by credit agencies, the larger of which maintain a permanent staff of agents at Companies House who do nothing but search company files; Dun and Bradstreet's seven agents, for example, examine over 30,000 files in a year. The total

of good trading results. Once again, however, evidence of actual harm is lacking. It is clearly possible that an intending takeover-bidder might be able to estimate the value of a competitor more precisely after studying his accounts, but in a sector where owner-managers predominate, if a takeover is to go ahead the price will normally be settled by negotiation, which would in any event require disclosure of considerably more information than is published. Perhaps the bigger danger is the attraction of competition, possibly leading to takeover offers under threat of direct competition and we revert to this in paragraph 17.24. In general, therefore, we feel that this danger of takeover has been greatly exaggerated. The vast majority of small companies are anyway private and are thus not susceptible to takeover against the wishes of the shareholders.

17.23 Though the danger from direct competitors may be exaggerated, we attach more significance to a second threat to the ability of the small company to compete on equal terms. This derives from the fact that many such companies rely on a single major customer for a large proportion of their work. 27·5 per cent of the manufacturers replying to our questionnaire sell 25 per cent or more of their output to a single customer. It is a reasonable assumption that most of these are suppliers of components or finished goods to a larger firm, and that their relationship with that firm is to a greater or lesser degree crucial to the survival of the business. In such cases disclosure of the small company's turnover reveals to the customer the extent of its dependence on him and, to a large extent, the profit being made on sales to him. The customer may decide either that the profit level is excessive or merely that the supplier is in no position to resist pressure to reduce his prices or alter his terms in some other way. The result is likely to be that the profit margin of the small company is squeezed. Again, it may be said that large firms will already have this information about their suppliers, but we think it likely that access to published accounts may significantly assist them. We know that some suppliers in this position have relinquished limited liability rather than reveal details of the business to a dominant customer.

17.24 We have already touched briefly on the third threat to the competitive position of the small company, which is that of the potential competitor encouraged either to enter the same line of business or to set up in close geographical proximity by the publication of good trading results. We discounted the danger of direct takeover since the owners of a private company are free to refuse an offer, but it is not so easy to dismiss the suggestion that a potential competitor, deducing from published accounts the profit to be made on a particular product, might decide to start supplying it in the belief that he could do so more cheaply. In the retail or service trades the analogous case is that a rival establishment may be set up near a shop whose accounts reveal unusually good turnover or profits: we are told that some multiple stores make use of filed accounts in this way. We have no doubt, indeed, that these occurrences are common enough, since several small companies have admitted examining their competitors' accounts in the hope of identifying such opportunities. We cannot see, however, that this is objectionable from the point of view of the national interest. At its highest it can only be one factor in taking the decision to set up a new branch or a new product line.

The question of privacy: directors' remuneration

17.16 It has frequently been suggested to us that the compulsion to publish the report and accounts of a private company is an invasion of privacy and is undesirable as such, apart from any unfortunate consequences it may have. What is at issue for the company is, however, not privacy in the normal sense but secrecy. It may well be advantageous for the small company to keep some of its affairs secret but it is for Parliament to decide where the balance of advantage lies as between the company and the public interest.

17.17 There is, however, one important issue in which the individual as distinct from the company is affected. This is the requirement to publish information which frequently reveals the remuneration of individual directors, which is the provision most resented on grounds of "privacy". The objection to this was well stated by the National Chamber of Trade in their evidence: "the submission of Accounts available for public inspection imposed upon the directors of family limited companies a duty to reveal a degree of private financial information not required from other individuals". It is true that this obligation puts directors of limited companies in a special category as far as the private sector is concerned, even though their remuneration is disclosed only within broad salary bands. It is also said, however, that quite apart from the feelings of individuals, the publication of directors' emoluments can harm the company. Labour relations inside the firm, for example, may suffer if workers resent what they consider to be excessive earnings by directors whereas these earnings often include an element of return on capital. Acrimony might also arise between directors and shareholders, and the National Building and Allied Hardware Manufacturers' Federation tell us that:

> An additional objection is that small firms are in the majority of cases family concerns and disclosure of directors' remuneration has already been the cause of family strife in cases where hitherto all had been satisfied with the conduct and outcome of the affairs of the business.

This is no doubt unfortunate, but it does suggest that in such a case disclosure has served its purpose of making relevant information available, apparently for the first time, to those who have a legitimate right to it. On the other hand, there is no evidence that disclosure of individual directors' remuneration serves a useful purpose for the general public.

17.18 The disclosure of total remuneration of directors is a different matter. It is necessary to show this total figure if the profit and loss account of a private company is to be at all meaningful, particularly under the current taxation system, which up to a point encourages the distribution of earnings as remuneration even if the sum so distributed is lent back to the company. **We therefore recommend the exemption of private limited companies with annual turnover below £500,000 from disclosure of the individual emoluments of directors; however they should continue to show the total amount in the profit and loss account.** We recognise that in many instances this will be equivalent to disclosure of the individual salary but there appears to be no way out of this dilemma, unless the profit and loss account itself is not to be published.

17.11 In general, therefore, the effect of the Companies Act 1967 on a small company with a turnover exceeding £50,000 and directors the aggregate of whose emoluments exceeds £7,500, is that it is required to give in its accounts its turnover, the emoluments of its Chairman and its highest paid director (if not the Chairman) and the number of directors with emoluments in each of the bands £0 to £2,500, £2,500 to £5,000, and so on; and, in appropriate cases, information about loans made to or by the company and information about when and by whom its fixed assets were valued. It is required to give in its directors' report the value of its exports or to state that it did not export, and it may be required to say something about its fixed assets. The company is required to publish its accounts and directors' report by filing them with the Registrar of Companies. It may have had to appoint a new auditor; if so, it would be because its former auditor had not the qualifications now required. A smaller company with a turnover which does not exceed £50,000 is not required to give information about its exports, and is not required to give information about its turnover unless it is a holding company or a subsidiary company. If the aggregate of its directors' emoluments does not exceed £7,500, the only information it has to give about those emoluments is that required by Section 196 of the 1948 Act. It is also prohibited except in certain limited circumstances from making loans to its directors.

17.12 The number of companies affected by these changes was of the order of 400,000—about 80 per cent of the total number of 500,000 companies existing in 1967. Of these the overwhelming majority were very small: though there were, and still are, a number of very large private companies, most private trading companies are small businesses or owner-managed companies of the traditional kind, sometimes with only one or two members and no employees. There are also very large numbers of moribund companies and non-profit-making companies, with which this Report is not concerned. The number of companies on the Register which are moribund or inactive is not known with any accuracy. That it is a large number is indicated by the fact that in 1969 and 1970 the Registrar struck off the Register the names of approximately 19,000 and 17,000 companies respectively on the ground that he had reasonable cause to believe that they were not carrying on business or in operation.

17.13 It may be worth remarking here that there are very many small companies whose owners derive no advantages from incorporation sufficient to justify its cost and the obligations it imposes on them. When profits are below a certain level company status is a definite disadvantage so far as taxation is concerned and it involves the legal costs of preparing and filing accounts. It may be that in such circumstances the proprietors have consciously decided to accept the cost of higher tax liability in return for the protection of limited liability, but we suspect that many assume company status for reasons of prestige without full appreciation of its tax implications or the legal obligations they have undertaken. It frequently transpires, when companies are prosecuted for failure to file accounts, that they are found to be tiny businesses (a village sweetshop was one example quoted to us) whose owners have no conception of the responsibilities attached to limited liability. Certainly no small business should incorporate without first taking the advice of an accountant.

17.14 The opposition to the 1967 Act, like the continuing controversy about it, related almost entirely to the requirement to publish three particularly "sensi-

17.4 The Companies Act 1967 added to these requirements. As regards (i), it added to the matters about which information has to be given. In particular information now has to be given, under Sections 3 to 8, about subsidiary and associated companies, the ultimate holding company, emoluments of individual directors if the aggregate exceeds £7,500 and, under amendments and additions to Schedule 8, about turnover, loans, the valuation of fixed assets, and rents receivable. As regards (iii), information has to be given in the directors' report under Sections 16 to 20 of the Act, about significant changes in fixed assets or about land with a market value significantly different from its book value, the turnover and the profit attributable to each substantially different class of the company's business, the number of employees and the annual amount of their wages, and exports. A complete list of the required contents of the directors' report appears in the Annex to this chapter.

17.5 The Companies Act 1967 also abolished the status of exempt private company. As a result all limited companies, including those which had been exempt private companies before the status was abolished, are now required to publish their accounts and reports by filing them with the Registrar. Another effect is that a small private company is no longer able to appoint an auditor with no qualifications (subject to an exception for a person who is authorised by the Department of Trade and Industry to be appointed auditor of such a company as having throughout the year ending November 3, 1966, been wholly or mainly occupied in practising as an accountant, otherwise than as an employee, and who on that date was the auditor of an exempt private company), and, after January 1971, will be unable to appoint as auditor a person who is a partner of, or in the employment of, an officer or servant of the company.

17.6 Most of the changes mentioned in paragraphs 17.4 and 17.5 were made to implement recommendations of the Jenkins Committee on Company Law (Cmnd. 1749). In particular the Government agreed with the Committee's statement that "disclosure is right in principle and necessary to protect those who trade with and extend credit to limited companies" and therefore endorsed the recommendation to abolish the status of exempt private company. In the Second Reading Debate on the Bill which became the Companies Act 1967 the President of the Board of Trade said: "Limited liability is, of course, to the general advantage and has made a huge contribution to economic growth in this country over many generations. But it is also a great privilege conferred by Parliament on privately-owned business, and Parliament and the public can reasonably expect limited companies to accept obligations in return. That is our justification for imposing this new duty on more than 400,000 companies" (*Hansard*, February 14, 1967. Volume 741, No. 143. Column 360). The Government also agreed with the Jenkins Committee's statement that "a company's turnover, considered in conjunction with other information, can provide investors with a useful guide to the progress of the business". The changes not based upon recommendations of the Jenkins Committee are those concerned with directors' emoluments, the salaries of highly paid employees, the turnover of and profit attributable to each substantially different class of a company's business, the number of employees and their wages, and exports.

17.7 Since one important purpose of abolishing the status of exempt private company was the protection of those who trade with or extend credit to limited

5. We hope that the CBI, or another authoritative source, will consider publishing further guidance, in consultation with the Registrar, on the treatment under the Acts of agreements, particularly trade association recommendations and information agreements, with special reference to the grounds for exemption from reference to the Court under Section 9(2) of the 1968 Act (paragraph 16.33).

we appreciate the extreme difficulty for him of producing a guide which would be adequately detailed but which could not later be quoted in court in defence or extenuation of agreements; it would be easy for defendants to claim to have been misled by official guidance and thus to prejudice the court's proceedings. However, in the past the Registrar has been willing to examine and comment on guidance produced by trade associations for their members, thus making his expertise available to the authors without giving the resulting publication the status of an official statement of the legal position. He has informed us that he would be willing to do this again, if consulted. To our knowledge no such guide has been produced since the passage of the 1968 Act. **We hope that the CBI, or another authoritative source will consider publishing further guidance, in consultation with the Registrar, on the treatment under the Acts of agreements, particularly trade association recommendations and information agreements, with special reference to the grounds for exemption from reference to the Court under Section 9(2) of the 1968 Act.**

The cost of proceedings under the Acts

16.34 We have been told many times that agreements have been withdrawn or abandoned, although their sponsors believed them to be defensible, because the legal costs of a defence in the Court are extremely high. The National Chamber of Trade claimed that: "whether or not an agreement is to be justified is decided not by whether the agreement is believed to be in the public interest, but by the enormous cost involved in the highly specialised legal field that has built up around the Acts". This may be going too far, and a distinction should in any event be made between those agreements made by a small number of small firms, and agreements which involve a large number of small firms. In the latter case, where there may be some thousands of members, the cost to the indivdual firm may be quite low, though the difficulty of raising a defence fund or increasing members' dues may be considerable. Even in the former case it is reasonable in theory that the parties to an agreement, who may be presumed to benefit from it, should bear the cost of its defence. We do not accept a statement made to us by the National Chamber of Trade in a submission which has since been published, that the cost of defending agreements has caused them to be abandoned "even where justification is simple and obviously in the public interest". We have no doubt that if the justification for an agreement were simple and obviously in the public interest the Registrar would make use of his power under Section 9(2) of the 1968 Act to seek exemption from referring it to the Court. The central point about the cost of proceedings, however, remains valid; small firms and even trade associations mainly composed of small firms may be at a special disadvantage if the defence of an agreement, even one found to be in the public interest, requires heavy expenditure. We can think of no remedy for this difficulty other than the general proposition that the Registrar and the DTI should be encouraged to use the power of exemption as liberally as possible, having due regard to their overriding duty to protect the public interest.

The position in the EEC countries

16.35 In the event of the United Kingdom becoming a member of European Economic Community, it would be obliged to accept the EEC rules on Competition Policy. Article 85(1) of the Treaty of Rome prohibits much the same sorts of agreements as those controlled in the United Kingdom, but the prohibition

they had wished it: the campaign of the Motor Agents' Association against trading stamps, which ran for over a year before action was taken by the Restrictive Practices Court, does not appear to have been very effective in curtailing their spread. There seems to be a danger that the principle of treating trade association recommendations as if all members had agreed to abide by them has rendered trade associations unable to take up what we would regard as legitimate attitudes on matters of public controversy. In these two cases, this inability could only be harmful to a small firm; no other kind of business could be in any doubt as to the advantages and disadvantages of trading stamps and bank credit cards.

16.30 Perhaps more inhibiting than the requirement to register known recommendations is the uncertainty of trade associations as to whether particular statements will be held to be recommendations and therefore registrable. The 1968 Act for the first time provided sanctions for failure to register. An agreement not registered in due time (i.e. before it comes into effect or within three months if that is earlier) is void and it is unlawful to give effect to the restrictions. Since restrictive agreements can be oral, it is very easy for a trade association official, perhaps in a speech to members, to give advice that may be held to be a recommendation. If he does, it is the duty of the association to register the recommendation. But very frequently a recommendation could be implied without intention or even awareness on the speaker's part, since the law is complex and difficult even for specialists to interpret. In such cases the recommendation will not be registered, and this failure could be very expensive, since under Section 7(2) of the 1968 Act any person who suffers loss as a result of an unregistered agreement may sue for civil damages. Trade association officials must therefore exercise great caution in advising their members, for an injudicious remark may lead to a civil action for damages. In addition, the Registrar may apply to the court for an Order restraining the parties from giving effect to the agreement or from making any other agreement without registering it in due time. However the Registrar has a discretion about applying for such an Order and he has said that he would not propose to do so if he were satisfied that illegal acts will not recur without an Order. In this connection he would take into account the nature of the void restrictions, the familiarity with the requirements of the Acts which it is reasonable to expect from the parties to the agreement and, assuming that the default was due to ignorance or oversight, the steps taken when it became apparent to them. Nevertheless the commission of an offence under the Acts is a serious matter, and the natural tendency of trade associations in these circumstances is to err on the side of excessive caution, with the result that their members are deprived on occasion of some inoffensive and useful advice.

Information agreements

16.31 It is too early yet to say whether the bringing of information agreements within the definition of registrable agreements will add significantly to the difficulties of trade associations. The Restrictive Trade Practices (Information Agreements) Order 1969 came into operation only in February 1970 and there have been no proceedings under it. The Order provides for the registration of agreements between two or more parties for the furnishing of information about the prices, terms and conditions on which goods have been or are to be supplied. No Order calling up for registration agreements about costs has yet been made.

were members of trade associations some of whose rules or recommendations were so defined by the Act. The agreements were initiated and enforced—so far as they were enforced at all—by the associations, and this was one of the most important and characteristic functions of the associations. For the main purpose of a trade association is to provide a degree of security and protection for its members, and a restrictive agreement, by shielding participants from competitive forces, is intended to do precisely that. (The desire for security and stability is no doubt the most common motive for joining a trade association.) Since the great majority of restrictive agreements have now been withdrawn or amended by the removal of significant restrictions, the function and raison d'être of trade associations have been radically altered. In general they can no longer operate as trade protection societies, but must hold their membership by virtue of the advisory and representational services they can offer. Many trade associations have given evidence to us about the Restrictive Practices Acts, but none has advocated reversion to the state of affairs which existed before 1956, perhaps because they recognise that in present conditions this is not a practical possibility. They do complain, however, that as a result of the legislation they are now prevented from rendering what they regard as legitimate services to their members. In some cases, the interests of the public are said to have suffered in consequence. If it is true that trade associations are seriously inhibited in their legitimate activities by the Acts, it is prima facie likely that small firms have been the main sufferers, since they have in the past relied heavily on trade association guidance on a wide range of subjects, from pricing policy and trade promotion schemes to the interpretation of the law.

16.26 The term "restrictive agreement" covers a wide variety of practices, and it is misleading to talk about them as if they were homogeneous. For our purposes it is helpful to distinguish between three types of agreement involving trade associations. First, there is the overtly restrictive agreement, whereby members of an association agree, or are bound by the rules of the association, to observe common policies on certain matters. Such agreements might be enforced by sanctions such as the threat of expulsion from the association, and whether this were so or not, to the extent that they were observed they limited the freedom of participants to decide their own trading policies and thus restricted competition. Secondly, there are recommendations, whereby a trade association might suggest a certain course of action to its members, without explicit sanctions (though we are aware of cases in which the threat of sanctions was implied). Under the 1956 Act, recommendations were held to have the force of agreements, since it was assumed that members would act upon them, and recommendations whose acceptance would entail restriction of competition thus became registrable. Thirdly, there is "advice" given by an association to its members. This can be done in a manner which constitutes an express or implied recommendation which, if the subject matter were one of the registrable restrictions, would be caught by the Act. Purely factual information cannot, of course, be held to be an agreement, but in some cases the court has held that factual statements have been made in such a way as to suggest a certain course of action, and thus to approximate to recommendations. One particular form of "advice" was explicitly dealt with in the 1968 Act: "information agreements" under which firms agreed to inform each other of intended price changes were to be registered, and in some cases the publication by trade associations of average price lists has been declared a restriction of this sort.

The question of price discrimination

16.22 The competitive weakness of small firms in some industries can be accounted for simply by the greater efficiency of large plants or capital-intensive processes: the dominance of large companies in these industries reflects this economic fact and the nation benefits from it. In other industries, however, where economies of scale are less important, it seems that it is the use of great market power, particularly buying power, which enables the large company to achieve dominance. An obvious example is the retail grocery trade. There are economies of scale in retailing, but they are comparatively slight: in themselves they cannot account for the growth of the great supermarket chains, which has been the most dramatic development in retailing since the war. In our view one of the main reasons for the success of the chains, and for the comparative rarity of "independent" supermarkets, is the ability of the chains to exact highly advantageous terms from food manufacturers and other suppliers. This enables them to offer goods at prices which the independents, no matter how efficient they are, cannot match, or to apply the additional margin in other methods of promotion. To some extent, of course, the advantageous buying prices of the chains reflect real savings in the costs of the suppliers; regular purchases in very large quantities offer economies in production planning and delivery costs which it is reasonable for the manufacturer to share with the distributors who make them possible. However, we do not believe that these true cost savings wholly account for the very large price differentials achieved by some multiples. In these cases the distributors are using their great buying power to exact concessionary prices, reversing the dominance of manufacturer over retailer which was formerly characteristic of this trade. In itself this transfer of benefits need not concern us: so long as the manufacturers stay in business and there is competition between the multiples, the public may be presumed to benefit (though this massive shift of bargaining power from manufacturers to distributors, which has happened in other industries as well as food manufacture, could, by inhibiting sufficient investment in the long term have serious consequences for a country heavily dependent on exports of manufactured goods). However, the shift in the balance of power within the retail trade may be more serious in the long term. The point is that the advantages which price discrimination on this scale gives to the multiples cannot be overcome by increased efficiency in operation on the part of the independents. The growth of the "voluntary group" movement was a reaction to the buying power of the multiples, and it has had considerable success, but the *1966 Census of Distribution* showed that members of voluntary groups still had appreciably lower gross margins, on average, than multiples. Furthermore, the "voluntary group" movement is largely confined to food retailing and even within that trade very many retailers are not members of groups. The consequence is that independent retailers, who are unable to obtain supplies at comparable prices, cannot expand their operations and, as has happened on a substantial scale, may be forced out of business or sold to large competitors. Moreover, to the extent that the special discount to major buyers depends on the continuation of a substantial volume of trade at full prices, and does not merely represent an acceptable reduction in the overall profit of the manufacturers, the benefit to the public is likely to be transitory, and may be dearly bought in terms of the long-term reduction of competition in the industry. Nor is the problem of price discrimination confined to retailing. In other industries small firms may suffer from discrimination practised by vertically integrated competitors, who are able to control the prices at which their smaller competitors obtain supplies.

the first place, it is very hard to demonstrate that significant economies of scale generally flow from merger activity. Many takeovers appear to be defensive in purpose—that is, intended to maintain existing market shares or to eliminate competition. There is certainly no evidence that increasing concentration in a given industry necessarily leads to growth in sales or improvements in productivity.[1] Economies of mass production are achieved mainly by concentrating manufacture within one plant, but the effect of most important mergers is more often to bring many dispersed plants under a single management. It is true that economies in marketing, in purchasing or in finance may be achieved in this way, but too often these appear to be outweighed by the diseconomies associated with remote and over-stretched management. There is danger in excessive readiness to encourage concentration in the hope of increased efficiency. In the second place, we do not find it impossible to conceive of restrictive agreements which would produce economies of scale. The rationalisation of production could be achieved by agreement, as well as by amalgamation. For example, two manufacturers of a complementary range of products might agree to specialise in different parts of the range, each installing only the machinery best suited to his speciality and thus avoiding wasteful duplication. (Uncertainty as to the investment plans of competitors is a common cause of failure to invest: it may equally lead to gross over-investment.) That this can happen without detriment to the public interest has already been accepted by the Registrar and the Department of Employment and Productivity (then responsible for the Acts) in the case of a rationalisation agreement between Pirelli General Cable Works Ltd and Enfield Standard Power Cables Ltd. In December 1969 the Department gave a direction to the Registrar under Section 9(2) of the Act discharging him from referring the agreement to the Court on the grounds that the restrictions it contained were "not of such significance as to call for investigation" by the Court. This agreement was between two large companies in a highly concentrated industry—the manufacture of supertension cables—and it brought about a significant rationalisation of the UK industry. We do not suggest that rationalisation agreements between small firms could produce economic benefits on this scale, but they would have advantages for the firms concerned and could produce genuine efficiency gains, to the benefit of the economy generally. We therefore think it too simplistic to argue that restrictive practices benefit only the participants while mergers are presumed to benefit the national interest, and to justify the differentiation in policy between them on that ground alone.

We are aware, of course, that rationalisation agreements containing no significant restrictions can already be exempted from reference to the Court under Section 9(2) of the Act (though we doubt whether many small firms would have this possibility in mind when considering whether to set up an agreement with other concerns since their knowledge of the restrictive practices law does not often extend to such subtleties). But we are using rationalisation agreements only as the most obvious example of the efficiency gains that might be derived from certain restrictive agreements. We think it possible to go further, and to suggest that the efficiency of the structure of industry as a whole might be improved by treating restrictive agreements between small firms with special leniency. What we have in mind is that the competitive weakness of small firms in many industries could be remedied by permitting them to combine in small groups offering some of the

[1] See S Moos, *Aspects of Monopoly and Restrictive Practices Legislation in relation to Small Firms*, Research Report No. 13.

firms in restrictive agreements. The Department examined ten per cent of the 3,000 agreements on the register and tried to estimate the number of small firms involved in each. The task proved exceedingly difficult and the figures that follow inevitably provide only a rough indication of the orders of magnitude involved.

16.15 This study suggested that about three-quarters of all agreements registered (about 2,200 of the 3,000 agreements) involved small firms (together with large firms in many cases) and that of these agreements about three-quarters were organised by trade associations. Most of them have now been brought to an end, perhaps only 10 per cent being still current. About 90 per cent of the agreements involving small firms were "horizontal"—that is, they involved no "vertical" arrangements between manufacturer and wholesaler or manufacturer and retailer. About 60 per cent were between manufacturers. Over 90 per cent of the agreements involved some form of common pricing arrangement, usually accompanied by other restrictions on, for example, tendering, quotas, patents or technology. About half the agreements had only regional or local, rather than national, application.

16.16 It is again difficult to compare the number of firms involved in these agreements with the total small firm population. Since 1956, when the first agreements were registered, many of the participants will have merged or grown out of the small firm category and many more will have gone out of business. The figures suggest, however, that in 1957 a very large proportion of all small firms in the country were parties, presumably through membership of trade associations to restrictive agreements and were thus to some extent shielded from competitive forces. As a broad estimate only about 10 per cent enjoy such protection now. The legislation has therefore radically changed in this respect the environment in which small firms operate.

16.17 The effects of this change ought of course to have been to the advantage of progressive small firms. They have benefited from the prohibition of various forms of collective discrimination which were formerly practised against them, and from the disappearance of such practices as aggregated rebate schemes which can be regarded as a form of discrimination in favour of large buyers. The outlawing of collective exclusive dealing agreements whereby, for example, a group of manufacturers might give an undertaking to a powerful customer or group of customers not to supply potential competitors, ought to have facilitated the entry of new firms into a number of trades. Again, the collective enforcement of rules, whereby trade associations would cut off supplies or withdraw membership from traders who cut prices or otherwise stepped out of line, has been brought to an end. Such practices were common before 1956 and were most frequently employed against small firms. The legislation has thus removed inhibitions on the ability of enterprising small firms to use their fullest competitive strength. Small firms must also have benefited from those modifications to standard terms and conditions (whereby discriminatory or other unfair provisions were removed) which the Registrar has required as a condition of making representations (under Section 9(2) of the 1968 Act) to the DTI that an agreement need not be referred to the Court. Nevertheless some small firms, and more especially their representatives, the trade associations, have complained that on balance the interests of small firms have suffered, rather than benefited, from the legislation. Of course the prime purpose of the legislation was the protection of the

economic welfare because of the higher levels of costs and prices which follow from such restrictions. This was the general conclusion of the Monopolies Commission inquiry into *Collective Discrimination* (Cmd. 9504). Their report, published in 1955, was the foundation for the Restrictive Trade Practices Act, 1956.

16.10 The 1956 Act required the registration of certain types of restrictive trading agreements and their subsequent examination by the Restrictive Practices Court. It was directed exclusively against *collective* practices; restrictive practices operated by a single firm, however large and dominant, are not covered by the Act though they may be caught by the Monopolies Acts. Broadly, an agreement is registrable if:

i. there are two or more parties to it engaged in business in the United Kingdom in the production, supply or processing of goods;
ii. more than one party to it accepts restrictions—that is, some limitation on his freedom to make his own decisions; and
iii. the restrictions concern such matters as prices to be charged for goods, conditions of sale, persons to whom goods may be sold, quantities or kinds of goods to be made, sold or bought.

Agreements relating to the employment of workers and the provision of services are not registrable. Nor are agreements relating solely to exports, though these must be notified to the Department of Trade and Industry. Because the Act was concerned with the practical rather than the legal effects of agreements, it is immaterial whether the agreements are oral or in writing, and whether or not they are intended to be enforceable at law. For the same reason—and this is of the greatest importance to small firms—the Act operates in relation to specific recommendations made by trade associations to their members as if the members agreed to comply with the recommendations. Such recommendations are thus in themselves registrable agreements. In the case of agreements made by trade associations (e.g. with other trade associations) the Act operates as if the members of the associations were parties to the agreement.

16.11 The 1968 Act amended Part I of the 1956 Act so as to make its operation more flexible and to improve its enforcement. One important change was that "information agreements" were brought within the coverage of the Act. An information agreement is one by which two or more parties agree to exchange information about one or more of the matters covered by the 1956 Act or about costs. Such agreements need not be registered until the Department of Trade and Industry makes a Statutory Order calling them up for registration; so far only one Order has been made, calling up information agreements relating to prices and to terms and conditions. This Order came into effect in February 1970. The 1956 Act also laid down the criteria by which restrictions are judged. The court may declare that any relevant restriction is contrary to the public interest unless satisfied that it falls within one or more of the "gateways" and, if it does, that it is not unreasonable having regard to the balance of advantages thus established and to any "detriment" arising from the operation of the restriction. One of the "gateways" is general and allows the parties to put forward whatever benefit they think their agreement confers on the public; what they must establish is that removal of the restriction would deny to the public as purchasers

it received only nine references from the Board of Trade, some of which concerned very small sectors of the economy, and although the number of references increased thereafter, by 1956, the year of the first Restrictive Trade Practices Act, only 22 references in all had been made. The Board of Trade's use of its powers under the Monopolies and Mergers Act of 1965 was similarly cautious. Of about 560 proposed mergers (not all of which materialised) considered by the Board of Trade[1] from August 1965, when the merger provisions came into effect, only 14 have been referred to the Commission. Mergers subject to consideration were those which appeared likely to create or intensify a monopoly situation (one-third of the supply of goods or services in the United Kingdom) or involved the taking over of total assets valued at more than £5 million. In less than 3 per cent of cases therefore did the Board feel that there was *prima facie* ground for considering that there might have been detriment to the public interest. Given the great wave of takeovers and mergers which swept over British industry in the later 1960s a more active consideration of its implications for the long term performance of the economy might have been expected.

16.6 It is of course true that the moral or exemplary effect of the Monopolies Commission's reports may have been far greater than the practical consequences of their recommendations. It is also true that both Government and industry have been greatly concerned with the alleged need to create enterprises of sufficient financial and technological power to compete effectively in international markets, and against imports, even where this might be expected to result in excessive dominance of the home market. But after making due allowance for these objectives we still feel that the operation of monopolies and mergers policy has been too exclusively concerned with discouraging certain kinds of market behaviour and has neglected what we believe to be the even more important need to maintain a competitive and balanced industrial structure. The legislation has not greatly affected the process of concentration, from which the potential to exercise market power arises. In determining the public interest too much weight has been attached to claims that greater size necessarily produces greater efficiency. Even where this proposition is likely to be true, there has apparently been little consideration of whether the efficiency gains could have been obtained in other ways less destructive of competition. Effective competition should ensure that firms operate efficiently and that the benefits are passed on to consumers; a restriction on certain types of behaviour can only prevent the abuse of market power and provides no guarantee of the more positive benefits of the competitive process.

16.7 Because it is our belief that small firms play an essential part in the competitive process we welcome the intention of the Government to strengthen the Monopolies Commission and widen its scope and powers as a "body for promoting competition throughout the economy".[2] We hope it will be encouraged to pay special attention to problems of industrial structure, and that in those industries where it is appropriate a determined attempt will be made to influence the long term environment so as to allow small firms to make their maximum

[1] Until October 1969 the Board of Trade was the responsible department. Then these functions were transferred to the Department of Employment and Productivity. In October 1970 responsibility was vested in the Department of Trade and Industry.

[2] See *House of Commons Hansard* Vol. 808 No. 58, 17th December 1970—Statement by the Secretary of State for Trade and Industry (col. 1578).

CHAPTER 16: The Monopolies and Restrictive Trade Practices Legislation

Introduction

16.1 The development in this country of a body of law, and of official policy, concerned with competition and the control of monopoly is entirely a post-1945 phenomenon. It is true that the origins of the law may be found much further back, in the old Common Law doctrine that conspiracy in restraint of trade is against the law, whatever its economic effects; but proceedings under this law were exceedingly rare in the first half of this century, and it may reasonably be said to have fallen into abeyance. During the inter-war period, and particularly in the 1930s, public policy became increasingly favourable to the growth of cartels, monopolies and restrictive practices. In sharp contrast to the situation in the United States, not only were there few legal restraints on the establishment of cartels and the use of monopoly power, but Governments took the initiative in promoting the cartelisation of some major industries and the "rationalisation" of others. The experience of the early years of the Depression, when severe problems of surplus capacity were exacerbated by fierce price competition, had undermined belief in the ability of a competitive system to meet the needs of a modern economy. The gradual abandonment of the free trade policy, completed in 1932, reflected this loss of confidence and, by removing from British industry the pressure of foreign competition, facilitated the spread of price-fixing and market-sharing arrangements. These tendencies were further encouraged during the Second World War, when in many industries competition was overridden by official control over the employment of labour, the use of services and materials (particularly imports), the nature, quality and quantity of goods produced and the prices charged for them. After the war, an important concern of industry, and the main concern of trade associations, was to defend established positions, that is, to achieve security rather than growth. It is important to remember, when considering the effects of monopoly and competition policy, that for many years it was assumed by both industry and Government that a high degree of constraint on the working of competition was necessary for the stability of the economy. This historical background largely accounts for the hostility with which industry regarded, and to some extent still regards, the monopolies and restrictive practices policy.

16.2 Official concern with the potential for harm of monopoly powers and restrictive agreements may be traced back to the White Paper on Employment Policy (Cmd. 6527) presented to Parliament in May 1944 by the Minister of Reconstruction. This stated that:

> There has been in recent years a growing tendency towards combines and towards agreements, both national and international, by which manufacturers have sought to control prices and output, to divide markets and to fix conditions of sale. Such agreements or combines do not necessarily operate against the public interest, but the power to do so is there. The Government will therefore seek power . . . to take appropriate action to check practices which may bring advantages to sectional producing interests but work to the detriment of the country as a whole.

There have been four major pieces of legislation in this field:

> The Monopolies and Restrictive Practices (Inquiry and Control) Acts 1948 and 1953.

TABLE 15.III

(See paragraph 15.7)

Retailing

This is defined as firms classified to MLH 820 (1958 SIC).

Small firms defined as those with less than £50,000 annual turnover—in 1966, about 97% of all firms in retailing.

Statistical inquiries sent to retailers

A. INQUIRIES COMPLETED ONLY BY LARGE FIRMS

1. Fuel return (monthly).
2. Employment return—reference L5 (monthly).
3. Trend of profits enquiry (quarterly).
4. Return of PAYE numbers, pay and tax deducted (quarterly).
5. Survey of company liquidity (quarterly).
6. Inquiries into superannuation and pension funds (quarterly, annual).
7. Inquiries into overseas financial transactions (quarterly, annual and three-yearly).
8. Inquiries into investment intentions (three times a year).
9. Annual inquiry into capital expenditure, turnover and stocks.
10. Earnings and hours of sales staff—reference ERD (annual, but ceased in 1969).
11. Analysis by occupation of numbers employed—reference L9 (annual, but ceased in 1969).
12. Census of Distribution—inquiry into floor space and self-service trading (*ad hoc*).

B. INQUIRIES COMPLETED BY SMALL FIRMS AS WELL AS LARGE: ESTIMATED PERCENTAGE OF SMALL FIRMS AFFECTED BY EACH INQUIRY

Under 1%

1. Continuing survey of road goods transport.
2. Monthly inquiry into hire purchase and other instalment credit business.
3. Monthly inquiry into retailers' stocks.
4. Quarterly inquiry into capital expenditure.
5. (New) earnings survey (annual).
6. Census of Employment (1969 pilot exercise)—reference ED 90.
7. Transport costs survey (*ad hoc*).

1–5%

1. Monthly inquiry into turnover.
2. Annual inquiry into capital expenditure and stocks.

6–9%

1. Census of Distribution—inquiry into transport costs (*ad hoc*).

10–19%

1. Sample Census of Distribution (approximately ten-yearly).

TABLE 15.II (*continued*)

6. Survey of engineering, technological and scientific manpower (three-yearly).
7. Census of Employment (1969 pilot exercise)—reference ED 90.
8. Survey of labour costs (*ad hoc*—held in 1964 and 1968).

6–9%

1. Monthly "production" inquiries.*
2. Inquiry into business expenses and receipts (five-yearly).

10–19%

1. Quarterly "production" inquiries.*
2. Earnings of administrative, technical and clerical staff—reference SL (annual).

20–29%

1. Employment returns—reference L2, 4 and S2, 4 (monthly).
2. Earnings and hours of manual workers—reference WE (six-monthly).

70–79%

1. Exchange of group B National Insurance cards—number of insurance cards held (annual).

90% plus

1. Quinquennial Census of Production.

   About a quarter of small firms completed the "long" form—reference CP3 (i.e. those with 25–199 employees);

   another third the "short" form—references CP1

   the remainder were only required to complete the simple preliminary inquiry form—reference CP2. Well over half these firms did not respond to this and were therefore sent form CP3 at a later date.

Source: Evidence of the Central Statistical Office.

Note

***Production inquiries—**

This term is used to describe the inquiries which are directed at particular sectors of manufacturing industry by sponsoring production departments, which request figures on the output of a particular product, or a restricted range of products, with a minority asking also for some related information. There are about 225 inquiries in all—42% of these are monthly; another 42% quarterly (these tend to have a greater number of participants each and therefore reach a larger proportion of firms than the monthly inquiries); the majority of the remaining 16% are annual. In most instances, a respondent to this range of inquiries would contribute to one or occasionally two of these inquiries only, depending on the nature of his business.

TABLE 15.I

(See paragraph 15.7)

Incidence of statistical inquiries sent out by Government departments

Numbers of inquiries, or inquiry-types, received by firms

Industry or Trade	(1) *Total No. of inquiries received by each industry*	(2) *Inquiries in Col. (1)* *(A) completed ONLY by LARGE Firms*	*(B) completed by SMALL firms as well as large*	*Inquiries in column 2(B) allocated according to the estimated percentage of small firms affected*											
				Under 1	1–5	6–9	10–19	20–29	30–39	40–49	50–59	60–69	70–79	80–89	90 *plus*
Mining and quarrying	25	14	11	5	1		2				1			1	1
Manufacturing	34	6	28	12	8	2	2	2					1		1
Construction	35	17	18	7	3	2	2		1					/	3
Road transport	18	9	9	4	4			1							
Wholesaling	25	8	17	11	1	1	2			2					
Retailing	26	12	14	8	2	1	1	1							1
Motor trades	20	8	12	6	3			1	1						1
Miscellaneous services*	23	Not applicable	Not applicable	16	2	2	1	2							

Source: Evidence of the Central Statistical Office.

Notes:

1. Columns 1 and 2 refer to the maximum number of inquiries which theoretically could be received by firms in each category, though, in practice, very few organisations would receive this number. The further analysis of column 2(*B*) allocates inquiries according to the proportion of small firms affected *by each inquiry*. Taking Mining and Quarrying as an example, this means that 5 inquiries have each been independently assessed as reaching under 1% of small firms. It is not possible to state, without making a detailed examination of all the registers involved whether the same firms are affected by all 5 inquiries; or entirely different firms are involved each time; or there is some partial overlap between them.
2. Column 2(*B*) also includes the very small number of inquiries that are completed only by small firms.

* The figures for Miscellaneous services, relate to firms of all sizes.

NB There are two important qualifications to this table. First, it weights all inquiries equally, whereas they differ greatly in length, complexity and frequency. Secondly, where a number of inquiries is shown as going to, say 10% of small firms it is very unlikely to be the same 10% in each case, so that the burden is more widely and fairly spread.

15.34 **Recommendations**

1. The effect on small firms of all statistical surveys should be carefully considered and every effort made to extend the present practices of sampling and of exemption of smaller firms wherever possible (paragraph 15.9).

2. The Survey Control Unit of the CSO should be given power to amend or veto all statistical surveys not meeting with its approval on grounds of expense, necessity, coverage or design (paragraph 15.11).

3. This power should extend to all departments of Government and to those quasi-Government bodies which commonly issue statistical enquiries (paragraph 15.12).

4. The use of statutory powers for the collection of statistics should be strictly controlled and in all cases explicitly justified (paragraph 15.12).

5. It should be clearly stated on every statistical enquiry whether or not its completion is obligatory (paragraph 15.13).

6. The development of the Central Register of Businesses is strongly commended, and it is hoped that resources adequate to ensure rapid progress will be devoted to it (paragraph 15.15).

7. In this context the CSO should reconsider the question of the preparation and publication of an enterprise census which would provide comprehensive coverage of all firms as soon as possible as part of its plans for the development of business statistics (paragraph 15.16).

8. The true cost of any statistical exercise, and not merely the often comparatively small proportion of cost falling on Government estimates, should be fully taken into account before starting an enquiry, and methods chosen which involve the least *total* cost rather than least Government expenditure (paragraph 15.18).

9. Any proposal for a new or revised statistical exercise should include an estimate in man-hours of the time required by respondents to complete the form (paragraph 15.18).

10. All departments should review all existing and proposed forms with an eye to their cost to industry—this review to extend to a reconsideration of the policies and administrative procedures giving rise to the need for these forms. Departments should also accumulate the total costs to industry of the forms for which they are responsible and review them annually (paragraph 15.29).

11. The Director of Statistics of every department or agency should be charged with more specific responsibility for all administrative forms issued by his department, and should be represented in all departmental deliberations about any policy or procedure with form-filling implications (paragraph 15.29).

12. Administrative forms should be designed wherever possible to serve statistical purposes, especially where this will permit the suppression or simplification of a statistical form (paragraph 15.31).

13. All statutory barriers to the passage of statistics between different departments should be stringently examined and demolished wherever possible. We regard this as of particular importance in the case of statistics collected by the Inland Revenue (paragraph 15.31).

14. The Government should quickly establish within a central department a powerful and expert secretariat whose function would be to plan, in collaboration with the CSO, an integrated system of administrative and statistical returns based

that due thought is given to the use of administrative returns for statistical purposes. Nor, finally, do we believe that these defects will be rectified unless the Permanent Secretary in each department concerned gives clear instructions that his Director of Statistics must be represented in all departmental deliberations about any policy or procedure with form-filling implications. **We therefore recommend that the Director of Statistics of every department or agency should be charged with more specific responsibility for all administrative forms issued by his department, and should be represented in all departmental deliberations about any policy or procedure with form-filling implications.**

15.30 *The long term.* Though our proposals for the short term would represent a significant improvement on the present position within Government departments, we must make it clear that we are putting them forward as no more than a necessary stop-gap. In the longer term they will be overtaken by a technological revolution in the arrangements for the collection and processing of data by the Government machine. We forsee a time, in the not very distant future, when Government will be obliged, by changing technology—the increased use of computers for the transfer and storage of information—and by the sheer weight of paperwork, to create an integrated and simplified system. We envisage that twenty years from now businesses will be required to make a carefully articulated annual cycle of returns which will suffice for purposes of tax assessment, for census and other statistical purposes, for the requirements of the Companies Acts and indeed for most purposes of Government. All departments would have access to the relevant and necessary data about all businesses, so that the need for many departmental surveys would disappear and those remaining could be simplified.

15.31 We have no doubt that it is an exceedingly difficult task to create an integrated information system. If, as we understand, some seven years will be needed to set up a Central Register of Businesses (merely the first stage of the total system), officials must be instructed to begin now to plan the system which will be needed in ten to twenty years' time. Two examples will give the measure of the task ahead. First, to secure the transfer of information between departments, or its storage in a data bank, would necessitate important changes in the legislation under which many statistical and administrative enquiries are carried out, because at the present time statutes for collecting statistics also impose on the collecting agencies obligations of secrecy. It will be a long and difficult task to persuade industry that its interests will be better served (as we are sure they will be) by the creation of an efficient information system than by the maintenance of confidentiality between departments. Second, it may well be equally difficult to persuade departments to surrender their autonomy to the extent that would be necessary if their administrative processes were to be redesigned to serve common as well as departmental purposes. We deliberately pass over without comment the technical problems, whose difficulty we can only wonder at. To recognise these difficulties, however, is merely to underline the importance of an early start on their solution, for we are convinced that the only issue is when, not whether, these changes will come about. **We therefore recommend that administrative forms should be designed wherever possible to serve statistical purposes, especially where this will permit the suppression or simplification of a statistical form. We further recommend that all statutory barriers to the passage of statistics between different departments should be stringently examined and demolished**

ment and size of profits[1]; although PAYE returns give a precise measure of employment, and corporation and income tax records reveal profit, the two sets of figures are never correlated. We accept that as far as the Inland Revenue is concerned, there may be no internal reason why they should analyse data in this way, but the consequence is that the economic departments, and other bodies, such as this Committee, are deprived of information unless they impose the burden of yet another statistical survey. Other departments also collect data for administrative purposes and fail to exploit them as a source of economic statistics. These problems will persist so long as departments are subject to no co-ordinating control over the administrative forms they generate. As we have seen, an attempt is being made to rationalise business statistics, and it might be thought that all we need is an authority in Government to subject administrative forms to the type of scrutiny that the CSO applies in the statistical field.

