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Financing Innovation

Supporting early stage, aspirational and growing businesses

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Executive Summary

Early stage, aspirational and growing businesses play a vital role in the British economy. They increasingly intersect with the digital and high-tech sectors, and are a key driver of innovation.

There are around 4.3 million micro businesses – those employing fewer than ten people – in the UK. These firms account for 31% of private sector employment and 20% of private sector turnover. At this level and above, a minority of high-growth firms are responsible for the majority of the growth in jobs. A priority for policymakers, therefore, is to remove barriers and target support for innovative businesses that have the aspirations and potential to achieve rapid growth.

This is particularly relevant as digital developments continue to open up new opportunities for innovation and business growth. Advances in the availability and accessibility of processing power and connectivity mean that it is possible to set up a digital business with relatively little by way of capital outlay. Technologies like cloud computing, wireless networks and software-as-a-service look set to push this trend even further. A recent study found that the internet and online businesses contributed almost one quarter of total UK growth over the past five years.

This research note, published ahead of Budget 2012, provides a short, policy-focused perspective on finance for innovation. We argue that policymakers need to move on from a debate that is too skewed around bank lending. For high-growth businesses there is a wide and dynamic funding "ladder" to climb as they mature – running from initial, angel and seed funding, through start-up and expansion venture capital, all the way to exit via a trade sale or initial public offering (IPO). For innovative businesses to thrive and grow there needs to be a healthy blend in the availability of finance – across debt and equity and with enough sources to see firms through all stages of growth. For each investor it is important to see a path to supporting a business, eventually exiting and realising a gain. Since there must be a buyer for every seller, a set of properly developed and liquid markets across the entire funding landscape matters.

We do not suggest that the proposals in this note are a silver bullet for instantly restoring economic growth. We do believe, however, that in the current economic climate it is more important than ever to ensure that we protect investments in innovation and enterprise that will pay off over the long term. The government can and should make further progress on measures that will help start-ups, business owners and aspiring entrepreneurs to focus on going for growth. Three specific proposals that we believe merit further attention are:

1. An Alternative Maximum Tax for new business start-ups

We propose that the government take forward work to develop a radically simple alternative tax regime for new business start-ups. This would run alongside the current complex tax rules, and be the default regime (with an opt-out) for all new business start-ups for their first three years.

Under this regime, new businesses would bypass all of the current complexity on charges, reliefs, rates and exemptions. Instead, they might face a single rate and allowance (perhaps based on gross profits, with streamlined rules for expenses and other deductions). A sufficiently simple regime would give business owners real clarity about their maximum tax liability each year.

This is not about a new tax break. We recognise the significant fiscal challenge that the government continues to face, and would expect the average business in this regime to pay broadly the same amount of tax overall as it does today. But by reducing the tax calculation down to the bare minimum – ideally short enough to fit on the back of a postcard – business owners would have one less distraction from running their day-to-day business and planning for growth.

Developing this as an alternative regime, rather than simply trying to sweep away the existing rules, is important for credibility and stability. Tax simplification is challenging – there will always be resistance to removing established reliefs, and a temptation to layer on new complexity in successive Finance Bills. An alternative regime makes radical simplification more realistic to achieve and leaves less scope for complexity to be reintroduced by stealth.

2. A new ISA allowance for retail bonds, and other measures to reward investors

We propose that the government modernise the popular Individual Savings Account (ISA) regime, by creating a new class of ISA tax relief specifically for investment in retail bonds (alongside the established cash and stocks & shares components).

This would help kick-start the market for investment in an important and growing source of non-bank finance for businesses seeking growth capital. Modern market technology now allows bond finance to be issued at scales appropriate for smaller companies (in the low tens of £ millions), and sliced small enough to make practical sense for individual savers (in the £ hundreds or thousands). But the reality is that awareness of these options remains low. A new tax-free investment allowance for retail bonds would take advantage of the ISA brand and annual ISA season to stimulate a wider market for this sort of non-bank business finance.

Such a change would help move the public debate on from bank lending, and provide a welcome boost for savers who have lost out from a sustained period of low interest rates. It should also be affordable for the Exchequer, at least in the near term (as non-ISA cash savings that might be switched into a new retail bond ISA are not generating much tax from interest income at present). If necessary the size of the new component could be scaled back to further control cost.

We also provide suggestions for measures that would support investors and entrepreneurs, and build up mainstream interest and engagement around business finance.

We suggest that the government continue to review the range of qualifying ISA investments, to reflect the growing range of options now available to investors. As alternative funding models mature, and as the regulatory environment and consumer financial capability adapts, further reform in this area could provide a boost for smaller companies and start-ups.

We also suggest changes to enable more people to benefit from tax reliefs relating to share ownership, including around the Enterprise Investment Scheme and Entrepreneurs' Relief. These changes would add further energy to the generous reliefs and exemptions already provided, which the government should be more vigorously promoting.

3. An Enterprise Kickoff Fund for young people, led by the private sector

We propose that the government back a new Enterprise Kickoff Fund for young people. This would be led by the private sector. It would provide small start-up loans on commercial terms to young entrepreneurs who would otherwise struggle to obtain finance, and in return receive a small equity stake in their business.

To make the fund economically viable, the government would commit to last resort recovery of bad loans through the income tax system. This would provide protection against all but the most extreme downside risks (effectively limiting write-offs to cases where an individual defaults and goes on to earn below the income tax threshold).

In keeping with the spirit of a private-sector led recovery, the fund would run under private management, and raise its finance from the private sector – perhaps by issuing bonds aimed at retail investors. By pooling across businesses and operating on commercial terms, the fund could offer an attractive risk and return profile for potential investors.

There is enthusiasm amongst young people for starting a business, and demand for better access to finance that would enable them to get going. The quantum of support need not be large – in many cases a few thousand pounds would be sufficient to get an idea off the drawing board. A fund along the lines described here would address the anomaly that young people can access relatively large student loans to support study, but often find it far harder to borrow smaller sums to start a business.

We think the potential scale of an Enterprise Kickoff Fund for young people is manageable. About 800,000 people turn 18 each year. So in steady state, a fund lending £3,000–5,000 to five% of this group (40,000 people) would need to raise and allocate £120–200 million a year. This is less than one half of one percent of the £54 billion subscribed to ISAs in 2010/11. Market forces may dictate a larger or smaller fund as demand for finance changes.

