Policy Briefing

The Uneven Spatial Nature of Access to External Finance in UK SMEs: Determinants, Impacts and the "Levelling Up" Agenda

Research Paper 100

June 2022

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. However, SMEs often encounter perennial problems accessing finance which can hamper productivity growth. These problems are often magnified 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. The study examines the Longitudinal Small Business Survey over the years between 2015-2020. The focus of this study is on bank finance as this is the dominant form of funding used by SMEs. While past research has tended to identify the problems SMEs face when accessing external finance – such as levels of credit rejections and borrower discouragement- typically they have overlooked the wider impact of these credit restrictions. In contrast, this study specifically examines the effects of self-exclusion from the credit market in the UK especially the impact this has on SMEs in terms of job losses and reduced turnover growth which are key drivers of productivity growth.

Key findings

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 self-exclusion from the market for external finance when finance is still required is a sub-optimal for future growth outcomes.

The general trend in terms of small firms seeking external finance from capital markets is downwards over the period examined, 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).

Authors

Ross Brown
University of St Andrews
Ross.Brown@st-andrews.ac.uk

Marc Cowling
University of Derby and Oxford Brookes University
Mcowling@brookes.ac.uk

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. 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 altogether. 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%).

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 are drawn to conclude that self-exclusion from external capital markets, often induced by a previous incidence of full rationing, has a clear and demonstrably negative effect on the ability of firms to create jobs and that these effects are strong at the regional level.

Policy and practice implications

The report suggests introducing spatially calibrated policy instruments could be one solution to help alleviate barriers to finance in certain parts of the country. In particular, loan guarantee instruments for SMEs could play a major role as a spatial policy 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 without greater policy intervention, future 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 remote policy objective for some geographical localities.

Full paper link:
https://www.enterpriseresearch.ac.uk/our-work/publications/