15.27 In the United States, where the reporting burden on industry is at least as heavy as in the United Kingdom, an attempt has been made to centralise control both of statistical and of administrative forms in the equivalent of our Central Statistical Office. The US Bureau of the Budget has responsibility to examine all proposed surveys and questionnaires from the point of view of their necessity and reasonableness and to give particular attention to their cost, including their cost to the respondents. They are expected to ensure that all surveys are designed for maximum usefulness to the Government as a whole and to the public where appropriate and to satisfy themselves as to the technical design of all forms issued. The only exclusions from their purview are tax and financial returns and reports by regulatory agencies. Since 1964 the Bureau has required that any proposal for a new or revised enquiry should include an estimate in man-hours of the time required by respondents to complete the form. As a result, the American businessman should feel confident that any form he is asked to complete has been scrutinised and approved by an impartial authority. It seemed to us very desirable that such a power should exist in this country and we have considered whether responsibility for administrative returns might be added to the CSO's present responsibilities. However, it appears that this is not a practical possibility. The CSO have assured us that with their present or foreseeable resources it would be quite impossible for them to undertake the task of vetting administrative forms. They have also argued—we think convincingly—that no statistical agency can reasonably be expected to carry out this task successfully, for two reasons. The first reason is that the overwhelming volume of administrative paper would make it impossible to give all administrative forms more than a cursory examination, so that the scrutineer would be effectively acting as little more than a rubber stamp. The second and much more important reason derives from the nature of administrative forms as an essential part of the administration of policy: unless the statistician or scrutineer were empowered to have his say on issues of policy he would be reduced merely to questioning the design of forms. For to suggest any more significant modification of an administrative form is normally to suggest the modification of some policy or administrative procedure. It appears that each of these problems has caused such difficulties in the United States that the Bureau of the Budget are now confined largely to looking at design aspects of administrative forms and even so find the burden almost insupportable. In a report published in 1968, the Senate Committee on Small Business found that

[1] The Inland Revenue could not, of course, divulge information about individual firms; we were seeking aggregated information, which raises no question of confidentiality.

paperwork in the longer term, will have the immediate consequence of adding marginally to the overall burden of form-filling on small businesses. Similarly, the new Earnings Survey will be based on a doubled sample size, so that more small firms will be affected. The new system of statistics on manufacturing industry will have a much greater effect. The proportion of small firms reporting output, etc, on a quarterly basis will increase from under one-fifth to about one-third and the frequency of reporting information on sales, purchases, capital expenditure, etc, will be annual rather than quinquennial. Detailed information on purchases will be required more frequently than in the past. All this will add markedly to the volume of form-filling in manufacturing industries —even though we are told that only the larger small firms, those with 25 or more employees in most industries, will usually be affected. It is to be hoped that the recommendations we have put forward can be put into operation as soon as possible and thus help to minimise these problems.

Administrative paperwork

15.23 If we have appeared critical of the Government Statistical Service we should make it clear that we applaud the urgency with which they have tackled the task of reform and the very real achievements that stand to the credit of the CSO and other parts of the Statistical Service. If in the rest of Government there were a similar readiness to appreciate the form-filling difficulties of small firms and equal energy in dealing with them, the problem with which we now have to deal would be much less severe. The volume of paperwork arising from the administration of Government policies dwarfs the statistics burden, in terms both of the number of forms generated and the cost to industry of completing them. This is of course inevitable; we have to recognise that practically all Government functions and almost every contact between Government and industry have to be carried out through the medium of forms. It would be pointless to try to list every administrative form; among those about which we have received complaints are Revenue returns, in particular PAYE returns, application forms for investment grants, claim forms for grants under the Industrial Training Act and purchase tax records, and these may be taken as a fairly representative sample. They exemplify the most common purpose of the administrative form, which is to facilitate transfers of money. The number and variety of these forms is so great that it makes no sense to discuss them in general terms save to say that their total impact on the small firm can be extremely serious. This is best illustrated by one or two quotations from the written evidence. The Pottery and Glass Wholesalers Association wrote that:

> the cumulative effect of taxes and levies such as import deposits, SET, Purchase Tax, training levy, bears more heavily on the small firm whose accountant finds himself increasingly engaged in non-productive work for the Government as a result of which the day-to-day business and future efficiency of the firm suffers. Large industrial organisations can afford to recruit additional staff to cope with this mass of paper work, the cost of which is more easily absorbed by their large turnover.

The CBI wrote that:

> It is noteworthy that more than two-thirds of the respondents to the CBI Questionnaire report that a reduction in the administrative work load imposed by Government would assist small firms significantly in their efforts to expand or improve their efficiency . . . the mass of current legislation and Government requirements in connection therewith require an immense amount of study and effectively occupy a good deal of management time.

Government expenditure. In this we might usefully adopt the present US practice which is described in paragraph 15.27. **We therefore recommend that any proposal for a new or revised statistical exercise should include an estimate in man-hours of the time required by respondents to complete the form.**

Timeliness of statistics

15.19 Several witnesses, including the Engineering Industries Association, have complained that official statistics are frequently published so late as to be useless. This is clearly going much too far but we ourselves were disturbed to find, when starting our Inquiry in July 1969, that the first results of the *1968 Census of Production* would not be available until mid-1971 and that the 1963 Census, itself not wholly analysed, was therefore the latest source of comprehensive information on the manufacturing sector. Similarly, the results of the 1966 sample *Census of Distribution* were not published in full until June 1970. In part, of course, this is the fault of respondents, some of whom are quicker to complain of the inadequacies of statistics than to complete the form sent to them. But in any case firms are given until three months after the end of their financial year to send in their completed returns. Part of the delay is also due to the stringent precautions and checks which have to be carried out because of the statutory protection of firms with regard to disclosure. We suspect that excessive concern for accuracy on the part of the statisticians also plays a part. It may often be possible, where all the results of a survey are not to hand, to impute results for those outstanding by extrapolating from those received without greatly detracting from the accuracy and value of the survey. There are difficult technical problems here, and we understand the Government Statistical Service is working on them. We would suggest that it is worth sacrificing a degree of accuracy to achieve greater speed of publication. Where small firms are concerned, both expense and delay are reduced by calling for estimates where audited figures are not readily available. Too often small firms turn over to their accountant questionnaires for which an accountant's standard of accuracy is unnecessary. Secondly, forms could be simplified in that the very technical notes and definitions now included in the form could be replaced by some short clear notes in layman's language. We are pleased to learn that the CSO are now giving high priority to improvements in speed generally and that a number of gains have already been made.

Value of official statistics to small firms

15.20 There is some justification for the small businessman's complaints that the statistics to which he contributes are frequently of no direct value to him when published. Most small businesses operate in a severely limited environment in terms of the number of their customers and suppliers and in a purely geographical sense. Furthermore, the majority of small manufacturers produce a narrow and rather specialised range of products, very often components of some larger product. National statistics cannot readily be presented in detail fine enough to be meaningful to such firms. Moreover, most small firms do no forward planning of significance; they plan only on a short term basis and the great value of statistics is in long term planning. To such firms national aggregates—say, of national output of their products—are far less valuable than to a large company whose actions significantly affect the size of its market and the behaviour of its competitors. This is not, of course, the whole story. The CSO have pointed out to us that there are ways in which the intelligent use of statistics can improve

less than 25 employees in most industries, or under 11 in a few where small firms are of particular importance in terms of the total output of the industry. The annual census will comprise the second component of the system, collecting aggregate information—totals of employment, wages and salaries, sales, purchases, stocks, capital expenditure and so on—covering the same units as the quarterly enquiries. The final component of the system will be the occasional—once every three of four years—enquiries into materials purchased and other subjects covered from time to time in the old quinquennial censuses. It is proposed to include all this information, together with other information relevant to the industry under review such as the latest index of production, import and export details, price information and so on, in a new series of quarterly publications.

The Central Register

15.15 Though such cases may be rare, we have seen examples of firms receiving far more than their fair share of inquiries in a year. No doubt this is the result of unfortunate coincidences—the same firms appearing in a number of different samples—but these are the cases which get publicity and they are not regarded by businessmen as grossly untypical. It is a weakness of the present organisation of Government statistics that the likelihood of such occurrences can only be guessed at and that little can at present be done to prevent or minimise overlapping samples. This is because most departments maintain separate registers of firms for their own purposes: there is no central register which would permit a single record of the respondents to each enquiry to be kept so as to facilitate sharing the form-filling burden more evenly. The statistical service is now working to create a Central Register of Businesses: its completion will be a considerable advance. Although, of course, overlapping cannot be wholly prevented because of the importance of random sampling, a Central Register would make it possible to minimise the number of occasions when firms are asked to provide the same information to several different agencies. It is perfectly reasonable for the businessman, having told one department the size of his output and the number of his employees, to feel resentment on being asked for the same information, perhaps within a few months, by another. It does not mollify him to be told that the internal organisation of Government departments makes the pooling of such information expensive or difficult; he would rather that the expense and difficulty were borne by the Government than by himself. **We therefore strongly commend the development of the Central Register and hope that resources adequate to ensure rapid progress will be devoted to it.**

15.16 When we began our Inquiry and tried to estimate the number of small firms in this country, we were surprised to discover that no comprehensive census, or even sample survey, had ever been carried out. Censuses were available for particular trades and industries, notably manufacturing and distribution, and for some other trades there were various more or less detailed *ad hoc* enquiries (for example, wholesaling), whereas for others (for example, hotels and catering) the information is far from comprehensive. Putting all the information together, we estimated that there were 1¼ million small firms in the country, of which a major proportion are not included in the censuses. This piece-meal approach, of course, has many disadvantages (the enquiries are held at different dates; it is difficult to standardise definitions; there are various size exemption

position of the CSO as part of the Cabinet Office and from the influence of the Director of the CSO, who is also Head of the Government Statistical Service. In conjunction with the issuing department, the unit examines projected new statistical inquiries, and also existing inquiries, and in the course of the reorganisation of industry statistics has also been able to question the requirements which they fulfil. As a result of its activities to date, some projected inquiries have been shelved or reduced in length and some existing inquiries reduced or eliminated. It would not be true to say that the unit promises to reduce very substantially the statistical burden: however it may at least arrest the upward trend in the burden, and at best effect some modest reduction.

15.11 In our view it is unfortunate that the CSO has no formal power, in the event of disagreement with a department about the necessity for, or the content of a statistical survey, to impose its view. If persuasion does not avail the department can go ahead whatever the view of the CSO. We would hope that outright disagreement of this sort is rare, but the fact that the CSO has no sanctions available to it means that in the last resort an unresolved disagreement with an issuing department must result in compromise or surrender by the CSO. The Survey Control Unit has operated so far on a relatively small scale and we would expect that its present methods of persuasion and guidance would prove excessively time-consuming if its coverage were much expanded. While the unit has made a promising beginning in its proposed role, we feel that the basic question of its authority requires further consideration. Formal powers might, in our view, be a solution and could be based on those of the Office of Statistical Policy in the US Bureau of the Budget. In the US no Federal agency may issue a new form to more than ten respondents without the approval of the Office of Statistical Policy. The only exceptions to this rule are certain fiscal, judicial and financial inquiries. We shall discuss later the effectiveness of the Bureau of the Budget's vetting of administrative returns, about which there is some doubt, but we see no reason why in the statistical field it should not be successful. **We recommend that the Survey Control Unit of the CSO should be given power to amend or veto all statistical surveys not meeting with its approval on the grounds of expense, necessity, coverage or design.** Such a control would give businessmen confidence that the costs and benefits of questionnaires had been adequately studied, in particular the costs falling on the respondent firms.

15.12 The influence of the Central Statistical Office is further diminished in that the survey control function is confined to central Government departments. Such creatures of Government as the Industrial Training Boards, the Economic Development Committees and the now defunct Prices and Incomes Board are not subject to the control. We think it important that they should be, since such bodies not only carry out many statistical surveys but also, in our experience, are the subject of complaints of the kind described in paragraph 15.5, and are not distinguished in the respondent's mind from central Government itself. **We therefore recommend that the survey control function of the Central Statistical Office should extend to all departments of Government and to those quasi-Government bodies which commonly issue statistical enquiries.** In particular all enquiries which are carried out under statutory authority, so that their completion is a legal obligation, should carry the imprimatur of the CSO. It has been suggested to us that departments are particularly inclined to authorise the collection of statistics likely to be of use to a nationalised industry. An example quoted to

nesses to complete. Of those inquiries which are completed by small firms as well as large, the majority go to less than 1 per cent of small firms. The general position may be summarised as follows: in manufacturing half of all inquiries go to no small firms or to less than 1 per cent of them. Outside manufacturing the equivalent figure is seven out of ten of all inquiries. A further four out of ten of manufacturing inquiries (two out of ten in other industries) go to between 1 per cent and 19 per cent of small firms. Only one out of ten of all inquiries go to 20 per cent or more of small firms and these are nearly all infrequent. However, there are two important qualifications to this Table. First, it weights all inquiries equally, whereas they differ greatly in length, complexity and frequency. Secondly, it should be made clear that where a number of inquiries is shown as going to, say, 10 per cent of small firms, it is very unlikely to be the same 10 per cent in each case, so that the burden is more widely and fairly spread than might appear from the Table. The implication of these figures is that the great majority of small firms are exempted from a very wide range of statistical inquiries and that the number of forms to be completed per firm is substantially less for small firms than for large ones. This impression is confirmed by examination of Tables 15.II, and 15.III which list, respectively, the inquiries sent to manufacturing industry and the retail trade, with the frequency of inquiries and the proportion of small firms covered by each. These show that the inquiries from which small firms are exempted include a large number of the more onerous and more frequent inquiries—such as, for example, the short term inquiries into stocks, capital expenditure, profits, investment intentions, liquidity, overseas financial transactions and use and stocks of fuel and steel, none of which go to more than one per cent of small firms. The inquiries which are sent to a higher proportion of small firms tend to be undertaken either annually or even less frequently.

15.8 The number of small firms as defined by the Committee is estimated to be of the order of 820,000. The CSO in their written evidence gave the following estimate of the average number of inquiries received per firm: ". . . of these more than 500,000 will typically receive forms in respect of one statistical inquiry only, or, much less typically, two; the frequency of receipt would be rarely more than annual and could be as infrequent as five—or ten—yearly. At the other end of the range—the largest 3 or 4 per cent of 'small' firms—respondents are typically likely to contribute to a short period output enquiry and a census output inquiry, the latter at annual or less frequent intervals, and probably to one, or perhaps two, inquiries in the labour field. Examples of firms contributing to more than four inquiries will doubtless exist but the number will be very few indeed".

15.9 We have tried to estimate the relative incidence of form-filling by calculating the number of statistical forms directed in an average year to small and large firms in manufacturing industry, remembering that manufacturing firms are the most heavily burdened. In doing this we have counted quarterly returns as four forms, monthly returns as twelve, etc. This method takes no account of the fact that, owing to a routine being developed, regular short-period inquiries may well be less burdensome than less frequent (even if regular) inquiries. Nor has any attempt been made to allow for the differing complexity of inquiries because quantitative information on this is not available. The calculations show that approximately the same number of forms are sent to each sector—430,000 forms to the small firm sector and 445,000 to the large firm sector. While each sector

seeking what is essentially the same information will define their needs in slightly different ways, so that the exercise carried out by the firm in response to the first request has to be done again with minor variations to meet the second. These variations may arise from genuinely different statistical, administrative and statutory needs in some cases, but we wonder whether, with more thought, some of them could not be eliminated. The problem is exacerbated under the present decentralised system, with each department solely responsible for its own administrative forms and largely for its statistical forms also, and with nobody responsible for planning and costing Government paperwork as a whole. We describe later the co-ordinating function of the Central Statistical Office in respect of statistical forms; the CSO has hitherto not been wholly effective in this respect because it lacks formal veto power, but we cannot emphasise too strongly the importance of the effort now being made to bring responsibility for all official statistics under a single authority. The degree of success achieved by this effort will determine the shape and content of our industrial statistics for many years to come. However we have found, to our dismay, that no parallel effort is being made to tackle the much larger problem of administrative forms, and that nobody in Government is charged with the responsibility of planning an integrated record system which would bring together all the available data about particular firms, whether derived from statistical returns or collected as a by-product of administrative procedures. Such a system, as we envisage it, would require the eventual establishment of a data bank, based on a central register of businesses, in which computerised records of all official transactions with businesses would be maintained for the use, (in unidentifiable or aggregate form) of statisticians, administrators, and, where appropriate, the public. It would be the basic source of business statistics and it should make possible a genuine reduction in the burden of official paperwork on industry—which otherwise appears certain to increase. The implications of this idea will emerge most clearly from a discussion of the problem as it now exists, so we shall defer further discussion until later in this chapter.

Official statistics

15.5 Statistical forms as we have defined them above are thought to account for a comparatively small proportion of the total number of forms issued to industry by Government. No estimate has been made in this country of the relative magnitude of the reporting burdens imposed on business for statistical purposes and all the other purposes of Government, but the Central Statistical Office have suggested that it would be reasonable to use the situation obtaining in the United States as a guide. There it has been estimated that at the end of 1969 statistical enquiries as we have defined them accounted for perhaps 15 per cent of the total reporting burden, measured in man-hours, placed on business by Federal agencies. Though it may be that the Americans collect and publish rather more economic statistics than we do, it is probably fair to assume that the proportion of statistical inquiries in this country is about the same—that is, somewhere between 10 and 20 per cent of the total form-filling burden. However, although many of our witnesses have not distinguished between statistical and administrative forms, where a distinction is made it is quite clear that statistical inquiries give rise to at least a substantial proportion of the complaints. The complaints most commonly received are the following:

CHAPTER 15: Form-filling: Statistical and Administrative Returns

Introduction

15.1 This chapter is concerned with the activities of Government departments and Government-created agencies as collectors and disseminators of information, and with the effect on the efficiency of small firm management of the volume of official paperwork with which they have to deal. Within this field, we shall distinguish between two sorts of forms, those whose only purpose is the collection of information for general statistical purposes—*statistical* forms such as the Censuses of Production and Distribution—and *administrative* forms—those which have a function in some administrative procedure, such as the collection of taxes, the issue of licences or the claiming of grants. The former are dealt with in paragraphs 15.5–22 and the latter in paragraphs 15.23–33. We are concentrating on Government because it is much the largest and most important source of the flood of paper which fetches up on the businessman's desk, but it is important to remember that much of what we shall say is relevant to a wider field than this. We have received vigorous complaints about, for example, trade association enquiries and about academic researchers.

Evidence of dissatisfaction

15.2 It came as no surprise to us that our invitation to witnesses to comment on "statistical and other returns required by the Government" produced a rich crop of complaints. Small firms have been complaining for years that the volume and complexity of official returns have been increasing to an intolerable extent. We claim no originality for the finding that small businessmen are seriously disturbed about the cost of form-filling in terms of executive time and the diversion of energies. This view is not confined to small businessmen themselves, moreover. The Midland Bank Finance Corporation told us that "the statistical and other returns required by the Government place an unreasonable burden upon the administrative structure of the small business". The Northern Economic Planning Council said "the burden of form-filling has increased relentlessly in recent years and falls particularly heavily on the small business with a sole proprietor, who, more often than not, is a 'practical' rather than a 'commercial' man". The root of the problem is that in most small firms the scarcest resource of all is management time, because as we have said in so many contexts, this usually means the time of a single hard-pressed man. His clerical and office staff is quite properly kept as small as possible and is therefore capable of dealing only with routine functions; any enquiry that is outside the ordinary, or which requires knowledge and understanding of the business as a whole, must be handled by the boss. The following is typical of evidence we have received from small firm proprietors on this point:

> Any returns required by the Government have to be filled in hastily by myself. I am not too sure what value they will be although they are done to the best of my ability in the time at my disposal. Since I am probably not alone in this, I wonder what use the combined attempts from the small firms are and how misleading they could be if anybody was trying to deduce accurate information for planning for the future.

Perhaps the most telling comment on this subject, however, was the reply of one of the small firms to whom this Committee addressed its questionnaire survey. It was as follows:

TABLE 14.I (*continued*)

Board (date formed in brackets)	*Total establishments/ firms within scope* (% small firms shown in brackets)	*Total employees* (% in small firms shown in brackets)	*Levy system*	*Net* 1969/70 *levy income* (% taken up by administrative costs shown in brackets)	*Provision for small firms*
Local Government (Voluntary board formed in November 1967)	No small firms	No small firms			No small firms in scope.
Man-Made Fibres Producing (February 1966)	42 ests. (4 firms) (No small firms)	55,710 (None)	0·05% of total emoluments	£33,308 (73·7%)	No small firms in scope.
Paper and Paper Products (May 1968)	1,838 firms (1,106 firms employing under 50)	228,327 (8%)	1·0% of total emoluments. Levy is "netted" against grants	£561,953 (15·5%)	Firms with emoluments under £30,000 are exempt from levy. A simplified claims procedure is planned. Firms with emoluments between £30,000 and £34,999 are reduced by £20,000, and for payrolls between £35,000 and £39,999 by £10,000 before assessment.
Petroleum (May 1967)	1,418 ests. (31%)	81,350 (22%)	£7 per employee. Netting of levy and grant is permitted.	£480,456 (9·5%)	The Board has established a Small Firms Advisory Committee. There is also a Management Advisory Committee for small firms. Firms employing under 11 are exempt from levy. Where there are between 11 and 20 employees the levy is £10 per head and the sum obtained is reduced by £60. There are 4 group training schemes in operation.
Printing and Publishing (May 1968)	10,445 ests. (88%)	380,000 (41%)	Levy of 1% of total emoluments or £19 per head whichever is less, is proposed. Netting of levy and grant is permitted.	£4,242,905 (5·9%)	There are 21 group training schemes in operation. The Board has surveyed the training requirements of companies employing under 75. Firms exempted from levy when emoluments less than £20,000 (small reductions in earnings before assessment; £50 in £20,000—£39,999 range).

TABLE 14.I (*continued*)

Board (date formed in brackets)	*Total establishments/ firms within scope* (% small firms shown in brackets)	*Total employees* (% in small firms shown in brackets)	*Levy system*	*Net* 1969/70 *levy income* (% taken up by administrative costs shown in brackets)	*Provision for small firms*
Electricity Supply (June 1965)	16 (No small firms)	218,000 (None)	0·05% of total emoluments	£93,667 (81·0%)	No small firms in scope.
Engineering (July 1964)	25,087 ests. (23,767 employing under 200)	3,406,750 (27%)	2·5% of total emoluments. Levy payments are "netted" against grants.	£87,079,000 (1·1%)	Exemption from levy under £35,000. Simplified general grant scheme for small firms is planned. Pays grant towards training officers employed by groups of small firms (defined as under 500) where impracticable to join in group training. There are about 170 group training schemes in operation.
Food, Drink and Tobacco (July 1968)	57,665 ests. (97·4%)	1,215,103 (in the 57,665 ests. for which data is available) (27%)	0·8% of total payroll. Firms with a payroll under £17,500 are excluded from levy but may opt into levy/ grant. Levy payments are "netted" against grants.	£8,501,904 (6·4%)	There is a working party on small businesses. There is a special grants scheme for small firms ("Training for Profit") There are 8 group training schemes in operation.
Footwear, Leather and Fur Skin (November 1968)	2,114 ests. (82%)	137,500 (57%)	1% of total emoluments. Emoluments are reduced by £1,000 before assessment. Netting of levy and grant is permitted.	£194,634 (25%)	

TABLE 14.I

Industrial training boards and small firms

(Levies published, approved or proposed at 30 July 1971)

Board (date formed in brackets)	*Total establishments/ firms within scope* (% small firms shown in brackets)	*Total employees* (% in small firms shown in brackets)	*Levy system*	*Net 1969/70 levy income* (% taken up by administrative costs shown in brackets)	*Provision for small firms*
Agricultural, Horticultural and Forestry (August 1966)	This sector is outside the scope of our Inquiry				
Air Transport and Travel (Set up in March 1967 as the Civil Air Transport ITB. Its name and scope were changed in March 1970)	210 ests. (NA)	84,000 (10%)	3·8% of total emoluments for BAA and UK airlines. The rest pay 2%. Travel agents pay 1%. Levy is "netted" against grants.	£509,776 (10·6%)	Firms with payrolls of under £10,000 are exempt.
Carpet (March 1966)	142 firms with 282 ests. (85 firms employ under 175)	48,346 (9·7% in firms employing under 175)	0·85% of total emoluments	£353,434 (5·5%)	Pays grant towards the cost of a senior instructor in companies with fewer than 500 employees and no full-time training officer. The Board sponsored a study by the Aston Small Business Centre in 1969 on the training needs of the small company. Firms employing under 11 are exempt from levy.
Ceramics, Glass and Mineral Products (July 1965; scope modified in May 1969)	3,259 (600 firms employ under 25)	359,000 (4·7% in firms employing under 25)	Between 0·75% and 1·5% of total emoluments varying by sector. Netting of levy and grant is permitted.	£3,708,292 (3·4%)	First £6,000 of earnings are exempt from levy. Special grant scheme for firms with a total emolument between £5,000 and £25,000. There are 15 group training schemes in operation.

needs of most small firms and that the only satisfactory solution to the difficulties we have recounted is for the boards to exempt them from the levy/grant system. Since we have seen no evidence that they are "poachers" of trained manpower on a significant scale—or, indeed, that in this respect their record is any worse than that of large firms—we do not accept that the need to "spread the cost of training more evenly" requires the continued payment of the levy by small firms. Very many small firms have already been exempted from levy/grant, but in general this has affected only the very small. We believe all small firms should be exempted, or should at least be allowed to opt out of the system. Though our size definitions, as given in Chapter 1, are a fair guide, we do not suggest that each training board should necessarily adopt them uncritically; the circumstances of different industries—and different boards—will necessitate some changes. **But we do suggest that each training board, in consultation with the industry and the Department of Employment, should formulate an appropriate definition of the small firm in its industry and shonld establish an exemption limit designed to exclude all small firms as so defined from the levy. Firms below these limits should be permitted to "opt in" to the levy/grant system if they think it desirable.** About half the training boards already allow their small firms to "opt in" if they so wish. Most of these boards charge a levy for the privilege, although some boards, e.g. the Engineering Industry Training Board, allow grant without prior payment of levy. It is also common practice for there to be a minimum "opting in" period.

14.23 We accept that if this recommendation is implemented some useful activities of the training boards may be endangered, but on balance we think that small firms would benefit from the change. We do not believe that the standard of industrial training in general will suffer; there are strong social and economic pressures which encourage employers to train, and the better small firms must respond to these, in their own economic interest. Inadequate training will be reflected in the difficulty of recruiting staff of suitable calibre, in reduced efficiency and eventually in poor profitability. We are in principle unwilling to accept the proposition that small firms must be under the tutelage of industrial training boards in order to perceive and follow their own best interests in this matter. The Industrial Training Act has provided a useful stimulus to training in the sector, but at a high cost; and we think it likely that the returns from further investment in this system would rapidly decline. If means can be found of preserving the most valuable aspects of training board provision for small firms, so much the better. We believe that the future role of the boards will be much less concerned with the administration of the levy/grant system, and more concerned with encouraging the spread of approved training methods and the provision of consultancy on training and associated matters. The boards should be encouraged to develop services of this kind which can be sold to small firms at suitable fees.

14.24 Some training boards would suffer financially from the exemption of small firms; though their administrative expenses would be substantially reduced, the loss of levy income would considerably exceed this saving. In other cases, the loss of income would be relatively unimportant. The Department of Employment has estimated the effect on the income of some boards of exempting all small firms as we have defined them from payment of levy. The Engineering Industry Training Board, for example, would lose £16 million in gross levy income, but would save some £12 million in grants they would not be obliged

by the Industrial Training Foundation, which has been operating for a number of years. Under this type of arrangement the firm, without joining a group, contracts with the independent training organisation for a specified period of a qualified training officer's time.

14.18 *The provision of management training.* All the training boards recognise the need for management training. This should strictly be limited to managers who are employed persons because the Industrial Training Act makes no provision for the training of employers and the self-employed. The Engineering Industry Training Board, for example, now sponsors a number of courses aimed at management. In 1969/70 the board ran 56 courses in financial control with over 900 members attending. There were in addition 42 parallel courses on production control, with over 700 members. This board also sponsors week-end courses, which are particularly attractive to the management of small firms. The Construction Industry Training Board has also introduced a course on management appreciation for small firms and they are now planning to hold ten such courses throughout the country. Other training boards have also made provision for the training of managers. Early in 1970 the then Government introduced a Bill to extend the scope of the original Act to provide, *inter alia*, for the inclusion of the self-employed and the owners of businesses. The Bill, did not, however, pass through the necessary stages before Parliament was dissolved for the General Election. The present Government has not reintroduced this legislation. However, we are told that some training boards are prepared to allow such self-employed people to take part in training courses and to make use of other facilities provided out of levy income. While it is unsatisfactory that this should have to be done on a semi-clandestine basis, it is better than nothing.

14.19 *Special training recommendations, guidance and grant schemes for small firms.* Many boards have borne the problems of small firms in mind when drawing up their training recommendations and grant policies. For example, the Road Transport Industry Training Board set up a new management training department known as Training Assistance in Small Companies (TASC) in January 1969. The Ceramics, Glass and Mineral Products ITB has a specially designed grant scheme for small firms within its industry. The Distributive Industry Training Board is introducing an "opt in" scheme (the "Under Sixty Scheme") for firms with annual payrolls of under £60,000 which will provide help in drawing up job specifications and training programmes, and will greatly simplify the operation of claiming grants and keeping training records. Another specially designed scheme for small firms called "Training for Profit" is being operated by the Food, Drink and Tobacco Industry Training Board; this scheme, too, has cut the paperwork involved down to a minimum, and has met with a good reception from the small firm managers in the industry.

14.20 *Special efforts to give direct advice.* The great majority of training boards have helped small firms through visits by training advisers, and by holding seminars and meetings. The Furniture and Timber Industry Training Board, for example, mentioned in its Annual Report for 1968/69 that the number of its training advisers in the field had doubled from 11 to 22 in this period and that they had been giving special attention to providing first-hand advice to the small establishment. In 1969/70 field staff increased from 22 to 24. The Foundry Industry Training Committee also commented in their Annual Report for the

Special arrangements for training in small firms

14.15 Training boards in different industries have sought to encourage forms of training to meet the needs of small firms under the levy/grant system by:

—encouraging group training;

—encouraging management training;

—issuing recommendations and providing guidance and grant schemes for small firms;

—providing direct advice;

—paying grant for "in-company" training.

These attempts at meeting the training needs of the small firm are considered below.

14.16 *The encouragement of group training schemes.* The small firm usually cannot afford to pay for the services of a training officer. A favourite solution to this problem which has been encouraged by the boards is for these small firms to band together and share the services of a training officer. This is not a new development. Group schemes had, in fact, operated in some industries many years before the Industrial Training Act 1964 (for example, the Engineering Industry Group Apprenticeship (EIGA) Scheme had started in 1957). Recent studies of small firm problems have given renewed impetus to group training. The following industrial training boards sponsor group training schemes:

Air Transport and Travel
Agriculture
Carpet
Ceramics, Glass and Mineral Products
Chemical and Allied Products
Clothing and Allied Products
Construction
Cotton and Allied Textiles
Distributive
Engineering
Food, Drink and Tobacco
Footwear, Leather and Fur Skin
Furniture and Timber
Hotel and Catering
Iron and Steel
Knitting, Lace and Net
Paper and Paper Products
Petroleum
Printing and Publishing
Road Transport
Rubber and Plastics Processing
Shipbuilding
Water Supply

The total cost to the boards in 1969/70 of group training schemes (including indirect support) is estimated by the Department of Employment to be in the

their first years of operation that the needs of the small firm required more study. As a result, (in July 1967) the Chief Officers of the industrial training boards invited the then Ministry of Labour (now the Department of Employment) to set up a Committee to study the training problem of small firms. This Committee (which we shall call the Chief Officers' Committee) was not given precise terms of reference but after discussion defined its task as follows:

> The Committee's task is to try to identify the types of training problems encountered by small firms in different industries and to indicate the techniques and methods which boards have found helpful in dealing with these problems. The aim is to make available to all boards the best and most successful practices which have been developed in the field by the training boards and also by the Industrial Training Service . . . .

The Chief Officers' Committee identified the same problems that we have found and made a number of detailed recommendations for the improvement of the provision made for small firms by the boards. These covered the following main areas:

i. *Communication between the training board and the firm*
The Committee recommended a greater emphasis on personal contacts with businessmen, including visits to the firms.

ii. *Management training*
They stated that "all firms at one time or another can benefit from management training. Because of the influence of managers on the conduct, attitudes and efficiency of small firms their training is particularly important and training boards will want to pay special attention to it. Management training in the small firm will often be concerned primarily with updating the knowledge of the existing chief executive". (One difficulty here is that the training of the self-employed is outside the scope of the Act.)

iii. *In-company training and the training of instructors*
The Committe recommended that boards might themselves provide courses for instructors in small firms. Some boards had, in fact, already done this—e.g. the boards for Hotel and Catering; Cotton and Allied Textiles; and Engineering. As an alternative they might "give assistance in drawing up in-company training programmes and recognising them for grant".

iv. *Group training*
The Committee considered that "because the management lacks time and expertise to set up and run its own training schemes and because the facilities needed are often beyond the means of a single small firm the idea of pooling resources becomes very attractive". The Committee made a number of detailed recommendations for initiating and administering group schemes.

v. *The application of levy/grant arrangements*
Under this important heading the Committee considered that "exemption of the smallest firms from liability to pay levy by setting a lower limit to the number of employees or to the payroll . . . is probably unsuitable for boards with a large number of small firms which have some training need. It may be particularly useful in the early days of the existence of a board, before it has developed its organisation sufficiently to be able to make the necessary contact with small firms. It may also be justified when the training board

> While this industry is, generally, in favour of the Act, there are bitter and justified complaints by small firms about its inflexibility. To at least three of the firms interviewed by me the training levy is just another tax, since the firms' circumstances make it almost impossible to use the facilities provided by the training board.
> (National Association of Scottish Woollen Manufacturers)

The Bristol and West of England Engineering Manufacturers Association stated that "the operation of this Act is too rigid to suit specialist companies, which most of our small firms are". A small firm stated that "the training boards seem, by and large, still to have their head in the clouds and appear to want teaching for teaching's sake. A more practical approach is required". The Furniture and Timber Industry Training Board (who have devoted a great deal of thought to the problems of the small firms which make up the bulk of their membership) stated in a survey of the training needs of small firms that "scarcely any systematic research has been conducted in small firms in order to identify their particular training problems" and that "the training boards themselves have, inevitably, at the outset taken the 'best' training practices in their industries and set these up as desirable standards for firms to aim at. Not surprisingly the 'best' practices have invariably been those of some of the leading large employers in the industries concerned. In addition, those with training expertise recruited into the training boards' staff have, again inevitably, mostly come from companies large enough to employ training specialists. It is not surprising that many small firms feel that they do not receive value for their training levy". Some very small firms with very simple processes may require no formal training at all, even "on the job", and can therefore derive no benefit from the services of a training board. At the other end of the spectrum there are highly specialised firms whose training needs the boards are unqualified to assess and which can rarely be met except by the firm itself. Such firms are likely to be allocated for the purposes of the Act to a training board with no knowledge of their work because the definition of its scope most nearly corresponds to the nature of their work. We have seen several such cases involving craft enterprises, totally removed from the field of mass production, whose operatives can gain little or no benefit from external training; the Federation of British Manufacturers of Sports and Games Ltd quoted cases of firms manufacturing cricket balls and billiard tables which had to pay levy to boards incapable of providing relevant instruction for their workers. We feel that in such cases the boards should simply accept that since adequate provision cannot be made for these firms they should not be levied. The ideal, of course, if the boards are to continue, would be for them to identify the training needs of individual firms and to pay grant to those firms which have taken steps to meet these needs, but the sheer number of small firms, in many industries, makes this impossible: the cost of making contact with them all and catering for their individual needs would be prohibitive. Those boards which have had most success with this policy are significantly those in sectors where small firms are less numerous.

The financial drain imposed by the levy

14.10 The majority of small firms pay more to the training boards in levy than they receive in grants. The replies to our postal survey showed that in manufacturing industry as a whole some 65 per cent of small firms received less in grant than they paid in levy. The proportion varied between different industries, but the general pattern of failure to recover the grant in full appeared to be constant across the whole of industry. This is perhaps to be expected: it is inherent in the

firms in its industry paying the levy but not claiming grant elicited the following six main reasons for not claiming:

We are too small to undertake formal training.	39%
We are too busily engaged in other ways.	27%
We cannot keep all the records required to substantiate claims.	24%
We don't have time to read the literature sent out by the Board.	22%
We don't think the training we give qualifies for a grant.	21%
We prefer to absorb the levy as a tax.	6%

(The proportions add up to over 100% because sometimes more than one answer was given.)

We think it significant that three of the six main reasons given above relate to the administration entailed by the levy/grant system. This aspect of the levy/grant system clearly colours thinking on the Act as a whole. One chairman of a small firm told us that of all the difficulties encountered in his daily work "this is the biggest irritant to the ordinary body of small firms".

14.7 In order to claim grant successfully it is necessary to satisfy the training board that appropriate training has been carried out by filling in a "claim form", which will show the number and types of employees receiving the different forms of training appropriate to them. We have seen the claim forms used by all the training boards which are relevant for our purposes, and some of them are very formidable indeed. (The boards are continually working to simplify and improve these forms, and some of them are designed to be helpful in their own right, by leading the businessman to formulate his training needs in a logical and constructive way.) It is obvious, since large sums of money are involved, that some record of training done must be supplied, and no doubt the completion of forms is the cheapest means of doing this, but the effect is to impose on the fairly simple training programmes of small firms a degree of formality that is quite unnecessary for the firms' own purposes, and which is often spurious in any case. The preparation of a formal training programme, involving all the work of producing job descriptions and the assessment of individual needs, requires a great deal of management time. The large firm, as a matter of course, has staff to cope with these tasks, but in most small firms they inevitably fall to the boss, since he is usually the only person in the firm capable of doing them. Apart from being in most cases unnecessary, therefore, the formal drafting of training systems can make excessive demands on management time. Many small firms regard form-filling for grant as a game in which they have to score points—and to some extent a game of chance at that, since they might succeed in one year only to see the rules changed in the next. For these reasons, large numbers of firms choose to forgo the grant to which they are entitled rather than undertake the work involved in claiming it: they treat the levy simply as a tax. We are glad to see that a number of training boards have now produced simplified claim forms for small firms, though some of them could with advantage be further simplified. The essential problem will persist, however; all systems involving the transfer of money also involve paperwork, and in small firms paperwork of any importance must usually be done by the boss. From the viewpoint of the training boards also, the administrative cost of dealing with small firms is disproportionately high, because though they pay less in levy than large firms the overhead cost of dealing with their returns and grant forms is not proportionately smaller. We suspect

Government's proposals for legislation stated: "There is no doubt that shortages of skilled manpower have been an important factor in holding back the rate of economic expansion". The then Minister of Labour, Mr John Hare (now Viscount Blakenham) stated in October 1963 that "few industries have developed any means of training the people that they need; there is no way of ensuring that all employers play their part; there has been little control of the quality of training and there have been few attempts to examine in a critical but constructive way methods and customs of training which have been in operation for several generations". The Government clearly thought that in many industries adequate training was provided by a few companies at their own cost while the remainder were content to "poach" trained men. It was hoped that the levy/grant system would ensure that firms which frequently "poached" trained labour in preference to undertaking training themselves would contribute to the cost of training in their industry. We have seen no evidence which suggests that small firms were, on the whole, net "poachers" of trained labour, but there is very little available information on this subject and the situation is, of course, likely to differ between industries; the road haulage industry has been quoted to us as an industry in which "poaching" was formerly very common. In engineering a great deal of the industry's training was carried out by a few renowned large companies. Some of these companies did not altogether mind being net losers of trained labour to other firms; they prided themselves on the excellence of their training and no doubt derived some benefit, in the form of valuable contacts with potential customers, from the eagerness with which their staff were sought by rival firms. On the other hand, some witnesses have suggested that in the construction industry small firms were on the whole net losers of trained labour to the large builders. The levy/grant machinery was designed to achieve the aims of the Act through a system of penalties and rewards which would provide an incentive for firms to train, or at least to review their position on training. The Furniture and Timber Industry Training Board told us that it is only the financial impact of levy/grant which has finally convinced employers in its industry that it does not pay them to skimp on training. Table 14.I briefly sets out the methods in use or proposed by each board for the assessment of levy on 30 July 1971. The normal methods have been either a *per capita* charge, or, more frequently, a percentage of payroll basis.

14.4 Since the Act's inception there has been an apparent increase in the number of people being trained as well as an extension of the scope of the training itself. In September 1968 an estimated 1·4 million employees were being trained in all industries and services. In the manufacturing industries the number under training is estimated to have increased by about 15 per cent between 1964 and 1968. Some of this increase may have been more apparent than real; firms now have an incentive to keep a full record of the training element in their everyday business, whereas before the Act there was no financial incentive to record every activity which contributed towards training. This meant that a great deal of "on the job" training went unrecorded. Since the Act, however, many firms have taken great care to record any contribution to the training of their employees, however indirect, in order to maximise their grants. It is by no means true, however, that all the gains achieved under the Act have been illusory. In some sectors of industry systematic training has been undertaken for the first time in the past few years, and it is impossible to believe that the Act has played no part in this. In other industries, where training was formerly sporadic or confined to a

Selective Employment Tax

9. We hope that it will be found possible to implement the Government's announced intention to abolish selective employment tax in the near future. If any form of taxation on employment or wages is to be retained we recommend that it should be non-discriminatory as between different branches of industry.

Interim recommendations on taxation of small firms

The Taxation of Close Companies

1. We believe that the shortfall provisions contained in section 77(2) of the Finance Act 1965 have been so misunderstood that they amount to an unjustifiable burden on close trading companies. We do not dispute that tax avoidance by the accumulation of income-tax-free profits inside the company is undesirable, or that in the case of investment income this might be a serious mischief. But we question whether the danger of avoidance by trading, as distinct from investment companies, is significant enough to justify the cost and complexity of the present system. We do not think that this is the case and therefore *recommend that shortfall assessment on the trading income of close companies should be abolished.* This would remove a fertile source of confusion, wasted effort and discouragement of enterprise.

Disallowance of Interest

2. We note that the Conservative Party's election manifesto expressed itself in favour of repealing "changes which have . . . disallowed the interest on many loans as a deduction from income for tax purposes". *We hope that this intention will be carried out and that sub-sections* 3(*a*) *and* 3(*b*) *of section* 20 *of the Finance Act* 1969, *at least, will shortly be abolished.* These have had unfortunate consequences for close companies by making it difficult for an employee, except in certain limited circumstances covered by statute, to purchase a share in the business, the main inducement which a small company can offer an able employee, and by making it difficult for members of the proprietor's family to buy shares in the company, for example, on the proprietor's death.

Capital Gains Tax on deemed disposals

3. Proprietors of interests in small firms suffer a disadvantage compared with holders of quoted securities when faced with capital gains tax, because they are very unlikely either to have adequate liquid reserves to pay the tax or to be able to raise money by selling shares. The taxation of unrealised gains is particularly onerous, and we favour a measure of relief from such a tax. *We recommend that unrealised capital gains, on all assets other than quoted securities, should be taxed on only part (say* 55%) *of the gain, the tax paid on such to be credited towards the tax payable on any subsequent realised gain on the sale of the asset concerned.*

Estate Duty Valuation

4. The valuation of the equity of a small business may be a long, difficult and uncertain process. It may also be expensive in terms of professional fees. We take the view that in many cases the need for such valuation can be largely attributed to the estate duty provisions and that it would be right to make an allowance for this. *We therefore recommend that a proportion, say,* 50 *per cent, of the cost of valuing assets other than quoted securities should be deducted from the estate for purposes of the duty.*

4. Close companies should be allowed to elect, by unanimous decision of the shareholders, to be taxed as partnerships. (Paragraph 13.58.)

5. As a general rule the tax reliefs which are available for pension schemes set up for employees including non-controlling directors should be extended to similar funds for proprietors of unincorporated businesses and controlling directors of close companies. (Paragraph 13.61.)

6. Such pension funds should have complete freedom as to the choice of investment including the freedom to plough back into the business. (Paragraph 13.62.)

7. Section 20 of the Finance Act 1969, which disallowed interest on loans for the purchase of interests in close companies as a deduction from income for tax purposes, should be repealed. (Paragraph 13.63.)

8. Unrealised capital gains, on all assets other than quoted securities, should be taxed on only part (say half) of the gain, the tax paid on such to be credited towards the tax payable on any subsequent realised gain on the sale of the asset concerned. (Paragraph 13.65.)

9. As a transitional measure retirement relief from capital gains tax should be raised from £10,000 to £20,000. (Paragraph 13.66.)

10. The extra-statutory concession for loans made by close companies to pay estate duty should be continued and made as widely known as possible. (Paragraph 13.73.)

11. The estate duty relief of 45 per cent now allowed to agricultural property and industrial buildings, plant and machinery should be extended to net trading assets, including any amount in the assets valuation of the concern which arises in respect of goodwill, and to controlling interests in unquoted companies to the extent that their value represents net trading assets, including goodwill, of the company. (Paragraph 13.74.)

12. A similar concession to that given for agricultural land should be given for ownership of industrial land and buildings whether or not the landlord uses them for a trade. (Paragraph 13.75.)

13. A proportion (say half) of the cost, including the cost of associated litigation, of valuing assets other than quoted securities should be deducted from the estate for purposes of the duty. (Paragraph 13.76.)