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Introduction

Early stage, aspirational and growing businesses play a key role in the British economy. Like their more established counterparts, these businesses produce goods and services, provide jobs and pay taxes. There are around 4.3 million micro businesses – those employing fewer than ten people – in the UK. These firms account for 31% of private sector employment and 20% of private sector turnover.[1] Amongst the 210,000 or so firms employing ten or more people, a minority of high-growth firms (around 6%) are responsible for over half of the growth in jobs.[2] A priority for policymakers, therefore, is to remove barriers and target support for innovative small businesses that have the aspiration and potential to achieve rapid growth.

The continually increasing importance of the UK's digital and high-tech economies provides a further impetus for supporting innovation and growth. Micro businesses account for 42% of employment in the computer programming sector, 45% in the motion picture, television and music production sector, and 77% in the non-R&D scientific and technical sector.[3]

With products and services increasingly built from human capital, data and software, the possibility of starting a business from scratch and taking it rapidly to scale has captured many people's imaginations. Many of today's household names in the digital space followed this sort of path from rapid prototyping to innovating at scale, and have overturned entire industries or created whole new ones on the way.

Some small firms with significant growth will go on to join the ranks of larger growth businesses - the "engine room" of our economy. A few will become world-class companies competing on the global stage. Over time the best of our ambitious and innovative small firms of today will prove as vibrant and vital a platform for our economic prosperity as our established large businesses. The continued existence and renewal of both, backed by an economic and policy environment conducive to innovation and growth, is crucial to the economic future of the UK.

[1] Business population estimates for the UK and regions, BIS 2011
[2] Measuring business growth, NESTA 2009
[3] Business population estimates for the UK and regions, BIS 2011

Last year we published *Looking to the future of growth*, as part of an effort to start an evidence-based and balanced debate around growth in the UK.[4] We called on politicians, the media, policymakers and the public to give more weight to the long-term future of the UK economy, rather than focusing solely on short-term politics and policies. A short primer on growth, and the importance of enterprise, innovation and competition, is included at Annex A.

This research note marks a further contribution to the debate on enterprise and growth. Taking our recommendations forward would help bring new certainty and confidence to business, and would provide practical support for the entrepreneurs, individuals and families that are the ultimate drivers of growth in the UK.

Innovation and the digital economy

Business innovation can take many forms. Sometimes agile businesses will develop and commercialise incremental improvements to existing products, services or business models. Other times innovation is more disruptive, ushering in radical advances that have the potential to reshape entire industries. Some examples of great British innovations, from ships and automobiles to the World Wide Web and advanced microprocessors, are included at Annex B.

Economists sometimes express innovation as technological progress. This is meant in the widest sense of the word - a new, more efficient business model is as much an improvement in technology as a new type of motor or microprocessor. Recent high-tech and digital innovations are having a particular impact. The internet now accounts for over 7% of UK GDP, and smaller companies that sell goods online grow eight times faster than those that remain offline.[5] A recent study found that the internet and online businesses contributed almost one quarter of total UK growth over the past five years.[6]

[4] Looking to the future of growth, Policy Exchange 2011
[5] The connected kingdom, Boston Consulting Group 2010
[6] Internet matters, McKinsey Global Institute 2011

Digital developments are opening up new opportunities for innovation and business start-ups. Advances in the availability and accessibility of computing and connectivity mean that it is possible to set up a digital business with relatively little by way of capital outlay. Tales of digital entrepreneurs forging new businesses in garages and bedrooms are already the stuff of business legend. Advances in technologies like cloud computing, wireless networks and software-as-a-service look set to push this trend even further, allowing businesses to rent services rather than acquire capital assets and focus ruthlessly on efficiency by only paying for what they use.

As a result of these factors, and of broader trends in the economy and society, momentum is continuing to build behind the UK's digital and high-tech start-up communities. University science parks have a long tradition of bridging the gap between research and commercialisation, and are increasingly sophisticated centres of knowledge sharing and enterprise. In London the developments around Tech City have helped to drive a growing cluster of digital enterprises and start-ups in and around the Shoreditch area.

Finance for innovation and enterprise

As outlined above, early stage, aspirational and growing businesses are an important source of innovation in our economy. For these businesses and the entrepreneurs behind them, finance can be a real concern. Around 12% of small businesses have not applied for external finance (e.g. a loan or overdraft) in the last year but would have liked to.[7] These are typically the smaller and younger businesses. For any business, taking an innovation from inception to market and preparing for long-term expansion takes time and money. Where a business is new, small or growing fast it may not be possible to rely on cash in the bank or retained earnings past the initial phase of growth. In these circumstances, the cost of operations and ability to access external finance are critical.

Since the start of the current financial crisis there has been much criticism of the banking sector for tightening up lending to small and medium sized businesses. Whilst there may well be room to improve the way bank lending for businesses works, constant negative attention on the quantum of small business lending misses the point. For banks, lending is a commercial decision (and the terms of trade are shifting, as Basel III shores up capital requirements and government action begins to erode the implicit guarantee).

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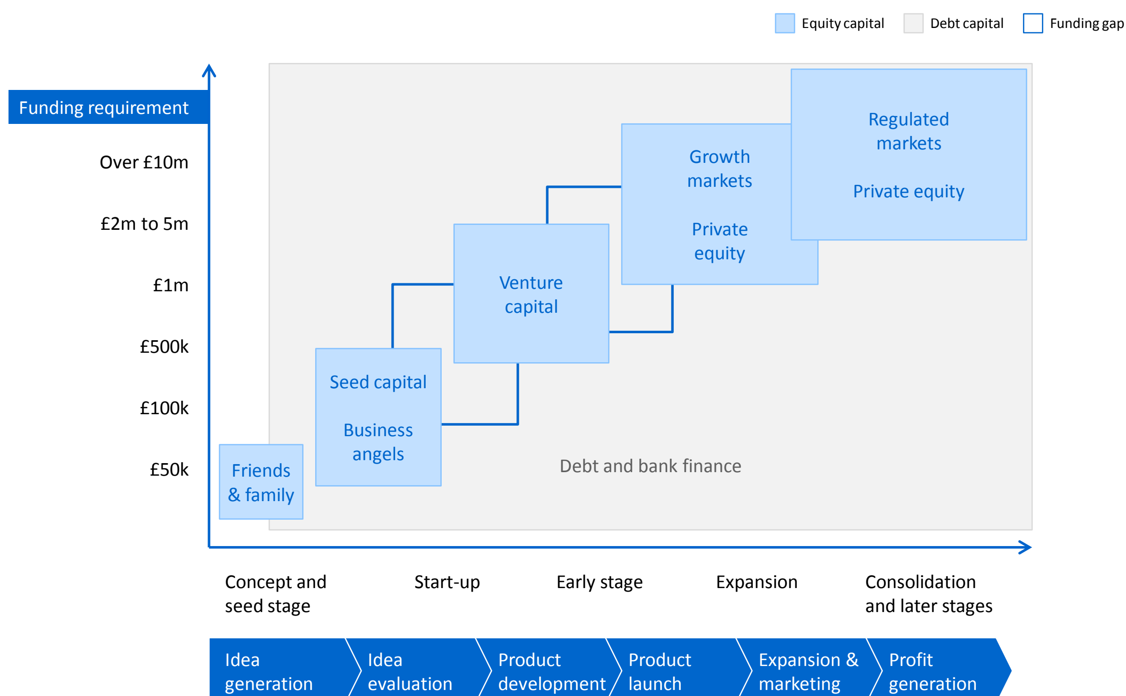
[7] SME finance monitor: developing a deeper understanding, BDRC Continental 2011

