Trades Union Congress

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Economic report

Small firms - myths and realities

This report sets out you:

- *How many people work in small firms in Britain today;*
- *How and why the share of employment in small firms is changing;*
- *The TUC's recommendations for developing government policy towards SMEs and the promotion of enterprise*

Introduction

Small firms are and will remain an important part of the UK labour market and the economy. Yet even basic questions such as how many people work in small firms or whether the share of total employment is going up or down have until recently been obscured by an almost total lack of hard statistical evidence

As a result, the information gap has been filled by limited one-off studies and – less creditably – by assertion based on widely held misconceptions. It is still commonplace to hear that all the new jobs come from small firms, or that a big small firm sector is a necessity for a successful economy.

The size of the small firm sector means that by necessity many new jobs will be created by small firms. But it is also a sector of job destruction on an equally large scale. The counterpart of easy entry is easy exit.

Many of the misconceptions about the role of small firms in the economy today stem from a basic confusion between small workplaces and small firms. Walk down any high street and you will see many small workplaces. But most will be part of much bigger regional and national chains. Small workplaces in big enterprises are far more the norm that most people realise.

This report seeks to give a factual account of the small firm sector based on official statistics from the DTI/Small Business Service in the UK, the EU Commission and the EU SME Observatory, the US Census Bureau, and the OECD.

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What is a small firm?

The EU defines a small or medium sized firm as employing fewer than 250 people. In the United States a small firm is any enterprise employing fewer than 500 employees. The EU size categories are set out below.

- Small firms – 1-49 employees
- Medium sized firms – 50 to 249 employees
- Large firms – 250 employees

Employment by firm size today

In 2001 about 18.1 million employees worked in the private enterprise sector, including the employees of public corporations, or roughly 80 per cent of all employees. The remaining 20 per cent worked in central and local government or the non-profit sector. Of the employees in the private sector:

- about 30 per cent (5.5 million) worked in small firms employing less than 50;
- Another 14 per cent or about 2.6 million worked in medium sized firms (between 50 and 249 employees).
- the remaining 10 million employees or 55 per cent worked in large firms (250 or more employees).

Details are given below for employment of employees and total employment. As can be seen, in 2001 there were about 1.5 million proprietors and partners in addition to the 5.5 million employees who worked in small firms.

Employment by firm size in 2001

Private firms and public corporations only

	Employees		Total employment	
	000s	%	000s	%
Small	5467	30.1%	6922	35.1%
Medium	2613	14.4%	2721	13.8%
Large	10079	55.5%	10092	51.1%
All	18159	100.0%	19734	100.0%

Note: small 1 to 49; medium 50-249; large 250 +
Source: Small Business Service/Office for National Statistics

Micro enterprises

Most of the small firm sector consists of very small enterprises with less than 10 employees – termed by the EU as "micro-enterprises". About 2.6 million employees or 48 per cent of small firm employee employment is in this size category. Overall, micro-enterprises accounted for 15 per cent of employee employment in the private sector.

Non-profit enterprises

These statistics exclude the non-profit sector, which includes mutuals, co-operatives and charities. In 2001 about 1.2 million employees worked in such organisations, with about 60 per cent working for large organisations.

Employment In Non-Profit Organisations

Employees	000s	%
Small	285	23.0%
Medium	215	17.4%
Large	740	59.8%
All non-profit	1238	100%

Note: small 1 to 49; medium 50-249; large 250 +
Source: Small Business Service/Office for National Statistics

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Enterprises without employees

The figures shown above also exclude just under 280,000 "firms" consisting only of an employee director and nearly 2.9 million "firms" who employ no one. This will include both genuine single person businesses and those classified as self-employed primarily for tax reasons or to avoid employer responsibilities.

Enterprises by industry

The small firm statistics allow some break-down by industry sector. However, these figures are only given on a total employment basis, so include proprietors and partners as well as employees. This inclusion will overstate the importance of small firms in employee employment, especially in industries with a high share of employment in small firms.

The service sector is often thought to be a small firm sector. In fact, most people in private service industries work in large organisations. Indeed, more people work in large firms in services (53.3 per cent of all private service sector employment) than in large firms in manufacturing (51.6 per cent of all manufacturing employment).

As we pointed out at the start of this report, many small workplaces are part of a big enterprise. The local branch of a bank is typically a small workplace employing less than 50 people, but the bank itself is a huge enterprise employing several thousand people nationwide. Most people in the service sector work for big enterprises in small workplaces.