13.74 The CBI and other witnesses have proposed that the estate duty relief of 45 per cent now applied to agricultural property and industrial buildings, plant and machinery should be extended to all assets, other than cash, of trading businesses, partnerships, and to unquoted shares. The relief for agriculture, which dates from 1925, was intended to prevent the break-up of agricultural estates, and its extension in 1954 to industrial property appears to be a recognition of the desirability of mitigating the impact of estate duty on productive capital. The limitation of the 1954 concessions to "industrial" buildings, plant and machinery reflects the emphasis placed in recent years on "productive" industry as opposed to "services"—which was carried to the point of straightforward discrimination in the selective employment tax and the investment grants scheme. To generalise the relief as suggested above would be consistent with the recent trend of official thinking away from discrimination of this sort, and could be particularly helpful to small businesses, which are heavily concentrated in the service sector. The main types of asset that would qualify for the relief would be commercial buildings, patents, goodwill, certain investments (though not portfolio investment) and possibly working capital. Cash and portfolio investments should clearly be excluded, and there are grounds for doubt about working capital also; there would be a strong temptation, when a proprietor was failing, to feed in assets which would qualify for relief, and this could be done very easily in the case of working capital. It would perhaps be necessary to prescribe that for purposes of estate duty any concession in respect of working capital should not exceed a figure based on the average working capital over the three years preceding death. As to the proposal that unquoted shares should also qualify for the relief, where agricultural property or industrial plant, etc., are owned and used by a close company in which the deceased held a controlling share, the 45 per cent is at present allowed; the reason for allowing relief in these circumstances is that the shares have to be valued on an "assets basis"—that is, by reference to the net value of the company's assets—and the relief is accordingly consistent with the statutory basis of valuation. Minority holdings of unquoted shares are not valued on an "assets basis", however, and to give the relief for all unquoted shares would discriminate against shares in quoted companies. The proper course here is to ensure that the valuation basis is truly that at which the shares might be sold, i.e. that there is an adequate allowance for non-marketability if valuation is done by comparison with quoted shares. We therefore believe that the relief should apply to unquoted shares only where they constitute a controlling interest in the company. **We recommend that the estate duty relief of 45 per cent now allowed to agricultural property and industrial buildings, plant and machinery should he extended to net trading assets, including any amount in the assets valuation of the concern which arises in respect of goodwill, and to controlling interests in unquoted companies to the extent that their value represents net trading assets, including goodwill, of the company.**

13.75 The present exemption is only allowed for assets used *by the deceased* in a trade. There is an element of discrimination in this, since relief on agricultural land is by reference to ownership only, and we believe that the concession should be given for ownership of industrial land and buildings whether or not the owner uses them in a trade. Such a relief would encourage the investment of capital in industrial property, and probably largely in property suitable for the smaller business, in the same way that the present relief has attracted substantial invest-

business. On the second of the CBI's arguments, however, we have serious doubts, since we are not convinced that the economy necessarily benefits from retention of control of a business inside a single family. There are of course outstanding firms which have remained in the hands of one family for generations, but it should not be assumed that the children of a successful entrepreneur will necessarily inherit his acumen and energy. Certainly we should not equate a change of management with extinction of the firm, as certain of our witnesses appear to do. Therefore, even if a "consanguinity concession" could be restricted to estates consisting of trading assets only, we should not feel confident in recommending it. In fact we think it inconceivable that so valuable a privilege should be made available only to small businessmen and their families. Thus while we believe that small business would benefit from a general reduction in inheritance taxation, and this might well be achieved by a return to a legacy duty basis, we believe that such a change would have to extend to all estates and not be confined to small business assets. It is not within our province to deal with such a sweeping change in general taxation in this Report.

13.70 *Problems of payment.* We would regard as more serious than the threat to family inheritance the danger that businesses may be weakened by the necessity to sell off part of their assets in order to meet the duty. The frequency with which either eventuality will occur depends on the proportion of trade assets within the total estate; it may be presumed that when the duty exceeds the non-trade assets, part of the trade assets may have to be sold off. The Inland Revenue have twice in the past investigated the relationship between trade assets and total estate. The first study was done in 1927 at the request of the Committee on National Debt and Taxation. The second was a special inquiry carried out in 1951. There were some differences between the two, but broadly their purpose was to analyse estates over £10,000 with trade assets over £1,000 in order to establish the relationship between estate duty payable and the size of trade assets. In both studies the number of cases where the duty exceeded non-trade assets was relatively small, so that *prima facie* the enforced sale or break-up of a business to pay the duty was likely to be a rare occurrence (though one may doubt the underlying assumption that personal belongings or family property will normally be disposed of before business assets are touched). However, in neither study was an examination made of the size of the problem in so far as it affects the family business sector taken in isolation; since this sector yields a small part of estate duty revenue it is possible that these surveys failed to reveal the seriousness of the problem in which we are interested. At our request the Inland Revenue kindly undertook a further study, in respect of 1967–68, of a representative sample of 445 estates, which is reproduced as Appendix VIII; on this occasion a special tabulation was made of the incidence of estate duty by size of trade assets (Table VI of that appendix). "Hardship" cases were defined as those in which the estate duty payable exceeded three-quarters of the non-trade assets and in which therefore it is likely that trade assets have to be utilised in order to meet some of the duty. It was found that where trade assets lay in the range £20–£100,000, between 8 and 21 per cent according to size of the estates fell into the "hardship" category: where trade assets exceeded £100,000, this proportion rose to two-thirds. In terms of manufacturing firms, this is roughly equivalent to saying that the liquidity of about one-seventh of firms employing between 20 and

see only a small proportion of the potential field. The importance of the private investor has been demonstrated in the United States, where during the late 1960s a remarkable flowering of successful new businesses, particularly in fields of high technological content, was to some extent financed by wealthy individuals actively seeking opportunities to invest in promising new ventures. The great attraction was certainly the possibility of obtaining very large long term capital gains, taxable at a maximum rate of 25 per cent. However, it appears that a significant, though minor, role was played by a special tax incentive for investors in a special class of new enterprises, known as "1244 companies" after the relevant section of the Internal Revenue Code. Such a company

i. must not offer over $500,000 in common stock on the "1244" issue;
ii. must not have aggregate capital exceeding $1,000,000 including the issue.

Any individual investor in such a company is permitted to offset against tax on other income a capital loss resulting from the investment; the maximum loss allowable for this purpose is $25,000 for an individual or $50,000 for a husband and wife filing a joint return. The effect of the concession is that an investor paying tax on income at a marginal rate of 90 per cent may keep 75 per cent of any capital gain he makes, but loses only 10 per cent of any capital loss; in other words, the investor has very little to lose and much to gain from investing in high-risk situations. Some expert witnesses in America told us that Section 1244, which is very well known, had greatly stimulated investment in new businesses. Such a concession could be an effective means of attracting private capital into the United Kingdom small firm sector also, since it would compensate to some extent for the much greater difficulty of realising an investment in a private (as opposed to a public) company, which leads to a greater danger of getting "locked-into" an unsuccessful venture. We do not recommend it now, since to do so would be a departure from neutrality between small and large firms which we do not think justifiable at the present time. Moreover, we foresee great administrative problems in limiting such a concession to wholly *new* private companies. *However, if in future it is thought necessary to provide a special stimulus to investment in small companies, this idea should certainly be considered.*

Taxation at death

13.68 Of all taxes, estate duty has been said by most of our witnesses to be the most inimical to the health of the small private business. This is not only because it creates certain special problems for the small firm, though these are important: the very concept of a redistributive tax on inherited wealth is seen as being hostile to the accumulation of capital in private hands, which is an essential characteristic of a private enterprise system. In paragraph 13.7 we suggested that the disincentive effect of estate duty is a disability peculiar to the small firm sector; large firms, since they are not normally family businesses, nor dominated by a single major shareholder, do not suffer the loss of motivation and the diversion of effort which the problem of providing for the duty may entail for small businesses. The small firm sector, as distinct from individual firms, has also suffered from the duty in that it has reduced the inflow of capital into the sector by impoverishing (relatively speaking) individuals who might otherwise have invested in, or founded, small businesses. However, it is not for us to argue the merits and demerits of a redistributive and egalitarian tax system, which raise issues far wider than the interests of small businesses, and we shall confine

(a) had a "material interest" in the company and (b) was a working proprietor. This had two unfortunate consequences for close companies. First, the restriction of relief in Section 20 Sub-Section (3)(a) to persons with "a material interest in the company" has made it exceedingly difficult for an employee to purchase a stake in his company. The opportunity to acquire a share in the business may be the main inducement a small company could offer an outstandingly able employee, but the attraction is substantially diminished by the removal of tax relief on a loan raised to purchase shares. Secondly, the new law, by restricting relief to working proprietors, has made it very difficult for members of the proprietor's family to buy shares in the company, for example on the proprietor's death, with borrowed money. This has been a very common procedure among family companies, and its disappearance may hasten the extinction or takeover of many such companies.

The Conservative Party's Election Manifesto expressed itself in favour of repealing "changes which have . . . disallowed the interest on many loans as a deduction from income for tax purposes." We were disappointed that this intention was not carried out in the recent Budget, and we **recommend that Section 20 of the Finance Act –969, which disallowed interest on loans for the purchase of interest in close companies as a deduction from income for tax purposes, be repealed.**

The taxation of capital

13.64 *Capital gains tax.* The introduction of capital gains tax has exacerbated the difficulties caused by high levels of income tax and estate duty. That is to say, it has helped to reduce the accumulation in private hands of wealth with which businesses might be founded or expanded. It may also have had a disincentive effect on risk-taking: the greatest advantage of self-employment has always been that success makes possible the accumulation of capital on a scale which is not possible for the employed person; this is still true, but the advantage has been diminished by capital gains tax. The most serious effect of the tax, however, has been to impose severe strains on the liquidity of firms whenever an interest in the business is passed on. We are very concerned at the increasing tendency towards taxation of capital—whether unintentional, as in the case of income tax, corporation tax and capital gains tax charged on illusory "profits" resulting from inflation, or deliberate. However, we do not wish to quarrel with the principal of a tax on realised gains. What is pernicious, in our view, is the taxation of unrealised or notional gains, particularly where realisation is not a practical possibility.

13.65 *Deemed disposals.* There are circumstances in which disposal of a capital asset is deemed to have taken place and to have given rise to a taxable gain although no money changes hands. They include, for example, a gift of shares to a relative or employee. Until the very welcome reliefs introduced in the 1971 Finance Act they also included the death of a principal shareholder or proprietor or, in the case of a trust, every 15 years where there was no life interest in possession. All "deemed disposals" give rise to special problems and in our view have undesirable consequences. For example: it is not uncommon for a proprietor to wish to reward or promote an exceptionally able employee by the gift of a share in the business, thus improving his motivation and perhaps providing for the succession. The presumption that such a gift gives rise to a chargeable gain discourages what we regard as a very desirable way of attracting

Revenue, with whom we discussed this proposal, was that if there were any disadvantage in being taxed as a company, this should be weighed against the undoubted advantages of limited liability, and accepted if the balance of advantage worked out that way, but we feel that this is to elevate a purely incidental differential into a point of principle. We do not believe that a point of principle arises here, unless it is held that a price should be paid for limited liability in the shape of a higher tax bill. **We therefore recommend that close companies should be allowed to elect, by unanimous decision of the shareholders, to be taxed as partnerships.** Once exercised, this election should be irrevocable for a period of, say, five years; it would not be acceptable that businesses should assume and discard corporate status from year to year as their profits rose and declined.

13.59 *Capital allowances.* Prior to the announcement, on 27 October 1970, that the investment grants system was to be replaced by a system of investment allowances, we received a great deal of criticism of the way in which the grants system affected small firms. This is not now worth describing in detail, but the essence of the complaints was that the system was expensive and unwieldy in operation, arbitary (or at least unpredictable) in its effects and, worst of all, that it discriminated unjustifiably against the service industries in which small firms predominate. We agreed, to a greater or lesser extent, with all these criticisms, and therefore proposed to recommend that investment grants be replaced by a non-discriminatory system of investment incentives and, specifically, that free depreciation be allowed to all businesses up to a ceiling of £5,000 per annum. (By fixing a low ceiling it could be ensured that the main benefit of this change would accrue to the small firm and the danger of larger firms sub-dividing themselves to obtain the depreciation would be minimised.) However in the light of the new system of capital allowances, under which 100 per cent depreciation in the first year will be available for new non-mobile machinery and plant in development areas, and for most other machinery and plant 60 per cent or 80 per cent of expenditure may be written off in the first year and 25 per cent of the reducing balance may be written off successively in later years, we have decided to make no recommendation on this subject. *We would, however, express the hope that this is only the first step towards* 100 *per cent depreciation in the first year for all machinery and plant, and to more liberal treatment for commercial buildings.*

13.60 *Personal taxation.* The increasing weight of taxation on personal income. as distinct from profits, has certain unfortunate consequences for the small firm sector. In paragraph 13.8 we suggested that high rates of income tax may restrict the supply of finance to small firms by impoverishing people who might otherwise invest in them. We return to this when discussing the taxation of capital. Even more important than this is the impoverishment of individuals who might otherwise set up in business on their own account. It is now exceedingly difficult for a man to accumulate reasonably early in life sufficient resources out of personal income to enable him to set up his own business; this difficulty cannot always be solved by borrowing, for most financial institutions require a substantial investment by the founder as a condition of their own participation in a new venture. Even if such a man can borrow the money to provide part at least of his own capital contribution, he will never be able to pay if off out of income. For the man already in business high personal taxation makes it impossible to buy out partners, for example, or to pay estate duty, out of income;

for shortfall assessments to be operated on a system of relatively infrequent spot checks, as was surtax, because much greater sums are now in question: if a spot check after say, five years, resulted in a shortfall assessment for each of those years the amount of tax involved might be a crippling blow to the company. Furthermore, even if annual checks were retained, all the evidence needed to determine what is a reasonable distribution for any company is in the hands of the company; it would be unreasonable to ask the Revenue to challenge the company's assessment with no evidence to go on. The first of these arguments will lose its force under the proposed new system of corporation tax, since only surtax will then be in question. The second, however, will remain valid. We therefore see no way to reduce significantly the time and cost involved if the present system is retained.

13.56 The total cost to industry of the shortfall provisions will of course be considerably reduced as a result of the Government's proposal that trading companies should not have to justify the level of their distributions out of trading income if that income is less than £5,000, with marginal relief up to £15,000. This exemption will also be extended to investment income provided it does not exceed 10 per cent of the trading income or £500, whichever is the less. This will effectively exempt completely more than half of the trading companies now falling within the scope of the shortfall provisions and is very much to be welcomed. So also is the proposed simplification of the rules relating to the close companies still subject to the provisions, which would in effect amount to a return to the pre-1965 position. Nevertheless, despite the abuses occasioned by the "Cripps umbrella"[1] we do not believe that any harm would be done to the national interest if all control over the distribution of trading incomes were to be relinquished. With the existence of capital gains taxation we think it unlikely that significant abuses would occur if close companies were permitted to retain the whole of their trading income. **It is therefore our view that shortfall assessment on the trading income of close companies should he abolished, and that no parallel provisions should be included in the forthcoming revision of corporation tax.** However well drafted, such provisions would inevitably give rise to the kind of misunderstanding which has bedevilled the administration of the present rules, and their cost, in terms of administration and disaffection, would in our view outweigh any harm they might avert. *We hope the Government will bear this view in mind in their consultations on this subject.* We recognise that if close trading companies were to be given this significant advantage it would be necessary to draft a watertight definition, for we accept that there is no case for such a concession to investment companies, where the real mischief of the "incorporated money-box" arises. However this should present no insuperable difficulty, since for some purposes the Inland Revenue already distinguish between them. While the extra tax gathered as a result of the shortfall provisions has been estimated at only £4¼ million (see paragraph 13.25), the Inland Revenue have also indicated that the abolition of shortfall provisions for trading companies may involve the loss of tax revenue on a *maximum* of £100 million. (Under the Green Paper proposals, only the equivalent of surtax on this sum would be involved, say £30 million.) We find it hard to believe that the pattern of company dividend distribution would change so radically as to involve anything like the maximum

[1] This was an undertaking given in Parliament by the then Chancellor of the Exchequer to the effect that the payment of surtax on undistributed profits of trading companies would not be called for in view of his request for dividend restraint.

working margin of liquid resources to provide a cushion for temporary set-backs or difficulties. In the last resort an oppressive or unreasonable shortfall assessment can be contested on appeal to the Tax Commissioners. We are satisfied that the provisions have been very well and sympathetically administered, and do not believe a significant number of companies have been harmed by compulsion to distribute an excessive proportion of their profits—though many may have done so out of ignorance.

13.54 The enforcement of shortfall assessments is comparatively rare. It will be remembered that there are some 220,000 close companies. Now we have seen the results (reproduced in Table 13.V) of a statistical survey covering companies whose shortfall position was settled during the 12 month period ending in June 1970: the survey excluded companies with trading income below £100, those covered by the abatement provisions and those in liquidation. Nearly 31,000 companies were included in the survey. Excluding subsidiary companies, some 22,000 were trading companies. Of the latter, some 7,000 voluntarily distributed 60 per cent or more of profits after tax, leaving about 15,000 which distributed less than the maximum required standard. In some of these cases further distributions were made after discussion with the Inspector; but in only 2,000 was a shortfall assessment made. The average level of distributions (including shortfall) for these companies was only 30 per cent. Even under the shortfall regime therefore close trading companies were required to distribute rather less than half the normal distributions of open trading companies. The direct effect of the shortfall provisions (that is to say, the further distributions plus the shortfall assessed) as revealed by the survey represented income tax and surtax on about £4 million. The hidden effect, that is to say, the extent to which close companies felt themselves bound to distribute because of shortfall, is impossible to determine and may well have been much larger, but as far as can be ascertained from the figures the burden of shortfall assessments on close companies was not heavy.

13.55 A more serious criticism of the provisions, in our view, is that their cost to industry, and to the Government, far outweighs any possible gain to the Exchequer. As we have seen, the great majority of trading companies have no difficulty in persuading the Revenue of their need to retain more than 40 per cent of distributable profits, if they have a worthwhile case, yet the cost of proving the point in time and accountants' fees, and the delay in getting a settlement may be substantial. We were informed by the Institute of Chartered Accountants that the accountants' time charged to one client for annual tax computations since the 1965 Finance Act has increased by 70 per cent. The Institute attribute the increase wholly to protracted negotiations on shortfall, though no substantial changes in the client's distribution policy have been required. In addition, separate fees have been charged to the company for advice in connection with its status as a close company amounting in total to more than 300 per cent of the basic pre-1966 annual fees for taxation services. The difficulty of making the case is said to be increased by uncertainty as to the likely reaction of individual tax inspectors. The CBI have proposed that the onus should be shifted from the taxpayer to the Inland Revenue to prove the need for distribution up to the required standard, and this has attractions since it would transfer part of the burden of cost also. It will be remembered that for some years prior to 1965 the onus was on the surtax commissioners to prove that surtax was payable. Regrettably, however, we cannot support this suggestion. It would not be possible

free of income tax and surtax, and subject only to capital gains tax on realisation. The net effect of the change to corporation tax was to leave the majority of small *companies* on balance better off, since they have generally distributed less than the 60 per cent of net profit which was the basis of the calculations used in arriving at the first corporation tax rates: conversely their *shareholders*, as distinct from the companies, have in general been somewhat worse off, since the net income left in their hands was of course reduced if the same distribution was made by the company. This accounted for much of the bitter resentment aroused by the change. Unfortunately the separation of the shareholders' interests from those of the company, though an accurate representation of the relationship between a large public company and its shareholders, is rather artificial in the case of the owner-managed company, of which it can plausibly be said that to tax the shareholder is tantamount to taxing the company. The proposed new systems of company taxation are intended to restore identity of interest: under either system the company would pay tax (whether corporation tax alone or corporation tax plus income tax on distributions) at effectively the same rate on the whole of its profits. Similarly, under either system the dividends received by shareholders would be effectively net of income tax. This will not be to the overall benefit of the small company sector in monetary terms if the general rate of corporation tax is increased as a result of the change. The Green Paper suggested that a 50 per cent corporation tax combined with the distribution relief would be equivalent in its effects to the present system. **But since the small company sector overall distributes a smaller proportion of its profit, on the basis suggested in the Green Paper it will pay more tax than under the old system. We hope that this will be taken into account when rates are finally determined.**

13.50 Now that the restriction on directors' remuneration as a charge on business profits in close companies has been removed, the major complaint against the present system relates to the enforcement of distributions through the shortfall provisions. It is certain that after 1973, when the proposed reform of corporation tax comes into force, the shortfall provisions in their present form will be discontinued. There will then be less incentive for a close company to withhold money from distribution. Nevertheless it is made clear in the Green Paper that some such provisions would continue to be necessary, whichever of the two possible systems is adopted, in order to ensure that distributions are not kept down below a reasonable level so as to limit the "surtax"[1] liability of shareholders. It is still therefore useful and relevant to consider the evidence we have received on the subject of shortfall.

13.51 The most important criticisms of the shortfall provisions are the following:

i. The obligation on close companies to distribute a given percentage of their profits, when the tax system encourages the retention of profits by public companies, is said to be illogical and unfair.
ii. The required standard of distribution (60 per cent of profits after payment of corporation tax) is said to be too high, leaving inadequate reserves for expansion of the business, or to keep pace with inflation.

[1] The use of the expression "surtax" is appropriate to the personal tax structure as it now is. From 1973–1974 when the new structure announced by the Chancellor on 30 March 1971 will come into force, a different definition will be necessary, and the word "surtax" should be understood accordingly.

similar period of rapid inflation) and to their conclusion, with particular reference to the replacement of depreciable assets, that it was preferable to keep to the fixed basis of historic cost rather than to change over to a new basis which would materially alter the incidence of taxation. (Paragraph 361.) At present businesses are charged to corporation tax or income tax and surtax, as appropriate, broadly on the basis of their commercial accounts with some adjustments, notably to standardise and accelerate the writing down of fixed assets for tax purposes compared with normal book depreciation. In general the Inland Revenue would expect to follow changes in commercial accountancy practice, for example on such questions as the basis of stock valuation, subject to adequate safeguards for the yield and equity of the tax system. The abandonment of the historic cost basis for calculating taxable profits in favour of accounts adjusted in some way for inflation so as to charge tax on a lower figure than the actual income raises much wider issues for the Revenue and could not, in their view, be regarded as an automatic consequence of the introduction of accounts adjusted for inflation for management purposes. Neither could it be assumed, if adjusted accounts were to be adopted, that the business sector would pay less tax than on the present basis. That would depend on the rates of tax fixed by Parliament and such factors as the rate of depreciation for tax under the new system and it will have been noted that in rejecting any differential fiscal relief for small businesses as a remedy for their present difficulties we have already drawn attention, in paragraph 13.13, to the cost which would have to be transferred to other taxpayers.

13.48 We respect the arguments against such a change in the basis for determination of profits for tax purposes, and recognise that the Royal Commission, having considered the subject at length, formed the view that no change should be made. However, we feel bound to take the contrary view, for three reasons. First, the rapid inflation of 1951 could be seen, and we believe was seen, as a temporary phenomenon, associated perhaps with the ending of wartime restrictions and the Korean War boom; drastic long term remedies were therefore inappropriate. It would be rash now to act on the assumption that inflation will be brought permanently under control; we think it more prudent in matters of such critical importance to be prepared for the worst. Second, at that time concern in the accounting world was concentrated on the effect of inflation on the cost of replacing capital equipment and special measures were recommended by the Commission which might be regarded as dealing with this. The difficulties in relation to working capital do not appear to have been much in mind at the time. Third, it may be that we place greater weight than did the Royal Commission on the maintenance of the real capital of businesses. The erosion of the capital base of businesses in general and of small businesses in particular seems to us to have been a major problem for some years and one which is of particular importance at times of rapid inflation such as the present. Moreover, we believe:

i. that even if the same sums had to be raised by direct taxes on business, to raise them as a proportion of real profits would alter the incidence of the burden between different businesses and would produce a better business climate for those who have to employ relatively large capital (both fixed and working);

ii. that in extremity—and for a large number of businesses this must cover 1970–1971—no tax would be payable if there were no real profits at all;

existence. Each of these proposals has attractions as a means of enabling small or new companies to accumulate capital in the business, but they are all open to substantial objections. First, any such device presents an incentive to tax avoidance: a reduced charge on small profits or on the first tranche would lead to companies subdividing themselves into a series of small companies all qualifying for the reduced rate, as has happened in America, while in the case of a "tax holiday" avoidance would be by means of repeated cessation and reformation of the same company. Anti-avoidance provisions would have to be very complex, and, whether or not successful, they would certainly create difficulties, anomalies and bureaucracy of the kind we have seen too often before. Second, a reduced rate of tax would benefit the small and static company as much as the small expanding one: for this reason the Royal Commission on Taxation, reporting in 1955, concluded that "We cannot accept that the exemption device is the right way to give help to the 'deserving' small company". Third, and most important, any concession on corporation tax would benefit only a minority of small businesses, since the great majority of them are not incorporated; we cannot devise an equivalent relief of income tax that could be confined to the profits of sole traders and partnerships, even if it were equitable to do so. Finally, the cost of such a concession to the Revenue would be considerable, if the relief were to be large enough to give worthwhile benefits to the most needy small firms. In Table 13.IV we show the cost of various possible levels of concession, in terms of the loss to the Revenue, and alternatively in terms of the increase in the general rate of corporation tax which would be necessary if the yield from the tax were to be maintained. A marginal concession would have little effect: even a reduction of 10 per cent in the rate of tax (that is, a cut of a quarter from its present level and therefore a major concession in Budgetary terms) would in itself provide additional resources of only about 1·5 per cent of shareholders' capital per annum, say an increase from 9 per cent to 10·5 per cent if all profits are retained (based on a 15 per cent return on capital employed). It should be borne in mind that most small firms have the option to take out profits in the form of salaries paid to proprietors, thus taking advantage of the lower rate of tax on earned income, before having to pay corporation tax at all. For all these reasons we are unable to recommend action of this kind.

13.46 In present conditions a much larger effect might be obtained by adopting an accounting and taxation system which would ensure that tax is charged only on real profits, and not on paper profits made as a result of inflation. We have referred to this problem in paragraph 13.9. It is the effect of inflation to make book profits appear unrealistically high: unless proper allowance is made for the rising cost of maintaining assets in real terms, earnings are exaggerated in the Accounts. This conceals from shareholders and perhaps even from directors the fact that the capital of the business is being eroded and that dividends are often really being paid out of capital.

13.47 We have discussed some aspects of this matter with the Inland Revenue. They referred us to the detailed consideration given to proposals for the adoption of revalorised accounts for tax purposes by the Royal Commission on the Taxation of Profits and Income in Part 3 of their Final Report[1] (following a

[1] *Final Report of the Royal Commission on Taxation of Profits and Income*, 20 May 1955. (Cmnd. 9474).

for this country and the treatment likely to be afforded to certain special classes of goods or of businesses.

13.41 VAT is a form of turnover or sales tax which is collected in instalments; liability to tax arises at each stage in the production and distribution chain. It falls on imports of goods, but tax which would enter directly into export costs may be rebated. The system used in the EEC and all other countries which have adopted the tax is that known as the "invoice" system, under which tax invoiced to a taxable person is deducted from tax invoiced by him to arrive at his net tax liability. It is to be presumed that we also shall adopt such a system. The basic principle is that the tax will apply to all business transactions of whatever kind, but there will be some specific exceptions. The supply of services, as well as of goods, would be covered. Except for importations of goods, transactions would only be taxable when undertaken by "taxable persons", such as companies, partnerships, individuals and other bodies engaged in trading or professional activities. All such persons would have to be registered with the authorities whether they in fact pay tax or not, and would have to maintain the accounts necessary to show their VAT liability and their entitlement to credit for VAT paid by them on inputs. The assessment of the tax would be based on prescribed accounting periods, perhaps of three months. Traders accountable for tax will be required to prepare and submit an annual summary of sales and purchasing during the year. The goods and classes of business which would be exempted from the tax are likely to include, for example, food—and therefore the farming and fishing industries—housing, financial services, newspapers, periodicals and books. Most important for our purposes, it is envisaged that small traders would be exempted because of the disproportionate administrative cost to them of the book-keeping with VAT. No definition of the "small trader" has yet been suggested. Since the final form of this tax is not yet decided, and as there is no experience of its operation in this country, we can only hope that the interest of small businesses will be fully borne in mind, and vigorously represented by the trade associations, in the consultations about VAT. It is important that it should not simply be assumed that exemption is always in the interests of the trader; the exempt trader will still pay the tax on his purchases without being able to pass it on and will benefit only in respect of his own "added value" in the final price to the consumer. If, for example, he is expanding his business and investing relatively heavily, he may find it disadvantageous to be exempt. In addition other businesses which he supplies will have no credit in respect of tax on goods supplied by him. Each small trader will therefore have to consider carefully whether claiming exemption would serve his interests.

III. Proposals for change

Taxation of income

13.42 As taxes on the business profits of, respectively, incorporated and unincorporated businesses, corporation tax and income tax must for certain purposes be considered together. We have received very many complaints about the taxation of profits, mainly under the following heads:

i. that the level of profits taxes is excessive, impairing the ability of small firms to expand, and even threatening their survival;

13.34 These general capital gains tax rules apply to companies equally with individuals. Companies, however, pay tax on their chargeable gains at the corporation tax rate (at present 40 per cent) while individuals and partnerships pay at the capital gains tax rate of 30 per cent, unless it is to the individual's (or individual partner's) benefit to pay under the alternative basis of charge. On this basis half the gain (up to £5,000) is exempted and the other half (plus any gains in excess of £5,000) is treated as if it were his investment income and taxable to income tax (and surtax) accordingly.

Estate duty

13.35 Estate duty is charged on property which passes on death, including settled property, and also on gifts made within seven years before death. Estates not exceeding £12,500 are exempt from duty; on larger estates duty is charged on successive slices of the estate at graduated rates ranging from 25 per cent to 85 per cent, but the total duty cannot exceed 80 per cent of the value of the estate. Duty is generally payable in one sum, but the duty on certain property (i.e. realty, leaseholds, unincorporated businesses and shares in closely controlled companies valued on an assets basis) may be paid by instalment over a period of 8 years,

if i. the duty on those shares together with the duty on other property which can be paid by instalments amounts to 20 per cent or more of the total duty for which a person is accounting in the same capacity, or

ii. immediate payment of the duty would cause undue hardship.

The agriculture value of agricultural property is charged at 55 per cent of the normal rates.

13.36 If the deceased was the proprietor of a business, the market value of his business at the date of death would be charged to duty as part of his estate. If he was a partner in a business, the market value of his share of the partnership would be charged to duty. In either case, industrial hereditaments and machinery and plant used in the business are charged at 55 per cent of the normal rates, like agricultural property.

13.37 If the deceased held shares in a company, duty is generally charged on the market value of the shares at the date of his death. There are, however, special rules for valuing controlling interests in "controlled companies" (broadly, companies under the control of five or fewer persons). If within 7 years of his death the deceased had effective control of the company (and, if it was not controlled by votes, the beneficiaries after his death also have effective control) the value of his shares has to be based on a valuation of the company's assets as a going concern. When shares are valued on the assets basis, the 45 per cent relief is given on industrial hereditaments, plant and machinery (and agricultural property occupied by a farming company). If shares valued on the assets basis are sold within three years after the death, relief may be available by reference to the sale price.

13.38 In certain circumstances estate duty may be chargeable under Section 46, Finance Act 1940, on the assets of a "controlled company" on the death of a person who has received benefits from the company within the previous seven

company is a trading company, a [illegible]
investment company.

13.23 If a shortfall assessment is made, the company has the right to appeal against it to the General Commissioners of Income Tax, who are independent local bodies set up to hear income tax and corporation tax appeals. A company might, for example, think that the Inspector's estimate of its required standard for a particular accounting period was too high and did not take full account of the company's business requirements: if agreement could not be reached informally, the Inspector would make a shortfall assessment, and the company could then appeal against it.

13.24 *Shortfall clearances.* At any time after its Accounts for a particular accounting period have been adopted at a general meeting, a trading company may send the Accounts and directors' report to the Inspector and ask whether he intends to make a shortfall assessment. The Inspector must then within three months either (a) say whether he proposes to make a shortfall assessment or not, or (b) ask the company for any further information he needs to enable him to reach a decision.

13.25 The amount of income tax and surtax assessed under the shortfall provisions was about £4¼ million for the year 1969–70. But this does not measure the full effect of the shortfall provisions, because it does not take account of the tax in respect of dividends which might not have been paid but for the shortfall provisions.

13.26 *Loans to participators.* If a close company lends or advances money to a participator or associate of a participator, it has to pay income tax on the amount of the loan grossed up at the standard rate (Section 286, Income and Corporation Taxes Act 1970). (Broadly, a participator is any person who has a share or interest in the capital or income of the company; and an associate is any person closely connected with him, e.g. a relative.) In effect, the loan is treated as if it were a dividend from which income tax had been deducted at the standard rate. If all or part of the loan is subsequently repaid to the company, the income tax charged is refunded to the company; where the borrower is an employee and his shareholding in the company is no more than five per cent, the loan is exempt up to a limit of £15,000. Also as an administrative practice, where a trading company makes a loan to executors to enable them to pay estate duty on shares which form a substantial part (one-third or more) of the ordinary share capital of a company, the income tax charge on the loan under Section 286 is suspended for up to five years if the executors can show that the duty could not otherwise be paid without realising some or all of the shares in the company on which duty is chargeable.

13.27 *Interest paid to directors.* There are limits on the amount of interest paid to directors and their associates which can be deducted from a close company's profits for corporation tax (Section 285, Income and Corporation Taxes Act 1970). Where interest is paid to, or to an associate of, a director who has a material interest in the company or its parent company the amount of interest allowable against corporation tax is limited to eight per cent of the lesser of (a) the total

part of the tax deducted is repaid to [illegible]
deduction of income tax ("franked investment income") are not liable to corporation tax; the income tax which has been deducted may be set off against the tax which the company has to deduct from its own dividends. The number of active companies within the charge to corporation tax is about 320,000. In his 1971 Budget Speech, the Chancellor announced the Government's intention to replace the existing system of company taxation by one which would be neutral between distributed and undistributed profits. A Green Paper (Cmnd. 4630) sets out the considerations which the Government have had in mind in proposing possible schemes for re-structuring corporation tax and makes it clear that the practical choice lies between two alternatives—a "two-rate" system and an "imputation" system. The differences between the two systems are very complex, but for most small companies irrelevant and it would not be worthwhile to describe them in detail here; those interested should consult the Green Paper. The essential feature of the "two-rate" system would be that tax would be paid at a lower rate on distributed than on retained profits. The rates of corporation tax (and of income tax, which would be deducted from dividends and paid over to the Revenue as at present) could be determined so as to ensure that the tax burden on distributed profits, taking income and corporation tax together, would be at the same level as corporation tax alone on undistributed profits. Under the "imputation" system, on the other hand, all profits, whether distributed or not, would bear tax at the same rate but part of the tax on distributed profits would be "imputed" to the shareholder as a payment on account of his eventual income tax liability on his dividends. The tax imputed in this way would be collected by the Revenue from the company by way of advance payment at the same time as the net dividends were paid to the shareholder. The Government have stated that in their view there are domestic reasons for preferring the "two-rate" system, but they have invited discussion and consultation on a wide scale, and have pointed out that the eventual changes must have regard to the development of company taxation within the European Economic Community. Whatever system is chosen, its main result will be to remove the present discrimination against distributed profits in the taxation of the company itself.

Capital allowances

13.18 The Government introduced legislation in the Finance Bill 1971 providing for a new system of depreciation allowances for expenditure on machinery and plant. The main features of the new system will be a new first-year allowance enabling 60 per cent of the expenditure to be written off for tax purposes in the year in which the expenditure is incurred and a standard rate of writing-down allowance which will enable 25 per cent of the reducing balance of the expenditure to be written off successively in later years. In the Development Areas capital expenditure on new machinery and plant (other than mobile equipment) for use on industrial premises will qualify for free depreciation. These changes are fully explained in the White Paper *Investment Incentives* (Cmnd. 4516) which was published in October 1970. The Chancellor of the Exchequer has also announced that legislation will be introduced in the 1972 Finance Bill to provide that, for expenditure incurred after 19 July 1971, free depreciation for machinery and plant in Development Areas will no longer be limited to industrial machinery and plant but will apply to new machinery and plant (other than mobile equipment)

ability and readiness to supp...
showed in the previous chapter, the capital market is most efficient at catering for the needs of the large company. Furthermore—and far more important—small firms are in general much more reluctant than large companies to take finance from outside institutions or persons. They are therefore more dependent on self-financing.

13.13 We therefore find that the current regime of high taxation operates differentially against the small firm sector in two respects. First, high taxes on capital (especially death duties) undermine incentives in small firms, which are frequently family businesses, more seriously than in large; and second, high taxation of profits and rapid inflation have combined to make the financing of expansion more difficult unless recourse is had to external finance on a scale which the small businessman is unwilling to accept and often unable to achieve. We accordingly considered the case for offsetting these disadvantages to small firms by changing fiscal policies: the effect of estate duties might be offset by some form of "consanguinity concession" whereby a lower rate of duty is applied to property left to a close relative—so that family businesses passing within the family, for example, would benefit: similarly, a preferential rate of corporation tax on the first tranche (say £20,000) of a company's profits would be of value to all, but particularly helpful to small companies. It is not difficult to think of further concessions which would be of special benefit to small firms and which could have substantial effects on the prosperity of the sector. However, as will appear later in the chapter, all such proposals seem to us either to be open to powerful objections, and we have been forced to reject them, or a means of reducing the total tax burden and therefore outside our remit. We see no acceptable means of offsetting the disadvantages arising for small firms from the general tax burden. This is unfortunate, but not catastrophic. We do not believe these disadvantages are so serious as to threaten the viability of the small firm sector. Furthermore, they are already offset to some extent by two important benefits enjoyed by most small businessmen. These are the advantages arising from the lower rate of tax charged on capital gains, which is particularly helpful to the man who builds a successful business, and the small but significant degree of latitude in the assessment of income for tax purposes which is enjoyed by many self employed persons. For all these reasons we make no recommendations designed to give small firms specially favourable tax treatment, though later in the chapter we shall comment on a number of proposals by witnesses which would have this effect. Our basic philosophy on taxation remains as set out in the Chairman's letter of 15 January 1971 to the Minister for Industry, Sir John Eden, in which he said:

> My Committee wish to emphasise again that what is needed is a taxation policy which will restore initiative, encourage entrepreneurial activity and improve the liquidity position of small businesses. We believe that continued reduction in taxation of personal incomes and of estates would be most likely to achieve this result.
>
> These matters would affect all equally and not small businesses preferentially. There are certain areas in which we believe that small businesses suffer inequities or unnecessary disabilities as a result of the present tax system and we have a number of recommendations to make on them. We are not proposing radical discrimination in favour of small firms, since we do not believe that a case could be made out for this at the present time.

carry relatively large stocks [illegible]
stock replacement. We have attempted to assess the quantitative impact of this factor on the basis of the accounts of small manufacturing firms returned in response to our postal survey. Calculations to allow for the effects of inflation have been made for the average manufacturing company, and the results are set out in Table 13.II. These should not be regarded as precise calculations since, of course, they are not based on the full information that an accountant would have at his disposal in preparing the accounts for an individual firm. The adjustments we have made should be regarded as no more than exemplifying the orders of magnitude involved. Adjustments have been made (on the basis explained in the notes to the Table) to allow for (a) the depreciation of fixed assets by reference to replacement prices rather than original cost, (b) the replacement costs of stocks, and (c) the maintenance of the net debtor/creditor position in real terms.

TABLE 13.II

Adjustments for inflation to the profit and loss accounts of the average small company in manufacturing in 1969

Appropriation account	£	£
Balance before charges below		12,573
Less directors' remuneration		5,252
Less depreciation at book values		1,982
Net accounting profit (before tax and interest)		5,339
Less additional provision for depreciation at current prices[a]	350	
Less stock appreciation[b]	500	
Less provision to maintain other net assets[c]	300	
Total adjustments for inflation		1,150
Net economic profit		4,189
Less taxation	2,293	
Less interest	599	
Less dividends	903	
Total appropriations		3,795
Retentions in the business out of the year's earnings		£394

Source: Committee's Questionnaire Survey, Research Report No. 17. The above accounts relate to incorporated businesses only, and hence differ from those quoted in Chapter 2.

Notes:

a. Assuming fixed assets (which at book values totalled £21,339) were bought on the average five years ago, and that prices have been rising at 3½ per cent a year (corresponding to the rise in the wholesale price index of manufactured products in the period 1963–69), depreciation as provided in the books will have been based on values that on average are some 17½ per cent (5 times 3½ per cent) too low. An additional provision has therefore been made of 17½ per cent of normal depreciation.

b. Prices of materials, etc., used in manufacturing industry rose in 1968–69 by 4 per cent a year; this proportion has been applied to the balance-sheet value of stocks (£12,681) to yield the approximate sum required to be set aside to maintain stocks constant in real terms.

c. A proportion as in b. has been applied to the value of other net assets (totalling £7,456) comprising debtors, cash and bank balances, other current assets, *less* creditors, acceptance credits and bills payable, and current tax liabilities. It should be noted that bank overdrafts and other loans are here treated as a source of finance.

versely, is not lightly reversed when circumstances change,
favourable than anticipated. It follows that in assessing the effects of taxation, developments over a substantial period, perhaps a generation or more, have to be kept in mind. Certainly the full effect of such recent changes as those of the 1965 Finance Act have not yet worked themselves through the system. It is nevertheless possible, and necessary, to make some judgements on these matters.

Incentives

13.6 The question of the disincentive effect of high taxation is exceedingly complex and controversial. It has never been convincingly demonstrated that effort and risk-taking in business respond inversely to tax changes, and it is necessary to make allowance for the almost universal tendency to regard oneself as excessively taxed when evaluating evidence on this subject. It can be argued that at some levels of income, when there is not substantial capital at risk, high taxation has an incentive effect. Nevertheless it is obvious that taxation *could* so alter the balance between risks and rewards, for example, as to make risk-taking a wholly irrational activity, and we are satisfied that in some circumstances high taxes do inhibit enterprise. Basically there are two kinds of decision which may be affected by changes in the risk/reward ratio: the decision whether or not to found a new business and the decision, once in business, whether or not to invest more effort or money in it. The first of these is hardly applicable to large firms; at foundation, practically all businesses are small. Now we have seen that small businessmen are by no means entirely motivated by the desire for wealth; they are also activated by many other motives, chief among them being the desire for economic independence. Nevertheless a man considering whether or not to start a business must weigh the potential financial benefits—the possibility of earning and accumulating a great deal more money than he could in most forms of employment—against the risks not merely of earning less than he otherwise might but also of bankruptcy. High and progressive rates of tax certainly reduce the rewards of success and may increase the risk of failure. They must therefore, in the long term, diminish the attractions of self-employment. This could be serious for the future of the small firm sector—and, ultimately, of the whole economy. Nevertheless it must be remembered that the total rewards from a successful business venture, which it is possible eventually to sell for a capital sum, are still very substantial—certainly greater than most people can hope for from the alternative modes of employment open to them.

13.7 The danger that the development of existing businesses, large or small, will be stultified by the disincentive effect of high taxation is more serious, and here also we believe the small firm is particularly likely to be affected. We see no ground for believing that current levels of tax on profits, properly so called, erode incentives more seriously in small firms than in large, but it is otherwise with taxes on personal income, and the small businessman frequently does not distinguish between the profits of the business and his personal income. Certainly the standard of living of the small businessman is far more closely related to the profits of his firm than is that of the manager in a big company, and he likewise has greater freedom, if he so chooses, to do less work if he feels that extra effort would be inadequately rewarded. But it is taxes on capital, which in the United Kingdom context mainly means estate duty, that most seriously affect the

concerned only with matters of detail.

of tax law or its administration, but it is also possible that the general impact of a high-tax system such as ours is more severe in some sectors than in others. If this were found to be true, and if acceptable remedies were available, it would be reasonable to compensate for this general imbalance in the system.

13.3 We are therefore seeking answers to two questions:

i. Accepting that a regime of high taxation of profits and capital places a burden on all firms in the private sector, is such a regime significantly more unfavourable to the survival and development of small firms than of large?

ii. Are there any particular features of the United Kingdom tax system which discriminate against small firms?

The second of these questions constitutes the subject matter of Section III of this chapter, where we discuss those features of the system which are said to differentiate against small firms. We there make a number of recommendations which, though individually small, would if implemented amount to a significant improvement in the small firm's position. We deal with the first question in the paragraphs which follow.

I. The effect of general tax levels on the small firm sector

13.4 During this century the United Kingdom, in common with other developed countries, has experienced an increase in the general burden of taxation which might almost be described as revolutionary and which has had profound effects on the distribution of wealth in the population. Such a truism hardly requires justification, but since our argument is to be based on the proposition that by historic standards we are living in an era of high taxation it may be worthwhile to illustrate the point: Table 13.I shows the rising level of income tax and the rising incidence of surtax and death duties since 1920. The true magnitude of this change can only be appreciated if allowance is made for the decline in the value of money over this period. The figures are therefore given at current and at fixed prices. If carried back before the first world war the change would of course be still more remarkable.