Even if banks were to lend more, the market may fail to reach the very smallest businesses where lack of a track record and / or absence of sufficient security can make it difficult to secure a bank loan. Moreover, where loans and debt finance are arranged, they can expose a company to solvency risks around the repayment period. There are real and fundamental differences between finance for working capital and finance for long-term growth. Contingently repayable loans and equity finance can often be preferable options, though demand may outstrip supply.

Growth businesses in industries like biotechnology and pharmaceuticals, with both high and long-term capital needs, provide a particularly clear illustration of the sorts of situations where finance means much more than bank lending.

The different parts of the finance industry do not operate in isolation, but instead are part of a broader funding "ladder" or "escalator" for start-up companies – running from initial, angel and seed funding, through start-up and expansion venture capital, all the way to exit via a trade sale or initial public offering (IPO). This underlines the point that a diversity of funding sources is the right goal for public policy in this area. Interventions need to be structured in a way that joins up all of the different aspects of funding for high-growth businesses.

Figure 1
The funding ladder for high-growth SMEs



Based on NESTA (2009), City of London (2010) and London Stock Exchange Group (2012) ILLUSTRATIVE

For the early and seed stages, it is important to ensure that the networks and links that the existing public funds share with the business angel community are maintained. This will help deliver a stream of companies for funds and investors to back. As companies enter the commercialisation stage, public markets for growth capital such as AIM and PLUS play an important role. In particular these markets help to stimulate venture capital activity, by providing an exit mechanism for venture capital investors who backed a company at an earlier stage.

So for innovative businesses to thrive and grow there needs to be a healthy blend in the availability of finance – across debt and equity and with enough sources to see firms through all stages of growth, from start-up to follow-on funding. For each investor it is important to see a path to eventually exiting and realising a gain. Since there must be a buyer for every seller, a set of properly developed and liquid markets across the entire funding landscape matters.

Embedding a simple, stable tax regime

In addition to securing sources of finance, business owners and managers also have to deal with the tax aspects of business finance. In the UK the tax experience for new, small and growing businesses has become exceedingly complex. This matters for two reasons.

First, dealing with countless tax planning strategies, advisers and paperwork, as well as the basic Self Assessment compliance requirements, is a non-trivial distraction from the important task of growing a business. Research commissioned by the Office of Tax Simplification (OTS) bears this out. For people who started a business in 2009-10, 54% say that "even though I keep good records and am careful filling in my [tax] form, I worry after I have submitted it that I might have made a mistake."[8] This worry does not appear to diminish with experience. Moreover, the same concerns were shared both by businesses with professional tax advisers and by those preparing and filing their own forms.

Second, extreme complexity can make it hard for tax to support public policy objectives. The OTS argue that fear and uncertainty have a clear effect on the perceived complexity of the tax system. This is a real problem as the cost of reliefs or exemptions legislated for strong policy reasons will be wasted if they do not incentivise a change in behaviour – and tax incentives will not be effective if no one understands them.

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[8] Understanding small businesses' experience of the tax system, The Futures Company 2012

This is a perennial problem. Despite significant (and ongoing) attempts to simplify the tax system and maintain a degree of stability, complexity tends to multiply. Between 2001 and 2010 the Tax Law Rewrite project systematically rewrote the UK's primary direct tax legislation to make it simpler and easier to use. Successive Finance Bills introduced measures to remove redundant reliefs, simplify complex rules and align thresholds. But governments will always encounter resistance when trying to rationalise or remove established reliefs and exemptions. And even in periods of sustained fiscal contraction, there will be a strong political impetus to tweak the rules when opportunities arise. As the Minister for the Cabinet Office put it recently: "all governments have an inbuilt tendency [to act]... it's what Sir Humphrey called the politician's syllogism: something must be done, this is something, and therefore we must do it."[9]

Nevertheless, in February this year the OTS published their recommendations on simpler income tax for the smallest businesses.[10] In their work the OTS focused on the very smallest businesses – with turnover below £30,000 and no employees. They propose a default regime based on simplified accounting and expenses, with an option to revert to Generally Accepted Accounting Principles and a strict apportionment of expenses should a business so desire. Businesses would be required to commit to one or the other for a period of time, and not be permitted to change regime every year.

We are broadly supportive of the recommendations from the OTS in this area. Based on past experience, we believe it will be important for the government to do as much as possible to ensure that whatever tax simplification measures it ultimately implements have the longevity and credibility that businesses hope for. In practice we think this means leaning toward radical simplification – to take away as much of the distraction of tax complexity as possible, and to make it difficult for Ministers to reintroduce complexity by stealth. It also means ensuring that the regime covers as many businesses as practicable, so that the benefits of simplicity reach a material number of firms with serious growth potential. As they stand, the OTS proposals would apply to around 2.5 million unincorporated businesses with turnover below £30,000. With a total of 4.3 million businesses that employ ten or fewer people, this means 1.8 million micro enterprises are above the OTS threshold. About 200,000 new businesses are born each year in the UK.[11]

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[9] Ten years of modernisation: looking back and the challenges ahead, Q&A March 2011

[10] Small business tax review: final report, Office of Tax Simplification 2012

[11] Job creation and destruction in the UK, 1998 – 2010, BIS 2011. The estimated number of companies formed each year is typically higher, as this also counts some existing businesses that choose to incorporate

We therefore propose the following pragmatic step: the introduction of an **Alternative Maximum Tax** regime for new business start-ups for their first three years.

