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The Uneven Spatial Nature of Access to External Finance in UK SMEs:

Determinants, Impacts and the "Levelling Up" Agenda

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NON-TECHNICAL SUMMARY

Finance is crucial for new and small and medium-sized enterprises (SMEs) as it enables them to undertake growth-oriented activities enabling them to expand and upscale their operations.

Conversely, a lack of capacity to self-finance their activities can impede and hamper entrepreneurial activities coming to fruition, especially by firms with limited relational networks to access informal funds from family and friends.

Despite this, SMEs often face perennial problems accessing finance which can hamper productivity growth. These problems can be particularly acute for SMEs located in certain parts of the UK, especially those located in northern and peripheral regions.

In this report, the authors provide new evidence on some of these problems SMEs confront obtaining finance in different parts of the UK. In particular, it examines the effects of self-exclusion from the credit market in the UK. The focus of this study is on bank finance as this is the dominant form of funding used by SMEs, accounting for 85% of all outstanding debt owed by UK SMEs

It is this rationing aspect of the small firm capital market that can have unanticipated consequences as firms that have been refused capital can self-exclude from the market due to first-person scarring effects. In other words, credit rationing is cumulative and results in self-reinforcing borrowing behaviour which prevents SMEs accessing external finance.

Past research has tended to identify the problems SMEs face when accessing finance without looking at the wider impact of these credit restrictions. In this report we provide novel evidence at the impact of this self-exclusion from the small business credit market in terms of how this affects sales and employment growth within SMEs.

In section 1 we introduce the context for the study and then in section 2 we outline the relevant literature on SME access to finance before outlining previous academic research on nature of spatial variations in terms of the UK small business credit market. Section 3 then provides information on the data used for this study together with some descriptive statistics. The study examines the Longitudinal Small Business Survey over the years between 2015-2020.

By way of preview of some key findings, we find that around quarter of a million smaller firms have dropped out of the UK capital market and that in many localities this has reduced job creation and sales income growth. Overall, we find that in a general sense stopping applying for finance when one still has a need is sub-optimal for future growth outcomes.

The general time-series trend in terms of small firms seeking external finance from capital markets is downwards over the period from 2015 to the onset of the Covid-19 crisis in 2020, although there is considerable year-on-year variation. What is apparent is that this demonstrates a distinct shift in the willingness of small firms to seek external capital in the UK since the Global Financial Crisis (GFC).

On the whole, this credit self-rationing negatively impacted SMEs in terms of sales and employment growth. On our two outcome measures which represent the key dependent variables of our final modelling of the effects of capital market engagement on growth we find that this was a period generally characterised by low growth and declining employment. The Covid-19 crisis led to a dramatic decline in sales of more than 25.3% and a 5.56% decline in employment.

In its totality, there appear quite stark spatial variations in access to finance with Northern Ireland and Scotland having the most problematic experiences of capital markets and this is reflected in a high incidence of simply refusing to even go to the capital market in future periods when they need funds. These locations have the largest demand for finance, but also face the greatest amount of rationing by banks.

We see that full rationing of funding applications is most prevalent in Northern Ireland, where 12.7% of finance applications result in a full rejection, the West Midlands (12.4% fully rejected), and Scotland (12.2% fully rejected). This compares to the relatively favourable outcomes found in the East of England, where only 10.1% of applications receive a full rejection, the East Midlands (10.2%) and the North East (10.3%).

Partial rationing of funding applications is most prevalent in Northern Ireland, where 14.2% of finance applications result in a partial rejection, Scotland (12.2% partially rejected), and Wales (10.5% partially rejected). This compares to the relatively favourable outcomes found in the North West of England, where only 7.2% of applications receive a partial rejection, the South East of England (7.9%) and East Midlands (8.0%).

A similar spatial picture applies to firms who simply stopped applying for finance. The incidence of firms stopping applying for finance is most prevalent in Northern Ireland, where 11.0% simply refuse to make funding applications even when they need finance, Scotland (9.9%), and London (9.4%). This compares to the relatively low incidences found in the South East England, where only 7.3% of firms stopped applying, the East of England (7.5%) and Yorkshire & Humber (7.6%).

We also observe that there was a negative relationship between employment size and firms who stopped applying for funds. In this sense, the problem of self-rationing in capital markets is heavily concentrated amongst the smallest size classes of firm. In contrast, firm age was not found to be significant. Very few industry effects were apparent.

The study found that innovating firms were more likely to stop applying. This was the case for goods & service innovators and process innovators. This is of concern in that it suggests that one of the key drivers of growth amongst the small business sector, the innovators, are withdrawing from capital markets even when they have a latent demand for funds.

We also estimated a dynamic model for moving from a state of applying for external funding to not applying. Here we find that firm size had no effect but innovative firms and particularly product and service innovators were more likely to change to a non-applying state.

At the broad geographic region, we find that firms that continued to apply for external capital when they needed it achieved high jobs growth in Scotland and Wales and that this effect was magnified in Wales where firms that stopped applying were found to grow their employment at a significantly slower rate. In this sense, we are drawn to conclude that self-exclusion from external capital markets, often induced by a previous incidence of full rationing, has a clear and detrimental effect on the ability of firms to create jobs and that these effects are strong at the regional level.

In terms of sales growth, at the regional level, we find that self-excluding from capital markets has a strong and negative effect on sales growth in the East Midlands and Yorkshire & Humberside regions of England, and in Scotland. The magnitude of the effect is particularly large in the East Midlands.

Our key concern was that lack of access to capital for investment in growth enhancing activities would have a real and tangible impact on their ability to generate new jobs and sales. At the macro-economic level, this would directly impact on the UK economy as smaller firms

create a disproportionate share of net new jobs and have increased their aggregate share of total UK GDP significantly over time.

We find a clear and distinct causal chain of events which have their roots in capital markets. When small firms make funding applications and are rejected in an absolute sense (full rationing) this increases the probability that in the future they will self-exclude from capital markets, although this is not the sole reason. Importantly, once a small firm has made this initial choice it becomes more embedded over time.

In an average year, we estimate that 230,000 small firms make this choice to self-exclude from capital markets even though they need additional funds. Ultimately this reduces their ability to grow their employment and sales as new investment in growth enhancing capability is scaled back. Importantly, there is a differential effect for both self-exclusion from capital markets due to full rationing and jobs and sales growth being constrained by this self-exclusion across UK regions and sub-regions.

The report suggests introducing spatially calibrated policy instruments. In particular, loan guarantee instruments could play a major role as a spatial policy is by using the four key parameters (the guarantee coverage ratio, the interest rate premium, the term structure, and the maximum loan size), to create unique configurations of these four scheme parameters to target specific types of firms located in particular spatial areas with high prevalence rate of full rationing and also self-exclusion from capital markets.

The authors conclude that this credit self-rationing behaviour will add further to existing regional and sub-regional economic inequalities in the UK, making the “levelling up” agenda an even more intractable policy objective for some geographical localities to achieve.