TABLE 13.I

Changes in effective rates of income tax, surtax and estate duty

(a) At current prices

		Income tax and surtax			*Estate duty*
Fiscal year ending 5th April	*Standard rate of income tax*	*Earned income at which standard rate payable* (1)	*Income* (2) *at which income tax and surtax takes:* *50% of earned income*	*25% of investment income*	*Value of smallest estate on which average rate is 33%*
	%	£	£	£	£
1920–21	30·0	541	22,794	2,096	1,522,389 (5)
1927–28	20·0	584	— (3)	5,934	1,522,389 (5)
1931–32	25·0	470	24,325	3,091	507,463 (5)
1935–36	22·5	445	31,185	3,975	507,463 (5)
1952–53	47·5	895	5,175	967	51,493
1957–58	42·5	901	7,991	1,168	51,493
1963–64	38·75	946	14,325	1,490	51,493
1965–66	41·25	972	12,772 (4)	1,424	51,493
1966–67	41·25	972	13,400	1,424	51,493
1970–71	41·25	746	13,454	1,472	51,389

fulfilled depends on the level of [illegible]

Summary and recommendations

12.98 We have found that small firms have suffered and still suffer a number of genuine disabilities, by comparison with larger firms, in seeking finance from external sources. First, they have suffered differentially, for the reasons given in paragraph 12.17, from the official ceilings on bank lending. Second, some institutional facilities available to large firms are not available to small ones. Third, for those facilities which are available, small borrowers must generally pay rather more than large ones; this is true of overdrafts, of term loans, of hire purchase finance and even of equity raised by public flotation. Fourth, many small firms are prevented by lack of information and by prejudice against borrowing from making use of the full range of facilities available to them. However, most of these disabilities reflect the higher costs of lending in small amounts or the higher risk of lending to small borrowers; they do not result from imperfections in the supply of finance. Indeed the ability and readiness of the financial institutions to exploit every new legitimate demand for funds is one of the greatest strengths of our financial system. We believe that the new freedom to be extended to the banking system will improve this still further. We therefore do not recommend the creation of a new institution for the provision of finance to small firms. Nor do we support the provision of finance at subsidised rates, whether through a new official institution, through existing commercial ones or direct to small firms themselves. We believe that small firms in general should be and are capable of paying the economic or going rate for the finance they need, provided they make full use of the resources, including net trade credit, available to them. If, at some future time, it is thought necessary to subsidise the provision of finance to small firms, we strongly recommend that this should be done within the existing financial system; the creation of an official body for this purpose would in our view distort the market in highly undesirable ways. Moreover what is required above all for the health of the sector is an economic and taxation system which will enable individuals to acquire or establish new businesses out of personal resources and to develop these on the base of retained profits. Without this no institutional financing arrangements can preserve the small firm sector.

opposed to simply small) firms, whose immediate past performance ... unimpressive, but which, if they could achieve a 'take-off' in their growth, would become the successful small or medium size firms of the future". This, however, is akin to the business of the venture capitalist, and as we have seen it is extremely difficult: the market is improving steadily both in the number and the skill of the practitioners, but we know no means of reducing the risk involved, nor any substitute for the judgement of the investor. Their main conclusion is the same as ours, that "there is no single major defect in financial facilities for small firms that calls for radical action".

12.92 This does not entirely dispose of the problem, for apart from the continued need for an adequate supply of private capital it is possible for the institutions to be doing all that can reasonably be expected of them and for the sector nevertheless to be in severe financial difficulties. It is possible, for example, for the institutions to be forced by conditions in the money markets to charge rates of interest which small firms find it practically impossible to pay. Some witnesses have told us that this is the position, and some foreign Governments, as we have seen, have felt it necessary to provide interest rate subsidies. This might appear to be justified by the fact that for some types of finance small firms must in general pay rather higher interest rates than large ones. However, we do not consider that the higher costs which small firms must pay constitute discrimination against them. Though unfortunate, these differences are rooted in the economies of scale which are present in most forms of financing.

12.93 Our second argument against subsidy is that with a given volume of finance available, a subsidy would divert resources from more profitable to less profitable uses; if this were not so—if the subsidised borrowers were as capable of paying the going rate for finance as the unsubsidised —the subsidy would clearly be unnecessary. Since capital is a scarce commodity, we believe it should be the object of policy to secure its most efficient use. It is clearly possible for the price of capital to become high, and for the development of industry as a whole to be retarded in consequence: this indeed is a necessary part of the functioning of a market, as distinct from a controlled, economy. But in these circumstances it is still less desirable that its allocation should be decided by other than economic considerations.

12.94 Our final argument against subsidised interest rates is that small firms on average achieve a higher rate of return on capital employed than large. This makes it difficult to sustain a case for affording them cheap money—they should indeed be able to pay the economic cost of the resources they use. Our judgement therefore is that the provision of subsidised finance to small firms in present circumstances is neither necessary nor desirable.

12.95 It is of course possible that this judgement will have to be reviewed for the reasons given in Chapter 8. Although we have there suggested that fiscal methods might be the best means of assistance, a serious deterioration in the position of small firms in the future might re-open the question of subsidised finance for small firms. If this were to happen, we strongly urge that assistance should not be given through the medium of an official agency lending at subsidised rates. The

iii. official financial support and encouragement for the establishment, by commercial banks, of affiliated financial institutions specialising in term loans to small and medium-sized concerns;
iv. official financial support and encouragement for the formation of trade associations and co-operatives which make term loans available to their members;
v. the establishment of, or financial support for, institutions and co-operatives which guarantee the credit standing of small businesses seeking term finance;
vi. subsidisation of interest rates charged by institutions lending to small businesses.

The best known of such policies are those of the United States, where, as we have said in Chapter 10, the Small Business Administration has been empowered to subsidise loans to small firms either directly, by the provision of medium and long-term loans at rates of interest significantly below commercial rates, and even below the SBA's borrowing rate; or indirectly by means of a guarantee whereby the SBA assumes 90 per cent of the risk of loss in case of default on a bank loan by a small firm whose credit it has guaranteed. Since the beginning of 1969 the direct loan programme has been in abeyance and the SBA has concentrated on loan guarantees, which are thought, by the SBA and the banks, to have great advantages, in that they bring small firms within the orbit of bank lending, which must in the long term be the mainstay of a successful business, and enable limited SBA funds to be spread much further than would be possible in direct loans.

12.88 There are thus many precedents for official intervention in favour of small firms in the financial field. However, we do not propose to recommend any such initiative, since in our view there is no imperfection in the supply of finance as it now stands sufficiently serious to warrant either the creation by Government of a new institution or a substantial change in the way existing ones are organised to do business. There is now no gap corresponding to the famous Macmillan Gap. This is not to say that existing institutional arrangements are perfect, still less that every small business will be able to find finance of the type it needs at the price it can afford to pay: but in spite of considerable efforts we have identified no body of legitimate unsatisfied demand significant enough to require radical changes in the market. We are satisfied that if such a demand were to develop, new competing sources of supply would speedily arise to meet it, since few sectors of the economy have shown such vitality, such alacrity in exploiting new opportunities, as the finance market. This is particularly true if, as we believe, the Clearing Banks are in future to have greater freedom from central control in the development of their services. The greatest strength of our financial system has been its flexibility in adapting to new circumstances and new demands. This flexibility derives mainly from the large number of independent operators in the field; since in financial transactions so much depends on the judgement of the investing institution it is desirable to have as many centres of judgement as possible. Given this we can be reasonably confident that any deserving firm will eventually, if it perseveres, find an institution willing to advance money on proper terms.

the period of credit required by ...
same treatment by the Export Credits Guarantee Department as other exporters. ECGD describes itself as a "Department of Government which carries on a commercial business providing insurance for exporters against the risks of selling overseas; it also furnishes guarantees of repayment to banks which supply finance for export credit. . . . By applying normal insurance principles it offers insurance at a reasonable yet economic price and in return gives value for money in terms of claims paid and efficient service". This body's credit insurance business has grown from £88 million in 1946–47 to £3,225 million in 1970–71. The proportion of British exports insured with ECGD has risen from 8 per cent in 1947 to more than one-third today. The number of current policies has risen from about 1,780 in 1947 to over 12,000. The main type of export business covered by ECGD is comprehensive insurance; this accounts for around nine-tenths of all the cover provided. An exporter wanting this type of cover must offer ECGD "all or most of his future export business in both good and bad markets" for a period of at least one year ahead. The obligation to take comprehensive cover is justified on the grounds that the general application of an insurance principle is necessary if ECGD is to be solvent and provide cheap cover. Most comprehensive cover business is on exports having short payment terms—cash to six months. Until 1 June 1971 ECGD also offered a Small Exporter Policy designed "for the manufacturer with no export experience and for the exporter of consumer goods or other small items whose export turnover has not yet risen above £100,000 per year". Premium charges under this Policy were higher than under the normal policy. The Policy has been discontinued because very few small firms used it (less than 20 policies were current in the early part of 1971) and it was therefore unprofitable. The Economists Advisory Group, in their survey of financial facilities for small firms, suggested that the Policy had certain disadvantages which reduced its attractiveness to small firms, and that its cancellation would not be a serious loss. We agree. The general services of ECGD stand in very high repute, and we received no serious complaints about them, beyond some general criticism of ECGD's "excessively conservative" attitude. This was not substantiated, and we accept the general view that ECGD's services stand comparison with any in the world.

12.85 We have seen no convincing case of a creditworthy small firm being denied export finance, and our general conclusion is that in this field small firms suffer no disabilities other than those inseparable from their size and the inherent limitations on their ability to raise outside capital. These disabilities could be overcome by the provision of specially susidised finance for small exporters, but this is a device that we cannot support. Nevertheless small firms will be involved to a greater degree in exporting if we become members of the enlarged European Economic Community and it is of vital importance that the small firm should continue to be able to obtain its proper requirements if the country is to obtain the full benefit from entry into the EEC, or indeed from increased activity in other export markets.

The case for Government intervention

12.86 Having completed this review of the financial system as seen from the viewpoint of the small firm seeking external finance, we are able to summarise

such inhibitions about court action. A large [illegible]
take nine months' credit instead of two or three—and we know of some famous ones who did precisely that in 1969—with complete impunity as far as their small suppliers are concerned. Our evidence on this subject is purely qualitative; we have no statistics to prove these points. But the qualitative evidence was remarkably unanimous and forceful.

12.78 This problem is not of course confined to this country. We were told that it is often serious in Japan, for example, and that there the Ministry of International Trade and Industry have powers to intervene on behalf of small firms with legitimate complaints of delayed payment by large customers, and to enforce payment. The power is little used, however, for the same reason that few small firms in this country take their big customers to court—the fear of losing future business. We have been unable to think of a sure means of enforcing prompt payment in the private sector of industry. The wider use of contracts embodying penalties for late payment might do some good; but they can only be enforced by recourse to law, and it is now common for such "penal clauses"—say, the charging of 1 per cent per month interest on delayed payment—to be ignored by companies secure in the knowledge that they will not be taken to court. An alternative remedy which has been suggested to us is the wider use of bills of exchange, which would fix a date for repayment and prohibit, except by negotiation, any extension of the credit period. Such bills could be discounted, thus providing the creditor with working capital more quickly than would otherwise be the case. We put this forward for consideration: it seems to us to have possibilities, but of course requires negotiation with the debtors. It is also administratively cumbersome when there are a large number of relatively small indivdual transactions.

12.79 The public sector offers better prospects of improvement, and it is possible that a lead given here would have some effect in private industry. We were told that central Government departments themselves have a bad reputation in this connection, as well as nationalised industries and public authorities, and we therefore discussed the matter with the Treasury. In the case of the departments, we are entirely satisfied that deliberate delay of payments does not occur. The number of payments is immense—some departments receive as many as 450,000 invoices in a year—and occasional mistakes inevitably happen, but prolonged and serious efforts have failed to produce a single valid case of deliberate delay. This is as it should be; departments have no liquidity problems and there is strong pressure to clear bills quickly. The average time taken is between one and three months, depending on the size and complexity of the contract. Some of the nationalised industries however (which do have liquidity problems) appear to be less conscientious; their average payment period is three months, but longer delays are not uncommon. Local authorities, particularly their public works departments, have also been heavily criticised, and the Federation of Building Trades Employers suggested to us that their internal audit procedures inevitably cause delays in payment of accounts.

12.80 We believe that all undertakings in the public sector should observe the highest standards in this matter. This would be facilitated by the adoption, for all contracts in the public sector, of a standard form of contract embodying

companies, was raised with us, but while [illegible]
serious examination. The amount spent on gambling in this country is indeed very large, but practically all betting is done in a form which offers a chance, however remote, of large and quick returns from a small stake. Most people stake sums which to them are quite marginal and which would certainly be useless for investment in equity. They certainly do not invest their savings in risky or "lock-up" ventures and this is what would be needed if the investments were to be of any use either to the investors or to the small firms invested in. Dealings of a few pounds a time would be hopelessly uneconomic from every point of view. The only form of gambling which bears the smallest resemblance to ordinary investment, in that savings may be held in this way, is the purchase of premium bonds, and here the differences are far more significant than the resemblances, clearly illustrating the difficulty of this whole concept. First, savings held in the form of premium bonds are completely safe (except against the ravages of inflation), whereas investment in small firms is risky. Secondly, premium bonds are completely liquid, whereas small firm securities may be extremely difficult to realise at all. Thirdly, transactions in premium bonds are very simple, whereas the intelligent buying of unquoted shares is dauntingly difficult even for experts. Lastly premium bonds offer the possibility of capital gains vastly greater in relative terms than could be hoped for from the most successful equity holding. There is nothing in this picture to make us believe that the small saver would be attracted to investment in the equity of the average small company. All the evidence suggests that he demands above all safety and liquidity for his savings deposits, even at the cost of a low rate of growth, and these are precisely what investment in small firms cannot provide. If the present regulations governing the issue of securities to the public were so far relaxed as to permit the marketing of many small securities, the likely consequences would be the entry into the market of undesirable operators who would engage in high-pressure selling of dubious stocks, the loss of their investments by a number of small savers, and a swift return to stringent controls.

12.74 A further proposition which has been put to us is that a unit trust might be set up to invest specifically in the shares of small unquoted companies, thus attracting private savings into the small firm sector. Though attractive, this suggestion is also open to what appear to be fundamental objections. Not only would administrative costs be forbiddingly high, but the difficulty of valuing the portfolio on a day to day, or any reasonably short term, basis, would be practically insuperable. The dealing basis would therefore be difficult to establish. Moreover it would be almost impossible to guarantee the re-purchase of units. It would present problems of a greater magnitude even than those involved in property bonds. However, these objections do not apply to an investment trust, of which there are a number investing in small companies with success.

12.75 We must conclude that none of the proposals for a "secondary market" that have been put to us offers any prospect of circumventing the basic problem of institutional dealings in small securities, which is that infrequent and small transactions would render the overhead costs of the operation altogether prohibitive. Indeed, we see difficulties in the whole concept of the secondary market. It would of course be admirable if some of these ideas—for example the formation of a unit trust dealing in small firm securities—could be experimented with

participations. The programme ...
mittent, and finally permanent, withdrawal of public funds, but nevertheless it can safely be said that the danger of excessive optimism in the investment of venture capital was amply demonstrated.

12.68 We can see no easy means, other than subsidy, of stimulating the provision of venture capital for small firms. The higher costs and risks of investment in small firms appear to us to be inescapable. There is no evidence that the standards of creditworthiness applied by the existing UK institutions are too high (the number of unsuccessful investments suggests the opposite) and there are no barriers preventing the entry of new institutions into this market. Subsidising the investor, perhaps by providing cheap Government funds for such investments, would no doubt increase the level of activity in this field (and the question of subsidies is further discussed in paragraph 12.87 *et seq.*) but would, we believe, lead to the same problems as have arisen in the USA.

A "Secondary market" in unquoted securities

12.69 Some witnesses have suggested that the flow of risk capital into small companies would be improved by the creation of a secondary stock market dealing in the securities of small firms. While we cannot support this idea, we recognise its attractions, and accordingly discuss it at some length.

12.70 The inability of small firms to raise capital on the stock market is one of the most obvious contrasts between them and large firms. It is widely believed to be a serious disability, and some witnesses have suggested that it might be remedied by the creation of an organised market in the shares of firms too small for quotation on the stock exchanges. Proposals for the creation of a "secondary" market of this kind commonly take two forms:

i. that the private placing with institutions or rich individuals of small firm securities, whether quoted or unquoted, which is now done in a small way by some stockbrokers and merchant banks, should be organised on a wider scale;
ii. that a new public market, analogous with the American "over the counter" market, should be set up in this country.

We shall discuss these in turn.

12.71 Although there are some private dealings in unquoted securities, the market in them is very small and very informal. Stockbrokers will occasionally put clients in touch with private companies wishing to sell equity, and there is some trade between institutions in unquoted shares, but dealings are very infrequent. This is true even of the smaller quoted issues, for many of which there is no effective market. Institutions are very unwilling to buy or hold unquoted stocks because of the high risk involved, the difficulty of obtaining information about them and the high overhead cost of running a portfolio consisting of many small items. In addition, the rules of most institutions combine a minimum size for individual holdings with a maximum proportion that may be held of any individual company's equity. At present, brokers or merchant banks that have

ments and dividends. In recent years,
capital has placed a premium on short term holdings. Charterhouse Industrial Development, for example, told us that they are now seeking to liquidate their investments within five to seven years, the average hitherto having been nine years. The current cost of capital has made it impossible to lend profitably at long term at their normal lending rate of 12 per cent, so that a relatively rapid turnover, leading to regular realisation profits, is essential. To seek an equivalent return solely through loan interest and dividends would entail expecting yields of 17 or 18 per cent, which even the best small firms would find it difficult to meet, and even so it would be impossible to generate sufficient profits to cover the occasional heavy loss. Although prepared to hold investments for a longer term, ICFC's experience is broadly similar; they would find it very difficult to run profitably without a substantial volume of successful equity investment. In fact direct equity investment has risen steadily as a proportion of the business done by ICFC, from 13·6 per cent in 1965–66 to 22·7 per cent in 1969·70. The convertible element in convertible loans has for some years accounted for a further 6·5 per cent.

12.65 *Venture capital.* We are using this term to mean equity participation in relatively new ventures—the subscription of capital with which a firm may be founded or a new idea developed. This operation is different in kind from equity participation in an established company: both the risks and the potential rewards are very much higher. This business is much more highly developed in the United States than in this country, though the venture capital movement in the UK has been greatly stimulated by the American example, and today there is a growing fund of capital available for investment in suitable projects. The ideal venture proposition as described to us in America is a small new company deliberately set up to exploit a new departure in technology or to provide a highly sophisticated technical service. Its founders will be young, highly qualified in technology, management or both, and will have every intention of building their company up to the stage of a public flotation in the shortest possible time. To obtain outside capital is for them the essential first step—unless that be to secure the research or development contract, usually Government financed, on which so many such companies have been based. There is thus no problem in persuading them to part with equity. The rewards of success can be very high indeed; American Research and Development, one of the most famous venture houses, saw an investment of $70,000 in Digital Equipment, a small computer manufacturer, grow to over $300 million in less than ten years. Similar, if less spectacular, stories are common in America. We were told that for a new company in a high technology field to achieve annual sales of $2 million in two years on the strength of a personal investment by the founder of $5,000 would not be specially remarkable, and that very successful companies have been marketed five years after foundation for 1,000 times their original capital value. Such results have been largely confined to new companies in fields of advanced technology (and even here, failures have been more common than successes), but they have helped to create a climate of optimism in which investors are positively seeking opportunities to put money into promising new ventures. This is, nevertheless, a field for experts. The degree of caution exercised by the most experienced American operators is illustrated by the record of one of the great New York venture capital houses, which has

dividends and/or with the possibility, [illegible]
stage of a successful public issue, of large capital gains. It is clear that only the most successful and promising small businesses offer the prospect of capital growth on the scale necessary to attract investors of this type.

12.59 The type of financing provided is normally the same as for nursery finance; a mixture of equity and convertible loan stocks. Most of the institutions demand pre-tax profits of at least £25,000 and all look for good growth prospects as a first priority. ICFC makes convertible loans as small as £5,000, and commonly puts risk capital into companies with total net assets below £100,000 or turnover below £150,000, but most institutions believe that profitable business cannot be done at this level. All venture capital houses are extremely discriminating in their choice of investments, and we see no likelihood that standards for equity participation by the institutions will ever be significantly lower than they are now.

12.60 From the viewpoint of the company seeking finance there are considerable psychological barriers to overcome before the decision to accept equity participation from outside can be taken. More than three-quarters of the cases dealt with concern established family firms, whose proprietors are likely to value above all else the independent authority their position affords, and who may never have considered parting with equity until forced to do so by some pressing need for capital. Many small businessmen are quite prepared to forgo growth, if the price that must be paid for it is the surrender of even part of the control of their business. It is perfectly reasonable for them to be guided in this matter by self-interest. If the introduction of new equity will not, on balance, leave them better off than before it is right to refuse it: why otherwise give up a part of the proceeds of the future growth of their business? What is not reasonable is for the businessman to expect, out of ignorance of its true cost, long term capital to be provided on terms that offer an inadequate return to the investor. Such expectations are very common, apparently because many small firms are badly advised as to the borrowing conditions they must expect to meet. It seems to be generally agreed among the financial institutions, however, that this hostility towards equity participation, very pronounced ten years ago, is growing less intense. Small companies seriously intending to expand are now increasingly ready to recognise that if they are unlikely to be able to finance major growth out of their own resources, due to high tax rates and inflation, their best hope is to secure the commitment of larger external resources. We think that if businessmen were better informed, very many more would decide it was in their interest to take institutional equity finance; and if the demand for such finance materialised, we are confident that many more institutions would come into this field and compete for the business. We should welcome such a development.

12.61 Notwithstanding the gradual change in attitudes towards outside equity participation, many companies withdraw their applications for capital, often before serious negotiations begin, when the presumption is that they have been deterred by the high cost of borrowing at long term. After this stage, negotiations may break down because an alternative source of finance has been preferred, because of a change in the applicant's fortunes, or because the collateral or equity stake demanded is thought too high. Abortive negotiations are costly for the institutions: it has been estimated that discussions with potential customers may

12.54 Nearly all small firms are debarred from [illegible] longstanding rules of the Federation of Stock Exchanges, which state *inter alia* that a quotation may not be granted unless the applicant company is expected to have a total market value of £250,000, and £100,000 in any one security for which a quotation is sought. These rules are intended to protect investors against fraud by ensuring the *bona fides* of the issue, and to ensure that the shares will be held widely enough to make a market. Over the years they have become steadily more severe. However, in practice, for purely economic reasons the minimum size for a quotation in London appears to be much higher than the rules demand; pre-tax profits of at least £150,000 are usually required (implying a total market value of approximately £1 million). Issuing houses and brokers are unwilling to deal with many issues below this size because of the problem of creating an effective market and because of the high fixed costs of investigation and administration. From the holder's viewpoint, shares in small companies have real disadvantages—they are less liquid, more risky and more trouble to manage than those of large companies. The issuing houses therefore impose high standards on all applicants for public quotation, and many are turned down. Those not rejected will find that raising small sums (in stock market terms) by means of a public issue is very expensive. Most authorities tell us that it is normally uneconomic to go to the market for less than about £250,000, because below this size the overhead costs of the issue become disproportionately high. The Economists Advisory Group estimated that the fixed costs of an issue of this size in London would amount to some 6·7 per cent of the sum raised, as against some 3·2 per cent of an issue of £1 million. Some of our witnesses gave considerably higher estimates for the cost of a £250,000 issue; one view was that it would be difficult to bring total costs below £25,000 for any issue on the London market. All agreed that initial costs, as a percentage of the sum raised, are far higher for small issues than for large, and the only means of reducing them suggested to us was that the advertising requirements might be relaxed for the smaller issues; for a London issue, whatever its size, full particulars have to be advertised in "two leading London daily newspapers", and one newspaper might be thought sufficient for a small issue. *We hope that the Council of the Stock Exchange will consider this, but it would not change the basic economics of the situation.* Apart from the big overhead elements in the administrative and marketing expenses of a new issue, dealing in the stocks of small companies is likely to be very unprofitable for jobbers and brokers, since turnover in these shares would be low and individual deals small and infrequent. To summarise, a public issue of shares is only possible for a tiny minority of the best small companies; only companies judged to have good growth prospects, a high quality of management and financial control and an excellent profit record will be granted a quotation, and even for these high flyers the cost of a first public issue is very high.

Direct equity participation by institutions

12.55 It is helpful to distinguish between three basic situations in which a financial institution may consider it worthwhile to take equity in a small unquoted business. The first is when the company, though not yet able to go public, shows good promise of doing so in the near future; this is commonly known as "nursery financing". The second is when an established business, without early prospects

business in the £15,000–£20,000 range).
The standard of property accepted as security may also be slightly lower than normal. The price which has to be paid for this is a rate of interest perhaps 1 per cent or 2 per cent higher than for an ordinary mortgage. It is too early to judge how successful this scheme will be, but we can see no reason why it should not succeed.

12.47 We know of no important "artificial" barriers to investment in small firms by insurance companies. Though they have been subject to mild qualitative directions in recent years, no company has claimed that this has restricted lending to small firms. The main limitations are those naturally arising from the small size of the borrower and the loan.

Sale and leaseback

12.48 This facility, which is rapidly growing in popularity, is another means of raising capital on the security of real property. The normal procedure is for the firm wishing to raise capital to sell its factory or other industrial property to an insurance or property company, which undertakes to lease the property back to the seller. The latter thus receives a capital sum for investment in return for rental payments. Forty-two year leases are common, with five to seven year rent reviews, but much longer leases can be arranged. We know of no special problems arising for small firms which have suitable property on which to raise capital, but such firms are a very small minority: it is essential for the property to be in itself an attractive long term investment for the institution putting up the capital and few small firms own such property. This facility is therefore of limited use to them. The provision of rented factories *ab initio* is of course equally important and we are glad to note increasing interest by developers and property companies in the ownership of suitable industrial and commercial properties which will supplement the activity of Government and local authorities in this field.

Equity capital

12.49 Equity capital may be raised either by a public issue of securities—that is, by "going public"—or by private negotiation with a person or institution willing to buy shares in an unquoted private company. The basic necessity in either case is the existence of investors willing to risk their capital on their judgement of the growth prospects of the company in question, and the ability to attract risk capital, whether public or private, is confined to a very few small firms, most of them at the top of our size range. Very few public companies, whether quoted or unquoted, are small by our standards and though there are many small private companies, most of these have no equity capital other than that of the proprietor and his family, and have neither the wish nor the capability to raise more from outside. Selling equity is thus a potential source of capital only for a minority of small companies—but an important minority, since their record and growth prospects must be outstanding.

12.50 The main sources of equity capital are the direct savings of private individuals and the funds of a wide range of institutions, including insurance companies and pension funds. During this century two outstandingly important developments have transformed this market—but on the whole without benefit to the small firm—by rendering more efficient and more institutionalised the

commercial vehicles. Hire purchase and leasing are the major types of instalment credit and of these hire purchase is more utilised by small firms. Both facilities provide finance for a specific transaction only and the borrower commits himself to a regular schedule of equal payments. The main providers are finance houses, hire purchase companies and to a lesser extent leasing departments or subsidiaries of clearing banks, merchant banks and other institutions such as the ICFC. The interest rate charged varies with the size of the loan and the credit rating of the borrower, but it is always higher than the overdraft rate. In the autumn of 1970 the going rate varied between 6·5 per cent and 8·4 per cent flat, which is equivalent to a true rate of 12–15 per cent on the declining balance. We do not know precisely the proportion of hire purchase finance going to small firms, but the proportion taken by industry in general was commonly estimated by the finance houses as between 15 per cent and 30 per cent of their advances. This facility is in principle available even to the smallest firms, but the amount the finance houses are willing to advance varies with the size of the borrower. Most will not lend more than about half the owner's stake in the business, and impose a minimum loan size of £200. It would be untrue to say that small firms are invariably charged the higher interest rates, but it appears that they are more often judged to be high risks and charged accordingly. Few big firms are charged the highest rates. Small firms should experience no difficulty in finding a provider of hire purchase finance. The finance houses sell their services vigorously and the borrowing procedure is simple and quick. Normally the only background information needed is the last three years' accounts, although personal guarantees are frequently required.

12.41 The usual reason for refusal of a small firm is the finance house's doubt that it will be able to generate enough profit to repay the debt and meet its other commitments. A poor profit record is a severe limitation. New firms, which by definition have no record of achievement, find it difficult to obtain facilities, as do those without up-to-date accounts. A reasonable asset structure is also required as a secondary security. Hire purchase business is, however, highly competitive, and we do not believe that any creditworthy firm should fail to find accommodation.

12.42 It is hard to determine the effects of credit restrictions on hire purchase finance. It seems clear that demand for the service, from all types of firm, increased during the period of restriction, but since the finance houses were subject to the ceiling their business was inevitably held back. Some of them appear to have squeezed small firms harder than large, on the ground that the former were held to be riskier business, and all avoided lending, so far as possible, to the very high risk industries, such as building. There was also a temptation to cut down commercial lending in favour of the more profitable motor and private domestic loans.

12.43 Leasing resembles hire purchase in that the lessor owns the asset and leases it to the customer in return for payment of a specified rental for a fixed period, usually up to five years. The main difference is that, though at the end of the period the asset is usually re-leased, or sold, to the customer for a nominal charge, there is no formal agreement to this effect. In addition to the sources of

hitherto subject to the ceiling on bank lending are anxious to extend their term loan business to small firms, up to maturities of about five to seven years, and we can expect that in the future (assuming that the credit ceilings are fully removed) this type of business will become highly competitive—to the small firm's advantage.

12.34 Term loans of rather longer maturity are not so attractive to those institutions which raise most of their funds at short term and are therefore reluctant to hold assets with more than five years to maturity. There are other institutions which are ready to make term loans of over five years, e.g. the ICFC, but they are much less numerous, and their interest rates are necessarily higher since their own funds are raised for longer maturities, and at interest rates markedly higher than the rates payable on short term deposits. This problem as to the availability, and cost, of term loans of over five years to maturity is however one which affects large firms as well as small. Basically it is caused by the difficulty for the deposit-taking institution of raising matching finance. The availability of term loans therefore decreases progressively with increasing maturity, especially over five years.

12.35 This does not necessarily dispose of the question whether existing institutions are willing to lend on terms acceptable to small firms. A number of highly expert witnesses expressed the view that creditworthy borrowers now have difficulty in raising loans between, say, £5,000 and £50,000 and 5 to 15 years' maturity, not because of an absolute shortage of lending institutions but because the institutions prefer to lend in larger sums and for different periods. For example, several witnesses argued that although the ICFC was created largely to provide finance of this kind, the average size of its advances has so far increased over the years that it is no longer catering for the genuinely small firm. It was further suggested that ICFC is in any case *sui generis*; it has few significant competitors and cannot alone hope to meet all legitimate demands for finance of this kind. Some witnesses have suggested that it is now necessary to create a new institution with a special responsibility to provide term loans at the lower end of this "gap", if necessary with backing from public funds.

12.36 There is however no substance in the contention that the average size of ICFC's advances has markedly increased since its foundation. The average size of their loans and investments, based on amounts outstanding, has remained remarkably stable in money terms since 1951 at about £60,000 and in real terms has therefore fallen substantially. The reason for this is the increasing number of small advances made, which more than compensates for the increased size of individual advances to larger customers. The average size of first advances, as distinct from further advances to existing customers, has remained constant over the past five years at about £44,000. (Information is not readily available for years before 1965 except that in 1951 and earlier years the average first advance was £60,000.) The percentage of ICFC's customers with outstanding balances under £20,000 has risen markedly from under 30 per cent in 1954 to over 40 per cent in 1970. The average size of ICFC's customers, in terms of total net assets, has also remained fairly constant in money terms and has therefore fallen in real terms.

due to the fact that failure to raise finance elsewhere induced applications for factoring services from uncreditworthy or excessively small firms.

12.29 Confidential invoice discounting resembles disclosed factoring in that it involves the purchase of book debts but this is the only common element. The fact that the debts have been transferred is not made known to the client's customers, and the discounting firm (referred to as the confidential invoice factor, or CIF) has no contact with them; the client collects debts and it is to him that the CIF has recourse. The annual turnover of this form of financing is estimated at £140 million. Only a small proportion of this goes to small firms, for whom this service is not generally appropriate. The discounting firms admit to a strong preference for larger clients on grounds of cost and security. They require a minimum turnover of £100,000, credit is not provided in excess of the paid up capital of the borrower, and there is a minimum loan size of £10,000. Even after passing all these tests, the small firm might be unable to provide adequate security. Competent management and good trading records over at least three years are desired. Because the interest charge does not vary with the size of loan or the credit rating of the borrower, and because overhead costs (of initial investigation and subsequent monitoring) are at least as high for small as for large clients, it is easy to understand the preference of the CIF for lending in large units. It may be asked why the greater risk of lending to smaller clients should not be compensated by higher charges. The main difficulty here is that signing a CIF agreement does not commit the client to doing any particular volume of business: he may not use the facility at all, or only very irregularly, and one or two deals of, say, £10,000 would be insufficient to justify opening an account. We feel unable to question the conclusion of the institutions that the introduction of variable rates would not greatly increase the volume of business done with small firms, because it would be very difficult to fix on rates appropriate to the needs of both parties. It is simply an unfortunate fact that the economics of this service require a volume of business and a standard of security that few small firms are capable of supplying.

Medium term finance

12.30 In this section of the chapter we are concerned with medium term fixed-charge lending, or term loans, and the hire-purchase and leasing of equipment.

Term loans

12.31 A term loan is one whereby the lender advances a fixed sum at a fixed rate of interest, repayable either by instalments over an agreed period or in full at a given date. In most cases the debt is repayable within seven years. In most industrialised countries this is the standard form of bank advance, but until very recently term loans, apart from medium term export credits and credit for ship-building, formed no significant part of the facilities of the joint stock banks in the United Kingdom, and among other institutions only the finance houses and ICFC loaned significant amounts to small firms in this form. The overdraft system has in this country largely performed the functions of term lending abroad, since as we have said it has become the custom for "running overdrafts" to

draw on customers who have acceptance credits. [illegible]
problem in discounting the bills. With respect to trade bills, discount houses vary in their willingness to deal with small firms, but the amount involved is small: the EAG have estimated that the total amount of finance provided by the discount market to small firms is probably less than £10 million. This is in spite of the remarkable increase in bill financing which took place in the late 1950s and early 1960s. (This upsurge was largely due to the fact that restrictions on bill discounting were at that time less severe than on bank lending. Since then, however, bill discounting has been subjected to the same restrictions as bank advances and this has significantly slowed the growth of bill financing.) In part the limited use of bill financing by small firms is due to the application of minimum size criteria by the twelve discount houses. Some houses state categorically that they only deal with firms much larger than those we are considering, and only four of the twelve claim to provide facilities for small firms as a regular part of their business. Even they do so only to a limited extent. They are not normally prepared to handle bills which are large in relation to the size of the firm concerned. Some are unwilling to accept accounts smaller than about £5,000 in total, and impose a minimum limit of £1,000 on any one bill. This limits their business with small firms quite severely. We hope that the relaxation of credit restrictions will allow the discount houses to reconsider their position in this matter—particularly those of them who do no business with small firms. If some find it possible to do such business profitably, there is no obvious reason why others should not do likewise.

12.25 There is a reference in the Report of the EAG to a second factor which appears to limit unnecessarily the use of bill finance by small firms. This is the interpretation by the accepting houses of the Bank of England's requirements in regard to the creditworthiness of bank bills. This stems from what appears to be a misunderstanding by some accepting houses of the Bank of England's procedures for ensuring that the bills in the market are of a high standard of creditworthiness. The Bank of England regularly buys a sample of bills in the market and makes representations to discount houses and/or Accepting Houses about any which it considers to be below certain standards of creditworthiness. This does not necessarily imply objection to bills drawn on small firms, but at least one institution has stated that it would expect objections from the Bank if it gave acceptance facilities to small firms. However, we have discussed this contention with the Bank of England, who deny that their screening procedures are unduly strict. Guidance given to the discount market encourages the use of acceptance facilities to finance the import and export of goods regardless of the size of the firm concerned. If there is a misunderstanding here we hope it can be dispelled, since bill financing has advantages which render its wider use among small firms highly desirable: its cost compares favourably with that of most other forms of short term borrowing, being but little higher than that of overdrafts, and investigation and transaction costs are also low. It could be a particularly useful facility for a small firm wishing to expand and engage in importing and/or exporting, but whose own resources are inadequate.

Factoring and confidential invoice discounting

12.26 These two services provide means whereby short term finance may be raised on the security of accounts receivable. The essence of the factoring

firms reporting a cut in their overdraft limits considerably [illegible]
whose limits were increased—though that alone, we suspect, would have sufficed to make 1969 an exceptionally difficult year for the banks and their customers—but that in a year of rapid inflation 86 per cent of the sample had a static or reduced limit. Some of those suffering reductions would no doubt have suffered them irrespective of official credit policy, because the trend of their business no longer justified the previous limits, but there is no question that the ceiling largely accounted for this remarkable state of affairs. Within the sample, there was no significant variation with size of firm, as is shown by Table 12.II.

TABLE 12.II

Proportion of firms reporting cuts in overdraft limits, by size of firm

Number of employees	*Percentage reporting cuts*
1– 24	31
25– 99	30
100–200	29

Source: Committee's Questionnaire Survey, Research Report No. 17.

We have been unable to make comparisons on this basis with firms outside our size category, since the necessary figures do not exist. However, examination of the official *Financial Statistics* (No. 108 and preceding issues) shows that whereas bank advances to the UK private sector, excluding advances to companies and personal advances, fell slightly in 1969, advances to companies increased somewhat, particularly in the early part of the year. Since our own research reveals no difference between the experience of incorporated and unincorporated small businesses, we may presume that the increase in bank lending to the company sector in 1969 was accounted for mainly by the larger companies.

12.22 Much of the pressure to which the clearing banks were subject in 1969 derived from the fact that their interest rates were seriously out of line with those in other financial markets; overdrafts were still available at 7½–10 per cent when the market rate for mortgage finance was 10½–12 per cent, for leasing 12–14 per cent and for hire purchase 12–15 per cent (true rate). The expected change of policy to which we referred earlier will entail a more strictly "commercial" and competitive attitude; the banks will in future take greater care that their lending rates stay close to parallel rates outside, and already it is not uncommon for them to charge 3 or 4 per cent above bank rate for overdrafts. Such charges were unthinkable until very recently. The clearing banks are also beginning to insist that "hard-core" overdrafts should be converted into genuine medium or long term finance. These changes of lending policy are not likely to be reversed when official credit restrictions are finally lifted. We therefore expect to see a move away from overdraft financing towards term lending at appropriate rates of interest. Where overdrafts are granted, they will be more strictly for short term purposes and may carry interest rates significantly higher than hitherto. The banks are also applying a wider "spread" of rates to take account of risk and

even if it can find them, to meet the terms on which they are prepared to lend.

12.18 It can now be seen that 1969 was an exceptionally difficult year for bank lending. Not only was the ceiling on bank advances rigorously maintained, but the clearing banks' liquid asset ratio gave them little margin for manoeuvre up to the autumn of the year, and was widely expected (wrongly as it happens) to decline dramatically by the end of the year and into 1970. Moreover, strong pressures were exerted by the larger customers. Bank finance was cheap relative to other sources of funds and many large firms drew more heavily on overdraft facilities that had already been agreed. With the lending resources of the banks severely restricted, therefore, it was perhaps inevitable that many smaller customers, especially those seeking bank finance for the first time, should find the banks unable to accommodate them. However, in the course of 1970 the situation of the banks improved somewhat, especially towards the end, when larger customers—influenced to some extent perhaps by adjustments to bank lending rates as well as pressures to fund—raised larger amounts of finance from the stock market and other sources. Smaller customers with long-standing overdrafts also seemed to experience greater success in obtaining long term finance from other institutions. All this eased the problems of small firms in meeting their genuine short term needs. One result of the liquidity pressures of 1969, along with other factors, has been an increased reluctance on the part of the clearing banks to see overdraft borrowing take on the character of permanent capital.

Overdrafts

12.19 By far the most important source of external finance for small firms—for the majority, indeed, the only external source—is the bank overdraft. This has been demonstrated by numerous studies and our own findings confirm it. Of the respondents to our postal survey 63 per cent of the manufacturers and nearly 50 per cent of firms in the service trades had had overdraft facilities in the previous twelve months. Among the manufacturers this proportion increased markedly with firm size; 78 per cent of those employing between 25 and 99 people and 84 per cent of those employing between 100 and 200 had overdrafts. By comparison, the number of small firms which raise finance from any other institutional source is negligible. (Perhaps the astonishing thing about these figures is not that they are high, but that so large a proportion of the sample, particularly in the service trades, had not made use of an overdraft.) External finance is synonymous for most small businessmen with "bank overdraft". If a request for an overdraft is turned down by the bank manager, they are most unlikely to look further. The role of the joint stock banks in financing the small firm sector is therefore absolutely crucial: their contribution dwarfs that of all other institutions combined, and they enjoy the confidence of most small businessmen to an extent which cannot be achieved over the whole field by any other lenders.

12.20 The bank overdraft has great advantages for the borrower, being flexible, obtainable with little formality, and cheap. It is cheap because interest is charged only on the debit balance outstanding from day to day, because repayment may be made at any time and because the rates charged have hitherto been generally

have not attempted to produce a comprehensive list of the institutions offering the services described; such lists have been produced before, notably by the Association of Certified and Corporate Accountants[1] and the Institute of Directors[2], and it is appropriate that this should be done by bodies in a position to bring the information up to date as necessary. We have restricted ourselves to short descriptions of the services available, their comparative costs, and their attractions to, and limitations on their use by, small firms. We believe this information is not likely to become out of date in the near future. Those requiring more complete and detailed information will find it useful to consult the Report of the EAG (*Financial Facilities for Small Firms*, Research Report No. 4).

Short term finance

12.14 The main providers of short-term finance may be classified under four headings: the London clearing banks and their counterparts in Scotland and Northern Ireland; the other banks; the finance houses; and the discount houses. The financial connections between institutions of these various kinds are in some cases very close: in particular the Big Four, besides holding a dominant position in the first category, have many subsidiary and associated companies falling within the categories of other banks and finance houses. The facilities provided by these institutions at the "short end" of the market are those on which lending ceilings have repeatedly been imposed by the authorities whenever they have found it necessary to pursue a deflationary monetary policy. Indeed, these four types of institution are the most "regulated" of our financial institutions; their services, more than any others, have been controlled and restricted for reasons of monetary policy. The most effective regulation during the period to which our evidence relates was the ceiling on bank lending, which applied to all four types of institutions, except the Northern Ireland banks, but in addition the clearing banks had to observe conventional ratios of cash and liquid assets to deposits and they were also subject to calls for special deposits. The finance houses were affected in addition by the regulation of hire purchase though this did not cover credit terms for most types of industrial equipment. Institutions outside these categories were subject to very general guidelines on their lending policies, but these were much less restrictive than the ceiling on bank lending. It is therefore, perhaps inevitably, in the field of short term lending that the credit squeeze has been most severe. This fact has coloured all the evidence we have received on the short term financial problems of small firms.

The effects of ceilings on bank lending

12.15 In forming a judgement on the future extent of these problems, our major responsibility appeared to be to take a reasonable view of the likely severity of official restrictions on short term lending. It is still, in fact, essential to do this,

[1] *Sources of Capital.* Available from the Association of Certified and Corporate Accountants, 22 Bedford Square, London WC1.

[2] *The Finance Problems of the Smaller Company.* Available from the Institute of Directors, 10 Belgrave Square, London SW1.

follows:

> With few exceptions, all replies to our questionnaire gave shortage of liquid capital as a major problem. The squeeze on overdrafts by banks has denied the small firm the ability to tide over temporary shortages through short term loans. Many small firms are facing a situation where their overdraft facilities are constantly used to the fullest extent, and where their cash flow situation is steadily deteriorating. Much publicity is now given to other available means of finance, e.g. hire purchase, leasing of assets and factoring of debts. In each case the servicing of such a scheme is extremely costly. Financial institutions, some of which are sponsored by the joint stock banks, are stating that they are more prepared to consider smaller loans to smaller firms secured on fixed or floating assets than has been the position in the past. The joint stock banks and the merchant banks are working in conjunction with other financial institutions which are endeavouring to meet some of the requirements of small firms which are creditworthy and which have some security available. However, such arrangements still seem to be available only in cases where the loan capital requirement is £50,000 or more, where the customer's profitability is commensurate with that type of loan and where security is available. The potential borrower finds that the rates of interest charged are almost prohibitive, such rates now ranging in the bracket from 12 per cent to 15 per cent per annum. Moreover, many such loan proposals can only be obtained for fixed terms, or subject to a penalty for early repayment, so that the borrower is committed to a very high rate of interest for a long period ahead, irrespective of any change in the general level of interest rates. There are plenty of institutions who are prepared to lend the money at the present high rates of interest on a medium or long term basis, but the comparatively small industrial concern is naturally apprehensive about entering into such a commitment.

The Chemical Industries Association told us that:

> Small firms suffer severely and disproportionately during periods of recession when credit squeezes and high bank rates impose crippling restrictions on their use of banking facilities.

12.11 These views were inevitably coloured by the fact that most of our evidence related to the year 1969, when the squeeze on credit was most severe and which can now be seen to have been an exceptionally difficult year for bank lending. Many witnesses, including some of the non-bank institutions, have expressed the view that credit squeezes inevitably bear most severely on small firms, and the clearing banks themselves, though strongly repudiating the suggestion that they deliberately discriminate against small customers in their administration of the ceiling, readily admit that under squeeze conditions they are prevented from rendering their normal standard of service to small firms. Nearly all the institutions agreed that the most beneficial action that could be taken for the small firm would be the removal of the lending ceiling, and we may hope that the Bank of England's proposal to do this will result in a marked alleviation of the small firm's difficulties. All the same, the evidence revealed a difference of view between the providers and the users of capital which could not be wholly reconciled simply by making allowance for the effects of the ceiling. The providers of long term capital, though unaffected by the lending ceiling, have been strongly criticised by many witnesses on the ground that they apply to small firms unrealistic standards of creditworthiness. It has also been suggested that no matter how willing the institutions may be to make capital available for small businesses, the rates of interest which they are compelled to charge by current market conditions have placed long term loan capital beyond the reach of most small businesses. This contrasts with the view put to us by the providers of long term finance, which was that in general the creditworthy firm can always find finance provided that the project for which capital is required is a sound one,

believe that it would be worthwhile for detailed inquiries to be made into the ... which other countries attempt to solve this particular problem.

12.7 Most authorities have agreed that the problem identified by the Macmillan Committee was genuine at the time. Since Macmillan, however, and particularly in the last 20 years, the situation has generally improved. It is true that the new issue market is still effectively closed to the small firm wishing to raise less than about £250,000 in equity or a much larger figure in loan capital, and that it is likely to remain so, for the same reasons as those given by the Macmillan Committee, but apart from this there has been an important development in the number and scope of the institutions catering for the longer-term needs of small firms. This development has been described by many authors,[1] and its most important features will emerge clearly from our own description of the major sources of finance later in this chapter. At this point, therefore, we shall describe briefly only the most significant changes.