This regime would run alongside the current complex rules, and be the default for all new businesses. Furthermore, a business would continue to qualify for the first three years of its life, regardless of how far it grows (this should help avoid a perverse incentive for businesses to limit their expansion plans). For the very smallest businesses – perhaps following the OTS definition – eligibility might remain open indefinitely.

For clarity and simplicity, the regime might feature a single rate and allowance, based on e.g. gross profits (or possibly even turnover). There would need to be a simple way to take account of expenses and deductions, including for e.g. VAT and employee PAYE liabilities, and to deal with losses. We would expect the rate and allowance to be calibrated to deliver an outcome that is broadly neutral in terms of overall tax paid for the businesses involved and for the Exchequer.[12]

As a whole the calculation might be similar in spirit to the "three line account" option in Self Assessment (which is available for those with turnover below the VAT threshold).[13,14] In principle it could be short and simple enough to fit on the back of a postcard.

Box 1: Streamlined tax regimes in practice

In the UK the "three line account" is a way of giving HMRC condensed information about an individual's business turnover and expenses. Rather than having to provide a lot of detailed information, taxpayers are only required to provide total turnover and total allowable business expenses. When completing the form online, net profit or loss is then calculated automatically. There is a box to flag details of any applicable adjustments, allowances or losses.

A similar regime operates in Hong Kong. Individuals in Personal Assessment file condensed information on income (from salaries, property and sole proprietor / partnership profits), deductions (for education, charitable donations, dependents' care expenses, losses and the like), and allowances (for children and other dependents). Individuals filing online can compute their tax liability automatically by entering information on a single page.

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[12] For a very radical option based on taxing turnover, which the OTS report that a significant minority of businesses have expressed support for, it may be desirable to set different rates by sector (or some other high-level characteristic) to reflect the fact that some types of businesses are typically more cost-intensive than others
[13] £73,000 in 2011-12
[14] Self Assessment – what you need to know about using the three line account, HMRC 2010

As what we are proposing would be an *alternative* regime, there would be an opt-out for businesses wanting to follow the standard, complex tax rules. Once a business opted out it would not be able to elect back in (a rule like this is probably required to minimise gaming).

Once the broad structure of an alternative maximum tax was settled, the rate and allowance could be reviewed on a periodic, pre-announced basis. The government would remain free to tweak, amend and adjust the standard tax rules, rates, reliefs, allowances and exemptions as often and as extensively as it saw fit.

Implementing such a regime would give business owners far greater clarity over their near-term and future tax situation. This would make it easier for people to focus on core business activities and to plan ahead for growth, with decisions about expansion rooted in economic fundamentals rather than elaborately orchestrated to achieve the best tax outcome.

We expect the Chancellor of the Exchequer to respond to the OTS recommendations on tax simplification in his Budget statement. We urge the Treasury to take forward work to develop a bold and far-reaching interpretation of tax simplification along the lines developed here.

Tax stability

Tax stability is an important part of simplicity (a tax regime that changes frequently cannot be considered simple). Stability also matters more as firms get larger, and the balance of activity shifts from responding to targeted tax incentives and reliefs to managing the tax implications of strategic corporate decisions.

The government published its approach to making new tax policy in June 2010, alongside the corporate tax road map.[15] The tax road map approach could be adopted for other tax reforms, to further reduce uncertainty for taxpayers. In *Looking to the future of growth* we proposed that the government legislate a road map for the whole tax system for the remainder of the Parliament. To give this added credibility a mechanism to make it difficult to make small deviations from the plan could be considered. The government might, for example, require a Treasury Minister to present a report to Parliament justifying any change scoring more than a certain amount in the public finances or affecting more than a certain number of individuals or businesses. To give certainty around longer term tax reform plans we also proposed the publication of a tax reform green paper in the first year of each Parliament.

Unlocking different sources of investment

Banks and pension funds are the traditional financial intermediaries for mainstream and mass affluent savers. The broad model for savings has grown up over time, as financial providers innovated with new products and the government extended tax-efficient wrappers - starting with PEPs and TESSAs and now Individual Savings Accounts (ISAs) and Junior ISAs. Individuals are typically exposed to cash savings and / or collective investments containing a portfolio of corporate bonds, gilts and main market equities.

For larger companies and larger investors it has long been possible to open up direct channels for business finance, with company debt purchased directly by professional investors. As the costs of issuing corporate bonds - due diligence, regulatory compliance and the like - are typically large and fixed, it has often not made economic or financial sense for smaller businesses to seek direct financing in this way. Similarly for individual investors, the minimum stake in a direct corporate bond issue is often (though not always) orders of magnitude too large to contemplate as a potential savings option.

With modern technology, however, the balance is starting to shift.

[15] Tax policy making: a new approach, HM Treasury 2010

Combined with standardisation of rules and procedures to make issuing debt cheaper, electronic exchanges with low transactions costs can be configured to permit investments in small denominations. This can make direct investment in company debt an option for savers prepared to invest on the terms involved (and in particular, a potentially attractive option for those seeking a better return than is currently available on cash balances). Of course even if this option became more mainstream, people might still end up purchasing these products through their bank or financial adviser – so banks would not be cut out of the loop entirely. But the range of products on offer would be wider, increasing choice for consumers.

Box 2: Innovations in electronic exchanges

The Order Book for Retail Bonds (ORB) is the retail corporate bond market in the UK. Participants are able to issue corporate debt directly to retail investors through a cost effective and transparent electronic market. Denominations as small as £1 mean that the platform is accessible for retail investors (and a recent bond on the market saw each investor purchase an average of £12,000).

Issues on ORB have been used to raise amounts in the low £ tens of millions, and in principle there is no reason why a smaller issue could not be supported. Clearly any issue in the order of £ millions is out of reach for all but the most exceptional start-up businesses. But for more established and rapidly growing companies looking to expand, this market could be a valuable additional source of finance.