Most jobs in services in large firms

Total employment in private firms and public corporations

Sector	Small	Medium	Large
Manufacturing	25.5%	22.8%	51.6%
Services	35.2%	11.5%	53.3%
Other industries	58.0%	12.5%	29.6%
All	35.1%	13.8%	51.1%

Note: small 1-49; medium 50-249; large 250 or more.
"other industries" are agriculture, energy and water and construction.
Source: Small Business Service/Office for National Statistics

Large firms are particularly dominant in private service industries such as financial services (82 per cent in large firms); transport and telecommunication services (70 per cent); and health and social work (62 per cent).

Employment in sectors such as retail distribution and hospitality (hotels and restaurants) is polarised between a significant small firm sector and an even bigger large firm sector with relatively little in between. SMEs account for just under 50 per cent of total employment in distribution and just over 50 per cent in hospitality.

Industries where SME employment accounts for between 60 and 75 per cent of total employment are business services (estate agents, accountancy, legal, IT, and security and cleaning services); personal and other services (recreation, sanitation, hairdressing, dry-cleaning etc); and private education service sector (including driving schools, language and tutorial colleges).

Small firms predominate in the rest of the private sector economy. Agriculture is massively small enterprise dominated, with 90 per cent of

employment in small firms, while construction has 75 per cent of total employment in SMEs.

Which industries have most of their employment in small firms

Total employment in private firms and public corporations

Industry	Small	Medium	Large
Agriculture	90.0%	-	-
Construction	60.6%	15.3%	24.2%
Personal services	49.5%	13.5%	37.0%
Education	48.6%	26.3%	25.7%
Business services	47.1%	16.4%	36.5%
Hospitality	42.5%	10.5%	46.9%
Distribution	36.1%	10.2%	53.7%
Health, social	26.7%	9.4%	64.0%
Manufacturing	25.5%	22.8%	51.6%
Communications	20.4%	9.7%	69.8%
Finance	10.7%	6.8%	82.4%
Energy, water	5.1%	-	-
All industries	35.1%	13.8%	51.1%

Note: small 1-49; medium 50-249; large 250 or more. Figures not published for agriculture and energy and water above 50 employees. Hospitality is hotels and restaurants; communications is transport, post and telecommunications.
Source: Small Business Service/Office for National Statistics

Employment in small firms is heavily concentrated in three industrial sectors – distribution (23 per cent of all small firm employment), business services (19 per cent) and manufacturing (14 per cent). Employment in medium sized firms is strongly concentrated in manufacturing, which accounts for a third of all employment in medium sized firms. The distribution of small firm employment across industries is shown in the table below.

Which sectors account for most small firm employment

Total employment in private firms and public corporations

Sector	Small	Medium	Large
Distribution	22.6%	16.2%	23.0%
Business services	19.4%	17.2%	10.3%
Manufacturing	14.4%	32.8%	20.0%
Hospitality	9.4%	6.0%	7.1%
Construction	9.3%	6.0%	2.5%
Health, social	7.9%	7.0%	13.0%
Personal services	6.2%	4.3%	3.2%
Communications	4.3%	5.2%	10.0%
Agriculture	3.5%	-	-
Finance	1.6%	2.6%	8.4%
Education	1.3%	1.7%	4.6%
Energy, water	0.1%	-	-
All industries	100%	100%	100%

Note: small 1-49; medium 50-249; large 250 or more.
Source: Small Business Service/Office for National Statistics.

The employment record

We do not know exactly how much small firm employment grew between 1980 and 1994 because we have no official statistics. It is extraordinary that despite the big claims made for small firms and the billions of pounds spent by successive governments in supporting the SME sector, it is only since the mid 1990s that fully reliable and directly comparable official estimates of employment in small enterprises have become available.

We do have some figures for the total number of enterprises in the economy, based on VAT registrations. These show that the overall number of enterprises in the economy grew significantly in the 1980s, but there has been no further growth since 1990. The increase in the total number of enterprises since 1980 has been

similar to the increase in the total number of self-employed. In an article published in October 1998, Joanna Selden of the DTI concluded that *"this shows most of the growth has been in one and two person businesses"*. Latest figures for enterprise and self-employment growth between 1980 and 2001 are shown in the table below.

Enterprise and self-employment growth 1980-2001

millions	Enterprises	Self-employed
1980	2.4	2.3
1994	3.6	3.5
2001	3.8	3.4
Change 80-01	+1.4	+1.1

Sources: Labour Market Trends, October 1998; Office for National Statistics; Small Business Service 2001.