12.8 In the 1930s, in response to the Macmillan Report, there appeared a number of investment companies specialising in the financing of small business: the most important of these were Charterhouse Industrial Development, Credit for Industry and Leadenhall Securities, but there were several smaller and more specialised institutions also, including a number of small Issuing Houses. Though the influence of their example was great, by modern standards and even by the standards of the time the combined resources of these companies were small—in 1938 the issued capital of the three named above totalled only some £875,000—and the volume of business done by them was correspondingly small. Those who were active in that market will admit, and some have done so to us, that it was not possible to meet more than a fraction of the potential demand for capital from small businesses. During the 1939–45 war, it was decided that the post-war reconstruction of industry would demand the devotion of much greater resources to this area and that a new institution specifically designed to fill the Macmillan Gap should be created. Accordingly, in 1945, the clearing and Scottish banks, with support from the Bank of England, combined to finance the creation of the Industrial and Commercial Finance Corporation Ltd (ICFC) with initial available resources of £45 million and a remit to make long term loans and subscriptions of share capital in the area between £5,000 and £200,000. Even allowing for inflation, this was provision of a wholly different order of magnitude from what had gone before. ICFC at once became, and has remained, by far the most important institutional provider of long term capital to small firms, probably doing a bigger volume of this kind of business than all other long term investors combined. For this reason we have devoted a good deal of attention to it. By 1959, when the Radcliffe Committee reported, ICFC branches were operating in Edinburgh, Glasgow, Manchester and Birmingham and the Corporation's total investments to 31 March 1960 amounted to £65 million. The Radcliffe Committee,[2] which discussed the adequacy of financial provision for small firms almost entirely with reference to the ICFC and the joint stock banks, were in general satisfied that the capital gap, in the terms of the Macmillan formulation,

[1] For example
The Financing of Small Business, by James Bates, Sweet and Maxwell, 1964.
The London Capital Market, by Norman Macrae. Staples, 1957.

[2] *Report of the Committee on the Working of the Monetary System.* Cmnd. 827.

their growth. The respondents to the Merrett Cyriax Survey recorded "credit" as "a major restriction on growth" in only the following percentage of replies:

	%
Manufacturing	21
Construction	15
Wholesale	2
Motor	—
Retail	4

ii. In other cases firms would not seek finance through ignorance, prejudice or moral scruples. In the Merrett Cyriax Survey, "almost 40 per cent of respondents in manufacturing industries felt that it was unethical to borrow capital". The Report of the Economists Advisory Group on *Financial Facilities for Small Firms*[1] stated "we have been impressed by the general inadequacy and fragmented nature of the advice and information for small firms on financial and related matters" and goes on to suggest, by way of remedy, the "establishment of a central agency" to provide education and information to small businessmen on financial matters. Even more important, in our view, is the psychological attitude of small businessmen, as revealed in the *Attitude and Motivation* Survey[2]: quite clearly a large number of small businessmen simply dislike and mistrust institutions, whether in the public or the private sector, on the grounds that they threaten their independence and this, for provincial businessmen, applies particularly to institutions based in London. One of the very few institutions which escapes this general hostility is the local branch of the joint stock bank, which is why to the vast majority of small businessmen the bank overdraft is the only acceptable form of institutional finance.

iii. We have no doubt that many small firms have not obtained, and could not obtain, institutional finance simply because they are not sufficiently creditworthy. The Economists Advisory Group, in their second survey carried out on our behalf (*Problems of the Small Firm in Raising External Finance*[3]), studied a number of cases of small firms unable to obtain institutional finance and found that the majority of them were less profitable than the average; that many were seeking funds for defensive reasons and were less managerially and financially sophisticated than the firms which succeeded in getting finance.

12.4 We must assume that self-financing will remain a dominant financial characteristic of the small firm sector, for it is the essence of small business as we know it that the owner should be risking his own capital on the strength of his energy, experience and talent and that he should be free of outside control in making his decisions. The continued health of the sector therefore requires, first,

[1] Research Report No. 4, *Financial Facilities for Small Firms*, by the Economists Advisory Group.

[2] Research Report No. 7, *Attitude and Motivation*, by C W Golby and G Johns.

[3] Research Report No. 5, *Problems of the Small Firm in Raising External Finance—The Results of a Sample Survey*, by the Economists Advisory Group.

Introduction

12.1 Our main purpose in this chapter is to consider whether the needs of the small firm sector for external finance—that is, finance additional to retained profits, share capital and owners' loans—are being adequately met by the financial institutions. If we may judge by the evidence we have received, it is very widely believed that the small firm has limited access to external finance, by comparison with large companies, and that the terms on which it can obtain such finance as is available, again comparatively speaking, are unduly onerous. We have to decide how far this is true and if so whether it is due to imperfections in the supply of finance, rather than to weaknesses on the demand side. Representations received suggested that the supply of finance might be defective in three important respects. There was a considerable body of opinion in favour of some or all of the following propositions:

i. that the operation of credit restrictions, and particularly of ceilings on bank lending, had particularly severe and damaging effects on small firms;
ii. that small firms have great difficulty in raising medium term finance in relatively small amounts—that is, between £5,000 and £50,000—and that to this extent the "Macmillan Gap", first defined in 1931, still exists;
iii. that the inability of most small firms to raise capital on the Stock Exchange is a serious disadvantage, necessitating the creation of a "secondary market" to give them improved access to equity capital.

We have devoted a good deal of attention to these problems, and much of the chapter is given over to them. Since consideration of these questions cannot easily be separated from description of the facilities that exist, they are dealt with as they arise in the description of the types of finance available, under the heads of short, medium and long term finance respectively. Two more general problems will be found to arise throughout the chapter: these are the problems of rising interest rates, which are said by many witnesses to be putting external finance of most kinds beyond the reach of the average small firm, and the question of the need for Government intervention to improve the access of small firms to external finance. Lastly, this chapter is intended to help with the eternal problem of the "information gap"—the lack of knowledge and understanding within the small firm sector of the financial services available and of the costs and conditions attached to them. We have therefore described, so far as it can be done with reasonable brevity, those of the services provided by the institutions which are likely to be of value to small firms.[1]

12.2 In considering the financial position of the small firm sector we have of course paid much attention to the working of the banking system, and in particular to the effects of the policies of the monetary authorities on the operations of the clearing banks, who are the main providers of external finance to small firms. A great deal of our evidence related to the effects of the ceilings on bank lending which have been imposed by the authorities when they have found it necessary to pursue a deflationary monetary policy and the chapter naturally

[1] A much fuller description can be found in Research Report No. 4, *Financial Facilities for Small Firms*, by the Economists Advisory Group.

work. Registered businesses are obliged to keep proper [illegible] dealings in chargeable goods. Separate records must be kept of all goods dispatched on sale or return, or similar terms, and of tax credits allowed on returned goods; copies of credit notes issued must be available for inspection. Statements of tax payable, with remittances, have to be made to Customs and Excise every quarter, or more frequently if Customs consider it necessary for security. All of this adds considerably to the administrative burden of the craftsman.

iii. The turnover limit for exemption from registration for purchase tax was fixed at £500 in 1940 and has never been changed. The effects of inflation alone have brought the great majority of craftsmen, who would formerly have been exempt, within the scope of registration.

11.6 Some at least of these problems will be removed by the replacement of Purchase Tax in 1973 by a Value Added Tax. The almost universal application of a single rate of tax will end the anomalies and distortions caused by the present system and will spread the burden of indirect taxation much more fairly, although in certain cases where raw materials account for a large proportion of the total cost of the product, the actual burden on prices may not be greatly reduced. In general a VAT, even at the rate of 10 per cent, which was mentioned for illustrative purposes in the Green Paper on the Tax (Cmnd 4621), would bear much less heavily on craft products than the higher ranges of Purchase Tax. It will create certain problems for craftsmen, as for other small traders, the most difficult of these being the decision whether or not to apply for exemption from the tax. The Government have announced that "small traders" will qualify for exemption but no definition of the small trader for this purpose has been suggested. Since exempt status will entail some disadvantages as well as advantages, it will be important for craftsmen and others to be well advised on this matter. Nor must it be forgotten that those who are liable to VAT will probably find the related paperwork as great a burden as under the present system.

Government support

11.7 In certain ways, however, the Government can and does support the crafts. The most important form of support is the provision of facilities within the education system, and particularly in further education, for people to learn about and practise the crafts. Almost anyone wishing to learn woodwork or pottery can do so, largely at public expense, in evening classes or adult education courses and this must increase public interest in and demand for craft products. It also helps to ensure the continuation of the handwork tradition and the future supply of craftsmen—besides providing a source of income for many craftsmen who teach their skills in the colleges of further education. Many schools also provide teaching of a high standard in craft subjects, but here the provision is patchy. Some schools have no facilities at all for craft teaching ,and for a large number of children who are introduced early to these subjects instruction in them ceases at the age of eleven, when the child must decide, or it is decided for him, what direction he is to take. If he shows any aptitude for academic studies, then he is persuaded and encouraged to go in that direction and he misses the chance of developing any practical aptitudes he may have. We have also been told that although extremely valuable work is being done in many schools "it is

Introduction

11.1 In this chapter we are concerned with a small and highly specialised segment of the small firm population: the independent craftsmen, who may be defined as self-employed, small scale producers of articles of high quality in a number of different, usually traditional, media. An arbitrary definition of "the crafts" has been sanctioned by long acceptance: it includes, for example, pottery, jewellery, stone masonry, woodwork, art metalwork, calligraphy and glassware, but not, say, painting, sculpture, fashion design and photography. The great majority of those who practise craft skills are not independent craftsmen in our sense; they are employed in industry, in small firms and large, and there they contribute greatly to the improvement of design and the maintenance of high standards of quality. Wholly independent craftsmen are very few in number. One estimate (by the Crafts Council of Great Britain) suggests that the number of craftsmen earning a living entirely by the sale of their own products is as small as 1,000. Other estimates are somewhat higher, and there are certainly many people who make objects for sale in their spare time, but there is no doubt that the total number of full-time self-employed craftsmen is small.

11.2 These craftsmen are in effect running small businesses—most of them very small indeed. Few have a turnover exceeding £5,000 a year and their capital is often negligible. However, the importance of these small businesses cannot be measured solely by reference to their output. The impact of work of the highest quality in whatever field of design is eventually felt throughout the economy and its effects are eventually seen, even in the mass production industries, in the raising of their aesthetic and functional standards. The outstanding success in world markets of the Scandinavian consumer goods industries can often be traced back to the influence of individual freelance designers, and to the preservation, despite mass-production techniques, of some of the essential quality of the hand-made article. Many British industries have appreciated this truth, and it is now common in such industries as pottery, cutlery and furniture manufacture to commission independent craftsmen-designers to produce designs which will be reproduced for the mass market. In this way the craftsman's influence reaches far beyond the small circle of his direct customers. This is an important function, and it will become more important in home and export markets as the standard of public taste rises. It is therefore desirable that craftsmen should be able to pursue their vocation in congenial conditions (since artistic creativity is easily smothered) and with at least the necessary minimum level of reward.

Problems of the independent craftsman

11.3 Unfortunately there is a degree of conflict between these requirements. If he is to make an adequate living from his work, the independent craftsman must also be competent as a businessman, for in many ways he is running a small business much like any other. This means that records and accounts have to be kept, if only for tax purposes, and that his goods have to be sold, sometimes against stiff competition both from other craftsmen and from mass-produced articles. If he is successful and is able to engage assistants, the problems of running the business loom even larger and take up an increasing proportion of his

2. Among the management advisory services we have considered we recognise none which meets our criteria for continuing subsidy. There is however, a need for a pure "signposting" or referral service which could not, we believe, be made to pay for itself, and this the Government should provide. This could best be done by setting up a network of Small Firms Advisory Bureaux in important industrial centres. (Paragraph 10.47.)

3. The functions of the Small Firms Advisory Bureaux should be to provide information in response to queries, and assistance on technical, financial and management problems by providing introductions to the appropriate sources of professional, commercial or official advice. These services should be available to firms in all industries. (Paragraph 10.48.)

4. The Advisory Bureaux should report directly to the Small Firms Division of the Department of Trade and Industry (whose creation we recommend in Chapter 9) and provide a source of first hand information about the progress and problems of the small firm sector. (Paragraph 10.51.)

5. Since small firms are most in need of a service of this kind, and since most of the approaches to the Advisory Bureaux will be made by them, it is desirable that the Bureaux should be widely publicised as Small Firms Advisory Bureaux. However it is not necessary that their activities should be strictly confined to small firms as defined in this Report. (Paragraph 10.53.)

6. Consideration should be given by the Small Firms Division, in consultation with other interested organisations, of methods by which the knowledge and experience of retired executives could be used to promote the efficiency and productivity of small business. (Paragraph 10.55.)

Department of Trade and Industry, despite any [illegible]
identification with Government. The Bureaux would in any case be seen to operate outside the main departmental structure, and their local, rather than their official, status would be the main point to emphasise. Since it is essential that the staff of the Bureaux should be capable of earning the trust and respect of business-men, as the ILOs have done, it is desirable that they should have had experience of work in industry: the normal civil service background is unlikely to be a suitable preparation for this work.

10.52 We have not tried to prescribe in detail the number, location and staffing of the Bureaux. We think it essential that they should cater for all small firms and not merely for manufacturers, as do the Industrial Liaison Centres, and this clearly has a bearing on all these points. It means that the locations of the existing Industrial Liaison Centres, which were chosen with manufacturing firms in mind, would not in all cases be suitable for Advisory Bureaux. A review of the spread and density of industry across the country would be necessary before decisions could be taken about their number and location. We have not attempted this, but would suggest that all important industrial towns and the chief towns in areas where industry is more thinly represented, should have Advisory Bureaux. The actual sites of the Bureaux should be in central and easily accessible areas of these towns. Their organisation and staffing would depend on the functions finally assigned to them. We envisage, however, that initially the staff of each Bureau would be very small.

10.53 **Though we have recommended the creation of a Small Firms Advisory Service, it would not be necessary to apply a rigid or restrictive limit on the size or type of firms who could use this service.** We see no purpose, for example, in trying to apply the size-criteria we ourselves have used in defining the small firm—which would perhaps be somewhat low in any case. The Industrial Liaison Service deals with manufacturers employing up to 500 people: firms of this size may often need assistance, and there would be a gain to the staff of the Advisory Bureaux, in terms of enlarged experience, from dealing with them. For purposes of publicity, etc, it would be necessary to devise some rough criteria of the size of firm which might benefit from the service; but it is undesirable that the service should be restricted on a size-basis. The cost, in time and in damage to public relations, of trying to ascertain the size of an enquiring firm, and turning away those above any size limits laid down, would far exceed any savings.

The encouragement of voluntary work

10.54 We hope that the creation of the Advisory Bureaux might help to preserve the voluntary work of the Local Productivity Associations, and their role as a unique local forum for management and labour on matters of common interest. We envisage that some of the facilities of the Bureaux, even if only a postal address and a telephone number, might be made available to the LPAs and that the heads of the Bureaux should be *ex officio* members of the Associations, as the Industrial Liaison Officers have been. We believe that this degree of indirect and largely moral support for the Associations is well justified, and we trust that the voluntary work of the LPAs will be recognised as a valuable contribution to the improvement of productivity, particularly in the small firm sector.

local service, identifying with and serving the local business
it would have to be centrally co-ordinated and financed, the local identity should be stressed. **We envisage that the local offices might be known as Small Firms' Advisory Bureaux, and that their functions would be to provide information and assistance on technical, financial and management problems by providing introduction to the appropriate sources of professional, commercial or official advice.** The staff of the Bureaux would provide a means of communication between small businessmen and the central Government, the management and technical services and the professions, including the academic community. They should not themselves undertake the diagnostic and problem-solving functions which Industrial Liaison Officers, for example, now carry out; these are akin to consultancy, and should be provided by others on a commercial basis. Their role would be basically responsive—that is, providing answers to enquiries made in person or by telephone and making arrangements for any longer-term or more specialised assistance that might be required. It would be for consideration how much "missionary" work, by personal visits to firms, should be done. We are sure there is no better way to make the acquaintance of a businessman and win his confidence, but visiting is time-consuming, and if done on a large scale would have obvious implications for the staffing of the Bureaux. Whether or not by means of visiting, however, the service would have to be adequately publicised. We have not sought to lay down a detailed specification for such a service, but in the following paragraphs we suggest the general lines on which we think it should be organised. First, however, we deal with the implications of our proposal for the Industrial Liaison Service.

10.49 The creation of a new information and referral service with a network of local offices has obvious implications for the locally-based services which already receive Government finance, and particularly for the Industrial Liaison Service. In some respects the functions we have suggested for the Advisory Bureaux would duplicate the work of the Industrial Liaison Officers, who do a good deal of signposting and provide much basic information for small manufacturers. This is not their main function, of course; they are mostly concerned with visiting firms, with the on-site diagnosis of problems and with arranging whatever help is needed to solve the problems. However, the extent of overlap would be sufficient to make it nonsensical, and confusing to the businessman, for the Government to maintain both services. This has caused us some disquiet, since, as we said in paragraph 10.30, we have considerable respect for the Industrial Liaison Service and we should not wish the valuable relationships it has built up with industry to be lost. We should therefore have liked to recommend that the Advisory Bureaux could be based on the Industrial Liaison Centres, so retaining the services of the ILOs and profiting from their contacts and from the high reputation many of them have established among local businessmen. We had it in mind that where possible, in order to maintain continuity, the Bureaux might even be located in the existing premises of the Industrial Liaison Centres. Reluctantly, however, we have had to accept that this could not be made to work, and that to try to assimilate the two services would result in confusion without preserving the best of the Industrial Liaison Service. The role we are suggesting for the Advisory Bureaux is much less ambitious than that of the ILOs, in that they would do little in-firm diagnosis of problems and would not themselves engage in problem-solving. The work is therefore unlikely to appeal to the Industrial Liaison

ment or any other outside advisory services. Most respondents were [illegible] nor aware of outside services or help . . . possibly because informants appeared to have had very little experience of using the facilities available, attitudes towards them tended to be critical.

As we have already mentioned, the same feelings, perhaps in less extreme forms, are excited by commercial consultants in the private sector. Because of them an expensive marketing operation is necessary to launch any new commercial service aimed at the small businessman. In the case of a Government service, however, these marketing costs are likely to be particularly high because of the extra barrier of prejudice that has to be surmounted. For this reason highly-qualified men have spent much time trying to persuade small businessmen to make use of free or subsidised services. Insofar as ignorance of the services available accounts for the general failure to make use of them we think it a proper use of Government money to remedy this ignorance by providing straightforward information. Such expenditure could be justified as a form of management education, on the same grounds as expenditure on education in general. But "missionary" activity designed to overcome prejudice or to persuade businessmen of the value of advisory services against their better judgement seems to us to be in a different category. If the method chosen is to make the services artificially cheaper, as in the case of the consultancy grants scheme, there is danger of a misallocation of resources: if the method chosen is propaganda or persuasion, apart from its dubious effectiveness, advisers tarred with the brush of officialdom are ill-placed to undertake it. Businessmen must be left to accept, for good or ill, the consequences of their own judgements.

10.44 As a general principle therefore **we suggest that all management advisory services, whether in the public or private sector, should be self-supporting, since the readiness of clients to pay and the ability of the service to survive on this basis are the only reliable indicators of their value.** The implication of this is that services such as those of the Low-Cost Automation Centres should be expected at least to break even financially. So long as they did so, it would be of no great importance whether or not they remained in the public sector. The only exception we would make to this principle is that a pure information and referral service might properly be provided free of charge.

10.45 We recognise that it takes time to launch a completely new service and that the initial marketing costs may be substantial, since firms will not easily be persuaded of the potential benefits. Some have suggested that this justifies subvention by Government in the early stages, after which the service would become self-supporting or would be "hived off" to the private sector. While we do not necessarily reject such an argument in principle, we believe that pump-priming or initial subsidies to services intended to be self-supporting should be subject to rigorous examination and, we believe, will only rarely be justified. In every case, firm target dates should be set for progress towards self-sufficiency, and pleas for continuation of the subsidy beyond the agreed programme accepted only in the most exceptional circumstances.

10.46 We make one exception to the general principle that advisory services should not be permanently provided at Government expense. We think there is a need for an information and referral service intended to advise businessmen on

obviously very different from those in Japan, ...
of the banks in manufacturing industry, and their ability to influence the activities of the firms they finance, have no counterpart here. Nevertheless, we think there must be lessons to be learnt from the success with which the products of Japan's multitudinous small firms are exported.

The case for subsidised services

10.39 We shall discuss the case for subsidisation of services by reference to two basic questions the answers to which should provide criteria by which the need for and the adequacy of particular services can be judged. They are:

a. What is the justification for the provision of services to industry at the tax-payers' expense?
b. Given that there is a role for the Government in this field, are its existing services performing it adequately?

10.40 To justify the provision of any service to industry by Government it is necessary in our view to satisfy two conditions:

i. that the service is needed;
ii. that private enterprise cannot or will not provide it.

To justify the provision of *free or subsidised services* two further conditions must be met:

iii. that the economic benefit to the nation deriving from the services is greater than their cost;
iv. that users of the services cannot or should not be expected to pay their full cost.

An example of services which may be held to meet all four conditions is the service to exporters provided by the Department of Trade and Industry and the Diplomatic Service. The case for management advisory services, however, is by no means so clear. All of the services listed in paragraph 10.30 have been heavily subsidised—they charge either no fees or considerably less than a commercial rate—yet we doubt whether in their case, either the second or the fourth of the conditions set out above is met, and we have some misgivings about the third.

10.41 In the first place, it is hard to demonstrate that the demand for management advisory services could not be met by the normal market mechanism. We do not know the exact number of commercial organisations offering services of this kind to industry, but it certainly runs into thousands if we take account of all the one-man firms of consultants which now exist. It is therefore hard to see why the Government, which has no insights into the problems of industrial management which are denied to others, should be so heavily involved in disseminating advice on them. If it is true that private enterprise has been slow or unwilling to move into the field in which the Government services are most active—broadly the field of small-to-medium-sized firms—how far is this due to the existence of subsidised services with which they would have to compete on unequal terms?

able to cope with most questions. [illegible]
the DTI and the FCO have a number of export promotion functions. The DTI, for example, sponsors British Weeks, store promotions and UK participation in trade fairs overseas, and in the latter case offers financial and other assistance to firms taking part. The overseas posts will give on-the-spot assistance in finding agents, in making contacts with foreign buyers and Governments and in dealing with the crises which arise from time to time.

10.35 Nearly all these services are at present provided free of charge. The most important exception to this rule is the Computerised Export Intelligence Service, subscribers to which currently receive 500 notices of export opportunities in fields in which they have an interest for £25: opportunities are matched by computer with the capabilities and interests of subscriber firms. However, recent statements by Ministers suggest that charging fees for export services is likely to become more common in future. The services are not directed at small firms in particular, though the Department of Trade and Industry told us that certain of the export services, e.g. finding agents or providing background market information naturally tend to be used mainly by the smaller and medium-sized firms. Very large firms, if they are seriously involved in exporting, tend to have skilled and experienced export staff and their own sales organisations overseas; except when negotiating for major contracts or selling to state-trading countries they are less dependent on official services. Small firms, by contrast, have special difficulties in penetrating overseas markets. First, it is extremely unlikely to be economic for most small firms to maintain a permanent sales staff in any foreign country, because sales in any one market will be too small to justify doing so. Second, the sheer cost of sending staff on exploratory or selling missions abroad may be daunting, if not actually prohibitive. Small firms must therefore generally rely on agents or distributors overseas, and even the choice of a competent and trustworthy agent is difficult for a small firm lacking advice about the territory. Last, and most important, in exporting as in so many other contexts, much of the administration involved—documentation, obtaining finance, etc.—and most of the travelling will fall on the top managment of the firm, and probably on the boss himself. For these reasons those of the official services which are intended to facilitate entry into a foreign market are of particular value to the small firm, especially where the overhead cost of exploration, or "trying the water", can be spread over several firms. The Department's Joint Venture Scheme makes it possible for firms to take part at modest expense in group displays at trade fairs abroad. Assistance is also given towards the travelling expenses of businessmen taking part in Joint Ventures outside Western Europe.

10.36 In principle the official services are available to all firms, no matter what their size or export record, but a distinction must be made between the "responsive" services, in which the Department reacts to requests from firms for help or information, and those services in which contact is initiated by the Department: visits to potential or actual exporters by the export officers of the Department's regional staff are an example of the latter. The "responsive" services are available to all, but direct approaches to firms are naturally concentrated on those with greatest export potential, and it is the Government's policy to raise the cost effectiveness of the services by increased selectivity.

Rural Areas of Scotland, whose aims and methods are broadly similar, though the retail trades are not excluded from its purview. In the crofting counties and the Isles the work is carried on by the Highlands and Islands Development Board.

10.31 In addition to providing most of the funds for all these services, the Government has at various times advanced money to independent bodies for specific purposes—usually as pump-priming assistance intended to get a new service off the ground. This was the case with the highly successful Small Business Centre at Aston University. The Centre for Interfirm Comparison, a non-profit-making service which aims to show firms how their performance compares with that of others in their industry, receives a fairly high proportion of its funds from Government. In 1970/71 this subvention amounted to £44,000, or 32 per cent of its total income. In the same year the British Institute of Management received about 7 per cent of its total income in the form of Government grants (£98,000) for the development of specific activities. It appears that there will always be a place for pump-priming, when novel ideas have to be tried out, and it is to be hoped that Government will continue to be receptive to such ideas. But equally there should, from the beginning, be a firm target date for the achievement of commercial viability and termination of the assistance.

10.32 In a novel and interesting attempt to improve the efficiency of the small firm sector, the Board of Trade in June 1968 launched a pilot scheme to encourage the use of consultants by small firms. The scheme was centred in Bristol and Glasgow and ran until February 1969. It was aimed in the main at businesses with between 25 and 500 employees. Fifty per cent of the cost of employing consultants was offered up to a maximum grant of £5,000 per business. The Department of Employment, to whom responsibility for the scheme was transferred in October 1969, have undertaken an evaluation of the results of this scheme, and have produced an interim survey covering 60 per cent of the grant-aided assignments. In the two cities 227 firms received grants for 278 projects. About 7 per cent of eligible firms in Bristol and 5 per cent in Glasgow applied for grants. The average cost of each grant-aided assignment was £2,775 and the total cost to Government in grants was £395,443. Approximately half of the firms who benefited under the scheme had used consultants before, though the smaller the firm the less likely it was to have had previous consultancy experience. Only about 4 per cent of firms taking part in the scheme were in the smallest category (1–25 employees), with a further 16 per cent in the 25–50 employee range. The remaining 80 per cent of firms taking part were therefore in the larger size ranges; 20 per cent having over 500 employees. Firms employing over 100 accounted for 59 per cent of assignments and 71 per cent of grant committed. Most of the firms surveyed were in manufacturing, and most of the consultancy assignments dealt with some aspect of management, although marketing, design and technical studies were also covered. It is interesting to compare this scheme with the Industrial Advice Grants Scheme in Northern Ireland. This was introduced in 1964 for a period of six years but was extended in 1970 for a further period of five years. Manufacturing, and since 1970 construction and hotel undertakings, are eligible for assistance and there is no size limit on applicant firms. There is no longer a statutory limit on the total amount of grant which

slanted towards them. The BPC has been heavily [illegible]
ment funds: the grant has normally comprised 75 per cent or more of its total annual income, and in 1970/71 it amounted to £643,000. It has now been decided by Ministers that in future the BPC and the LPAs should look to industry for their financial support and that the grant should accordingly be phased out by the end of March 1973. In the light of the Government's decision BPC have concluded that with one exception there is little chance of putting their centrally-organised activities on a viable commercial basis and these have all now ended. The exception is the production, sale and hiring of films, and BPC is continuing for the next year or so with a small production programme. They expect that the revenue from film sales and hirings will fully cover their Headquarters costs from 1972/73 onwards. The present intention is to maintain BPC in being as a very small co-ordinating unit for those LPAs which decide to continue. It is not clear what role the CBI and the TUC will have in relation to the BPC when the grant ends. The LPAs have been considering their future in the light of the cessation of the grant to BPC, and a small number has decided to close down. Others have amalgamated, leaving 83 of the original 143 LPAs which currently intend to continue in being for the foreseeable future. They plan to retain their Productivity Officers and thus continue their in-firm diagnosis and counselling service. Though we are told that they varied greatly in quality, the best of them have elicited a powerful commitment of enthusiasm and voluntary effort from local industrialists and trade unionists, and have made a genuine contribution to the improvement of member firms' efficiency. The element of voluntary co-operation between employers and trade unionists is particularly valuable. Their membership is by no means confined to small firms; in fact, some associations rely heavily on a few large companies for funds, for leadership and for facilities such as study-visits to their premises. Although the LPAs' degree of dependence on the Government's grant has varied they are aware, and are planning on the basis, that they will rapidly have to increase their self-generated income—which includes subscriptions and profits from their activities—in order to be self-supporting after March 1973. We hope and trust therefore that the withdrawal of the Government grant will not result in the collapse of the whole local movement.

v. *The National Council for Quality and Reliability.* NCQR was originally set up by the BPC and until January 1970 was financed and serviced by the Council: since then it has received from the Department of Trade and Industry a direct grant accounting for some 85 per cent of its total income. In 1970/71 the grant was £25,000. Its purpose is to promote higher standards of quality and reliability by means of publications, conferences, training and information services. There are 80 quality and reliability groups in the country through which most of this work is done. NCQR itself has only four permanent staff. Since the Government have recently decided that the grant should be discontinued the work of the national body seems certain to be brought to an end, though the voluntary groups may be able to continue.

vi. *The Manpower and Productivity Service.* This service is an integral part

in paragraph 10.31 we refer briefly to these.

Description of the services provided

10.30 We have received evidence about eight important services wholly or mainly financed by Government which are mainly intended for, or used by, small firms. A brief description of each follows:

i. *The Industrial Liaison Service.* The Industrial Liaison Service aims to assist smaller manufacturing firms (with less than 500 employees) to improve their efficiency and technological strength. There are 75 Industrial Liaison Centres based on colleges of technology and universities. The 85 Industrial Liaison Officers who run the centres are members of the staff of the educational establishments at which centres are located. The Department of Trade and Industry pays a grant of two-thirds of the direct running costs to maintain the centres (£270,000 in 1971/72), the other third being met by the colleges and thus indirectly by the rate-payer and tax-payer. (The financing arrangements in Scotland differ in some respects.) The ILO is responsible to the head of his college, but the DTI, through its Regional Offices, takes a close interest in the way the service operates. The main activities undertaken by ILOs are introductory visiting to make contact with firms, assessing the types of information and advice which may be needed, and indicating the wide range of sources of assistance available, including the resources of colleges themselves; and offering a general referral or signposting service. In a large number of cases the ILO first helps the firm to define its problems and then suggests possible sources of advice; he also answers specific requests for information and signposts to sources of advice. Most of the enquiries handled are technical but managerial enquiries are also dealt with and their importance is increasing. ILOs make about 13,000 visits a year and answer 26,000 enquiries of all kinds. The service is free. The great assets of the ILOs are their ready availability, at the cost of a telephone call, their local status, which contrasts with the remoteness of most consultants or advisory services, and their ability to make personal contact with the businessman on his own ground. This is by far the best way to establish a relationship of trust; most businessmen ignore promotional literature and invitations to courses and seminars, but will listen to a visitor who can talk sensibly with relevance to their own situation. The ILOs, all of whom have industrial experience as well as academic qualifications, are well fitted to do this. In some areas the ILOs' apparent independence of Government has been found to be a definite advantage when dealing with the local industrialists, while in many other places just the reverse has been true and the ILOs' connection with Government has proved a positive advantage. In general, we have been much impressed with this service, many of whose officers appear to have won the respect and confidence of businessmen in their locality. Such small firms as are aware of the existence of the service have found its "signposting" facility particularly valuable, since they commonly have no idea where to turn for help among the multiplicity of services available—or else do not even know the services exist. Some ILOs participate in local small businessmen's clubs and other activities, thus helping to widen knowledge of and trust in the service.

staff from doing such work. If work of this kind were to be officially encouraged, we presume that some degree of uniformity in these matters would be necessary. Perhaps the best arrangement would be for the lecturer to keep the fruits of his labour. However fees were fixed, they might be expected to be lower than those of commercial consultants, reasonably enough, since most lecturers would not be undertaking management consultancy in the full sense. Their experience of industry would normally be insufficient to permit them to carry out the diagnostic function which is the essence of management consultancy, and in general their role would be limited to advising on well-defined technical matters. By no means all teaching staff would be suited even for this, but those who have the rare combination of qualifications and personality needed for consultancy work should be given every encouragement. The experience of Loughborough Consultants Ltd, a company formed by Loughborough University, which broke even financially at the end of its first year of operation with no assistance from Government, is an encouraging indication of what can be done. **We therefore recommend that suitably qualified staff of universities, technical colleges and similar institutions should be encouraged within agreed limits to carry out consultancy in industry.**

10.26 The interaction between the Business Schools and small firms has so far been of trivial proportions. Few small businessmen have attended Business School courses, and few graduates of the Schools have attempted to make a career in small business. This is understandable, since salaries and prospects of the kind that such young men can command are not normally to be had in small firms. Nevertheless, if we may judge by experience in the United States it is to be expected that more such people will in future prefer the higher risks, but potentially far greater rewards, of self-employment to the security of the big company. It is increasingly common in the USA for new ventures with a very high growth potential to be founded by young men with complementary skills in technology and management, and in such situations the possession of a business school degree is a powerful attraction to the investors whose support is vital to the take-off of the business. We hope that, as Business School graduates spread through the economy, investors here also will be ready to support them in new ventures. *It is therefore important that the Business Schools should carry out research into the role of individual entrepreneurs and provide courses for them. The Business Schools should also seek to interest students in the possibility of founding or working in a small firm*, either by placing students with suitable firms during their courses or by finding placement jobs for them after graduation. We are glad to note that some thought is already being given to these possibilities by the London Business School among others.

Government advisory services

10.27 Our main purpose in this chapter is to examine the rationale for the involvement of Government in the provision of advisory services, and to consider whether, if there is a function here which only Government can perform, its performance could be improved by rationalisation or reorganisation of the present effort. Because official policy on this subject has changed and is still

very smallest would gain from an objective and skilled appraisal of their performance, and from the application of well-tried methods to their problems. Work done by Professor Harry Johnston has suggested that average savings following a consultancy assignment are equivalent to a 200 per cent return on fees. We can neither confirm nor question this figure from our own knowledge but we believe that it would be very unusual for a firm employing a reputable consultant not to derive a net profit from doing so. There is ample evidence that most firms, after using consultants for the first time, are sufficiently impressed with the results to do so again. The difficulty is to make the first contact, and the only viable method of doing so on a big scale appears to be the devotion of much larger resources to marketing among small firms by the consulting profession. In 1968 the Board of Trade launched an experiment in selling consultancy to the small firm by offering subsidies on a limited scale, but for reasons which will appear when we discuss later in this chapter the general principle of Government subsidies, we do not believe that this is a desirable, or, in the long term, a practical means of solving the difficulty. *We believe that it would be helpful if the consulting profession were to reconsider their attitude to advertising:* at present the Code of Practice of the Management Consultants Association regards it as unprofessional conduct "to advertise consulting services in the public press", and this effectively excludes the most obvious means of informing small firms of the services available to them. *We would hope that the Association might be persuaded to reconsider this policy.* If advertising by individual firms were thought impermissible, an alternative would be collective advertising by those firms which are interested in doing consultancy among small firms. No doubt the best way to overcome prejudice is to prove in practice that consultancy pays, but to dispel ignorance is an essential first step. Even so, we have to recognise that it would be unrealistic to expect or advise the great majority of small firms to employ consultants, because the scale of their operations would not warrant it.

Universities, technical colleges and business schools

10.24 Academic institutions of most kinds arouse in most small businessmen a degree of mistrust second only to that accorded to Government. We have established in our study of the background of small businessmen (Chapter 2) that only a small minority themselves have higher educational qualifications, and the number who have attended any Business School course is negligible. Possibly for this reason, they tend to exhibit the practical man's scorn for academic opinions in a fairly extreme form—not altogether without justification, for few academic economists have any experience or knowledge of the small firm sector. The universities and business schools, with some conspicuous exceptions, have regrettably neglected this important area. However, we have noticed that the colleges of technology, the polytechnics, and those universities which were formerly colleges of advanced technology, stand in much higher repute among small businessmen than the other universities. This is partly because many such businessmen have attended courses at these institutions and are therefore familiar with what they can do. But the main reason is that the traditional universities tend to concentrate on advanced "academic" research which is unlikely to be applicable to the problems of the typical small business, though the small minority of firms working in fields of advanced technology may gain

carry out what are in effect consultancy assignments but do not charge commercial fees for them. The number of consulting firms in the country is uncertain. The British Institute of Management maintain a register which at present contains 1,400 firms, some of them employing only a few men, but the total number of firms offering consultancy services is certainly far larger than this. Many individuals, especially teachers in universities and technical colleges, carry out consultancy on a part-time basis. The industry has expanded rapidly in recent years: the Management Consultants Association estimates that demand for consultancy services has until recently been increasing by 20 per cent per annum, and in 1970 the number of consultants was thought to be increasing at an annual rate of between 12 per cent and 20 per cent. Demand has fallen off sharply over the past year, but no doubt this is a temporary phenomenon.

10.19 Management consultants have not hitherto devoted much attention to the very small firm; though the Management Consultants Association informed us that they carry out a large number of assignments for firms employing between 100 and 200 people, firms below that size very rarely employ consultants and the profession as a whole makes little effort to interest them. It is easy to see why this is so. The profession has been growing rapidly and has been able to maintain a very high level of resource-employment by concentrating on larger firms. There is thus little incentive to venture into the unproven and difficult field of consultancy for the very small firm. So far as we are aware, only two consulting organisations of any size—NUMAS Consultancy Ltd, which ICFC have recently acquired, and ICFC's own Management Services Division—have specialised in small firm consultancy and much of our information on the problems of doing so is supplied by them. Basically, there are two serious difficulties in providing consultancy for small firms: first, the consulting operation is not, as might be thought, necessarily more simple than advising a large firm, but in some ways more difficult; and second, the strong sales-resistance of the typical small businessman necessitates a powerful marketing effort which the majority of consultants, given a high level of demand for their services, are not prepared to make. It is consequently very difficult to run such services profitably.

10.20 Because the small firm will rarely have identified correctly the problem giving rise to the need for advice, the consultant will need very wide experience, since his first task will often be to survey the whole of the firm's operations and identify the basic trouble. This point was well made by a representative of the Management Consultants Association, who said:

> If ICI ask you to come in and do some time study on the loading bay you can be pretty sure that is what they want, whereas if a small business asks you to do that you have not a clue whether that is really the problem.

The small businessman who calls in a consultant is normally aware only that something is going wrong and he expects the consultant to diagnose the trouble and suggest a solution. Very often, he is a very lonely man, unwilling to discuss his problem with his staff and having nobody else with whom to share the decision making. In these circumstances, if the consultant can gain the businessman's confidence he may perform a very valuable service in providing a sympathetic

Certainly the strong prejudice of many small businessmen against any form of borrowing other than by overdraft, and their ignorance of the terms on which it is likely to be possible, suggest that there is great scope for improvement in the advice they receive on financial matters.

Trade associations and chambers of commerce

10.15 In the preceding chapter we have mentioned the effect of the multiplicity of weak trade associations on the representational strength of the small firm sector. In the context of management services also, the number of trade associations, and the relative ineffectiveness of many of them, reduces the value of their contribution. Trade associations have many advantages as potential sources of specialist advice on management in their trades. They have an intimate knowledge of their industry and a continuing relationship with members, and they can take the initiative in persuading firms of the value of modern management techniques without incurring the suspicion that professional management consultants so often encounter. There are signs that, with the decline in importance of the trade associations' traditional protective role as a result of the enforcement of the restrictive practices legislation, more attention is being paid to educational activities designed to increase the efficiency of members. Some associations have been outstandingly successful in this field. The Wool Textile Delegation, for example, has founded three separate agencies for this purpose: the Wool Industries Research Association, the Wool Industry Bureau of Statistics and, most interesting for our present purpose, the Wool Textile Management Centre, which trains members of the industry in work study techniques and also operates a successful specialised consultancy service with its own staff of 24 consultants. In the retail sector, the National Federation of Ironmongers runs a very effective consultancy service, specialising in the improvement and modernisation of shop layout. Many other examples could be given. Trade associations are in fact very well placed to provide consultancy for their members. Within any one trade there are likely to be many common problems, which may permit the development of a standardised consultancy package at lower cost than would be possible if every assignment had to be treated as a separate project. Given this element of specialisation, it may be possible to employ staff with less wide general experience, again reducing the cost of the service. Regular contact with members should reduce the cost of selling the service, and certainly facilitates follow-up action. It is the more unfortunate that, in spite of these advantages and notwithstanding the examples we have mentioned, the majority of trade associations do not provide effective management advisory services for their members.

10.16 The main reason for this is that even the most simplified advisory services are expensive to run, because of the calibre of the personnel needed and to a lesser extent because of the cost of marketing such services. Nearly all trade association advisory or consultancy schemes of which we are aware are subsidised from the general funds of the association; in some of them, less than half the cost of running the scheme is recovered in fees. There is no doubt that some trade associations are inhibited by lack of funds from developing consultancy services. The Economic Development Committee for the Distributive Trades, in a report dated September 1969, concluded that the only effective way to bring management consultancy to the small firms in the industry would be through

accountant stands out as by far the most commonly used. As a result of his regular audit work he will normally have a more intimate knowledge of a client firm than any other outsider, and the accountant's training, at its best, provides an excellent basis for an examination of the overall operation of a business. In particular, the accountant's expertise is relevant to those vital areas of management in which small businessmen are weakest—costing, estimating, budgeting and financial control. No other source of advice is of equal importance. It is the more unfortunate that the full potential value of accountants' services has not been realised and that in recent years their contribution to the improvement of efficiency may actually have declined. There are several reasons for this. First, there still survives in some accountants a traditional diffidence about venturing outside the strict limits of their professional function—a fear that to offer advice on general management would be an unwelcome intrusion. One small firm wrote that accountants "are reasonably good at answering your questions but appear to give no advice unless you know the question that you want to ask". All too often, the small businessman does not know what questions to ask. The Institute of Chartered Accountants told us that "The attitude of most of the small companies is, 'Tell us what we ought to be doing' ". The accountant must therefore be prepared to play an active role when dealing with small firms, and the leaders of the profession recognise this. It is increasingly common for auditors' services to larger companies to include a report on the accounting and management systems in use, and even among small firms the emphasis in auditing of recent years has been on the examination of accounting systems; it is becoming generally accepted that the auditor should interest himself in more than just the final Accounts. There are however three very important constraints on the accountant's ability to do this for small firms. The first is the attitude of many small businessmen. It is often extremely difficult to persuade them to change old habits or to think seriously about their problems, and a busy accountant cannot afford to waste time arguing with a client who refuses to see sense. Secondly, the accounting profession as a whole has been under intense pressure as a result of the profound changes in tax and company law which have taken place in recent years. The introduction of corporation tax, SET and investment grants, the reform of company law in 1967, even the imposition of training levies, all increased the volume and the difficulty of the accountant's ordinary work, so that management services were forced into the background. One professional accountant told us that a management services scheme opened on a modest scale by his firm in 1964 has had to be suspended for this reason. Thirdly, the time of good accountants is expensive, and it would be difficult for many small firms to meet the cost of the more active role we should like to see more accountants performing. However, we were pleased to note the excellent article by the Institute of Chartered Accountants of Scotland, published in the *Accountants' Magazine*, June 1971, entitled "Services for Smaller Businesses", which advocated a more positive and management-oriented approach to small firm problems.

10.13 Many small businessmen turn to their solicitors for help with business problems as well as strictly legal matters, because the solicitor is commonly a trusted confidant, and one whose discretion can be absolutely relied upon. It is the individual's personal quality, rather than his legal training, that counts. However, the increasing complexity of the legal system within which business

outside help is the chronic shortage of time, due to the heavy pressures upon him, which prevents him making use of the help available. It is generally useless talking to anyone but the boss himself about improving any aspect of the performance of a small firm; he has to be convinced before any change can be effected. Indeed more often than not it is his own attitudes or habits that will need changing. For this reason a management consultant carrying out an assignment in a small firm will spend much of his time talking to the boss. The real value of most advisory services is as a form of training for the businessman himself. But the boss will normally be the busiest man in the firm and the hub on which it turns. He must offset against the potential benefits of any advisory service not merely its financial cost, if any, but also the time he must devote to it at the expense of his daily work. This is why it is extremely difficult to attract small businessmen to seminars and courses; advice is much more acceptable if it can be brought to his door, preferably at a time of his own choosing. The keenest small businessmen may attend courses, but will usually prefer them to take place in the evenings or at weekends.