Reflecting these developments, we argue that it is time to modernise the ISA regime to reflect the growing range of ways in which businesses can now seek finance. ISAs are phenomenally popular with investors, with over 15 million accounts subscribed to in 2010-11.[16] Of the £54 billion subscribed during that year, around 71% was invested in cash ISAs, and 29% in stocks and shares ISAs. Within this, the average stocks & shares ISA subscription was £4,600, compared to an average cash ISA subscription of £3,200. This suggests there is strong demand from individuals wishing to make non-cash ISA investments. The rules around precisely what qualifies for a cash or stocks & shares ISA are complicated.[17]

[16] Individual savings account statistics, HMRC 2012
[17] Individual savings account frequently asked questions, HMRC 2012

For the tax year 2011-12, the individual allowance is £10,680, of which up to £5,340 may be subscribed to the cash component. The total cost to the Exchequer of ISA tax relief for this year – i.e. the tax forgone on the total of all the financial assets accumulated and still remaining in ISAs since the first days of the original TESSA and PEP regimes – is estimated at £2.1 billion.[18]

We repeat here our proposal for **a new class of ISA tax relief specifically for investment in retail bonds** (alongside the established cash and stocks & shares components), to help stimulate a wider market for this sort of business finance. As we argued in *Looking to the future of growth*, an additional investment allowance (of around say £5,000) specifically targeted at small and medium sized firm debt would send a signal to financial providers and individuals to more actively consider investing in this way. In particular by leveraging the ISA brand and annual ISA season this would incentivise banks and other financial providers to open up access to this market for their retail customers, and could thus deliver a vital boost to the market for funds for mid-sized companies.

Such a change would help move the debate on from bank lending, and provide a welcome boost for savers who have lost out from a sustained period of low interest rates. It should also be affordable for the Exchequer, at least in the near term (as non-ISA cash savings that might be switched into a new retail bond ISA are not generating much tax from interest income at present).

New platforms and future reform in this area

Beyond developments with centralised exchanges, technology has also enabled a new market in peer-to-peer lending and crowd funding. This may be particularly suitable for firms at the small end of the scale, providing an opportunity to attract direct investors wishing to make relatively small investments. By diversifying sources and uses of funds through the network, risk can be controlled (though not eliminated) and both sides can benefit from better terms.

[18] Estimated costs of the principal tax expenditures and structural reliefs, HMRC 2011

Box 3: Innovative new funding platforms

There are a number of new and emerging funding platforms based on online peer-to-peer and crowd funding principles. Examples from the UK include:

- Funding Circle and ThinCats, which are focused on connecting individual investors with businesses seeking loans
- Zopa, RateSetter and YES-Secure, which are focused on connecting investors with individuals seeking loans
- Seedrs, which is in development and will focus on direct, online investment in the equity of start-ups

When the ISA rules were written, some of the more recent innovations in business funding did not exist. Of course not every investment option will be appropriate for every investor – so it will be important for the regulatory environment to catch up first, and for individuals to continue to take responsibility for making informed investment decisions. As alternative funding models mature, the government should begin preparing the ISA wrapper to accommodate a wider range of appropriately regulated investments. Over time this will help give people more choice over how they save. This could provide a further boost for smaller companies and start-ups looking to raise finance through alternatives to the traditional bank lending channel.

We recognise that there is a case for maintaining the status quo, in order to protect both consumers and the ISA brand. Balanced against this is the aim of developing a culture where individual investors are more comfortable routinely buying and trading a wider range of financial products. In the long run it will be important to tackle the root causes of low financial capability and deliver appropriate regulation of evolving financial products and services, so that individuals can feel confident in their financial decision making.

Other tax incentives for investors in equity and enterprise

There is a range of other tax reliefs and exemptions available for individuals taking an equity stake in small and growing businesses. Overall these are already very generous for the investors who take advantage of them, and we believe the government should be promoting them more vigorously (see Box 4 for the key features). A full review of the rules, reliefs and exemptions is included at Annex C.

Box 4: Tax reliefs and exemptions

- Entrepreneurs' relief in Capital Gains Tax (CGT): this delivers a 10% effective tax rate for the first £10 million of capital gains made over a lifetime (provided the individual holds at least 5% and is an officer or employee of the business)
- The Enterprise Investment Scheme (EIS): provides upfront income tax relief (30% on the cost of investments up to £1 million from 2012) and ongoing CGT relief
- Seed EIS: a modified version of EIS to be introduced in Finance Bill 2012 that provides a CGT holiday for gains reinvested in a Seed EIS investment, along with income tax relief (50% on investments up to £100,000 from 2012) and ongoing CGT relief
- Venture capital trusts (VCTs): a scheme for people wanting to invest in a number of high risk companies whose shares and securities are not listed on a recognised stock exchange. Investors benefit from reliefs from income tax and CGT on disposals

Beyond a reduction in headline rates for business investments, the main practical change that we believe would be welcomed by many small businesses and investors would be for the EIS (and other schemes) to be extended to employees and directors, as it is argued that these are often the first equity investors in a start-up business. Similarly the entrepreneurs' relief in CGT could be reformed to extend eligibility to more employees and / or relax the rules requiring a 5% holding in the company in question. This would be in line with a broader effort to drive an enterprise culture into the mainstream in the UK and widen share ownership.

Of course, one of the main barriers to tax reforms that would help small and medium sized businesses are the European state aid rules, which preclude a Member State favouring certain undertakings (and thereby by distorting or threatening to distort competition) by granting aid or providing state resources. This may make it challenging to focus tax reliefs without explicit approval from the European Commission. Nevertheless we believe the government should give serious consideration to its options, implement changes where it believes there are good grounds to do so, and make the case in Europe where necessary. This would be in line with the government's broader position on ensuring that European legislation poses as small a burden as possible for UK businesses.[19]

[19] Government ends gold plating of European regulations, BIS 2010

Practical support for young entrepreneurs

All of the measures reviewed or proposed in this paper would be worthless without the entrepreneurs who step up to start businesses and innovate. There are countless examples of successful entrepreneurs, and even if the government does nothing on this front there will be many more: enterprise will always be an attractive option for some people.

Nevertheless, as outlined at the start of this paper, we believe that Britain and the British economy would benefit from a deeper and more dynamic enterprise culture. Political leadership, education (from a relatively early age – certainly starting at school rather than university), good infrastructure and strong networks of peers and mentors all matter. But words of encouragement for enterprise alone will not cut through real financial barriers. These barriers are particularly important for young would-be entrepreneurs, who are less likely to have personal savings to draw on and are missing the track record required to convince external investors.

Therefore, and building on the recent debate in the UK around how we support young people when they leave school, we believe there is merit in the idea of providing accessible loans for young people who choose to start a business instead of – or soon after – going to university. The information asymmetry outlined above means that potential young entrepreneurs may face particular difficulties obtaining finance to start a business. The quantum of support required may well be small – perhaps in the order of a few thousand pounds. This is particularly the case in today's digital economy, where large capital outlays are not required by many of the new and agile businesses that are coming to market.