Small firm employment 1994 to 2001

It is widely stated that SMEs create most of the new jobs. The Small Business Service has published one study that claimed that 85 per cent of the new jobs created between 1995 and 1999 were created in SMEs.

However, the SME statistics show that the share of employment in SMES has been falling since at least the mid 1990s. We only have statistics for total employment in SMEs, and this tends to be erratic from year to year. Comparing three year averages of 1994-1996 with 1999-2001 shows that over this period total employment in SMEs has changed little, increasing by less than 2 per cent. In contrast, almost all the increase in total private sector employment has been in large firms, with an increase of 17 per cent. The share of total private sector employment in SMEs has fallen from 52.3 per cent in 1994-1996 to 47.7 per cent in 1999-2001. The table below gives details.

Employment by firm size 1994-2001

Total employment in private firms and public corporations

	SMEs		Large firms	
	000s	%	000s	%
1994	8931	50.8%	8661	49.2%
1995	9488	54.3%	7983	45.7%
1996	9353	51.7%	8746	48.3%
1997	9096	50.0%	9111	50.0%
1998	9411	49.9%	9434	50.1%
1999	9340	49.1%	9697	50.9%
2000	9189	48.0%	9946	52.0%
2001	9643	48.9%	10092	51.1%
Change	Three year averages			
94-96	9257	52.3%	8463	47.7%
99-01	9391	48.7%	9912	51.3%
	+1.4%		+17.1%	

Note: SMEs less than 250; large 250 or more
Source: Small Business Service/Office for National Statistics. TUC estimates

There is clearly a paradox here – if most of the new jobs are being created by SMEs, as the Small Business Service (SBS) suggests, we might expect their share of total employment to be going up not down.

As we suggested earlier, large-scale job creation among SMEs has been more or less matched by large-scale job destruction among SMEs. As well as jobs lost in existing firms, roughly 10 per cent of all new businesses registered for VAT fail within a year, and about 35 per cent fail within three years.

However, a second possible explanation is that SMEs are growing and moving out of the small firm category and becoming large firms. We

think this unlikely. The European Observatory on SMEs could find no evidence this was happening across European labour markets in the 1990s. Firms changing size had some impacts within the SME sector, especially at the bottom end, but "*there is no significant impact of firms crossing size-bands on the SME/LSE growth differential" (Sixth Report, 2000, p.60).*

We think it more plausible that the shift in employment away from SMEs is driven by the further consolidation of employment into bigger enterprises in some service sector industries – notably distribution, hospitality, personal and other services, and health and social work services. Between 1994 and 2001 the share of employment in large firms in hospitality grew from 34 per cent to 47 per cent and in distribution from 43 per cent to 54 per cent.

We see this caused by big national and regional chains securing a growing market share at the expense of independent operators who find it hard to compete against the economies of scale and purchasing power available to big enterprises. The table below shows changes in the share of employment by industrial sector between end 1994 and start 2001.

Which industries saw the biggest shift to large firm employment

Total employment in private firms and public corporations

Large firm share	1995	2001	Change
Industry	%	%	% points
Hospitality	34.1%	46.9%	+12.8
Distribution	43.1%	53.7%	+10.6
Other services	27.8%	37.0%	+ 9.2
Health	55.0%	64.0%	+ 9.0
Communications	64.1%	69.8%	+ 5.7
Finance	78.9%	82.4%	+ 3.5
Construction	21.0%	24.2%	+ 3.2
Business services	35.4%	36.5%	+ 1.1
Manufacturing	50.8%	51.6%	+ 0.8
Education	28.8%	25.2%	- 3.6
All industries	45.7%	51.1%	+ 5.4

Notes: all industries includes energy and water and agriculture. Large firms employ 250 employees or more. Hospitality is hotels and restaurants; communications is transport, post and telecommunications. Other is personnel services, recreation and sport, sanitation and other community services
Source: Small Business Service/Office for National Statistics

The conventional assumption that more enterprises must always mean more jobs and fewer enterprises must always means less jobs is simply not true under current market conditions. For example, in distribution the number of enterprises employing at least one person fell by 15 per cent but the total number working in the remaining enterprises went up by 20 per cent between end 1994 and start 2001.

IT services – a partial exception?

The collapse of the "dot-com" bubble has taken the shine off the high tech sector, but in reality employment in the dot-coms was tiny. High tech services have been and continue to be a major growth industry and a source of new and mostly high quality jobs. Most people – over 60 per cent - in this service industry work in small firms.