10.9 We have some evidence on the relative acceptability of the main non-Government sources of advice. A survey carried out by the Association of British Chambers of Commerce in 1969 included the question "If you need help, to which of the following would you be most likely to turn?" Replies were received from 3,740 firms as follows:

Accountant	1,383
Solicitor	561
Bank manager	543
Chamber of Commerce	496
Trade association	485
Business consultant	143
CBI	129

The outstanding feature of this Table is that the sources most likely to be called upon are localised and familiar; accountants, solicitors and bank managers will usually be personally known to the businessman seeking help. The same is true of chamber of commerce officials (another localised service) and to a lesser extent of trade associations. It is unfortunate that this survey throws no light on attitudes towards those services provided or financed by Government, though some respondents may have classified these in the rather vague category of "business consultants". Our other evidence, however, leaves us in no doubt that if a separate category of "Government services" had been included it would have come bottom in the poll by a comfortable margin. The reasons for this are complex, and will be dealt with later in this chapter, but in view of what we have said about the need for wide acceptability if a service is to be useful, the prejudice against Government services has unfortunate implications.

Sources of help

10.10 The providers of advisory services to small firms may be broadly classified in the following groups:

to exploit new techniques and seize ...

v. *Information use and retrieval.* Ignorance or mistrust of developments in this field, such as the introduction of new simple business machines and the use of data processing bureaux, make it difficult for some small businessmen to follow the detailed progress even of their own firm, and their failure to make use of published information reduces their ability to plan effectively for the future.

vi. *Personnel management.* Personnel selection and provision for management succession cause great problems, and most managers will confess to worries about the quality of the labour they are able to recruit, notwithstanding the well-attested fact that job satisfaction and labour relations in small firms are usually of a very high order.

vii. *Technological change.* Small firms find it difficult to keep abreast of technological change, partly through lack of qualified staff and partly through failure to make use of published technical data. It should be added, however, that many small firms are able to rely on larger customers and suppliers to keep their technical capability up to scratch.

viii. *Production scheduling and purchase control.* The lack of these skills frequently makes it impossible to meet delivery dates, avoid unnecessary "waiting time" and optimise stock levels.

10.6 Such tidy classifications of management problems are of course oversimplified and somewhat arbitrary. Moreover it would be very wrong to suggest that such problems are confined to small firms. The problems are mostly interrelated, and the individual manager will generally worry about the development of the business as a whole rather than about discrete functional difficulties. Furthermore, broad generalisations of this kind can always be refuted in particular cases, and there are many highly efficient small firms about which none of the assertions above could be made without qualification. Small businessmen in general would not accept that they are less efficient than their counterparts in big industry, and man for man they may not be; a man running his own business, if it is of any size at all, is after all engaged in a very difficult operation, in which mere survival is something of an achievement. It is also quite possible for a small firm to be generally efficient, in spite of a low level of management skills, simply because of a high ratio of management time to total operating time. Our point is that they could be more efficient, and we have no doubt that the overall standard of management in small firms is low because the routine administration side of management which consumes so much of the small businessman's time is not properly systematised and delegated. It is increasingly important to be able to use systems efficiently, and it appears to us that many small businessmen prefer to emphasise the instinctive element in their work and are unhappy even with simple systems. The Merseyside Productivity Association—one of the most active in the country—made this point well:

> A lot of owner-managers are afraid of systematic management. One reason for this is the fear that the techniques will usurp their authority and decision-making role. Another reason is that if the technique is a success in releasing their time for more dynamic management planning this will find them wanting. This makes them cling to the comfortable management practices that they know best because entrepreneurial ability is not always matched by academic or scientific capability.

Introduction

10.1 In this chapter we shall consider the need of the small firm for advice and professional services from external sources and the role of the Government in helping to meet that need. We shall confine ourselves largely to what may loosely be termed "management services". We understand by this all those services which are aimed at assisting the manager in the more efficient administration and running of his business.

10.2 One of the outstanding characteristics of the small firm is the simplicity of its management structure. The typical small firm is directly managed by its owners, who themselves take nearly all important decisions and probably oversee their execution as well: our postal survey showed that over 85 per cent of small firms are controlled and managed by one or two men, usually one: only in the larger firms in our size range is there a subordinate managerial structure, and even the delegation of specific functions such as marketing is comparatively rare. This direct dependence on the proprietor in every facet of the detailed running of the business is the source of most of the strengths, and many of the weaknesses, of small firms. It accounts, for example, for the rapidity with which decisions can be taken, it makes for high morale among employees and it should ensure that the main requirement for the survival and growth of the business—to make profits—is not forgotten. On the other hand, the skills and experience of any one man are necessarily limited. The majority of small firm proprietors have no professional or other formal qualifications and only a tiny minority have specific qualifications in management. They run their business on the basis of their experience and commonsense. This may be very effective so long as the scale of the firm's activities remains small enough for one man to control them all effectively, and so long as no serious crisis overwhelms his pragmatic management. Either of these eventualities, however—significant growth or a need to consider drastic changes in the firm's policy—is likely to reveal a need for certain specialist skills which are most unlikely to be found within the average small firm.

10.3 Every large company as a matter of course employs specialists in the functional fields of management. These include, for example, financial management and accounting, purchasing, production planning and control, marketing and personnel management. The small firm is prevented by the scale of its operations from employing a specialist in every function, and in any case, the imposition of a management structure more suited to a large organisation would lead only to confusion and/or unnecessary expense. So far as they are needed, therefore, and so far as the need is recognised, sophisticated management skills and specialist knowledge must usually be brought in from outside. (It is very often the case that the need is not recognised.) The implication of this is that there is a very large potential market among small firms for advisory and management services of all kinds. Our purpose in this chapter is to consider the nature of this market and the extent to which its needs are now being met. We shall first try to establish what kinds of service small firms most need. Secondly we shall discuss the respective roles of Government and private enterprise in providing these services.

would be easy for the present, broadly satisfactory, [illegible]
to worsen dramatically without anyone in Government being aware of the fact, simply because procurement officers are not required to consider the effect of procurement policy on the structure of industry. We believe that the Government's power, for good or ill, as a major purchaser of many goods and services is so great that it should not be exercised with an eye simply to the pursuit of economy. In fact, of course, major departments do have regard to other considerations: for example, the Ministry of Defence have traditionally used their buying power to support and preserve strategically important United Kingdom suppliers and the Ministry of Technology sought to influence the structure of various industries, for example computer manufacture, through its procurement policies. **The preservation of a competitive industrial structure is also a proper object of policy, and we therefore recommend that all major buying departments should be required to have regard to the effects of their buying policies on the structure of industry in general, and particularly on the small firm sector.** We do not believe that this necessarily conflicts with the pursuit of economy. The use of the widest possible range of suppliers and contractors ought in the long run to keep prices down, even if in the short term it were necessary to accept some slight additional costs through the letting of contracts in small units, for example.

9.40 We do not suggest that it would be desirable to vest in the proposed Small Firms Division powers comparable with those of the Small Business Administration. In our departmental system the direct responsibility of each department's Accounting Officer to the Public Accounts Committee could hardly be preserved if he were subject to external compulsions. In any event it is certain that the Small Firms Division as we have envisaged it would not be large or powerful enough to exercise powers of intervention in the internal policies of other Departments. However, this should be unnecessary. We are proposing merely that the Small Firms Division should ensure that purchasing departments are aware of the effects of their actions on industry structure, and particularly on the small firm sector, and that small firms are not unfairly or unnecessarily handicapped in the competition for public contracts. The most important step to be taken here is to require that contracts should be broken down, where this is possible without loss of efficiency, into lot sizes small enough to allow small firms to bid for them. The role of the Small Firms Division in this field, as we see it, would be:

i. to study the procurement procedures of the main buying departments;

ii. to promote the adoption of procedures which facilitate the participation of small firms in Government contracts;

iii. to remind other departments, through the Procurement Policy Committee and through *ad hoc* contacts, of the capabilities of small firms;

iv. to receive and investigate complaints against buying procedures which discriminate against small firms.

We therefore recommend that the proposed Small Firms Division of the Department of Trade and Industry should give early attention to the effect of official procurement policies on small firms, and should promote policies designed to maximise competitive participation by small firms in suitable Government contracts.

purchases and its power in some areas of the p...

certain fields where the Government is effectively the sole domestic buyer—as with armaments and large aircraft—and in others where its purchases are large enough to have a dominant influence on suppliers; computers are a case in point. Though less obvious than in these examples, its purchasing power is also very important in fields more suitable to small business. The National Health Service, for example, buys enormous quantities of drugs and other medical supplies which may be manufactured or sold by small firms. The Armed Services buy food, catering services, clothing and a multitude of daily necessities which small firms are as well able to supply as any other. Most departments, and particularly the Stationery Office, buy printing services on a massive scale, and if we include local authorities, the public sector is by an enormous margin the largest buyer of building services. A deliberate policy of discrimination in favour of—or against—small suppliers could therefore have the most dramatic effect on the prosperity of the sector. In fact no such policy exists. The general rule for all Government purchasing is that competitive tenders should be invited wherever possible, and the overriding concern of purchasing departments is to obtain the best value for money—for which they are answerable to the Public Accounts Committee. A large number of contracts are of course "nominated" or "negotiated" contracts, because only one firm is thought to be capable of doing the work in question satisfactorily or because great advantages can be derived from involving the contractor in the planning of the project at the earliest possible stage: on a major building project, for example, it may be desirable to have the architect and the builder working together from the beginning. We cannot quarrel with these practices. Our concern is with the possibility that, on competititive tenders for which small firms in theory have an equal opportunity to compete, they may in practice obtain fewer contracts than their abilities warrant. This could come about in many ways. First, competitive tenders are more frequently "selective" than "open"—that is, tenders are invited only from firms on an approved list of suppliers—and it is possible that small firms may have particular difficulty in demonstrating their fitness for inclusion on the list. Second, where a choice must be made between a large, well-known firm and a smaller firm not previously used, both inertia and the desire for security will influence the procurement officer in favour of the former. It is obviously easier for him to use the contractor he has always used than to investigate a new one. Furthermore, the procurement officer will feel secure against blame, in the event of failure on a contract, if he has chosen a large firm with a well-established reputation, whereas failure by a new and little-known contractor may expose him to censure. We suspect also that some departments are ill-informed as to the capacities of smaller firms. Most important of all, there is a tendency to let contracts in ever larger sizes, thus reducing the likelihood that small firms can bid successfully for them. Where it is possible to obtain genuine economies of scale by this means, no complaint arises, but we fear that the expansion of contracts sometimes goes beyond the point of maximum economies to scale. The standardisation of contracts, which is being explored by departments now, is likely to increase this tendency. For all these reasons we suspect that the continuously growing importance of the public sector as a buyer of goods and services is on balance detrimental to the small firm sector.

ponement, provided that small firms can be given the opportunity to compete with larger ones on reasonably fair and equal terms. But the Small Firms Division must not take our hopes for certainties, and must take it upon itself, as its most important task, to monitor the small firm sector continuously, as we have suggested in Chapter 8, so that the responsible Minister may be warned in good time should it become apparent that strict neutrality will not suffice to maintain a viable small firm sector.

9.30 If such a Division were created, specific responsibilities, arising from or additional to the general functions we have suggested in paragraph 9.28, would inevitably devolve on it. We have been aware of two important areas of policy for which no existing body in Government has a clear responsibility and which we hope the Small Firms Division would tackle with some urgency. These are the effects on small firms of entry into the European Economic Community and the question of Government procurement. These may be taken as examples respectively of the consultative role of the Division and of its policy-making role.

Entry into EEC

9.31 So far as we are aware, there has been no official study of the likely consequences for small firms of United Kingdom entry into the Common Market. This is of course an extremely difficult question, and it is inevitable—and perhaps proper—that resources should have been concentrated on the attempt to predict the consequences of joining for the economy as a whole (which is equally difficult) or for particular industries (which may be somewhat easier). Nevertheless, if a Small Firms Division had existed, we have no doubt that some thought would have been given to the effects of entry on small firms and their education in the manner in which they could best prepare for membership of the Community. We think that study of this question should be one of the early tasks of the Division if it were set up in response to our recommendation. We ourselves have been unable to devote to this the time and resources needed to form a clear view on so complex an issue: but it is evident that entry into the EEC will accentuate some of the processes which have contributed to the decline of the small firm in the United Kingdom, as well as providing new opportunities for the most enterprising.

9.32 The most obvious effects of entry will be the creation of new trading opportunities through access to the enlarged Community market, and the accentuation of competition within the United Kingdom market. As we have seen in Chapter 7, one of the reasons for the decline of the small firm has been the continuing expansion in geographical terms, thanks to improved transport and communication systems, of the market that may be supplied from a given point: this has brought small firms which existed to serve a highly localised market into direct competition with large firms able to supply the regional or national market. Although the improvements in technology on which this development depended will not be repeated, entry into the EEC will have some of the same effects: large firms throughout the Community will seize the new opportunities to expand, and their expansion will be to some extent at the

could be required to take full account of the problems and needs of small ... within their industries, and if necessary to make special provision for them. It is also suggested that the common interests of small firms as a class are less important than their individual interests in the progress of the industry in which they operate, and that to treat them as small firms first and, say, retailers or engineers second would obscure this fact and do them a disservice. There is force in all these points. In particular, we recognise the great diversity of the small firm sector and the difficulty of framing any policy that would be appropriate to the whole of it; we fully accept that useful policies must start from an appreciation of the different roles played by small firms in different industries. Nevertheless we believe that small firms have enough common problems and interests to make the creation of a focal point in Government both necessary and rewarding. In any case, the present system of dispersed, non-specific responsibility has been tried over a long period and has resulted in a virtual absence of coherent thought about or policies towards small firms; even studies of specific industries, so far as we are aware, have delved no further into the role of small firms than is entailed by consideration of the case for "rationalisation". We do not believe that these matters would be improved merely by a general instruction that in future more attention should be paid to them. *So long as small firms are nobody's main responsibility, no one will devote much time or thought to them.*

9.27 We therefore make the following recommendations:

i. **There should be created within the Department of Trade and Industry a Small Firms Division responsible for the development, inter-departmental co-ordination and implementation of policy towards small firms and for the administration of such official services as are provided for them.**

ii. **A Minister of the Department of Trade and Industry should be expressly designated as the Minister responsible for small firms, and he should oversee the work of the Division.**

iii. **So far as possible the separate identity of the Small Firms Division should be stressed and publicised** (the Export Services Division of the DTI is a good example of the way in which an important entity within the Department can establish its own individual presence).

iv. **All other Departments with trade or industry sponsorship functions should designate an official with specific responsibility for liaison with the Small Firms Division of the Department of Trade and Industry, and for his Department's policy towards small firms.**

9.28 We foresee that these recommendations will be subject to criticism on two grounds, both in some degree valid. First, it will be argued, as suggested in paragraph 9.26, that small firms would suffer from the separation of responsibility for them from the "sponsorship" of their industry. We agree that it would be unfortunate if all questions relating to small firms were referred indiscriminately to the Small Firms Division, when more often than not it would be proper for them to be dealt with in the context of the relevant industry. But we are not proposing that this should happen. The sponsoring divisions for particular industries must of course retain responsibility for firms of all sizes within those industries and must continue to deal with all of the industries' problems that arise. The Small Firms Division would be concerned with questions relating generally to small firms as such, whatever their industry. Most such questions

small firm sector to meet international competition. Given Japan's ... structure, they regard it as quite inescapable that serious effort should be devoted to this. The inclusion of the Small Business Agency in the major industrial department of Government is clearly successful, and its approach to the subject, as a matter for economic debate and judgement, is more in tune with United Kingdom traditions than the crusading commitment of the United States SBA.

9.20 It appears, however, that the Japanese do not have to contend with one of our major problems—the antipathy towards Government which is typical of small businessmen here and in most other Western countries. Small firms in Japan are fairly amenable to Government intervention and assistance, whereas it would be difficult in this country to persuade small businessmen that an equally forceful Small Business Agency would not be a threat to their independence.

9.21 Following strong political pressure from the small firms lobby the French Government attempted in June 1969 to overcome mistrust by appointing two Junior Ministers with specific responsibility for small and medium sized firms, one in the Ministry of Industry and Scientific Development, responsible for manufacturers, the second in the Ministry of Finance, responsible for the distributive and service trades. They have no executive staff and thus no direct control over the administration of programmes for the assistance of small firms. We were told that France has a large number of relatively inefficient small firms which serve a large and dispersed national market and which have for some years been under severe pressure due to financial stringency, technological inadequacy and growing competition within the EEC. It is generally believed that modernisation and rationalisation must go much further, and the Government's main concern has been to further this process while moderating the inevitable hardships during the period of readjustment. These appointments show how a powerful and well-organised small firm lobby can secure political attention to its problems.

Proposed organisation in the United Kingdom

9.22 We are satisfied that special arrangements for the representation of small business within Government are also necessary in this country. It may be said that the institutions set up in the USA, Japan and France would not have appeared but for the political pressures exerted by the small business lobbies in those countries, but there is no question that these institutions perform valuable economic functions, whatever the motive for their creation might have been. In this country we lack both a coherent policy towards small firms and the knowledge on which a policy might be based. Neither lack will be remedied until it is made the responsibility of a specific body in Government to see that this is done. It would not be appropriate simply to imitate the institutional arrangements or the policies of other countries; their problems and their political traditions are different from ours. However, we believe that something can be learned from the French and Japanese arrangements, which are more relevant than those of the USA to conditions in the United Kingdom. How, then, should the representation of small business within the Government machine be organised?

the supply of goods and services. At the very least it is a cross check against the prices quoted for contracts.

iii. *The management programme.* The SBA also provides a wide range of advisory services, mostly free, of which the most important are direct infirm "counselling" on technical or management problems, the provision of courses and seminars and the publication of thousands of pamphlets and books on management techniques. (300 million copies of these publications were distributed in 1969.) The emphasis is on training the manager, and much of the work is at an elementary level. The services are heavily used to "back up" SBA's financial assistance, and the grant of a loan may be made conditional on attendance at a management course or the use of a consultant. One interesting feature of the management programme is its heavy reliance on the voluntary services of retired businessmen—the Service Corps of Retired Executives (SCORE)—who may devote one or two days a week to visiting and advising businessmen with management problems.[1] More complex problems may have to be referred to a professional consultant, in which case a list of three or more will be offered.

iv. *The investment programme.* Under the Small Business Investment Act of 1958, the SBA is empowered to license Small Business Investment Companies—private companies able to take equity in small firms and to make long term loans to them—and to invest in them substantial public funds, in a ratio of $2:$1 of private capital. The availability of cheap Government funds and valuable tax advantages brought about a mushroom growth of SBICs, but the profitability of the industry has been disappointing, its financing is a subject of fierce political controversy, and the future involvement of the SBA is in doubt.

v. *The economic opportunity programme.* In recent years the SBA has become so heavily involved in the provision of economic assistance for racial minorities and the under-privileged that this may be regarded as a programme in its own right. Neither its motivation nor its achievements, however, are very relevant to our own small firm problem—though it is conceivable that in time we also may need measures to encourage the economic, as well as the political, integration of our racial minorities.

Although opinions vary widely as to the effectiveness of the SBA in its executive role, and although there is great controversy about its political and financial roles, there appears to be general agreement in the US that the mere existence of this body as a focus of responsibility and political interest has done much to advance the interests of the small firm sector.

9.17 This short description of the SBA is enough to show, in our view, that it would be exceedingly difficult to fit such a body into our system of Government. Leaving aside the justification for particular policies, it would be impossible for any department in this country to identify itself so firmly with the interests of the industry or economic sector it represents, notwithstanding, or even in spite of, the general economic policy of the Government. In the United States the legislative procedures for the allocation of funds between departments are such

[1] There is also a more recent development, the Corps of Active Executives, who act in effect as unpaid consultants to small firms.

sense of persecution and the frustration—should be removed if possible, if only because they reduce the efficiency of the small business sector.

Government organisation in other countries

9.14 Many of these problems derive from the fact that nowhere in the machine of Government is there a department, branch or section specifically charged with responsibility for policy towards small firms. Neither the Board of Trade nor the Ministry of Technology had such a body, and none has been created since their merger in the Department of Trade and Industry. Nor have the other departments concerned with industry, so far as we are aware, any special arrangements for dealing with small firm questions. In this respect our departmental organisation differs from that of other industrialised countries which we have visited, which have usually found it necessary to create within the machine of Government a focal point with responsibility for policy towards small firms and for carrying out executive functions concerning them. The best known of these is perhaps the US Small Business Administration (SBA), an independent department of state set up in 1953 to foster the interests of small firms. Other examples are the small business agency created by the Japanese Government within the Ministry of International Trade and Industry, and in France, the offices of the Ministers for Small and Medium-sized Businesses which were established in June 1969 in the Ministry for Industrial and Scientific Development and the Ministry of Commerce. Brief descriptions of the institutional arrangements in these countries may serve as indications of the alternatives to our own system that have been found practical elsewhere—though, as will be seen, the economic, structural or political problems they are intended to solve are somewhat different from ours.

9.15 There is an astonishing contrast between the degrees of political attention paid to small businesses in this country and in the United States. Whereas there has been no official study of the small firm sector in Britain prior to our own, in the United States Select Committees of Congress and the Senate have for many years been collecting information, examining policy and publishing voluminous reports on the state of small business. Whereas we have had no department responsible for small firms, and no policy towards them, the United States has had since 1953, in the Small Business Administration, an official agency wholly occupied with the administration of policies intended to promote their interests and increase their efficiency. This high degree of interest is partly accounted for by the fact that the small business lobby in the US is extremely powerful and effective; the United States has over 5 million small firms and they can mobilise, through very strong local and national associations, voting power which, at least at State level, is a factor to be taken seriously by all politicians. There is however no doubt that the political parties and society in general are genuinely convinced of the need for a healthy small firm sector, on both economic and social grounds; the respect paid to the traditional values of free enterprise and personal independence is not mere lip-service, and they are prepared to go to considerable lengths to preserve these values. The Small Business Administration is the embodiment of this philosophy.

of the distributive trades. As with SET and Investment Grants, its differential effects on small firms, to the extent that they were foreseen, were accepted as part of the price of a policy favoured for other reasons.

9.9 Perhaps the best example of incidental harm done to small firms by the operation of a "neutral" policy is the effect of the intensification of the credit squeeze which took place in 1968. In November of that year the banks and finance houses were instructed to reduce by March 1969 their outstanding lending to 98 per cent of the level obtaining at the end of October 1967. In form, and no doubt in intention, this policy was completely neutral as between large and small firms, but given the great dependence of small firms for external finance on the institutions subject to the lending ceiling there was little possibility that it could be wholly neutral in its effects. The instruction to give priority within the ceiling to exporters (medium term export credits were actually exempt) accentuated the problem, since a smaller proportion of small firms than of large ones are direct exporters. The 1969 credit squeeze, which is discussed in detail in Chapter 12, contributed greatly to the disaffection described at the start of this chapter.

9.10 Discrimination against small firms can of course arise from an excessive regard for the supposed virtues of large size, and many witnesses have in fact claimed that Government is excessively concerned with large firms, not merely because of their real contribution to the national wealth, but also because of a mistaken equation of great size with great efficiency. The creation of the Industrial Reorganisation Corporation, though it had no direct dealings with small firms, acquired a symbolic importance because it was thought to reflect the belief that in most industries efficiency and international competitiveness could best be secured by the concentration of production in fewer hands. Departments have occasionally pursued the same ends by other means; the Ministry of Technology, for example, made no secret of its forceful sponsorship of one major British computer manufacturer, which was exercised through its procurement policies. It is not for us to argue whether either policy was mistaken but they serve as examples of the apparent bias towards large units of which Government stands accused. In Chapter 16 we shall suggest that the tacit acquiescence of successive Governments in the wave of mergers which has taken place since the early 1960s is another example of the uncritical acceptance of the fashionable belief in large units.

9.11 We have also received complaints that Government departments are biased towards large firms through being better informed about their problems and more ready to help in their solution. In particular, the large firm can expect a more sympathetic hearing in its approaches to Government, because it has better access to Ministers and to senior officials. Inevitably departments give special attention to the problems of big firms because of their potential effect on the national economy, but it is not only the magnitude of the problems involved which accounts for the special attention accorded to big industry. Large companies make great efforts to ensure that Ministers and senior civil servants are acquainted with their views and requirements in a way that would be impracticable for every individual small firm. Furthermore, it is a great deal easier for departments to negotiate with companies accustomed to official

9.5 When all this is said, however, we are in no doubt that there is a malaise among the small firm population whose implications for the growth and efficiency of the sector are serious. Briefly stated, it is a feeling, apparently widespread, that enterprise goes unrewarded and effort is not worthwhile because both Government and society in general fail to recognise their importance. All such generalisations are open to endless qualification, of course, but there is some substance in the charge that successive Governments have over the years been at best indifferent to the needs of the small firm. In Chapter 7 we listed a number of factors whose effect has been to diminish the size and relative importance of the small firm sector since the war, and to make more difficult the task of the small businessman. The activities of Government are only one of the factors affecting the business environment. Society as a whole is changing rapidly in ways that the small businessman may find uncongenial and over which the Government has little control. The rate of technological change, the introduction of sophisticated management techniques, the adoption of capital-intensive production methods and above all the increasing economies of large scale operation in the fields of marketing and finance have adversely affected small firms at least as seriously as any policies of Government. The growth of powerful trade unions which are geared to dealing with big industry on a national scale has meant that the small businessman is normally faced with a labour market whose nature, in terms of pay and conditions, is largely determined in negotiations to which he is not a party between the unions and big industry. The relative status of the independent businessman, as of other privileged groups, has fallen as the general standard has risen. Connected with all of these, but perhaps more demoralising than any of them, the small businessman has lost a part of that confidence in being the master of his own fate which we are assured is one of the greatest rewards of self-employment. This is true of everybody in society to a greater or lesser degree, but if we are right in thinking that small businessmen in particular are characterised by their independence and individuality—which is certainly the image they have of themselves—they will suffer more than most from the development of a closely-integrated corporate way of life.

9.6 These long term changes in the social and economic environment are more difficult to perceive than the well-publicised activities of Government and they offer no outlet for the resentment of those who are adversely affected. The Government is easily identified, on the other hand, and it tends to be used by the aggrieved as a symbol of all that they find wrong with society. To some extent, therefore, the bitterness of complaints about Government is merely a reflection of the frustration caused by intangible processes which are beyond the control of the individuals affected. There remains, however, a residue of legitimate ground for complaint about the record of Government in its dealings with small business, which have been characterised by ignorance of the effect of many policies on the small firm sector, and by lack of attention to the functions of the small firm in the industrial structure. These weaknesses are reflected, and partly caused, by the absence of any focal point in the official machine with overall responsibility for small business.

The attitude of the small businessman towards Government

9.1 Most of the remaining chapters in this Report are concerned with the effects on small firms of the policies pursued over the years by different Governments. Generally speaking, these policies have not been framed with the interests of small firms particularly in mind, nor in the light of a coherent general policy about the structure of industry; their differential effects as between firms of different sizes and hence their effects on industrial structure, have been largely fortuitous. Our purpose in the present chapter is to discuss the reasons for the lack of appreciation in Government of the substantial importance of the small firm sector in the economy and to consider the effect of this lack on relations between the sector and the official world. We shall be looking at the political, and to some extent the social, environment within which the small businessman must operate, and at his attitudes to this environment. We shall therefore be dealing at least as much with opinion as with fact, but we regard this chapter as no less important for that: whether or not a person's beliefs about his environment are accurate, they colour his behaviour; wholly fallacious beliefs, if held by enough people, can be very significant political or economic factors. It is of course difficult to discuss such matters objectively, since they are not capable of precise measurement, but there is sufficient consistency in the views of witnesses to make some valid generalisations possible.

9.2 It emerged very clearly from the written evidence we received that many small firms believed themselves to be operating in a generally hostile environment as a result of the actions of Government. In addition to their numerous complaints on specific issues, small firms and their representative organisations complained of generalised hostility or indifference on the part of Government, calling in evidence what they see as the total effect of Government policies in many fields. For example, some three-quarters of the respondents to a survey carried out by the CBI in the autumn of 1969 claimed that Government policies had limited the development of their companies. "An alarming number" of them were said to be "hurt and bewildered, doing their best to function properly in what they felt to be an unfairly hostile environment". Many felt "that the days of the small company are numbered". The Institute of Directors stated that "Government appears too often to create an environment hostile to the success of the small company". Similar statements could be taken from the majority of the written submissions we have received, and we have quoted a number of them below in order to indicate the tone of much of the evidence on this point. The wide variety of sources quoted is of interest.

> "There is no doubt that in recent years small firms have had fears for the future and legislation by successive Governments has created a feeling of not being wanted. To improve the position, this fear must first be dispelled"—British Button Manufacturers' Association.
>
> "It is urgently necessary for Government to create a more congenial and encouraging atmosphere within which small firms may operate, and to some extent this will depend upon the realisation by Government that as one small company put it—'Great oaks from little acorns grow' "—Chemical Industries Association.
>
> "The owners of small businesses . . . feel unwanted, the odd man out"—Publishers Association.

Small Firms Division, one of whose main responsibilities will be to monitor the health of the sector. If in the light of new information it should appear to them that our view of the future is too optimistic—if the *1968 Census of Production*, for example, gives evidence of acceleration of the rate of decline—then it will be necessary to consider what action the Government should take to support the sector. Unfortunately we cannot define the point at which the decline in small firms will become critical. We can, however, suggest a number of symptoms of ill-health in the sector which should be watched for:

i. *Lack of new entrants.* We should regard it as an indication that the vitality of the sector had reached a dangerously low ebb if the number of new entrants into industries apparently suitable for small firms were to fall and remain significantly below the average for earlier years. There is already some evidence that the birth rate of new companies in this country has fallen in recent years and it is proportionately lower than in the United States.

ii. *Ageing of the small firm population.* Lack of new entrants should cause the average age of firms in the sector to rise. This, too, might be seen as a warning of the onset of decay (particularly since the Merrett Cyriax Survey[1] lends some support to the belief that small firms are at their most dynamic during the first twenty years or so after foundation).

iii. *Over-concentration.* If study of particular industries revealed a continuing process of over-concentration (by reference to the optimum unit sizes for those industries) we should assume that extraneous forces were preventing the effective entry of new firms.

iv. *Rate of business failure.* This would be the most obvious indication of trouble, but it is difficult to interpret, and it is obvious that not all bankruptcies are to be deplored on economic grounds.

v. *Too few high-fliers.* A most important symptom would be a reduction in the number of small firms growing to become an effective challenge to the existing market leaders. This might be detected in a long term fall either in the number of new flotations on the Stock Exchange or in the number of firms successfully negotiating the difficult transition from small to medium size (from one-man control to an organised management structure).

We would hope that regular monitoring of forward indices covering such symptoms would permit the approach of danger to be foreseen, and remedial action to be taken in time. It would be a great deal easier to take measures to maintain balance and vitality in the competitive structure than to restore them once lost.

8.17 A major difficulty the Department will encounter in this task is that, as we have found, statistical information on these processes is not yet collected systematically. For example, there is no official record of new entrants into business other than the registration of new companies (which are not necessarily new firms); most unincorporated businesses are not recorded at all. The new system of annual sample censuses will not in itself throw any more light on questions of industrial demography than did the old *Censuses of Production* and *Distribution*, although the Central Register of Businesses being compiled by the

[1] *Dynamics of Small Firms*, Research Report No. 12.

the desirable size of the small firm population. Our own research and existing knowledge provide little help here. We have to choose between two possibilities—that the decline will continue, in the absence of remedial action, until the small firm sector becomes too small and weak to perform the "seedbed" function, or that it will level off so as to leave us with a smaller but still viable small firm sector, with no tendency to further decline. To the extent that the decline is caused by normal competitive forces, the latter is more likely to be true; on the other hand, if market forces are being seriously distorted by artificial factors it is possible that the decline will continue, producing a serious imbalance of the industrial structure.

8.13 Though there is little solid ground for choosing between these two possibilities, we have based our recommendations on the latter (more optimistic) forecast, partly because we think it more likely to be correct, partly because recommendations based on the pessimistic forecast would be both extremely controversial and costly to implement and should not therefore be undertaken merely as a precaution without a greater certainty in diagnosis than it is at present possible to achieve. We believe that there are many factors which distort competition, some of which, as will be apparent from the remaining chapters of this Report, could be removed or mitigated: on the assumption that action to this end will be taken, our judgement is that before the decline of the small firm sector reaches the point of crisis at which drastic intervention would become necessary, the genuine and important advantages that small firms enjoy in many industries will make themselves felt; the decline will tail off; and a new equilibrium will be reached. We cannot forecast what this equilibrium point, in terms of the number of small firms then existing, will be, since that would involve predicting the effects of a complex of competitive and technical forces not yet in existence, but we have no doubt that the number will be smaller than at present. We thus take a more optimistic view than would be justified on the basis of a simple extrapolation from the course of events described in Part I, and we must admit frankly that we do so with considerable misgivings. There is little sign in the statistics of a fall in the rate of decline, and the safest prophecy might well be that present trends will continue indefinitely. However, we base our view on our belief in the fundamental power of market forces and on the vigour and adaptability of the small firm as a form of business organisation. If, as we believe, the small firm is for many purposes a very efficient organism, with special advantages in the exploitation of new opportunities, it should be able to take advantage of the weaknesses and inefficiencies that over-concentration would inevitably produce in the structure of big industry. In other words, we do not believe that if market forces are allowed reasonably free play the process of economic concentration will proceed indefinitely. Some support for this belief can be derived from study of the United States, where small business appears to be holding its own, except possibly in the manufacturing sector, more successfully than in this country. It is not impossible that the same forces that have apparently slowed down the decline of the small firm in the more advanced economy of the USA will assert themselves here. For example, rising real incomes will increase consumer demand for specialist or luxury products at the expense of mass-produced articles, as appears to be happening in the United States. Again, higher average levels of personal wealth must increase the number of people able to raise the initial capital with which to set up in business on their own account.

we rely on it to perform the essential selected function [illegible]

8.7 If we could give a clear and unequivocal answer to this question a firm basis for an intelligent long term policy towards the small firm sector could be evolved. Unfortunately, the present state of our knowledge of the dynamics of the sector and of the industrial structure as a whole does not permit any final judgement to be made. We believe that a vigorous small firm sector is vital to the health of the economy because it is the medium through which regeneration takes place, but the continuous process of regeneration is one that cannot be predicted in detail. It is not possible to identify in advance those small firms which will eventually grow into large companies, will nurture the great businessmen of the future or will prove the forcing-ground of new industries. It is obvious that of the vast number of firms now comprising the sector, only a tiny minority will ever fulfil this role. Of the rest some will achieve less spectacular growth and the majority will remain small. It is reasonable to assume, and we believe this, that the most active and vital elements in the small firm sector are the newly founded firms in those industries where new technologies or market expansion make rapid growth possible. Even among these, however, we see no way of identifying the genuine "fliers", and we do not believe, even if they could be identified, that Government could design and operate policies of sufficient sensitivity to benefit them alone. It is inconceivable that the dynamic minority could be preserved by selective measures in an environment which had been allowed to become radically uncongenial to small firms generally. It is, of course, possible that the most dynamic would preserve themselves almost irrespective of handicaps, but to gamble on this would not be a sensible basis for policy.

8.8 We cannot therefore accept the argument that since this particularly valuable contribution of small firms to the long-run development of the economy is made by only a small minority of them, we can afford to concern ourselves only with the fortunes of that minority. We have to ensure that the small firm population remains large and healthy enough to continue to throw up, as it has in the past, a sufficient number of dynamic new enterprises to revitalise and renew the economy. It is therefore a matter for concern that, as we have pointed out in Chapter 7, there are many powerful forces, some of them apparently irreversible, making for greater industrial concentration and a reduction in the number of small firms. It is indeed possible that the danger point has already been reached. We believe this not to be so, but it is clear that if the decline continues, the danger point will at some stage be passed and the sector will cease to be capable of making its proper contribution to the long term efficiency of the economy. If that were to happen, or appeared likely to happen, say in the next decade, there would be a strong case for prompt and powerful discriminatory action by the Government to restore or preserve an effective small firm sector. The most important single question we have had to consider during this Inquiry is whether there is a case for such action now, and this is the main judgement we have to make on the strength of Part I. We thus return to the question posed at the end of paragraph 8.6; how serious is the decline in the British small firm sector that we have described in Chapter 5?

outlet is small, often the most efficient form of business organisation is a small firm. For this reason many important trades and industries consist mainly of small firms. (Chapter 3)

iii. Small firms add greatly to the variety of products and services offered to the consumer because they can flourish in a limited or specialised market which it would not be worthwhile or economic for a large firm to enter. (Chapter 3)

iv. Many small firms act as specialist suppliers to large companies of parts, sub-assemblies or components, produced at lower cost than the large companies could achieve. (Chapter 3)

v. In an economy in which ever larger multi-product firms are emerging, small firms provide competition, both actual and potential, and provide some check on monopoly profits and on the inefficiency which monopoly breeds. In this way they contribute to the efficient working of the economic system as a whole. (Chapter 3)

vi. Small firms, in spite of relatively low expenditure on research and development by the sector as a whole, are an important source of innovation in products, techniques and services. (Chapter 4)

vii. The small firm sector is the traditional breeding ground for new industries —that is for innovation writ large. (Chapter 4)

viii. Perhaps most important, small firms provide the means of entry into business for new entrepreneurial talent and the seedbed from which new large companies will grow to challenge and stimulate the established leaders of industry. (Chapter 3)

We attach importance to all these functions, but there is an important distinction to be made between the first six and the last two. The distinction is that, in the absence of artificial disadvantages the first six ought to be reflected in the competitive efficiency of the small firms concerned; though there are monopolistic elements in the economy, we believe it remains sufficiently competitive, taken as a whole, to provide the small firm with the necessary incentives and rewards to fulfil these functions. With respect to the last two on the other hand, it could be true that small firms have been and still are the natural seedbed of new industries, new talent and the large companies of the future, even though their ability to survive the operation of market forces was in doubt. Let us illustrate this distinction with a few examples.

8.4 First, while it is obviously desirable that those who prefer self-employment or employment in small firms should be free to seek it, there is no *economic* reason why the Government should artificially preserve small firms in order to gratify that preference. The job satisfaction of those who work in small firms is, we believe, of great economic value to the community in that it conduces to efficiency, but if it ceased to do so, it would not make economic sense to cite this job satisfaction as a ground for subsidy or differential support. Similarly, though the role of small firms as specialist suppliers is of great value, it is so only so long as they perform it efficiently; if changes in technology or market conditions make it profitable for a large company to manufacture a component which it has previously bought from a small supplier, there can be no *economic* case for intervention to restore the old relationship. Again, the preservation

process of concentration is not within our terms of reference. We make a brief discussion here, first, because it might otherwise be supposed that the decline of the small firm simply reflected an upward movement in the average firm size of *all* sectors of the population of firms and secondly, because the emergence of the very large company is itself a contributory cause of the decline of the small firm. It is noteworthy that in manufacturing, average employment among the smallest 95 per cent of establishments has increased by 3 per cent over the five year period 1958–63 while average employment among the largest 5 per cent of establishments has increased by 8 per cent (see Table 7.I). In terms of enterprises the difference between the growth in firm size would be greater because of the trend towards an increase in the number of establishments per enterprise.[2]

TABLE 7.I

Average number of persons employed in manufacturing establishments

	1958	*1963*
	Persons per establishment	
Average employment in the top 5 per cent of firms	1,002	1,080
Average employment in the remaining 95 per cent of firms	40	41

Source: Reports on the Census of Production 1958 and 1963.

7.24 The activities of the large companies that have emerged as a result of the general process of concentration have contributed to the decline of the small firm in two ways. The first is that like the State, as firms grow larger the concentration of their purchasing activities also stimulates further concentration. It is widely recognised, for example, that concentration in food retailing has stimulated concentration in food manufacture. The second is that the dominant position of large companies in certain markets may result in barriers to the entry of small new firms. In many cases small firms have, of course, disappeared in these industries because of the existence of economies of scale, but we believe that where existing firms refuse to supply their products to others, refuse to distribute the products of others or employ discriminatory price competition, the entry of new small firms into these industries may be prevented. Instances of many barriers to entry of these types can be found which are not contrary to existing monopoly and restrictive practices legislation, but we have not investigated them in detail.[3] We hope that the review of monopoly policy now under way will pay particular attention to the need to eliminate as many as possible of these barriers to the entry of new enterprises.

[1] See Hart, P E and Prais, S J, "The Analysis of Business Concentration: a Statistical Approach", *Journal of the Royal Statistical Society*, Series A119(2) 1956 and Bannock, *op. cit.*

[2] It appears that the smallest 95 per cent of firms showed a *decline* of about 10 per cent in their average employment over this period, while the largest 5 per cent showed an increase of some 20 per cent in average employment.

[3] Small firms, as well as large, may erect barriers to entry against competitors but large firms normally have more opportunity to do so. Examples of refusal to supply as it affects both large and small firms are to be found in *Refusal to Supply*, a report by the Monopolies Commission, Cmnd. 4372, HMSO 1970.

important in practice, the growth of [illegible]
restricted the field of activity for small firms. With the important exception of the road haulage industry (since denationalised), small firms have normally been left in private ownership, but the nationalisation of an industry effectively prevents the entry and growth of new small firms into that industry.

7.17 In the second place the purchasing activities of the State as a major or dominant buyer of a wide range of goods and services inevitably discriminate, albeit unwittingly, against the small firm. The nationalised industries, public corporations, local authorities and central Government are all very large purchasers of goods and services from the private sector. In the interests of administrative efficiency, and in the search for economies in purchasing, these organisations tend to place their orders in relatively large amounts at a time and often by selective tender. Bulk purchasing inevitably favours the large supplier. Selective tender favours large, well established contractors of unquestioned reputation. We shall return to these matters in Chapter 9.

7.18 Thirdly, and more importantly, there has been Government intervention to achieve changes in industrial structure in the presumed interests of overall economic efficiency. This type of intervention has a long history. Efforts to secure the rationalisation of the shipbuilding, textile, steel and coal industries in the 1920s and 1930s had the avowed object of accelerating the concentration of these industries. More recently, there have been schemes in the cotton textile industry and the Industrial Reorganisation Corporation has been a prominent though short-lived instrument of public policy in this field.

7.19 A fourth way in which the increasing role of the State in the economy has adversely affected the small firm sector has to do with environmental problems. Increasing population, its increasing concentration in urban areas and the progress of technological development have all made necessary an increasing number of regulatory controls as, for example, in the fields of public health, fire and sanitation, traffic regulation, development and planning controls and atmospheric pollution. In addition, the reasonable desire to take some of the benefit of growing prosperity in the form of better education and social welfare has led to the expansion of educational facilities, and to increased State activity in respect of retirement and medical benefits, industrial training, regulations on industrial safety, terms of employment, redundancy payments and so forth. Most of these activities of the State probably place a bigger administrative or financial burden on small firms than on large.

7.20 In some instances, as with the Redundancy Payments Acts or social security contributions, these measures have directly raised the costs of employing labour in firms of all sizes. In all cases they have led to increased overhead administrative costs which have inevitably weighed more heavily on the small than on the large firm. The same goes for the State's increased need for statistics to assist it in implementing its policies.[1] We shall return to these matters in Chapter 15.

[1] It is interesting to note that where economic activity is conducted on a small scale resources may be allocated efficiently enough by many small decisions in response to market forces, but where it is carried on in larger units, either by State of private enterprise, the relatively fewer and more important decisions have to be taken in the light of statistical information.

much easier to manage than they were before the invention of the telex. These developments have also favoured small firms but to a lesser extent, although in co-ordination and control the small firm continues to enjoy the inherent advantage which accrues to any undertaking which can be supervised by one man. What therefore is relevant to the fate of small firms is not only that the development of management techniques has enabled large firms to become rather more efficient: it is also that they have not greatly increased the maximum feasible span of control which one man is capable of exercising. This is important because it means that if the optimum size of firms, should, for any reason, go on increasing then, unless the maximum span of control can be increased significantly, the role of the owner-managed business will inevitably contract.

7.9 The growing complexity of the modern economy requires more and more knowledge and adaptability and may make it more challenging for the self-employed and the owner-managers of small firms to keep up to date and cope. However, the demands on larger firms are increasing also and the small firm can offset some of its disadvantages by specialisation. On balance, the small owner-managed business should be better able to adapt to change because of its inherently greater flexibility and adaptability.

Transport and communications

7.10 Improved travel and communications have affected the relative competitiveness of small firms adversely because markets have changed rapidly from local to national and are fast becoming international.[1] The research referred to in Chapter 3 demonstrates that, within the sample of small firms investigated, exporting firms are larger than non-exporting ones and that the larger the firm the more likely it is to be an exporter. On this and other evidence we conclude that small firms are less well placed than larger ones to benefit from expanding international trade. Very substantial economies of scale in both marketing and production arise in export business. It would, however, be unwise to place too much weight upon the expansion of Britain's export trade as a factor accelerating the decline of small firms. Historically, small firms have often played an important role in the rapid growth of exports and they continue to do so today in, for example, Japan and Hong Kong. Furthermore, several European countries which are at least as dependent as we are on exports, for example the Netherlands or Switzerland, have a relatively larger small firm sector than we have.

7.11 More important for small firms has been the changing balance, within the British economy, between local and national economic activity. This change has, in fact, been going on since the industrial revolution.[2] Road improvements and technical developments in haulage have made for lower costs: nevertheless it is doubtful if the reduction in the cost of transport reckoned per mile relative to other costs and prices has been of much significance. It may be the increased speed and ease of transport, rather than its lower cost per mile, which have

[1] We would note in passing that the process of concentration of manufacture into a limited number of national units has not necessarily reduced the number of suppliers to any given market: a single local source of supply in a particular locality may have been replaced by a number of competing national sources.

[2] *British Industries and their organisation*, G C Allen. Fifth edition, Longmans, 1970.