The evidence shows demand from young people for access to finance that would help them on the first steps to starting a business. The Virgin Media Pioneers scheme has seen over 80,000 people access tailored resources for early-stage entrepreneurs, and over 1,600 people sign up to join an online community. Participants are diverse across geography, gender and ethnicity, and have an average age of 24.[20] Similarly the StartUp Britain campaign, which launched in March 2011, has seen over 160,000 people engaged with its campaign to celebrate, inspire and accelerate enterprise.[21] A range of polls have reported that around half of young people would like to start their own business.[22]

We therefore propose a private sector led **Enterprise Kickoff Fund** for young people. In this model, a new private sector fund (or funds) would provide finance to young entrepreneurs who would otherwise find it difficult to raise money. To make this economic, the government would provide protection against downside risk by committing to recover any payment defaults through the income tax system. This would limit write-offs to individuals that defaulted and went on to only earn below the income tax threshold.[23] The government's tax-gathering prerogative puts it in a unique position to support such a scheme.

We envisage loans being extended to young entrepreneurs at a commercial rate of interest, in order to eliminate arbitrage opportunities and cover the cost for a private sector organisation to administer the fund. The fund would also take a small equity stake in each business it supports. This extra ask would help focus support on people unable to obtain a loan through the normal channels (where they would not typically have to surrender any equity). Moreover, any dividends or capital gains earned would help to make the fund attractive to potential investors. In the spirit of enterprise and a private-sector led recovery, we believe the fund should remain in the private sector if at all possible.

[20] Control shift: the rise of young entrepreneurs, Virgin Media 2011
[21] About us, StartUp Britain 2012
[22] See for example polls commissioned by Hiscox, PC World and AXA UK
[23] And in these cases the cost would fall on and be absorbed by the private sector fund, not the public finances

Box 5: Business finance for young entrepreneurs

This sort of scheme would have three participants, with roles broadly as follows:

- Young entrepreneurs. Individuals would complete a light-touch, pro forma business plan to record what sort of business they were planning to start. They would then be loaned a small amount of money to help get them started. They would pay a commercial rate of interest on the loan and in due course repay the principal. They would also surrender a small equity stake in their business, with an option to buy this back at a later date or if certain conditions were met.
- Private sector fund. This would raise capital from retail savers and other investors (perhaps by issuing retail bonds qualifying for ISAs). The capital raised would be used to extend loans at commercial rates to young entrepreneurs seeking start-up finance. The fund would also take a small equity stake in the businesses it financed, using the upside from this to help make investments attractive for savers.
- The government. Only involved for oversight and in specific instances where an individual entrepreneur defaults on their loan and other attempts to recover the money have failed. In this small minority of cases the state would step in to facilitate loss recovery via the income tax regime. The mechanics would be similar to student loan repayments (though perhaps faster to conclude, as the sums outstanding would on average be lower).

We think the potential scale of an Enterprise Kickoff Fund for young people is manageable. About 800,000 people reach the age of 18 each year. So in steady state, a fund extending £3,000–5,000 to five% of this group (40,000 people) would need to raise and allocate £120–200 million a year. This is less than one half of one percent of the £54 billion subscribed to ISAs in 2010/11. As we are proposing a private sector fund, its precise size and coverage will be determined by demand and supply in the market. If there is demand from a larger group of aspiring young entrepreneurs, on terms that are sufficiently attractive to private investors, then a substantially larger fund is conceivable.[24]

[24] This may be particularly relevant when the scheme is introduced, if eligibility is extended to slightly older people who might otherwise have missed out

Of course there is an argument for opening up eligibility to a wider age group – or potentially even to aspiring entrepreneurs of any age. We believe that the initial focus should be on young entrepreneurs as this is where we see the most clearly defined market failure. This would also help deliver support for young people who do not choose to follow a path to university, providing support for all forms of progression. And by virtue of their youth, investments in this group should have the greatest long-term payoff in terms of their economic contribution if and when their businesses are successful.

There are a number of private sector precedents for incubator finance for new businesses. A recent example, which also suggests that support can be delivered on commercial terms, is the Wayra Academy that Telefonica is currently bringing to the UK. This will provide office space and small loans (albeit up to about £40,000) to a number of start-up businesses, in exchange for an equity stake and first refusal on any products successfully developed.[25]

The experience of developing, setting up and launching Big Society Capital (formerly the Big Society Bank) should also hold important lessons for future development of policy in this area. This is being set up to develop a market in investments made on the basis of positive social returns as well as financial returns, and is being capitalised with £400 million from dormant bank accounts.[26] It is too soon to judge whether this has been successful – but it does demonstrate that there is interest and energy behind schemes of this sort.

The government would of course need to consider the best way for HMRC to administer claw-back of defaulted loans via the tax system. We would expect this to be easier to manage than recovery of student loans, since it would only need to be invoked in exceptional cases (we would expect most loans to be recovered through the usual channels) and for smaller sums.

[25] Telefonica set to accelerate UK start-ups, Telefonica 2012
[26] Big Society Capital launched, Cabinet Office 2011

Conclusion

This research note focuses on practical policy levers that could be used to support early stage, aspirational and growing firms. We do not suggest that proposals included in this note are a silver bullet for instantly restoring economic growth. We do believe, however, that in the current economic climate it is more important than ever to ensure that we protect investments in innovation and enterprise that will pay off over the long term. The three key proposals in this note – on tax simplification, ISAs and young entrepreneurs – are all designed to work with the grain of the market and support small businesses going for growth. They are affordable for the Exchequer and we urge the government to give them proper consideration.

Annex A: A primer on growth

As a country we strive for rising standards of living and a fairer society. We measure progress by looking at a range of metrics, including economic growth, the environment, health, wellbeing and social cohesion. Economic growth is the focus for this paper.

The classic metric for a country's economic activity is GDP. Broadly speaking, for a given time period this can be measured in one of three ways: adding up the value of all the goods and services produced by businesses, adding up all the spending done by consumers, or adding up everyone's incomes. When everything is properly accounted for, these three measures will all produce a consistent figure.

We measure progress by looking at how GDP is changing over time (typically we use real GDP per capita, to strip out the effects of inflation and population change). When the economy is growing, the value of the goods and services produced in the UK increases year-on-year.