Total employment in SME computer related services increased significantly from just under 160,000 at the end of 1994 to just under 280,000 at start 2001, a rise of over 80 per cent. However, employment in large firms went up twice as fast, so the share of SME employment went down from 73 per cent of total employment at end 1994 to 63 per cent by start 2001.

It is of course possible that what we are seeing is extreme dynamism, with rapidly growing firms moving out of being small and medium sized firms into the large firm category. Although we remain sceptical that this can explain the shift to large firm employment in the economy as a whole, this industry has been growing so fast it may prove an exception to the rule. However, we still think it more plausible that what we are seeing is very rapid growth moving firms out of micro-business into the small and possibly medium sized categories, while established bigger scale market players are expanding even faster in response to rising commercial and domestic demand.

Policy issues and conclusions

We end as we began by restating that SMEs are an important part of the UK labour market and they do create many new jobs each year. Our intention in this report is to set a more realistic assessment of that contribution and how it has been changing.

A common theme throughout this report is the amazing lack of hard statistical evidence at national, international and regional level. But our guess is that the share of employee employment in SMEs has probably changed only modestly over the past twenty years.

Our over riding view is that it is the state of the economy that is the single biggest factor in determining the overall health of the small business sector. Economic stability is the most effective way of delivering a "pro-enterprise" environment.

The key issue for the UK is improving the performance of the SME sector, particularly in areas such as training, innovation, and productivity. We can see no evidence that having a bigger small sector than we do at present would improve economic performance. It would therefore be misguided to judge the success or failure of the government's policies on crude indicators such as whether the total number of enterprises or the SME employment share in the economy is going up or down.

A modern enterprise policy must take a broad view of enterprise and entrepreneurial behaviour. Too often enterprise is seen simply in terms of start-ups or the activities of a handful of colourful individuals. We should be as concerned at promoting enterprise at all levels of business and at all levels of management throughout the economy.

However, we should also be clear what sort of "entrepreneur" and entrepreneurial behaviour that we want to encourage. Few would argue that we need more of the colourful "entrepreneurs" maximising shareholder values

through the financial deals beloved by the financial markets that produced the Enron and WorldCom scandals. The City also initially widely praised the poor decision making at the top that eventually brought former world-class companies such as Marconi to the edge of bankruptcy. Nor do we need more asset strippers whose primary concern in breaking-up companies is to realise the most cash in the shortest possible time.

Better economic performance in the long run depends on the entrepreneurs and managers who grow and strengthen businesses for the long term by building high performance workplaces and investing in the workforce. As the recent TUC report *The Low Road* points out, the big question in the workplace is not whether people at the top provide "leadership" but how do they shape up as effective managers. The evidence suggests we have a serious shortfall in managers willing and able to implement new ideas and new work practices, drawing on best practice from across the industrialised world.

We can see no convincing evidence that regulation and improved employment protection have significantly affected small firm development. It is the more highly regulated economies in Europe where the small firm sector is the most important. A healthy small firm sector can exist within a stronger framework of employment protections than we have at present in the UK.

We fully support the Government's policy to develop better regulation, particularly in areas where regulatory requirements have become out-dated or are so complex or obscure that firms are uncertain what they have to do in order to comply. We also strongly support policy initiatives to help small firms comply with their legal obligations, for example, by offering clear and easily accessible advice and support services.

As part of the Third Spending Review, a cross-Departmental review has estimated that spending across the whole public sector on small business cost the taxpayer £2.5 billion a year. Of this £1.8 billion is spent on targeted programmes that at present reach about 10 per cent of all small businesses. The Small Business Service alone will cost £360 million by 2005-2006. These are not trivial sums. The Small Business Service is now being asked to review government services to improve their effectiveness and efficiency.
We have a number of recommendations for the future development of policy towards enterprise and the SME sector:

- economic stability offers the single most effective way in which government can provide a pro-enterprise environment;
- we recommend a broad-based policy to encourage entrepreneurs and managers to at all levels to promote long term growth and industrial partnership above short term profit maximisation as an integral part of the government's productivity initiative;
- policy objectives towards SMEs should be framed in terms of improving quality, performance and compliance rather than crude quantity measures – we need better quality rather than more quantity;

- policies to promote small firms, start ups, and remove barriers to growth should build on the Government's targeted approach, focusing on areas with low levels of entrepreneurial activity; ethnic minority business; and high tech services where the biggest opportunities for dynamic small firm development exist;
- the government and the SBS with the social partners should give the highest priority to ensuring the widest possible take up by SMEs and their employees of the fiscal incentives available through the Employer Training Pilots for workforce development and training.