7.3 While there is much general impressionistic evidence that technological advances have, in the long term, favoured large scale production, there is virtually no systematic or precise evidence on the extent to which they have affected the competitive position of small firms since the 1930s. It is obviously true that in a number of industries technological development has increased the most efficient size of plant and equipment, as in air-frame manufacture, oil refining or sheet steel production. In these industries the most efficient size of plant is far above that which could be employed by a small firm with present techniques. In most cases, however, small firms have not been important in these industries at any time since World War II. It is more difficult to find examples where new technical economies of scale of plant have operated during the post-war period to the detriment of small firms. In road transport, for example, the smallest unit of equipment is obviously one vehicle, or one vehicle and a trailer, and although other economies of scale are available to firms with a larger fleet (for example, in respect of administration and servicing), these do not arise from the size of units of equipment. Indeed in this particular industry no economies to scale of plant or equipment can in practice be identified[1] and the small firm is not in decline. Moreover, in none of the industry reports commissioned by us were present-day economies of scale of plant given emphasis over other kinds of economies—notably those arising in marketing and finance.

7.4 Many industries, as diverse as the retail trades, catering, bread-baking, shoe and computer manufacture are highly concentrated or becoming concentrated, even though it seems to be generally acknowledged that plant economies of scale in these industries are not of dominant importance. Recent literature dealing with such economies does not in fact throw very much light on the current deterioration in the competitive position of the small firm,[2] though in the course of history up to the last war plant economies of scale must often have decisively tipped the balance against the small firm, particularly the small manufacturing firm. (Examples are automated metal finishing processes, re-rolling plant, foundries and forging). But it would appear that the really dramatic effects of changes in plant technology worked themselves out in the course of the inter-war period and that subsequent major increases in the optimum size of plant have occurred mainly in industries where the small firm had already virtually disappeared, such as public utilities, transport equipment, shipbuilding, heavy electrical engineering and parts of the chemical and oil industries. Nonetheless a persistent, if more gradual process, of what might be called "technological creep", continues to raise the optimum size of plant in most branches of industry. This is not restricted to manufacturing industry: indeed in recent years it has been more in evidence elsewhere, in the distributive trades for example. The most efficient use of the self-service layout is not available to the smallest shop, nor are the full use of automated warehouses or the most sophisticated techniques for stock control available to the smallest wholesaler.

7.5 But "technological creep" is not wholly in one direction: in some industries there are signs that recent technological change has been favouring the smaller

[1] See B Bayliss, *The Small Firm in the Road Haulage Industry*, Research Report No. 1.

[2] e.g. Bain, J S, *Industrial Organisation*, Wiley, New York; Chapman & Hall, London, 1959, Pratten, C F, and Dean, R M, *The Economics of Large-Scale Production in British Industry*, Cambridge UP, 1968.

businesses; the broader statistical series of "discontinued businesses" shows that as many as eight per cent of all operating businesses were discontinued each year at the beginning of the 1960s. This range of "failure rates" is clearly too broad to permit any valid comparisons to be made with this country.

6.18 Bankruptcy figures have also been examined, but they do not appear of much help since they include bankruptcies of persons as well as of non-incorporated firms (US analyses indicate that 84 per cent of all bankruptcy cases filed are those with occupations described as "employees").

6.19 Thus, as far as births and deaths are concerned, the limited comparisons we have been able to make with the US suggest that birth rates of new companies are lower in this country; that little can be said on death rates; and that the average age of surviving firms is probably rather higher in Britain.

[1] The statistics are quoted from the *Statistical Abstract of the United States 1970*. It appears that the statistics on US failure are intended to provide a consistent indication of changes in the business climate over time, but they do not relate to all business concerns; the number of concerns in business listed by Dun and Bradstreet for 1961–65 was 2·6 million, compared with 1·5 million corporations and 10·0 million proprietorships and partnerships recorded by the tax authorities. However, even if the number of recorded failures were related only to the total of 1·5 million corporations, the failure rate for the US would still be only about 1 per cent.

that country, the comparisons have not proved satisfactory. In view of the difficulties experienced with the US data, and the limitation of the available time, it was decided not to pursue comparisons with other countries for which the information available is generally more limited.

Small firm birth rates

6.11 In 1968 the number of new companies registered in Great Britain was 21,000, and in the United States 234,000; taken in relation to their human populations, 0·4 companies were registered for each thousand of the population here, and 1·2 companies per thousand in the United States.

6.12 At first sight the rate of new firm formation in Britain is only a third of that in the US; but statistics of incorporation do not by any means tell the whole story with regard to the formation of new firms, the major qualification being that very many new businesses are formed each year without incorporation (some of which may of course seek incorporation at a later date). For the United States the number of new unincorporated businesses recorded in the statistical series has in recent years been somewhat greater than the number of incorporations; but apparently not all unincorporated businesses appear in the statistics of new business formations; the total number of active unincorporated firms assessed for tax in recent years exceeds the number of active corporations by a factor of seven.[1]

6.13 For the United Kingdom no statistics on the formation of new unincorporated businesses are available. An indication of the ratio of the number of all active unincorporated firms to that of active companies can be obtained from taxation statistics, and this yields a ratio of just over seven to one, very similar to the ratio found in the United States.[2]

6.14 Thus, in both countries companies represent only a fraction of the total number of firms and, though the fraction is very similar, it may be hazardous to make inferences from such a small part of the whole. There is, however, some further relevant evidence on the life-cycle of firms: for the United States it is known that there is a very high turnover of new enterprises, and that the median age of the business population is only about seven years; that is, half the firms currently alive were founded in the last seven years.[3] In this country, according to the sample survey of small firms carried out by Merrett Cyriax Associates for this Inquiry, the median age of firms, suitably adjusted, appears to be very much higher, varying from 19 years in the retail and motor trades to 69 years in construction; in manufacturing it was 22 years.[4]

[1] The statistical series on new business formations in the US has been seriously revised from time to time; the statistics referred to above have been taken from the 1963 *Statistical Supplement to the Survey of Current Business* which gives, for 1962, new businesses as 430,000 and incorporations as 182,000. The information on tax assessments relate to 1967, when there were 10·0m proprietorships and partnerships, and 1·5m corporations (*Statistical Abstract of the United States, 1970*).

[2] Inland Revenue Statistics 1970 gives the number of companies in 1967 as 255,800 and the number of schedule D assessments on sole traders and partnerships in 1966 as 1,859,700.

[3] See Betty Churchill, Age and life expectancy of business firms, in *Survey of Current Business*, December 1955. The average ages vary from 5 years in construction to 10 years in finance; for manufacturing the average age is 7·5 years (all data are for the US, end-1954).

[4] See Chapter 2, Table 2.V.

other industries in Britain with the US, although it should be [illegible]
such comparisons are less precise than in manufacturing. It appears that in some trades—retailing, road transport and services—small firms are less important in the US than here, and in others—wholesaling, construction and mining—small firms are more important in the US. For the economy as a whole (including manufacturing) the small firm sector in the US is rather more important than here; we estimate that it accounted for 34 per cent of employment in 1963 compared with 29 per cent in Britain (using definitions that have been matched as far as possible).

Changes in the share of small firms

6.6 The long term decline in the share of small firms which is shown in the UK statistics (and set out in Chapter 5) is, not surprisingly, also to be found in other countries. More recently, however, two of the very advanced countries, US and Canada, appear to have shown a reversal of trend, with small *establishments* accounting for a greater share of manufacturing employment; there is also an indication of a similar trend in Germany for the period 1963–67. This is shown by the comparisons set out in Table 6.III relating to a period of about a decade chosen to be as close as possible to the period covered by the UK censuses held in 1954 and 1963. During that period in the UK the share of small establishments in manufacturing employment declined by 2 percentage points (from 33 to 31 per cent). The precise years chosen for other countries were governed by their census dates. It is interesting to note that in Germany, perhaps the natural comparison, the decline in the share of small *establishments* (excluding Handwerk) appears to have levelled off in recent years. The actual census figures were 33·5 per cent in 1963 and 34·2 per cent in 1967 although the apparent increase is within the likely margin of error in the figures.

TABLE 6.III

Changes in the proportion of total manufacturing employment accounted for by small establishments in recent years

		Per cent	
		Employment share at	
		beginning	*end*
United Kingdom	1954–63	33	31
Declining share			
Germany	1953–63	40	34
Sweden	1950–65	56	53
France	1954–63	58	51
Japan	1956–66	59	54
Australia	1953–63	62	60
Switzerland	1955–65	66	61
Norway	1953–63	70	65
Rising share			
United States	1954–63	37	39
Canada	1955–64	46	47

Note: These figures are derived from the same sources as those in Table 6.I and are broadly comparable with them.

6.7 The apparent reversal of trend in the United States could, however, be misleading, since it does not indicate a reversal of the downward trend in the share of small *enterprises*. What has been happening is that the number of establishments per enterprise has been increasing. We have already seen in

The share of small firms in employment

6.1 We have examined the *Censuses of Production* of a number of countries to see how the importance of the small firm sector in Britain compares with that abroad. The results, in terms of the proportion of manufacturing employment in small establishments (those employing under 200), are set out in Table 6.I.

6.2 Somewhat to our surprise the results indicated that the process of concentration had gone further here than elsewhere: no country was found where small establishments had a lower share in manufacturing employment than in the United Kingdom.

TABLE 6.I

Proportion of manufacturing employment in small establishments in Britain and other countries

		%
UK	1963	31
Germany	1963	34
USA	1963	39
Canada	1968	47
Belgium	1962	51
France	1963	51
Sweden	1965	53
Japan	1966	54
Netherlands	1962	58
Australia	1963	60
Switzerland	1965	61
Norway	1967	64
Italy	1961	66

Sources: Compiled by the Research Unit from national and international statistical year books and national census data. See also footnotes to para. 6.3.

Note: Comparability of these figures is affected by the different dates to which they relate.

6.3 We are of course aware that international comparisons of this kind are hazardous since the precise coverage of industries is hardly ever the same in one country as in another. Despite the co-ordinating activity of the various international organisations (UN, OECD, EEC), it is clear that statistics of this type cannot yet be compared too closely.[1] The EEC reached the stage of organising industrial censuses on a comparable basis for 1963 in the six member countries, and has published the results in a single volume;[2] however, it appears that various sources of incomparability still affect the data, especially with regard to repairers (according to their kinds) and activities that combine manufacturing with retailing (such as baking and sausage-making), and these have a pronounced effect especially on the recorded numbers of small firms. We were

[1] In their report, *Problems and Policies Relating to Small and Medium Sized Business, 1971* the OECD do not attempt statistical comparisons for this reason.

[2] *Endgultige Ergebnisse des Industriezensus von 1963*, Statistiches Amt der europaischen Gemeinschaften, Luxemburg, 1969.

Proportion of turnover and labour force in small organisations in wholesaling and miscellaneous services, 1966

Per cent

	Proportion of turnover in small organisations	*Proportion of persons engaged in small organisations*
Trades dominated by large organisations:		
Wholesalers[a]	12	25
Laundries	18	20
Dry cleaners	30	29
Trades dominated by small organisations:		
Launderettes	74	79
Shoe repairers[b]	89	89
Hairdressers[b]	94	96

Source: See footnote 1 to para. 5.29.

Note: (a) Data relate to 1965.

(b) Information relates to establishments (not organisations as elsewhere in the Table). A small establishment (or organisation) is defined as one having an annual turnover of £200,000 or less in wholesaling, £50,000 among laundries and dry cleaners and £20,000 among launderettes, shoe repairers and hairdressers.

5.31 In two of the trades dominated by large organisations, the relative position of the small organisations has shown no change; but in wholesaling the importance of small organisations declined considerably between 1950 and 1965 (see Table 5.IX). The figures we give have been calculated in a similar manner to those on the retail trades and allowance has been made for the effect of the change in the value of money on our definition of a small firm. The proportion of small organisations in wholesaling fell slightly between 1950 and 1965, the proportion of total sales accounted for by them fell by nearly half and the proportion of the total labour force engaged in them fell by ten percentage points. These are substantial changes over such a short period of time.

TABLE 5.IX

Relative importance of small organisations in the wholesale trades 1950–1965

Per cent

	1950	*1959*	*1965*
Proportion of total number of organisations	78	77	76
Proportion of total sales	22	12	12
Proportion of total number of persons engaged	35	..	25

Source: See footnote 1 to para. 5.29.

Note: Small organisations are defined as those having an annual turnover of less than £200,000 in 1963; this criterion has been adjusted for each year to take into account the change in the value of money. Figures relate to firms operating with stocks and making satisfactory returns.

services has been compiled from information available in official inquiries into these trades; for the other trades we have relied on the various Research Reports that we commissioned.[1]

5.25 The small firm has remained a dominant feature of the *road haulage* industry; and there has been relatively little change since the 1930s in terms of the size distribution of operators. Existing hauliers, and particularly the large ones, have grown at substantial rates, and this has increased the number of larger firms in the industry; but the influx of predominantly small firms into the industry has maintained the proportion of small firms: about half of all firms still operate only one vehicle. However, the new entrants have entered the industry through licences which have restricted the type of operations they carry out much more than those which were issued to common-carriers in the inter-war period. Although the small firm is dominant in terms of numbers, the one-vehicle firm is responsible for less than one-tenth of the total receipts of the industry.

5.26 With the rapid increase in car ownership after the war, changes in the *motor distributive trades* have inevitably been dramatic; the total number of establishments more than doubled between 1950 and 1962, followed by a decline of nine per cent between 1962 and 1967. The fall in the total number of organisations between 1962 and 1967 was most marked for petrol stations, motor cycle dealers and general repairers, while specialist repairers and accessories firms (both predominantly small firm trades) increased in numbers. The increase in total turnover has been even more considerable: from £850 million in 1950 to almost £3,000 million in 1962, and to £4,350 million in 1967 (these figures are in constant 1962 prices). Together with this expansion in the number of establishments and total turnover, the trade has seen considerable structural changes; whereas in 1950 petrol stations accounted for about one-half of all organisations and vehicle dealers about 30 per cent, by 1967 vehicle dealers accounted for the highest proportion (about 40 per cent) and petrol stations for less than 30 per cent. However, this classification of organisations under a single major activity is to some extent an arbitrary device, useful for Census purposes, but obscuring the general practice of motor traders to carry out a variety of activities. Most activities in this trade, with the exception of vehicle dealers, remain the preserve of small firms; in 1962 only one per cent of repairers and two per cent of petrol stations had a turnover of more than £100,000 and the figures are almost exactly the same for 1950 and for 1967 (in real terms). The authors of our Research Report (No. 9) were not able to establish trends in the share of small firms in the motor trades through lack of information.

5.27 The statistical information available on the *hotel and catering trades* which, in fact groups together a very varied number of trades, is less extensive than for the other industries and also seems to be less comprehensive; the various incomplete surveys available are not consistent with one another and

[1] See Research Reports Nos. 1, 9, 10 and 14.

	Total number of establishments	Small establishments as a proportion of the total	Small organisations as a proportion of the total
	thousands	%	%
1950	551	96	96
1957	545	96	..
1961	542	94	95
1966	504	95	..

Source: Reports of the Censuses of Distribution and Other Services.

Note: Both small establishments and organisations are defined as those with an annual turnover of £50,000 or less in 1963. Allowance has been made for the effect of changes in the value of money on this definition. We had insufficient information to enable us to estimate the absolute number of small organisations in 1950 and 1961 on the same scope as the 1966 data, we have confined our figures on organisations to the *proportion* of the total.

5.19 Although the retail trades are important in terms of the numbers of establishments and of firms, the average firm in these trades typically employs far fewer persons than in manufacturing (3 and 27 respectively); so that while retailers form one-half of all small firms by number, only one-third of *employees* in industries within the scope of our Inquiry were engaged in the retail trades. The retail trades also differ from other trades in that they employ a relatively high proportion of part-time workers and for this reason it is necessary to measure employment in retailing in two ways: first, the total number of persons engaged and secondly, the full-time-equivalent employment.

5.20 The total number of persons[1] working in all retail establishments increased by 200,000 (or 8·5 per cent) between 1950 and 1966, but the total number of persons engaged in small establishments remained fairly steady throughout this period. There was a fall in the *proportion* of persons working in small establishments, from 72 per cent in 1950 to 67 per cent in 1966 (see Table 5.VI).

TABLE 5.VI

Persons working in retail establishments, 1950–1966

	In all establishments	In small establishments	Small as a proportion of all	Proportion working part-time (all establishments)	Full-time equivalent (all establishments)
	thousands	thousands	%	%	thousands
1950	2,348	1,679	72	20	2,113
1957	2,472	1,730	70	25	2,158
1961	2,485	1,640	66	26	2,154
1966	2,556	1,718	67	33	2,138

Source and Notes: As for Table 5.V.

5.21 The incidence of part-time employment increased considerably between 1950 and 1966; in 1950 only one-fifth of the total number of persons engaged

[1] Including working proprietors.

Number of establishments and enterprises in manufacturing in the UK, 1924–1963

Thousands

	Establishments			*Enterprises*		
	Total	*Small*	*Larger*	*Total*	*Small*	*Larger*
1924	163	160	3	..	..	..
1930	168	164	4	..	..	..
1935	148	144	4	140	136	4
1948	108	103	5	..	..	..
1951	102	96	6	..	..	..
1954	97	91	6	..	..	..
1958	93	85	8	70	66	4
1963	90	82	8	64	60	4

Source and Notes: As for Table 5.I.

5.14 The information published in the 1958 and 1963 *Censuses of Production* makes possible a quantitative analysis of changes in the ownership of small establishments. The results of such an analysis are summarised in Table 5.IV which shows that in 1963 large enterprises owned over 2,000 more small establishments than five years earlier. There was also a net fall of more than 3,000 in the total number of small establishments over this period so that the proportion of small establishments owned by large enterprises rose from 12 per cent in 1958 to 16 per cent in 1963. These are very substantial changes in a relatively short period of time and must presumably partly reflect the combination of small enterprises into larger units and the acquisition of small enterprises by larger enterprises. (See Chapter 2, paras. 2.9 *et seq.*)

TABLE 5.IV

The ownership of small manufacturing establishments in 1958 and 1963

	1958	*1963*
Total number of small establishments	79,748	76,429
Small establishments owned by small enterprises	69,884	64,431
Small establishments owned by large enterprises	9,864	11,998
Proportion of small establishments owned by large enterprises	12%	16%

Note: These figures were obtained by deducting the numbers of establishments owned by small enterprises from the total number of small establishments given in the *Reports on the Census of Production*, 1963; we have ignored the differences in scope between the two sets of tabulations which, in our judgement, do not affect the conclusions drawn. The figures in this Table also differ from those of Table 5.III because of unsatisfactory returns.

Changes in retail distribution

5.15 The retail trades account for the largest proportion by number of the firms that come within the scope of our Inquiry; in fact, nearly one half of all small firms are engaged in the retail trades. Despite their numerical importance (there were about 350,000 retail *organisations*[1] in 1961) only four *Censuses of*

[1] An organisation is defined as "any undertaking operating one or more establishments within the scope of the census"; two or more subsidiaries of a parent company are treated as separate organisations, even though they may both engage in retailing. The definition of an organisation is thus narrower than that of an enterprise as defined for the census of manufacturing.

Employment in UK manufacturing, 1924–1968

	In establishments			In enterprises		
	All establishments	*Small establishments*	*Small as a percentage of total*	*All enterprises*	*Small enterprises*	*Small as a percentage of total*
	thousands	*thousands*	*%*	*thousands*	*thousands*	*%*
1924	5,115	2,257	44	..	..	..
1930	5,179	2,238	43	..	..	..
1935	5,409	2,375	44	5,409	2,078	38*
1948	6,871	2,538	37	..	..	..
1951	7,382	2,576	35	..	..	..
1954	7,537	2,500	33	..	..	..
1958	7,781	2,498	32	7,649	1,812	24
1963	7,960	2,436	31	7,846	1,543	20
1968	7,870*	2,280*	29*	..	..	..

Source: See footnote 1 to para. 5.1.

Note: Small establishments or enterprises are those employing 200 persons or less. There are some slight differences in coverage between the enterprise and establishment data.

5.8 Provisional figures supplied to us from the 1968 Census and given in Table 5.I, indicate that the decline in the share of small establishments continued between 1963 and 1968. Although final and detailed figures are not yet available it would be optimistic indeed to believe that the decline in the share of small enterprises in manufacturing employment had ceased.

5.9 Employment, as a measure of the importance of small firms, suffers from a possible defect that attaches to any measure based on inputs, namely, that it cannot take account of the effects of changes in productivity; for example, if labour productivity had been increasing more slowly in small firms compared with large, too high an estimate would have been given of the relative contribution of that sector to the output of the economy. For this reason it is desirable to supplement the above statistics on employment by using net-output measures as reported in the censuses.

5.10 To enable comparisons in absolute terms to be made over time, we have allowed for the change in the value of money using an index of prices of manufactured goods. Any possible difference (as between large and small manufacturing firms) in the movements of prices received and paid have been ignored, but such differential movements have probably been small compared with the approximately three-fold general increase in prices over the period.[1] The results of our calculations are set out in Table 5.II.

[1] The index of prices has been taken from *The British Economy—Key Statistics 1900–70* (London and Cambridge Economic Service, The Times, London, 1971). Better comparisons over time would require more detailed calculations in which outputs and inputs for each industry would be deflated by separate price indices and this may be expected to give somewhat different answers (especially for 1951 when there were violent price movements associated with the Korean War). We should not expect the general picture to be very different.

we have done earlier in Chapter 3. Thus, however dramatic the changes described below may appear to be, the statistics probably conceal the truth about the rate of change of concentration in the British economy as a whole.

5.4 Various adjustments and interpolations have had to be made to the published census data to allow, as best we can, for changes in industrial and geographical coverage that have taken place over the years (see footnote 1 to para. 5.1). The adjustments made, although small in relation to the economy as a whole, are of some importance in obtaining a correct picture of what has happened to the small firm sector; of course, they inevitably incorporate a certain element of arbitrariness, but we believe the picture is not over-sensitive to the precise adjustments made.

Changes in manufacturing

5.5 The most accurate and, perhaps, most significant measure of the role of small firms in the economy is the proportion of the total labour force employed by them (it will be recalled that we have defined a small firm in manufacturing as one employing 200 persons or less). Based on the information given in the Censuses, Table 5.I sets out the numbers employed in small and in all establishments in manufacturing from 1924 to 1968; the Table also gives the *proportion* of the labour force working in small establishments.

5.6 The total number of people employed in manufacturing expanded steadily throughout the period, the overall increase being of the order of 3 million persons, or some 55 per cent, between 1924 and 1963. As far as can be seen, this increase was concentrated entirely in large establishments; the numbers employed in small establishments hardly changed over the period, having risen slightly until 1951 and fallen slightly since then. As a result the *proportion* of the total workforce in small manufacturing establishments declined steadily throughout the whole period falling from 44 per cent in 1924 to 31 per cent in 1963.

5.7 The decline in the share of employment has been sharper in terms of *enterprises* than in terms of *establishments* (see Chart on facing page), and in 1963 just under 20 per cent of the total labour force in manufacturing was employed in small enterprises. Five years earlier, in 1958, the proportion had been 24 per cent; and in 1935 (for which year our estimates are, however, subject to more serious reservations) the proportion had been in the region of 38 per cent. The data on enterprises give a different picture from that on establishments, of course, because many enterprises, even among those employing 200 persons or less, have more than one establishment and the number of multi-establishment enterprises (and the number of establishments they have) is increasing rapidly. We shall return to this subject in para. 5.14.

implemented) to set up his own business, perhaps to fail and possibly in either event, to sell out to a larger firm.[1] Many of these elements of industrial growth and change involve small firms but to isolate their individual contribution to innovation alone leads to an under-estimation of their role in the process as a whole.

4.36 It will be noted that we have been discussing the role of small firms in innovation mainly in the context of manufacturing. This simply reflects the availability of information. Outside manufacturing there are important innovations such as the self-service system, the credit card, or car-air ferries, which may be just as important from an economic point of view as purely technical innovations in manufacturing. There is no reason to suppose that the role of small firms in innovation outside manufacturing is any less important, indeed it may be more important because of the generally lower capital costs of development work.

4.37 In summary, therefore, although many aspects of the innovative process cannot be quantified, it appears that small firms continue to make an important contribution. It seems possible from the evidence that their contribution is greater in invention than in innovation. The share of small firms in innovative activity appears to be less than their share of employment of scientific manpower but higher than their share of R & D expenditure. Small firms also make a major indirect contribution to the process of industrial innovation and the activities of small and large firms in the innovative process appear to be complementary. Our conclusion on the role of small firms in invention and innovation is, therefore, complementary to that on their role in competition, and reinforces the need to ensure an industrial climate in which new small enterprises can be established and can grow.

[1] E B Roberts and H A Wainer, "New Enterprises on Route 128", *Science Journal*, December 1968.

those required for invention. For the United States, only 4 per cent of total reported R & D expenditure is on basic research (in no industry did it exceed 20 per cent), 20 per cent on applied research and 76 per cent on development.[1] For the reasons already mentioned, R & D expenditure, the employment of scientific personnel and the patent statistics are no less ambiguous a guide to the relative innovative performance of small firms than for invention. Qualitative evidence, notably the work of Jewkes, Sawers and Stillerman (*op. cit.*), strongly suggests that the role of small firms in innovation is less important than in invention but that it remains substantial and shows no tendency to diminish.

TABLE 4.VII

Proportion of employment of all and qualified personnel in small manufacturing establishments to totals for all establishments in manufacturing, 1968

Per cent

	Total employees	*QSEs*	*Technicians*
All manufacturing	31·1	15·5	21·2
Food, drink and tobacco	26·4	16·1	20·7
Chemicals and allied industries	23·4	10·0	16·8
Metal manufacture	15·1	6·8	11·0
Mechanical engineering	36·3	25·8	30·0
Electrical engineering	14·8	6·7	11·4
Electronics	10·3	13·6	7·7
Aircraft	5·8	3·6	2·8
Motor vehicles	11·7	7·8	13·2
Other vehicles	20·0	10·4	9·8
Textiles, clothing etc.	48·2	29·5	33·9
Other manufacturing	42·9	25·4	39·2

Source: J G Cox, Research Report No. 2, *op. cit.*

4.34 A number of attempts have been made in the United States to measure innovative performance directly, notably those of Edwin Mansfield, but they have been restricted mainly to highly concentrated industries and have not proved conclusive.[2] We could trace no previous attempts to measure innovation by size of firm in Britain and for this reason, despite the formidable technical and conceptual difficulties, we commissioned Professor Freeman and his colleagues at Sussex University to attempt a general inquiry of the same type as that carried out by Mansfield but over a wide range of industries in manufacturing, construction, public utilities and coal.[3] The results, which identified some 1,100 important innovations, attributed to about 800 different firms and selected by panels of experts, are summarised in Table 4.VIII. They relate to 50 industrial groups accounting for over half of the net output of the industries covered. These figures indicate (subject to qualifications given in the source quoted) that small firms

[1] National Science Foundation, 1966. Quoted in E Mansfield, *The Economics of Technological Change*, Norton, 1968.

[2] E Mansfield, *Industrial Research and Technological Innovation*, Norton, 1968.

[3] C Freeman, Research Report No. 6, *op. cit.*

little incentive, as well as limited ability, to innovate since they face only limited competition and will be heavily committed to existing products and processes. At the other extreme it is argued that modern technology has now evolved to the point where significant innovations are beyond the financial and managerial resources of all but the largest companies.

4.28 As generalisations we cannot accept either of these extreme points of view. There is ample evidence that private individuals and small firms continue to make major inventions and that small firms pioneer major new products to a very significant extent, even in areas of the most advanced technology.[1] It is equally true, however, that small firms, in the sense in which we use the term, cannot possibly play a major innovative, as distinct from inventive, role in activities requiring very large numbers of employees and capital such as airframe manufacture or the construction of electrical generating plant. The appropriate questions about the role of small firms in innovation seem to us therefore to be: first, is their role in innovation greater or less than their share of economic activity as a whole and in particular of the necessary resources that small firms employ? Secondly, to what extent are the innovative activities of small and large firms complementary?

4.29 The principal difficulties met with in all studies of innovation are the lack of empirical data and the problem of measurement. The sources of innovation is a subject on which until recently, at least, little systematic attempt has been made to collect information. Even when information is available it is difficult to interpret: was the discovery of the evaporation principle of refrigeration more or less economically important than that of the materials and techniques which led to its production and wide distribution at low cost; was the invention of wireless telegraphy more or less important than that of broadcasting and television that came later; is one major innovation more or less important than a thousand minor innovations and improvements?

4.30 On the question of invention, as distinct from innovation, the evidence suggests that individuals working either by themselves or in small firms make a disproportionately large contribution particularly in relation to their expenditure on Research and Development (R & D). This conclusion is now generally accepted and can be supported by four kinds of evidence: first, case studies of technological innovations; second, studies of the proportion of patents registered by large and small firms; third, statistics on the share of large and small firms in the employment of Qualified Scientists and Engineers (QSEs); and fourth, statistics on the relative shares of small and large firms in recorded total R & D expenditure.[2] We shall not review all this evidence here although we have set out the new data collected for us by the Department of Trade and Industry on employment of QSEs and technicians in small firms in Table 4.VII.

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[1] See, J Jewkes, D Sawers and R Stillerman. *The Sources of Invention*, Macmillan, 1958.

[2] See Jewkes, Sawers and Stillerman, *op. cit.*; C Freeman, *The Role of Small Firms in Innovation in the United Kingdom since 1945*, Research Report No. 6, *J G Cox*, Research Report No. 2, *op. cit.*

by their greater dependence upon a narrow range of activities than large firms, which are more likely to be diversified and thus able to offset losses in one activity against profits in another. Small firms also depend to a greater extent upon the efforts of single individuals who are not only fallible but subject to illness and other influences which directly affect performance. Finally, larger firms are more likely to be able to exert some degree of control over their market and quoted companies in particular may be subject to greater incentives to maintain profits and dividends at stable levels. These factors could explain the whole of the difference noted; however, in so far as profit may include an element of reward for risk taking, the differences in risk taking as between small and larger firms also must be taken into account. It is, of course, in the social interest that firms should place new products or services on the market and that these new, trial ventures should be, wherever practicable, on a small scale so that the social costs of failure are minimised. This brings us to the second and third aspects of the performance of small firms that we mentioned at the beginning of this chapter—those of competition and innovation.

Competition and innovation

Competition

4.22 The first half of this chapter has discussed the relative efficiency of small and large firms in terms of the return on capital and output per person. We have seen that on the limited evidence available there are no grounds for thinking that small firms are any less "efficient" than large firms in the use of the overall resources they employ. In the remainder of this chapter we discuss two other important aspects of efficiency: competition and innovation. It should be remembered that economic progress, though often taken for granted, is not automatic but requires either more human and capital resources, or the application of new ideas for using these resources. At all events, a change in methods and pattern of production is required. Innovation is the process by which these new ideas are introduced; an actively competitive framework should ensure both that existing methods and resources are used as efficiently as possible and that new ideas are, in fact, introduced.

4.23 We have already touched on the competitive role of small firms in promoting economic efficiency in the previous chapter. We strongly support the widespread belief that in a free enterprise economy the customer's protection against exploitation, the responsiveness and adaptability of the system to consumers' needs and the supplier's incentive to greater efficiency, all rely very much on the maintenance of effective competition between the various firms supplying any given market. For this condition to be satisfied it is desirable that there should be not one or two but many separate firms competing for the buyers' custom at every stage in the production and distribution of goods and services. There should, moreover, be a possibility at all times of new firms setting up, with the opportunity of becoming formidable rivals to the existing suppliers. Some economists would go as far as to claim that the more competing firms in any market the better; but in practice where total markets are limited in size the availability of economies of scale not only in production but in marketing and other functions may often mean that there is some conflict between the need for

firms[1] but there are also a number of studies among quoted companies showing that the rate of return declines with size; in Table 4.V, we have abstracted from these studies figures relating to the very smallest group of quoted companies, those with net assets of under £250,000, and compared them with those for all quoted companies. The former group will have been only slightly above the maximum size of small firms as defined by this Committee. The difference in rates of return appears to be in the region of 2 per cent in favour of the smallest companies. The companies included in these samples are all quoted companies, and the comparisons are therefore subject to a smaller extent to the qualifications on accounting practices, mentioned above, relating to re-valuation and directors' remuneration.

TABLE 4.V

Comparisons of rates of return on net assets between small quoted companies and all quoted companies

Period	*1949–53*	*1948–60*	*1954–63*
Size of sample	2,549	364	186
Rates of return for:			
Small quoted companies	17·9%	19·3%	18·6%
All quoted companies	16·2%	18·5%	16·5%

Sources: 1949–53: Calculated from B Tew and R F Henderson (Ed), *Studies in Company Finance* (Cambridge 1959).
1948–60: A Singh and G Whittingdon, *Growth Profitability and Valuation* (Cambridge 1968).
1954–63: J M Samuels and D J Smith, Profits, Variability of Profits and Firm Size, in *Economica*, May 1968.

4.18 Taking all the evidence together (first the comparisons between small firms and quoted companies and, secondly, the comparisons within the quoted company sector), the suggestion that small companies show a higher return on capital may therefore be regarded as probably correct, notwithstanding the qualifications attaching to each source of evidence. The difference in rate of return is however not very great.

[1] A further sample of companies, those applying to the Industrial and Commercial Finance Corporation (ICFC) for finance, referred to in Chapter 2, also shows higher rates of return than quoted companies; but, as we have noted, such firms are presumably more expansion-minded than average and cannot be regarded as representative of all small firms. The interview study of small firms carried out on our behalf by Merrett Cyriax Associates (Research Report No. 12 *op. cit.*) does not provide return on assets figures but notes that the median profit margin of turnover for small manufacturing companies is lower in that sample, at 2·4 per cent, than in a sample of quoted companies, where it was 6·7 per cent; the reason suggested there is that small companies have a lower capital intensity (i.e. less capital per unit of sales). We have some doubts however as to the validity of the median margin in the Merrett Cyriax sample: it seems extremely low (at 2·8 per cent) compared with that for our postal survey (described in Research Study No. 17) where the median margin on turnover in manufacturing was 4·2 per cent in 1964 and 3·9 per cent in 1968 (the arithmetic averages were 5·6 per cent for both years). In the Merrett Cyriax survey an "unweighted" median is quoted which is very much higher, at 5·7 per cent, than the weighted median, suggesting that there has been a very heavy weighting imposed on the sample in favour of the less profitable companies. Further, the number of manufacturing firms in the Merrett Cyriax sample was only 114 and, together with the wide variability in the results, this may well imply that the comparison is not statistically significant. P Lund and D Miner, Research Report No. 11 (*op. cit.*) include a summary of two other small scale inquiries.

resources, it suffers from the same deficiency as the first, that is it allows only for differences in inputs of one factor of production, in this case capital, and neglects differences in the others, in this case labour and management.

4.11 The financial accounts of businesses, unlike Census data, are available only on a sample basis although they do contain information on total capital employed, not merely that embodied in fixed assets.[1] The available information on comparative returns on assets among small and larger firms is reviewed below.

4.12 A sample inquiry was undertaken by the Inland Revenue for 1961–62 into the Accounts of some 2,000 companies submitted for tax assessments and the results were tabulated for different sizes of company;[2] the companies concerned were those defined as private exempt companies, that is those which did not then have to file accounts with the Companies' Registrar. This inquiry is of considerable interest since the accounts will have been examined by the tax authorities, and therefore have been subject to a certain inherent standardisation and checking for accuracy; in addition, the problems associated with a low response rate, which affect all voluntary and unofficial inquiries (including that sponsored by this Committee) are absent. Three size categories were distinguished in the Inland Revenue inquiry according to the level of profits (as assessed for profits tax in the year 1956/57): (a) £4,000–£20,000; (b) £20,000–£50,000; and (c) over £50,000. The first category and part of the second category probably cover the type of company that falls within the scope of this Committee.

4.13 The rate of return (defined in the report as "net income as a percentage of net assets") was found to rise somewhat within this group of companies, from 14·4 per cent for size (a), to 16·7 per cent for size (b), to 17·0 per cent for size (c); more important was the finding that these rates were higher, by 2–4 per cent, than that derived from the published accounts of large quoted companies, for which the rate of return at that time was 13·2 per cent.[3] As noted in the commentary published together with the tabulations, the lower rate of return calculated for quoted companies is to be attributed in part to the greater degree of revaluation of their fixed assets; private companies have little interest in carrying out the extensive calculations needed for a revaluation, and such calculations are, in any case, irrelevant in accounts submitted for taxation. Another difficulty in comparing the profitability of large and small companies is that sums treated as directors' remuneration in the smallest companies may include an element of profit on capital employed, and hence the residual profit is understated; for larger companies this element is relatively smaller (this may account for the apparent tendency for the rate of return to rise with size within this sample of exempt companies). These qualifications are of course well-known and affect, in varying degrees, almost all comparisons of this type that have been made.

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[1] The best available information relates to incorporated businesses and in particular to quoted companies. For unincorporated businesses reliable information is very scarce and not necessarily comparable with that for companies, as we noted in Chapter 3, para. 3.24. A major proportion of all small firms are of course unincorporated and where we refer to "firms" below they are included in the sample under discussion.

[2] The analysis was published by the Board of Trade in *Economic Trends*, No. 169, November, 1967.

[3] Tabulations of the results of other large companies that were not quoted (but not exempt from filing accounts) showed a return of 13·4 per cent, virtually identical to that for large quoted companies.

not, however, necessarily indicate a lower level of output per unit of labour input since the units of labour input are not, on average, the same for small and large firms. We noted in Chapter 2, para. 2.39, that small firms pay lower wage rates than larger firms for broadly equivalent grades of labour and that hourly earnings are lower still in small firms because of a lower incidence of overtime and shift working. There is also evidence that the composition of the labour force differs between small and larger firms so that the skill-mix would be lower.[1] The incidence of part time employment may also differ between large and small firms. Sufficient statistical information is not available to assess the relative importance of differences in rates paid for the same type of labour on the one hand and differences in the degree of skill employed and hours worked on the other, but we should expect both differences to be reflected in a lower wage and salary bill per person employed in small firms than in larger firms.

4.6 The wage and salary bill by size of firm is tabulated in the 1954 Census and it can be seen from Table 4.II that wages and salaries per person employed do in fact rise with firm size. From the third column of this Table it can be seen that the effect of adjusting the relationship between labour input and output to take account of differences in wages per head is to reduce the amount by which net output per head in larger firms exceeds that in small, from 18 per cent down to 3 per cent in terms of wages paid.

4.7 Because of the extent to which wage rates, even for the same type of labour, are lower in small firms this adjustment must over-compensate for the over-statement of labour input in small firms and we conclude that the residual difference in output per unit of labour input lies somewhere near the high end of this range, that is to say, nearer 18 than 3 per cent.[2]

Return on capital

4.8 Net output per head is, of course, influenced by the amount of capital invested in the business through the effect of investment upon labour productivity. The relevant information on the capital available per employee is summarised in Table 4.III. Information on power equipment installed has not been tabulated by size of firm since the 1924 Census; though out of date, the figures are worth reproducing here since they provide a measure in physical terms: they show (column 1) that in small firms the average employee had 31 per cent less

[1] This difference is consistent with the lower capital intensity of small firms. Information is available from the 1924 Census of Production and a special inquiry carried out by the Ministry of Labour in 1961 that the employment of women declines as firm size increases. Among manufacturing firms employing under 200 persons in 1924, female employees accounted for 32 per cent; among firms employing over 200 persons, only 23 per cent were women (*Census of Production, 1924, Final Report*). Intra-industry comparisons suggest that the proportion of administrative, technical and clerical workers is higher in industries in which large firms predominate than elsewhere. Finally, J G Cox, *Scientific and Engineering Manpower and Research in Small Firms*, Research Report No. 2, confirms that the proportion of qualified scientists, engineers and technicians is substantially higher in large firms than in small.

[2] There are additional complexities in Census material which should strictly be taken into account: net output as defined for Census purposes, besides providing for employee remuneration, interest, profit and depreciation on capital, also includes amounts for certain ancillary expenses which should be charged against net output, in the same way as raw materials are charged. These are: rents, rates, advertising and selling expenses, payments for repairs, hire of plant etc. (See *Guide to Official Sources: No. 6, Census of Production Reports*, HMSO, 1961.) There is no indication in the Census tabulations of how important these items may be, and how they vary with size of firm.

Efficiency in the use of resources

4.1 In this chapter we examine the available evidence on how well small firms compare with large firms in three aspects of efficiency: in their use of resources, in maintaining competition, and in contributing to invention, innovation and technological progress. The assessment of the economic efficiency of firms presents many conceptual and practical problems. The principle is simple enough: it is to compare the relationship between inputs and outputs, just as we might measure the efficiency of an internal combustion engine by comparing the power output in relation to the quantity of fuel consumed; but as soon as one attempts to apply that principle in statistical terms difficulties arise, especially in the measurement of inputs. Entrepreneurship, as a factor of production, can be recognised but is hardly capable of measurement; physical assets can be valued in various ways, and some measure of "capital input" can thereby be arrived at, but the valuation put on such assets in balance sheets is not always appropriate for this purpose. In addition there will be monopolistic elements in the economy which may make payments (or receipts) a doubtful measure of the quantity of goods or services bought (or sold); this equally affects wages. Comparison of the economic efficiency of large and small firms is thus especially difficult particularly where, as is usually the case, the small firms involved are not engaged in exactly the same activities, selling in the same markets or using the same production processes as the large ones.

4.2 We recognise that statistical evidence is inevitably rendered somewhat inconclusive by considerations of this type; nevertheless we have thought it right to review the two types of study that have often been carried out and which bear on the issue of the efficiency with which resources are employed in firms of various sizes. The first type is based on Census data, which relate to particular industries and compares net output per person employed in firms of different sizes. The second type of study is based on samples of the financial accounts of companies, which are available for limited sections of the economy, and compares the rate of return on capital in companies of various sizes.

Net output per person

4.3 It is sometimes suggested that small firms are less efficient simply because net output produced per employee (as recorded in successive *Censuses of Production*) has been substantially lower in small firms than in large. In the paragraphs that follow it is shown that this interpretation is too superficial.

4.4 The most recent information from the *Census of Production*, relating to 1963, showed that net output per person employed in small manufacturing enterprises was some 23 per cent below that in large enterprises (£1,097 per person in enterprises employing under 200 persons, against £1,425 in larger

3.VIII suggests that, in all but the machinery, electrical and transport equipment industries, small exporting firms actually export a greater proportion of their output than larger exporting firms.

TABLE 3.VII

Estimated value of turnover and exports of exporting firms in the North West Region of Britain, 1969

	Turnover £ million	*Exports £ million*	*Exports as % of turnover*
Small exporting firms	260	82	32
Other exporting firms	2,990	1,082	36
Small as % of total	8	7	—

Source: See Table 3.VI.

TABLE 3.VIII

Value of turnover and exports of exporting firms in the North West by SITC group-heading

SITC Group		*Turnover (£ million)*	*Exports (£ million)*	*Proportion of turnover exported (%)*
5	Small exporters	37	18	49
	Large exporters	388	120	31
6	Small exporters	96	30	31
	Large exporters	748	118	16
7	Small exporters	94	30	32
	Large exporters	1,235	821	67
8	Small exporters	34	5	15
	Large exporters	619	24	4
All above groups	Small exporters	260	82	32
	Large exporters	2,990	1,082	36

Note: Group 5: Chemicals and explosives.
Group 6: Leather, rubber, cork, paper, textiles, iron and steel manufacture.
Group 7: Electrical and non-electrical machinery, transport equipment.
Group 8: Miscellaneous manufacturers, clothing, footwear and furniture.

3.30 On the basis of this information about the North West Region it would seem probable that the direct export contribution of small firms is substantially less than their share of total output or employment but that among firms which do export there is only a small difference between the export performance of small and large firms.

3.31 The belief that small size is an insuperable disadvantage overseas has no doubt inhibited many small firms from entering export markets. The figures above suggest that this belief is mistaken and we hope that they will encourage more small firms to try their hand at exporting. As an illustration of the seope and variety of export achievement open to small firms, we give below in Table 3.IX some examples selected from among the small manufacturing firms which received the British National Export Council Award in 1970. The 92 eligible companies that entered for the 1971 Award increased their exports from just over £15 to nearly £23 million over the year. The smallest entrant had six employees and the largest 191: the average payroll was 101 and exports per head averaged £2,443.

the small firm sector, 1968

Per cent

	Manufacturing	*Non-manufacturing*	*Together*
Companies	93	69	86
Non-incorporated firms	7	31	14
	100	100	100

Source: Research Unit estimates based on the Committee's Questionnaire Survey and subject to a substantial margin of error.

TABLE 3.V

The share of small firms in national employment, 1968

Per cent

	Manufacturing	*Non-manufacturing*	*Together*
Small firms:			
Companies	18½	28	25
Non-incorporated	1½	12	4
Sub-total	20	40	29
All other firms	80	60	71
Total	100	100	100

Source: Research Unit estimates. See Table 3.IV.

Profits, capital and capital expenditure

3.24 The information available on the profits and capital stock of small firms is extremely limited.[1] The problems of putting small firms into their context in national accounts aggregates arise not only from lack of information but also from conceptual difficulties. The information published in the national accounts does not show unincorporated businesses separately from households, nor is it at all clear how in practice any really meaningful estimates of profit or capital can be arrived at for small firms. In disclosing profitability the accounts of owner-managed businesses are ambiguous in that income of the owners consists of a managerial salary and a return on capital, the split between the two being arbitrary and largely determined by tax considerations. Further, the smaller unincorporated businesses in particular do not keep detailed accounts or accounts that are separate from the proprietors' household accounts; while their capital assets, particularly a dwelling or car, may be used for both purposes, in such a way that the cost cannot be apportioned accurately (though it has to be apportioned in an arbitrary manner for tax purposes). For these reasons we saw little point in attempting the hazardous exercise of estimating the trading profit, capital stock or depreciation of businesses in the small firm sector and we are not aware of any satisfactory attempts to do so.