Economic growth reflects overall increases in the volume of factors of production (land, physical capital, labour, human capital / skills, and information) and improvements in our ability to combine into goods and services that people value. In a market economy there are three essential ingredients:

- Entrepreneurs: to take on new business challenges
- Innovation: to give us new and better ways of doing things
- Competition: to drive out inefficiency and prevent market dominance

Broadly speaking, economic policy should be designed to enable these forces to improve total factor productivity. Consistent, stable polices that promote enterprise, innovation and competition pay off in terms of economic growth in the longer term.

Annex B: Great British innovations

British entrepreneurs and businesses have a proud history of invention and innovation. Classic examples, from the industrial era up to the present day, include:

- Cat's eyes. These reflective markers are used as a safety device to highlight road markings, and are now in widespread use around the world. Invented by Percy Shaw in 1933, patented in 1934, and manufactured by Reflective Roadstuds Ltd in Halifax from 1935.
- The vertical take-off jet. The Short SC.1 was the first British fixed-wing vertical take-off and landing (VTOL) aircraft. Designed to meet a Ministry of Supply request for tender in September 1953, and constructed at Short's Belfast factory in Northern Ireland.
- The passenger steam ship. SS Great Britain was the first to combine iron construction and a screw propeller in a large, ocean-going vessel, and the first iron steamer to cross the Atlantic in 1845. Construction overseen by Brunel at a dry dock in Bristol.
- The bagless vacuum cleaner. These use cyclonic separation to maintain suction even as the vacuum cleaner picks up dirt. Developed by James Dyson who set up his own company in 1993 and established an initial research and manufacturing base in Wiltshire.
- JCB diggers. JCB delivered a range of firsts in construction equipment through the 1950s, with the name now synonymous with mechanical diggers and excavators. The company was founded in 1945 by J C Bamford and based in Staffordshire.
- The World Wide Web. Developed by Tim Berners-Lee, who used a NeXT computer as the world's first web server and wrote the first web browser in 1990. The web debuted as a publicly available service in 1991, and Berners-Lee uploaded the first photo in 1992.
- The wind-up radio. Trevor Baylis constructed the first prototype of his wind-up radio in 1989. With financial backing in 1996 he set up a company to develop the product. In 1997 a new generation of wind-up radios were in production in South Africa.
- The Mini. Originally under development as the XC/9003, and overseen by Alec Issigonis at the Austin plant in Longbridge. The Mini went on to become the best-selling British car in history, with a production run of 5.3 million vehicles.
- ARM microprocessors. Developed by Acorn Computers and first implemented in the Acorn Archimedes range in 1987. ARM products are now dominant in a wide range of mobile phones and other consumer electronics products. Based in Cambridge.

Annex C: Existing policies on investment and enterprise

As part of its growth agenda, the government has announced a number of initiatives to assist businesses looking to access finance. These build on earlier initiatives; some will benefit a wide range of businesses and others are particularly focused at the smaller end.

Key tax incentives and reliefs

Capital gains tax (CGT). Prior to 6 April 2008 CGT was paid at an individual's top rate of tax, subject to taper relief. With taper relief, it was possible to reduce the effective rate of CGT on the disposal of business assets to 10%. From April 2009 CGT is charged at 18% on an individual's gains in excess of the annual exempt amount. From June 2010 a 28% rate of CGT was introduced for gains in excess of the threshold for the basic rate of income tax.

Entrepreneurs' relief. Entrepreneurs' relief was introduced from 6 April 2008 to provide relief from CGT on disposals of certain business assets or shares or securities in a personal company, subject in both cases to certain conditions being met (including that the company is a trading company or the holding company of a trading group). Where the qualifying conditions are met CGT is charged at 10% on gains up to the lifetime allowance (£5 million from 23 June 2010, increased to £10 million from 6 April 2011). A personal company is one where the investor holds at least 5% of the ordinary share capital in the company and is entitled to at least 5% of the voting rights. The 5% minimum shareholding requirement is considered to be too restrictive as it prevents employees from investing and is also open to potential abuse as the shareholding requirement can be met without the investor having a genuine 5% economic interest in the company.

Enterprise Investment Scheme (EIS). The EIS is designed to help smaller high risk trading companies raise funds from business angels who may be directors (but not employees) of the company. It provides the investor with income tax relief of 30% of the cost of the investment up to £500,000 (£1 million from April 2012) in qualifying companies and relief from CGT for the increase in value of the shares. The relief is dependent on a number of conditions including that the shares must be held for 3 years from the date of issue and also that the investor must have no previous connection with the company.

Venture capital trusts (VCTs). A VCT is a listed vehicle that enables investors to invest indirectly in a range of smaller high risk trading companies and, subject to certain conditions being fulfilled, the investment qualifies for both income tax and CGT relief.

Business tax rates. The small profits rate of tax was reduced to 20% (from 21%) from 1 April 2011 and applies to a standalone company with taxable profits less than £300,000. This still offers a benefit to companies with small profits (that may not be small companies) but the differential between the small profits rate of tax and the main rate of corporation tax is gradually being eroded as the main rate of corporation tax is currently decreasing (26% for FY 2011 and anticipated to reduce to 23% from 1 April 2014). However the reduction in corporation tax rates is being paid for by a reduction in the rate of writing down allowances for plant and machinery (from 20% to 18%) and special rate assets i.e. integral features and long life assets (from 10% to 8%) from 1 April 2012.

Capital allowances. As mentioned above the rate of capital allowances is decreasing from 1 April 2012 and first year allowances are no longer available to small companies as an incentive for investment in capital assets. From April 2008 the annual investment allowance was introduced which gives 100% allowances on the first tranche of qualifying expenditure. This was initially £50,000, increased to £100,000 from April 2010 and is to decrease to £25,000 from 1 April 2012. In addition for businesses (of all sizes) based in six of the new Enterprise Zones, 100% capital allowances will be made available in Finance Act 2012.

R&D tax credits. There is a specific regime for R&D tax credits for small and medium sized enterprises undertaking qualifying research and development activities, which allows a super deduction for qualifying expenditure. This is currently 200% but is set to increase to 225% from 1 April 2012. For loss-making companies there is an option to receive relief by way of tax credits - this reduces losses available to be carried forward but can greatly assist cash flow.