3.25 Because small firms, on average, use much more labour-intensive methods of production than large firms, their share in total capital expenditure is smaller than their share in total output or employment. We estimate from our question-

[1] See Chapter 2 above and also Chapter 2 of Economists Advisory Group, *Financial Facilities for Small Firms*, Research Report No. 4.

industries concerned. Their importance varies considerably from one industry to another: generally speaking, small firms have a relatively greater share of the labour-intensive service trades than they do of manufacturing and mining, while in road transport and construction they occupy an intermediate position.

3.18 It should be noted that none of the three measures is an ideal measure of the share of small firms in economic activity nor do any of them correctly reflect the importance of small firms to the economic system. The number of firms is obviously unsatisfactory as a measure of their contribution since no regard is given to the effects of size, and some small firms may be virtually inactive. Net output as a measure of work done and valued at market prices appears at first sight to be unambiguous enough but it is subject to difficulties of interpretation and has certain technical measurement problems. Employment is a clearer concept and is more accurately measurable, but can be misleading when used to compare the importance of firms employing different production methods or still more between firms in the service trades which are labour-intensive and those in manufacturing where relatively more capital per person is employed. Moreover, as units of input, all men are not equal, some work only part time, while some contribute more and are paid more than others. (See Chapter 4.)

3.19 Although different definitions are used for different industries, nevertheless small firms can be looked upon as a sector within the total firm population. The relative importance of different trades in this sector in 1963 is set out in Table 3.II.

TABLE 3.II

The importance of different industries within the small firm sector, 1963

	% of totals for all small firms		
	Employment	*Net output*	*Number of firms*
Manufacturing	34	43	7
Retail trades	28	21	46
Hotel and catering trades	11*	10	16
Building and construction	10	11	10
Miscellaneous services	6	1	7
Wholesale trades	4	5	4
Motor trades	3*	5	5
Road transport	3	3	5
Mining/quarrying	—	1	—
	100	100	100

Source: Research Unit estimates. See Table 3.I.

3.20 The Table shows that half of all small firms within the scope of this Inquiry in the United Kingdom are in retail and wholesale distribution, with hotels and catering next in importance; in terms of net output and employment the contribution of small firms is greatest in manufacturing. The predominance in number of small firms in both retail distribution and hotels and catering reflects the fact that a large proportion of those firms have no employees outside the immediate family.

3.12 Our second category, *specialist* firms, are those small firms carrying out functions that large firms do not find it economic to perform at all. Although they may include large firms among their customers, as in several of our examples in the preceding paragraphs, they do not do so to a dominating extent, as with the satellite firm. Examples of specialist firms are the small firms engaged in repair and maintenance in the building industry, jobbing engineering firms and specialised retail outlets such as bookshops.

3.13 Our third category of small firms, the *marketeers*, are those which compete in the same or similar markets as large firms; computer software companies, fashion merchandise manufacturers, restaurants, insurance brokers, travel agencies and garages, are all examples of businesses in which small firms market their services in more or less direct competition with large ones.

3.14 We have attempted to quantify the numbers of firms in each of these categories. This is not a simple matter but it appears that the majority of small firms are marketeers. In the Merrett Cyriax dynamics study, Research Report No. 12 (*op. cit.*) some 78 per cent of the manufacturing sample were classified as competing with large firms, 16 per cent were specialists and only 6 per cent were satellites of larger companies. Lydall (*op. cit.*) using a rather different definition[2] found that about half of a sample of small firms in manufacturing were producing products of their own design for sale to all comers. He also found that the proportion of marketeers increased with the size of firm, i.e., jobbing was most common among the smallest firms. Outside manufacturing industry, and particularly in the distributive trades, the proportion of small firms that compete directly with large firms is in general even higher. In other trades small firms may be particularly important as specialist suppliers. In construction, for example, small firms account for 48 per cent of all repair and maintenance work but for only 27 per cent of new housing construction.[3] Moreover, even in the numerous branches of industry where marketeers predominate, a substantial number of small firms may be heavily dependent on one large customer, even though not to the extent that they could be classified as satellites. According to our questionnaire survey, in manufacturing as a whole, 35 per cent of small firms are dependent on one customer for 25 per cent or more of their business, and in metals and metal manufacture one half of small firms sold more than a quarter of their output to one customer.

3.15 In order not to overburden our Report with lengthy qualifications and illustrations from individual industries we have been forced, despite the misgivings we have already expressed,[4] to deal with inevitably complex matters at a fairly high level of generalisation. We hope therefore that the reader who

[1] Some companies criticised their small suppliers' general lack of adequate financial controls, production planning and a tendency to take on more work than they could handle. These matters are dealt with in Chapter 10.

[2] He distinguished between firms producing to customer specification (jobbers) and those making their own products for general sale.

[3] See P Hillebrandt, *Small Firms in the Construction Industry*, Research Report No. 10.

[4] See beginning of Chapter 2, para. 2.1.

3.8 It follows from what we have said so far that there may be no distinguishable role for a small firm in a particular industry, just as there may be no distinguishable role for a large firm. Most industries consist of firms of various sizes co-existing to supply the market, and in our view a balanced industrial structure of this kind, wherever it is possible, is the one most likely to achieve efficient and flexible economic development. Increasingly, however, in modern conditions the most efficient size of firm is very large in relation to market size and hence there may be some conflict between the need for a sufficient number of small firms to maintain flexibility and competition and the need for firms to be of the most efficient size at any particular point in time. This problem is accentuated by the growing capital-intensity of production and distribution and the tendency for business to become more diversified so that economies of scale in marketing, purchasing and finance are being exploited over progressively wider fields of operation. These last two factors, although not often very important fifty years ago, have come to be of major importance today so that to discuss the role of the small firm without mentioning them would be an over-simplification. In the past, businesses tended to be specialised, that is to say, activities were restricted to a fairly narrow field and once a firm reached the optimum size it was less likely than a firm today to diversify into other fields. Some economists argue that the increasing modern tendency for firms to diversify their activities (so that the achievement of substantial size in one field is followed by a diversification into others) is a consequence of the separation of ownership and management noted in Chapter 2 section iii. This separation, it is argued by these economists, results in greater emphasis on corporate growth at the expense of profit and specialisation.[2] We are more in sympathy with others who ascribe it to a second factor, the increased possibilities introduced by modern marketing and the increasingly large capital requirements of modern business. Whilst at any given time there is always an optimum size of production plant, marketing costs, and to a lesser extent finance costs, tend to go on declining as a firm grows larger and, unlike production plant, they are not necessarily specific to any particular industry or product. The tendency for oil companies to distribute and sell tyres, batteries and motoring accessories in addition to oils and petrols through their sales outlets illustrates some of the opportunities for marketing economies open to large firms. These advantages of large scale organisations have greatly stimulated the development of conglomerates into which many small and medium-sized firms have been absorbed, as well as leading to the continued diversification of other firms not normally regarded as conglomerates. The major limitation on the expansion of a large firm through diversification has come to be the ability of its management to deal efficiently with the problems of a large, diversified organisation.

3.9 In summary, therefore, it is an over-simplication in modern conditions to suggest that the size of a firm is determined either by the size of the market or by the size of the most efficient production plant. The ultimate limit on growth is increasingly a managerial one rather than one decided by production economies

[1] Some of these have subsequently been taken over by other firms.

[2] See Robin Marris, *The Economic Theory of Managerial Capitalism*, Macmillan, 1964, and R Marris and A Wood (Eds) *The Corporate Economy*, Macmillan, 1971.

The functions of small firms

3.1 The simple, and as we shall see over-simple, answer to the question why are some firms large and others small, is to be found in economies of scale. This means that the role of small firms is to carry out functions which they can perform more efficiently than larger firms, that is to say, activities which are not efficiently performed on a large scale. Obvious examples of such activities are the village shop or the launderette around the corner which are small because they serve a limited local market—a large establishment set up in such a location would not be fully utilised; it would be uneconomic, and indeed might be forced to close through an inability to cover its own costs. Some small firms may be small not because they are supplying a geographically limited market, but because their market is limited for other reasons—perhaps because their products are new or unusual, as with certain types of scientific equipment, or perhaps because they are beyond the pocket of all but a small section of the community as with certain luxury goods.

3.2 Under competitive conditions and provided the market is large enough, firms may be expected to continue to expand while their costs per unit of output go on falling. A firm which expands to the point at which its unit costs start to rise will, after a time, lose the advantage on which its expansion has been based.

3.3 The various sources of economies of scale have been analysed in great detail by economists and we will not attempt to summarise their analysis here, although we shall return to the subject in Chapter 7, paragraph 7.3. For our purpose, however, it is useful to distinguish between two sources of scale economies—first, those arising from the use of large scale *plant* and second, all the other economies that arise from large-scale *organisation*. The first group are the more familiar and arise because the capital cost of machinery is borne by the whole of the output of that machinery and because, within limits, the capital cost of a machine tends to rise less than proportionately to its productive capacity. It follows from this that, within these limits, the larger the machine that can be employed the lower the capital cost per unit of output. It is often assumed that production economies of scale are the only really important ones but other types of scale economies are increasingly important. These economies arise from precisely the same principle—that the unit cost of any activity is lower the greater the number of units of output over which it may be spread. Thus marketing costs per unit of sale may fall as more is sold, for example even where the production of those units is spread over many small plants in different parts of the country; another example is that a sales force of travelling salesmen can efficiently handle more than one product; and again an advertisement in a national newspaper will cost no more if it is placed by a firm selling a large quantity than by another selling a much smaller quantity. As a firm grows it may also find that its purchasing, stock requirements and administrative costs do not rise proportionately to sales. Finance is another sphere in which there are scale economies.

3.4 Economies of scale of both types are not unlimited, of course. The second group are, on the whole, less limited than the first and this is why firms in some industries may continue to grow far beyond the point at which they are able to

diffuse efforts so permeate our way of life it is impossible to deal with them *in extenso*. We will, therefore, refer briefly to two aspects of the contribution of small firms only—in relation to the consumer and to local affairs. Every reader will no doubt have his own ideas as to the other topics which we ought to have included.

2.51 One of the most important contributions of the small business to the community is in providing a wide range of choice and a high standard of personal service to the consumer. It is recognised that in many ways the spread of standardisation and mass-production methods bring advantages but they inevitably reduce the consumer's choice. The economic benefits of mass-production cannot be enjoyed without some rationalisation in the range of products available to the consumer. Equally, however, rationalisation can proceed beyond the point where economies of scale cease to be significant or where the reduction in the number of suppliers goes so far as to create a monopoly situation where the benefits of scale are either not passed on to the consumer or, worse still, are lost through managerial inefficiency. Where this occurs the consumers' field of choice has been reduced without any corresponding reduction in price or improvement in quality. This problem is not, of course, restricted to manufacturing. Small retailers may provide the only outlet for locally produced fruit, vegetables and handicrafts which, although competitive in price, might not be available from branches of those multiple stores that do all their buying centrally and on a national basis. Many small firms, particularly in the service trades, exist to supply minority groups. Most serious bookshops, small businesses which manufacture the requisites for the more esoteric hobbies or shops that stock the goods used mainly by immigrants—such as those that sell Indian, Greek or Turkish food—are examples. Other more widespread instances are to be found among the small cafes, including lorry drivers' restaurants, and the small hotels and boarding houses used by commercial travellers, building workers and lorry drivers, or for the annual holidays of those in the lower income groups, including old age pensioners. None of these activities is likely to be economically operated by large concerns and some of them will disappear altogether, and freedom of choice thereby be impaired if conditions and opportunities for small business are allowed to deteriorate too far. Above all, most of us value the personal service which small businesses provide almost as a matter of course and which large businesses have to strive, not always with success, to achieve.

2.52 Another major contribution of the local businessman to his community has been his willingness to contribute his experience to the service of the community in which he lives and works. Small business provides a valuable source of practical men to serve in local government, on the bench and in local, charitable and social organisations. These men are experienced in the organisation of activity on a local scale and have deep roots in the local community having in many instances effectively replaced the squire as the local benefactor and leader. The representatives of larger firms not only may have less relevant practical experience but they may live in the area perhaps only for the duration of an assignment. This subject has received little attention here but in the United States concern has been expressed at the fact that the economy of many towns is totally dominated by branches of national companies whose local executives

report.

> I'd hate to work for someone in London—you'd sell your soul and just be a number—it's the personal ambition and satisfaction you get in your own business which is the point.
> (Owner, Road Transport, Northumberland)

This desire for independence appears to be over-riding and indeed may on occasions even operate against their own economic interest. According to our own questionnaire survey (see Research Reports Nos. 16 and 17, *op. cit.*), average salaries of directors and working partners in small firms are not high in relation to average earnings of other comparable occupational groups (although comparisons are difficult), and in particular are low in comparison with earnings in managerial positions in larger companies. Many businessmen in small firms recognise that money is not their prime motivation and that they might earn more elsewhere, especially in relation to the effort and risk involved:

> You want a reasonable return on your capital, but basically it's not the money, you do it for personal satisfaction. I'm in business to work and get somewhere, I couldn't lounge skiving half the day like they do in big companies.
> (Owner, Printing, Home Counties)

2.47 The desire for independence may well conflict even with the interests of their own business. Many owner managers of small firms recognise that should their businesses expand beyond a certain point, they would then be obliged to engage supervisory staff, take a partner or have recourse to external sources of finance, all of which would inevitably lead to some loss of independence. The desire for independence may also adversely affect the small firm's willingness to profit from outside advice. The authors of our motivation study concluded:

> The powerful underlying need to maintain and preserve independence and the strong feelings of personal satisfaction derived from one's own achievement go a long way to explaining the attitudes to outside help and assistance. Government assistance was seen as leading to Government intervention; using more sophisticated financial assistance than that provided by the local bank manager would lead to a loss of independence because the organisation giving the assistance would want some measure of control over the firm. Having rejected "the boss", respondents didn't want to suffer the paternalism of Government or anyone else for that matter. Because the sense of satisfaction derived from personal achievement was so important, many of these respondents appeared almost to turn a deaf ear to any outside source of advice or help. They neither knew or wished to know about it.

As Merrett Cyriax Associates put it in Research Report No. 12 (*op. cit.*) the "management of small companies is in many respects a way of life" to the individuals concerned.

2.48 *Social origins of owner-managers.* The special character of the owner-manager of the small firm tends to be reinforced by his family traditions. The large proportion of businesses run by the founders' descendants show that the sons tend to follow in their fathers' footsteps. Indeed it is our impression that the general climate of opinion is now so antipathetic to business and particularly small business that except for those whose father is in business on his own account and for whom entry into small business is not only encouraged, but relatively easy, the tendency is for young people not to adopt independent business as a career. As to the social standing of the independent businessman, it is our impression that it may now be lower than it has ever been. This is some-

Average earnings for male time workers in selected occupations, by size of firm, June 1969

New pence/hour

	Size of firm (employees)					
	25–99		*100–499*		*500 and over*	
	Excluding overtime premium	*Including overtime premium*	*Excluding overtime premium*	*Including overtime premium*	*Excluding overtime premium*	*Including overtime premium*
Selected skilled grades	47·8	51·4	51·8	55·8	59·7	62·9
Selected semi-skilled grades	41·0	44·4	42·3	45·9	51·1	55·0
Labourers	35·5	38·2	36·8	40·0	41·0	44·2

Source: Earnings of manual workers by occupation: June 1969, in *Employment and Productivity Gazette*, October 1969; the "selected" grades are "all other grades", excluding eight grades of skilled workers which are distinguished in that publication. The overtime earnings shown here do not include payments at standard rates for the additional hours worked nor do they include shift premia where such premia are shown as a separate item in the respondents' return. (See footnote 1 to para. 2.38).
shift premia where such premia are shown as a separate item in the respondents return. (See footnote 1 to paragraph 2.38).

2.41 It is true that a very much smaller number of small than large firms are unionised and for this reason their employees are less well organised and less disposed to take strike action. The growth of trade unions and the necessity for collective bargaining have been associated with the concentration of work people in larger and larger units. In a small firm an employee normally may, if he wishes, speak to the owner himself. In a large firm problems of communication arise and some kind of organisation to represent employees' interests is necessary. We are not suggesting that the present problems of industrial relations in this country would be solved if the role of small firms in the economy were greater, but perhaps they would be less acute. In making comparisons between large and small units this question of individual satisfaction has therefore to be taken into account.

iv. *Motivation and social origins*

2.42 *Ownership and control.* At the beginning of this chapter we commented on the difficulties and dangers of generalising about small firms. When we come to look at the human and social factors affecting them we can see that firms are, in fact, as varied and individual as the men who founded them. Although true of all forms of business this is particularly true of the small firm which, as we noted in paragraph 2.3, is usually not only the creation of one man but directly managed by him or his family and therefore bears the stamp of an individual personality. As a business grows it inevitably becomes managed less and less directly by one man and this in turn inevitably dilutes his personal influence. With increasing size, businesses require increasing recourse to external sources of capital. Not only does management by a single individual tend to become more remote but the ownership of the business tends increasingly to be in the hands of people other than those who manage it. Thus among the firms in which we are interested, the founder, owner or owners of the business and the firms' management are either one and the same person, or if not, are almost invariably members of the same family. Among the very largest firms on the other hand the founder has usually long since disappeared from the scene and the directors and senior managers are only exceptionally related to him and themselves own an insignificant proportion of the equity of the business. Ownership of these largest

Proportion of firms with shift working among male manual employees, by size of firm, May 1970

Per cent

	Size of firm (employees)			
	25–99	*100–999*	*Over 1,000*	*All firms*
Firms working shifts	16·0	50·0	87·4	36·7
No shiftworking	84·0	50·0	12·6	63·3
All firms	100·0	100·0	100·0	100·0

Source: Hours of work, overtime and shiftworking, National Board for Prices and Incomes Report No. 161 Supplement. (Cmnd. 4554–I, HMSO, 1970). The data cover Manufacturing, Mining, Construction, Utilities and Transport.

2.37 In our postal inquiry addressed to a sample of small firms a question was included on wage-rates; firms were asked how their wage-rates (for the same skills) compared with those paid by larger firms in their area. The impression given by the replies (see Table 2.XVIII) was that small firms thought on balance that their wage-rates were the same or higher. These are subjective impressions which as we shall see appear to be in conflict with the statistics and it seems doubtful if many proprietors of small firms have a precise knowledge of the wage-rates paid by larger firms.

TABLE 2.XVIII

Wage rates in small firms compared with large firms in the same district

	% of respondent firms
Wage rates in small firms as compared with large:	
Lower	6
About the same	51
Higher	18
Do not know	25

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.38 Official inquiries into *earnings* have almost invariably shown smaller average earnings in small firms; of course this need not necessarily be inconsistent with the possibility that *wage-rates* are the same or higher. Earnings per hour can exceed wage rates per hour for a number of reasons and in at least two of these special factors could widen the gap between average earnings and average wage-rates more in large firms than in small. First, as we mentioned in paragraph 2.36, employees in large firms may earn more because of the greater incidence of shift work. Moreover, although total average hours worked are slightly longer in small than in large firms, the latter pay for a slightly higher proportion of hours worked at higher overtime rates (see Table 2.XIX).[1]

[1] This effect is no doubt exaggerated by the fact that the earnings figures cannot exclude shift premia unless they are explicitly so labelled by the employer. It follows that implicit shift working premia will be an important component in the reported earnings of large firms where shift working is more prevalent.

Balance sheet structure of slow and fast growing small firms in manufacturing and non-manufacturing industries

Per cent of total assets/capital and liabilities

	Manufacturing				*Non-manufacturing*			
	Slow growers		*Fast growers*		*Slow growers*		*Fast growers*	
Tangible fixed assets	35·0		33·3		26·1		25·7	
Goodwill	0·7		1·0		2·7		1·0	
Total fixed assets		*35·7*		*34·3*		*28·8*		*26·6*
Stocks and w.i.p.	21·6		21·0		28·1		23·2	
Debtors	25·2		33·3		27·4		43·3	
Cash	9·7		4·6		8·6		4·6	
Other current assets	7·7		6·7		7·1		2·2	
Total current assets		*64·3*		*65·7*		*71·2*		*73·4*
All assets		*100·0*		*100·0*		*100·0*		*100·0*
Ordinary shares	23·6		13·1		33·6		23·5	
Preference shares	2·6		1·1		1·0		1·0	
Capital and revenue reserves	38·6		25·8		19·8		18·4	
Owners' loans	1·1		5·0		5·8		4·4	
Capital and reserves		*65·9*		*45·0*		*60·2*		*47·3*
Long term loans	3·8		6·5		3·9		4·9	
Bank loans	6·6		8·5		10·1		9·0	
Creditors	20·0		33·7		23·7		33·8	
Other current liabilities	3·7		6·3		2·1		5·0	
Total liabilities		*34·1*		*55·0*		*39·8*		*52·7*
All capital and liabilities		*100·0*		*100·0*		*100·0*		*100·0*

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.31 The tendency of fast growers to finance themselves to a greater extent by means of borrowed funds manifests itself in a number of ways: (a) In fast growing manufacturing firms, externally borrowed funds provided 50 per cent of all the new funds employed by them between 1964 and 1968, as compared with 20 per cent in the case of the slow growers. Thus for fast growers external borrowings virtually matched their retentions. In non-manufacturing, borrowing formed 35 per cent of total sources amongst fast growers, but slow growers showed a decline in their borrowed funds during this period. (b) 48 per cent of the fast growing firms in manufacturing attempted to obtain additional outside finance as compared to 27 per cent of the slow growers. In non-manufacturing the pattern was similar. Of those applying for additional outside finance, 83 per cent of fast growers in manufacturing were successful, but only 56 per cent of the slow growers. It is of course difficult to resolve the chicken-and-egg questions which are raised by these figures (are the firms fast growers because they raised outside finance, or did they obtain outside finance because of their demonstrated ability to grow?); our postal survey cannot provide conclusive evidence on this. The survey of successful and unsuccessful borrowing firms conducted for us by the Economists Advisory Group under the direction of Professor J H Dunning, however, provides support for the view that fast growth is of great help in securing further finance.[1] (c) A higher proportion of fast growers have bank overdrafts than is the case amongst the slow growers; furthermore, a higher proportion of fast growers increased their bank overdrafts during the period under

[1] The Economists Advisory Group, *Problems of the Small Firm in Raising External Finance—The Results of a Sample Survey*, Research Report No. 5.

non-manufacturing industries, especially in relation to ...
very great differences within these broad sectors: small firms in catering, for example, have an exceptionally high ratio of fixed to total assets (75 per cent)—because they give little credit and keep relatively small stocks—while in the wholesale trades the business requires that a relatively high proportion of assets is held in the form of stocks and debtors so that the fixed asset ratio is relatively low (25 per cent).

2.22 These wide variations between trades, which also no doubt occur within broad trade classifications, greatly complicate the comparison of asset structure between small and large firms. Within our sample of small firms the fixed asset ratio does not vary according to size. Compared with quoted companies, the average small firm has a lower fixed asset to total asset ratio and this is also in general true within particular industries; whether this is a result of size or of differences within industries, however, is not clear. For example, the fixed asset ratio of small firms in the chemical industry is significantly lower (32 per cent) than that of quoted companies (51 per cent), but this is probably because small firms in that industry are concentrated in the less fixed-capital-intensive processes and not because they use to any substantial degree less capital-intensive methods than large firms to produce the same product. In short, whilst our survey confirms what can be seen from Census data on capital expenditure by firm size (see Chapter 4 para. 4.8)—that small firms use relatively less fixed capital than large firms—it cannot answer the question of whether or not this is because they use different (less capital-intensive) production methods than large firms engaged in the same lines of business.

2.23 Turning now to the employment of current assets, we find that small firms, as a whole, have a similar debtor/turnover ratio to quoted firms. This suggests that small firms do not have to offer more extended credit terms to their customers in order to compete with larger firms. The type of industry, rather than the size of firm, seems to be the main determinant of the extent to which firms give credit. As is generally known, credit sales are more important among manufacturing firms than among non-manufacturing firms.

2.24 Small firms in our survey increased the net trade credit given during the period under review. On the whole small firms give more credit than they receive, but the excess is smaller in non-manufacturing than in manufacturing, and smaller for non-incorporated firms than for incorporated firms. The smaller firms in our survey tend to be net givers of credit to a lesser extent than the large.

2.25 The proportion of current assets invested in stocks and the value of stocks in relation to turnover also varies from industry to industry. For example, among small manufacturing firms the stock/turnover ratio in 1968 varied from 6 per cent in Food to 16 per cent in Textiles; these ratios changed little over the period under review. In all trades the small firm consistently holds a lower proportion of its current assets in the form of stocks than does the quoted company in the same trade. Within the small firm sector, the stock-ratio (in relation to both sales and total current assets) also rises substantially with size.

of growth and a correspondingly wide range of financing patterns. The [illegible] sample of firms indicates that faster growing firms rely to a much greater extent on external borrowing than slower growing firms: long term loans and bank loans finance 26½ per cent of total assets for this sample (see Table 2.XIII). Similar differences emerged in the sub-sample of fast growing manufacturing firms in our own postal survey (see paras. 2.29 to 2.32 below). When related to the value of the owners' interests in their firm (i.e. capital, reserves and owners' loans), external borrowings amounted to 59 per cent for the ICFC sample, 24 per cent for our sample of small firms and 34 per cent for quoted companies.

2.16 Bank credit forms the greater part of external finance for small firms (63 per cent of manufacturing and 48 per cent of non-manufacturing firms in our survey had overdraft facilities) and the use of bank credit appears to increase with size of firm within our sample: thus, in 1968 bank credit amounted to 3.2 per cent of annual sales among the respondents in manufacturing employing less than 25 persons, compared with 5·8 per cent amongst the largest surveyed firms (employing between 100 and 199 persons). In non-manufacturing, the corresponding figures were 2·6 per cent and 4·9 per cent. When the average small firm is compared with the average quoted company it is not clear that it is either more or less dependent on bank finance: it depends on the comparison made. In relation to the book value of total assets, small firms appear to rely more on banks (overdrafts and bank loans form 9 per cent of total assets for small firms and 6 per cent for quoted companies); but in relation to sales, bank loans appear to be less important for small firms than for quoted companies (bank loans are 3½ per cent of sales for small firms and 5 per cent for quoted companies). However, although small firms *on average* do not show a clear difference in their dependence on bank finance, the firms in the ICFC sample show very much heavier borrowings from banks (11 per cent of total assets compared with 6 per cent for quoted companies), as well as heavier other borrowing (16 per cent compared with 13 per cent for quoted). Fast-growing manufacturing firms in our sample (see paras. 2.29 to 2.32 below) also showed greater reliance on bank borrowing.

2.17 Generally speaking, the liquidity of small firms (as measured by the ratio of their current assets to their current liabilities) is not significantly different from that of large quoted companies. The current ratio for all quoted companies in 1968 was 1·6, and that for all small firms was 1·8; but for the smallest manufacturing firms (those employing under 25 employees) the current ratio was also 1·6.

2.18 The cash in hand and at bank of smaller firms (those employing less than 100 persons in manufacturing, and less than 25 in non-manufacturing) are greater than their bank borrowings, that is they are on average net suppliers of funds to the banking system. As can be seen from Table 2.XV cash in relation to overdraft fell sharply between 1964 and 1968, especially amongst the smallest firms, although the experience of the small firm sector as a whole in this respect was not radically different from that of quoted companies. The replies to our questionnaire (when multiplied-up by the appropriate sampling fractions) suggest that total bank advances to small manufacturing firms in 1968 were of the order

with the financial structure of small firms is mainly based on our survey; a description of the survey, together with fuller details and analysis, is given in our Research Reports Nos. 16 and 17 (*op. cit.*). It should be borne in mind that what follows compresses a mass of data into a small space and that here, as elsewhere, generalisations about heterogeneous populations of incorporated and unincorporated businesses in a wide range of industries are subject to substantial qualifications.

2.13 Table 2.XIII compares the average balance sheets of the following groups of firms: our sample of small firms; quoted companies; and a sample of small firms that had obtained finance from the Industrial and Commercial Finance Corporation Ltd (ICFC). The last group consists, of course, of firms which are a selected group able to justify the receipt of long term external finance and may therefore be expected to grow more rapidly than the average small firm; their financing pattern is on that ground of some interest. The results of dividing our sample into limited liability companies and unincorporated firms, for manufacturing and non-manufacturing separately, is shown in Table 2.XIV.

2.14 *Financial structure.* The accounts of the average small firm in our sample suggest that it obtains a slightly smaller proportion of its finance from external borrowing than does the average large firm: long term loans together with bank loans and overdrafts provide finance for about 14 per cent of total assets for our sample firms[2] compared with 19 per cent for quoted companies. A substantial proportion of firms do not borrow at all (see para. 2.16), and for those that do the contribution of external borrowing to total finance is of course higher than the percentages just quoted. There were variations between industries which are concealed by the broad groupings in the Table but these variations were not as great as might be expected, principally, we assume, because of the relative importance for small firms of long term mortgage finance for premises.

[1] Details of previous Surveys in this field are given in P. Lund and D. Miner, *Three Studies on Small Firms*, Research Report No. 11 which refers amongst others to a survey by the Board of Trade on the basis of Inland Revenue returns that we have found particularly useful ("Patterns of Company Finance", *Economic Trends*, 169, November 1967, pp. viii–xviii. See also Chapter 4, para. 4.12); further financial information is available in our interview study Research Report No. 12, *op. cit.* The deficiencies in our survey referred to are the result, not only of a response rate which, although up to expectations for a survey of this type, was too low to exclude the possibility of bias in the response and of normal sampling error, but also of errors and ambiguities in response to a necessarily complex questionnaire which could not be satisfactorily eliminated at the editing stage. The results for non-manufacturing industries, for example, indicate a bias in response towards the larger firms: in retailing the average employment in the survey was seven persons per firm whereas according to the census (see Table 1.I) the average employment was three persons per firm; the design of the survey in manufacturing allowed the stratification and eventual re-weighting of the results—in non-manufacturing this could not be done. The data for non-manufacturing industries, therefore, are particularly suspect.

[2] Owners' loans are often not distinguished in the accounts from other external loans, and an estimate has been made of their extent and excluded from external loans.

the extent of merger activity among small firms since the sample includes only those small firms which retained their independence or which remained small despite their merger activity (that is to say it excludes firms which expanded out of the small firm sector over the period, either through internal growth or through acquiring other firms, as well as firms which lost their independence through being acquired by others). In fact a very large proportion of the numbers of small firms that cease independent trading every year do so through being acquired by other firms. According to the Merrett Cyriax Survey, Research Report No. 12, over half of the firms in manufacturing which left the small firm population sample since 1963 did so through being taken over; even in retailing as many as one-seventh of the firms losing their identity had been acquired over the period (see Table 2.XI). Only about one-third of the acquired firms gave financial failure as a reason for giving up their independence (see Table 2.XII). Some firms were induced to merge in order to meet estate duty, some through an inability to provide a successor.

TABLE 2.IX

Independent manufacturing firms in 1969 which had taken over or merged with others since 1964

Number of employees	*% of firms in sample*
1– 24	3
25– 99	9
100–199	18
All small firms	5

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.10 The survey questionnaire asked about the sources of competition and about the number of firms which respondents regarded as serious competitors. The majority of small firms in manufacturing industry see themselves as having a large number of competitors, and they consider that their main competition comes as much from large firms as from small. In non-manufacturing industries the competitive situation is similar, except that small firms in the distributive trades feel more particularly subject to competition from large firms. Only very rarely do the activities of small firms integrate more than one stage of production or distribution. The amount of such vertical integration in the small firm sector is greater the larger the size of the firm.

TABLE 2.X

Independent non-manufacturing small firms in 1969 which had taken over or merged with others since 1964

Industry	*% of firms in sample*
Catering	1
Construction	4
Motor trades	2
Retail distribution	4
Road transport	10
Wholesale distribution	6
All non-manufacturing small firms	4

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

Size of firm (number of employees)	*1–24*	*25–99*	*100–199*	*All*
Average age of chief executive (years)	52	55	56	54

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

As can be seen from Table 2.VI, within the sample the average ages were higher the larger the firm. Only 2 per cent of chief executives were under 30 years old in all firms, 26 per cent over 60 in manufacturing and 29 per cent in non-manufacturing industries (see Table 2.VII). From the limited information available on the ages of directors of public companies it appears that the age distribution of chief executives among small firms contains a somewhat higher proportion of men under 40, but is otherwise broadly the same. The chief executives of small firms, however, do tend to be much older than the *managers* in large firms with whom in some respects their position is more comparable.[1]

TABLE 2.VII

Age distribution of chief executives in small firms

Per cent

Age range	*Manufacturing industries*	*Non-manufacturing industries*
Under 30	2	2
30–39	14	11
40–49	28	24
50–59	29	35
Over 60	26	29
All small firms	100	100

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.6 The majority of chief executives of small firms do not have any formal post-school management educational qualifications at all (see Table 2.VIII). Nevertheless, as many as 21 per cent of manufacturing chief executives have a degree or a professional qualification, and a further 8 per cent have an accountancy qualification. The construction industry has the highest number of chief executives qualified by examination with 43 per cent having a further qualification. Even in retailing, which is at the other end of the scale, 18 per cent have some higher educational qualification.

[1] These comparisons are based on three studies: G Copeman, *Leaders of British Industry*, Gee, 1955; Acton Society Trust, *Management Succession* 1956; D G Clark, *The Industrial Manager—his background and career pattern*, Business Publications, 1966. The first of these studies covered industrial and commercial public companies with assets over £1 million, the second manufacturing firms employing 10,000 or more persons, the third was a small sample covering both private firms with over 600 employees and public undertakings in the Manchester area; we have made comparisons with the ages of managers in private industry.

Size of firm	Quoted companies	Non-quoted limited companies	Unlimited companies	Partnerships	Sole proprietorships	All
1– 24 employees	0·0	77·4	2·6	7·4	12·6	100·0
25– 99 employees	1·0	94·6	1·1	2·3	1·0	100·0
100–199 employees	5·4	91·7	1·6	0·7	0·7	100·0
1–199 employees	0·4	81·0	2·3	6·2	10·0	100·0

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

TABLE 2.II

Legal status of small firms—non-manufacturing

Industry	Quoted companies	Non-quoted limited companies	Unlimited companies	Partnerships	Sole proprietorships	All
Catering	0·0	6·5	0·0	24·7	68·8	100·0
Construction	0·0	72·4	0·2	9·1	18·3	100·0
Motor trades	0·0	46·7	0·3	21·4	31·5	100·0
Retail distribution	0·4	34·5	0·6	22·6	41·8	100·0
Road transport	0·8	35·2	0·0	19·5	44·5	100·0
Wholesale distribution	0·7	82·7	1·8	4·6	10·2	100·0
Total Non-manufacturing	0·3	33·3	0·4	20·3	45·8	100·0

Source: Committee Questionnaire Survey, Research Report No. 17, *op. cit.*

2.3 *Ownership and management.* Small firms are almost exclusively under their proprietors' control and a large proportion of them are family businesses of one sort or another. Over 85 per cent of respondents are controlled and almost certainly owned by one or two people; this was true for both manufacturing and non-manufacturing. A further 13 per cent (in manufacturing) are controlled by three, four or five people. Generally speaking, the larger the firm the more dispersed the ownership. As a result, although in manufacturing only about a fifth of firms are wholly owned by one person, in the retail trades sole proprietorship predominates. There is rarely a formal management structure; firms are simply run by their owners. Virtually all small firms are managed by people with a stake in the firm, and the majority are managed by those having a controlling interest, usually the founder or members of his family. In 81 per cent of small firms in manufacturing the "boss" was the founder of the business or a member of the founder's family and over a third of all small manufacturing businesses and over two-thirds in the distributive trades are wholly owned by first, second or third generations of the same family.

TABLE 2.III

Owner-managership and controlling interests in small firms

	(a) Number of partners or shareholders having a controlling interest					
	1	2	3–5	6–10	11 and over	All
	Percentage of all small firms					
Manufacturing	39·4	46·3	13·0	0·8	0·5	100·0
Non-manufacturing	42·0	46·6	10·0	0·5	1·0	100·0

Inquiry and as defined in paragraph 1.9. We have excluded agriculture, the professions and financial services from any detailed examination in order to simplify our task and on the grounds that their problems are highly specialised. Moreover, the interests of small firms in these industries are being looked after, in the case of agriculture by the Ministry of Agriculture, Fisheries and Food and in the majority of other cases by strong and highly expert professional or trade associations. The majority of enterprises in these industries are, however, small in the sense of our terms of reference and again most of our conclusions will apply to them.

1.12 It is worth emphasising here that a substantial proportion of the enterprises with which we are concerned are essentially forms of self-employment, where employees other than the proprietor are members of his family. Edward Hollander, the author of a study on small business in America, calls these "little business" to distinguish them from larger "small" firms in which the owner acts more fully as a manager.[1] Our definition of a small firm cannot directly be related to any of the legal forms of business enterprise. Not only most "little businesses" but also the majority of all the small firms with which we are concerned are unincorporated, that is to say they are sole proprietorships or partnerships. Very few quoted public companies fall within our statistical definition; but on the other hand our definition appropriately excludes many private limited companies that are too large to be managed in a personal way by their owners. The closest definition in legal terms of the population of small firms in the industries in which we are interested would probably be all the proprietorships and partnerships and "close" companies,[2] although quite a number of close companies are again too large to fall within either our statistical or economic definitions.

1.13 It is argued by the Institute of Chartered Accountants that the lack of a legal distinction between those companies in which the proprietor is in a position "to dominate every aspect of . . . management" and those in which he is not, either because of the size of the concern or the dilution of ownership or both makes this necessary, is an important deficiency in company law as it now stands in this country.[3] The Institute have, therefore, proposed a new distinction between "Proprietary" and "Stewardship" companies to replace the now virtually defunct distinction between private and public companies. The terms of this suggested distinction are such that "Proprietary" companies would mainly fall within our economic definition of small firms (see also Chapter 17).

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[1] Edward D Hollander and others, *The Future of Small Business*. Praeger 1967.

[2] A "close" company is, effectively, a company controlled by five or fewer persons. See Chapter 13, para. 13.19.

[3] Companies Legislation in the 1970s, *Accountancy*, April 1969.

practical purposes we are obliged to use a "statistical definition" (see para. 1.9).

1.5 The first characteristic, that of small market share, is an important element in any definition of small business because the vast majority of what are usually regarded as small firms do not have a large enough share of their market to enable them to influence to any significant extent the prices or total quantities of goods and services sold, that is to say in national terms at least, they face many competitors. Whether or not a firm employing less than 200 employees is small in this sense depends upon the absolute size of the market and how narrowly it is defined. A small market share is not, therefore, an unambiguous criterion of smallness in business but the lack of any real power to affect its environment which normally accompanies a small market share is an essential characteristic of the small firm.

1.6 By "managed in a personalised way", we mean that the owners themselves actively participate in all aspects of the management of the business and there is no general devolution of the decision-making process. Thus, although they may have one or more intermediate layers, e.g. supervisors or foremen to interpret their decisions and transmit them to the employees, and although—in the larger small firms—they may devolve certain specialised functions, such as accounting or production, on to the more senior of their employees, the owners themselves still take all the principal decisions and exercise the principal management functions.

1.7 Independence, or the exercise of ultimate management responsibility, is the third distinguishing characteristic of the small firm. Although a small subsidiary of a large firm may have a very high degree of independence, ultimate authority, for example for capital expenditure, lies elsewhere. Specifically, independence means that the owner-manager(s) have effective control of the business even though the freedom of many small businesses may be circumscribed by obligations to financial institutions.

1.8 The vast majority of enterprises in manufacturing employing less than 200 people do, in fact, conform to our criteria of owner-management, small market share and independence, but so also do many manufacturing firms employing 500, or even more. We recognise that no single quantifiable definition can ever be entirely satisfactory. Outside the manufacturing industries quite different definitions are necessary. For example, in retail distribution a firm employing 200 people would typically have at least ten shops with a total turnover in excess of several million pounds and would be a very large organisation in terms of the distributive trades.

1.9 We have, therefore, for these statistical and descriptive purposes of our studies, adopted the 200 employee upper limit for manufacturing and a series of more or less arbitrary definitions in terms of whatever measures appear appropriate for other trades. The size limits we have adopted were chosen because they are those commonly used for statistical purposes and are given in Table 1.I. It will be seen from column 2 that these convenient statistical break-points cover the vast proportion of all firms (by number) in the industries listed, and from column 3 that they represent a significant proportion of total employment in the

Tables

.. Not available.

— Nil, or less than half the final digit shown elsewhere in the table.

* Estimated figure subject to substantial margin of error.

Rounding: There may be a slight discrepancy between the sum of constituent items shown in a table and the total as shown; this results from rounding figures to the nearest final digit.

Text

Technical terms are defined where first mentioned in the text; see index.

findings and conclusions in more
external factors, mostly arising from the activities of Government. Our recommendations are confined to Part II, and many of them call for changes in legislation or policy. The Report is obviously addressed in the first instance to Government, but we hope very much that it will prove useful and informative to a very much wider audience—to trade associations, to small businessmen themselves and to teachers and students—and we have written it with this in mind.

11 It will be obvious from the list of chapter headings, particularly those of Part II, that we have felt it necessary to deal with many highly complex and technical subjects on which we have no special expertise; this is inevitable when considering the fortunes of a sector which shares all the problems of British industry in general, in addition to those peculiar to itself. We have been greatly assisted by the efforts of the relevant Government departments to keep us within the bounds of accuracy, both by providing basic information and by checking successive drafts of the Report. During the course of our Inquiry many important policies have come under review by Government, particularly following the change of Government in June 1970, and some major changes have been announced. This has meant that we have been able to make known our interim views on certain issues to those responsible for formulating new policies. We have greatly appreciated this opportunity and we hope that these views have been of value.

12 In a Report of this kind, which necessarily deals largely with economic issues and in which we have had to deal in a brief compass with a huge and varied sector of the economy, we have been forced to write largely in terms of statistics and broad aggregates. There is an obvious danger that the essence of the matter will be lost under this mass of impersonal data, and it must not be forgotten that what we are basically talking about throughout this Report is people: the small firm sector can only be sensibly discussed in terms of the people —and many of them we know to be remarkable and highly individualistic people—who are prepared to accept the risks and responsibilities of the entrepreneur. They are people who have foregone the greater security that is provided by employment for a secure wage, perhaps in a big organisation, in favour of the challenges and rewards of independence, and they above all others in society must bear the uncertainties and stresses resulting from technological and economic changes. We are conscious that our Report may at times appear to reflect inadequately our regard for the contribution of the small business to the vitality, variety and humanity of our society, because these things can hardly be measured in statistical terms. But that contribution is enormous; without small firms this country would be an infinitely duller, poorer and less happy place. Fortunately the economic arguments alone are powerful enough to establish the need for an active small firm sector so that there has been no need to attempt to quantify this non-economic contribution.

13 It is usually the case that prolonged study of any subject reveals problems undreamed of at the outset and this Inquiry has been no exception. We had no doubt from the first that the future prosperity of the small firm sector was an

to accept the criterion of employment-size suggested in the terms of reference because a labour force which would be reckoned small in manufacturing industry might be very large in the road transport industry or in the distributive trades: all other simple quantitative criteria are open to similar objections.

4 Much as we should have liked to consider every branch of industry and commerce in detail this was clearly impossible. In order to reduce our work to manageable proportions we have not studied the agriculture, horticulture and fishing industries or the professions, nor have we collected detailed statistical information about them. We felt that since the special problems of these industries have already been studied in detail, either by the responsible departments of Government or by powerful professional associations, we should be unable to add much to knowledge about these activities. However, the small units in these sectors are businesses in their own right, and they share many of the common problems of the small firms in those areas of industry and commerce which we have studied in some depth. To the extent that they do so, our findings are relevant to their position. In many other instances our examination of specialised trades and sub-trades has been sketchy, although we have endeavoured to include their activities in our statistical analyses. We believe that our Report will be of interest and value to all small firms whether they operate in those fields which we have studied or those others which, regretfully, we have not.

5 Even when limited in this way, the scope of the Inquiry remained formidable, and our early researches revealed a startling lack of information, whether inside Government or in published material, on the general state of the sector. Many people are knowledgeable about particular problems affecting small firms, or about particular industries in which small firms predominate, but we know of none who would claim expertise on the sector as a whole. We were not therefore in the position of a Committee called upon to pronounce judgement on the strength of a body of generally accepted fact; we were ourselves obliged to assemble the basic information on which to base our account of the small firm sector and our judgement on its problems. This we did in four ways.

6 First, we issued a general invitation to all interested parties to submit written evidence on a wide range of questions which we considered relevant to the health of small firms. In Appendix I we reproduce a letter inviting the submission of evidence which was sent by the Chairman to some 2,000 organisations including trade associations, chambers of commerce, Government departments, banks, universities and other institutions dealing with small firms. Advertisements in similar terms were placed in the national and local press. In response to this appeal we received some 400 written submissions, mainly from trade associations and individual firms. Inevitably, and properly, most of this evidence was intended to demonstrate the value of the small firm sector or the need for changes in official policies affecting it. It was a particularly valuable source of information on the relative importance attached by businessmen themselves to the various problems confronting them.

7 Because we recognised a need to supplement this qualitative and subjective material with hard facts, we also carried out a postal survey addressed to some 16,000 small businesses. Two questionnaires were sent to each firm, one covering

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