Seed Enterprise Investment Scheme. Finance Bill 2012 is to introduce a new form of tax relief for investors in the smallest companies via the Seed Enterprise Investment Scheme. This is similar to the EIS scheme but is initially anticipated to apply to shares issued between 6 April 2012 and 5 April 2017 (although his may be extended by Treasury Order). The draft legislation indicates that this is a modified version of the EIS scheme, offering a higher rate of income tax relief (50% on a maximum investment of £100,000) for equity investments in companies with fewer than 25 employees and gross assets of less than £200,000. The original regime that was subject to consultation indicated a wider and more flexible regime allowing investment in companies other than by equity; however the draft legislation published in December 2011 has dropped these wider proposals.

National insurance holiday. The June 2010 Budget announced an exemption from employer's national insurance for a three year period, effective from 6 April 2011. The scheme, which applies in certain targeted areas, provides an exemption from employer's national insurance up to £5,000 per employee for the first ten employees in their first year of employment hired in a company's first year of business.

There are of course other tax measures, both current and planned, that are not specifically aimed at SMEs but which will benefit this sector of the business population. The patent box regime is one such example.

Tax simplification

A more general initiative is the Office of Tax Simplification (OTS) which was established by George Osborne in July 2010. The aim of the OTS is to make recommendations to ministers that will deliver simplification in specific areas of tax.

In February this year the OTS published their recommendations of their review on small business taxation. They have focused on streamlining tax administration for small businesses, on a simpler tax regime for the smallest businesses (as described in the body of this note) and disincorporation. On the latter the OTS identified that a number of the smallest companies would like to move to an unincorporated status. To help this group, the OTS proposed the introduction of a tax relief so that companies can disincorporate without incurring significant tax cost. This would have the dual benefits of reducing admin burdens and facilitating business reorganisations.

Red tape challenge

The Companies Act 2006 represented a simplification and modernisation of company law and was designed to create a more flexible framework in which companies can operate. In January 2012 a discussion paper was published by BIS,[27] and changes are also being considered to the audit regime and non financial reporting for SMEs.

[27] Company Law - providing a flexible framework which allows companies to compete and grow

David Cameron launched the *Red Tape Challenge* in April 2011. One of the aims is to free businesses from regulation to enable them to compete and create jobs, and this is to be achieved by stopping unnecessary new regulation and to reduce the burden of existing regulation. Where regulation imposes bureaucratic burdens the government wants to ensure that the burden is proportionate to the ultimate aim of the regulation. The focus will be on existing regulations via a series of consultations. Where new regulation is proposed, there must be a clear justification for government involvement.

One initiative included in the deregulation agenda for small firms and start ups is a three year moratorium on domestic regulation. However this will have no impact on European regulation.

One of the key areas arising from the Red Tape Challenge is the package of employment law reforms announced in November 2011, designed to remove the barriers that employment law presents to growing businesses. Making employment law simpler and less restrictive will help to create an environment where it is easier for businesses to create new jobs. The reforms will improve the way that businesses take on staff, manage disputes and let staff go, whilst continuing to offer protection to employees. Key elements that may assist small businesses are the proposed abolition of 40% of domestic regulations relating to employment law, simplifying the existing dismissal procedures and, specifically for micro businesses, the introduction of a compensated no fault dismissal procedure.

Other areas that will be scrutinised under the Red Tape Challenge include health and safety regulations and the reporting of non-financial information (to avoid duplication and to make company reports clearer).

There are specific regulations surrounding financial promotions that apply when SMEs seek public funds which impose a significant burden on both the company seeing funds and the investor or the investment vehicle. Whilst this may not present a barrier to sophisticated investors it is nonetheless a complex area and could benefit from simplification.

The government has consulted on helping to reduce small businesses expenditure on accounting and reporting fees by introducing audit exemptions and changing the accounting framework for small businesses. Other areas that would benefit from simplification might include employment contracts (to the extent that these are not covered in the existing initiative relating to employment law under the Red Tape Challenge) and articles of association. Consideration could be given to recommending a short form that could be adopted for start up companies.

Other regulatory and non-tax policies

In addition to the various tax initiatives considered there have been a number of non-tax initiatives to encourage investment in start up or small companies. These are mainly on the back of the Growth agenda and include the following:

- Project Merlin. As a result of this, a report will be published quarterly detailing total and SME gross lending figures across the five main banks, identifying trends in lending to SMEs.
- The National Loan Guarantee Scheme. This is a £20 billion scheme designed to lower the costs of loans to small businesses.
- The Enterprise Finance Guarantee Scheme. This is a loan guarantee scheme to help facilitate additional bank lending to viable SMEs who are unable to access normal commercial debt finance due to insufficient security.
- The Business Finance Task Force. Sponsored by the British Bankers Association, this will ensure that SMEs will have better access to finance (including through the Business Growth Fund), support the Enterprise Finance Guarantee Scheme (helping mid-sized businesses access syndicated debt markets and credit easing), improve customer relations (including supporting a network of business mentors) and providing better information and promoting better understanding.
- The Business Finance Partnership. This will look at alternative sources of non-bank funding for small businesses including asset finance (via leasing) to help SMEs invest in new equipment. It is complemented by the Breedon review. This is an industry-led taskforce to investigate the challenges faced by businesses in diversifying their finance, ensuring the flow of credit to businesses via various sources of debt and credit products (e.g. corporate bonds).

- The Regional Growth Fund. This is a £95 million government investment to provide support for enterprises with the potential for creating long terms private sector led growth and employment. It will run for three years to 2014 and is facilitated by HSBC, NatWest and RBS. Funding will be provided by grants to SMEs subject to certain conditions being met.
- The Business Angel Company Investment Fund. This has been created with a grant from the Regional Growth Fund to boost the number of quality of business angel investment.
- One Click Registration. This will be available from 1 April 2012, enabling businesses to register at Companies House, and sign up for PAYE registration, corporation tax and self-assessment via a single portal.
- The Web Fuelled Business initiative. This offers free places on one-day seminars to ensure that businesses are able to exploit the global opportunities offered by the internet. The training covers e-commerce, search engine optimisation, online advertising, export finance and the use of social media.
- The National Export Challenge. This, coupled with the web resource *Open for Export*, is intended to assist SMEs in breaking into new markets.
- Business mentoring. There are a number of initiatives investing in business mentors which may be of particular value to individuals starting up their first company.
- A £75 million investment in high tech SMEs as part of the government's Innovation and Research Strategy for Growth. This includes giving high tech businesses access to the finance and facilities needed to develop and commercialise products, as well as an "innovation vouchers scheme" to give SMEs access to academic support. The government is also aiming to boost high-tech economic growth with a package of measures including access to test facilities and private investment.

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