



EXECUTIVE SUMMARY

DEMAND- AND SUPPLY-SIDE FINANCING ISSUES
(‘FRICTIONS’), GROWTH EXPECTATIONS AND
INVESTMENT PLANS: EVIDENCE FROM UK SMALL
AND MEDIUM-SIZED ENTERPRISES (SMES)

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1. Executive Summary

UK business investment has been low for decades relative to other G7 economies. Low investment in fixed capital, skills and innovation matter as they lead to reduced labour productivity growth and lower living standards. Among factors blamed for low investment by SMEs, issues with finance supply (e.g., cost of borrowing) and finance demand (e.g., risk/control/debt aversion) as well as low-growth ambition and expectations have received considerable attention from policymakers. In this context, we examine how SME investment plans are driven by the growth ambition and growth expectations of their owners ('entrepreneurs') and a lack of financial resources.

Firstly, we study how entrepreneurs form growth expectations and how this impacts investment plans. We consider six types of investment plan, encompassing plans for fixed capital, R&D, (product and process) innovation and (leadership and workforce) skills investment. While we anticipate investment-plan likelihoods are increasing in growth expectations (and decreasing in uncertainty about growth), cognitive bias (such as confirmation bias) may cause entrepreneurs to systematically underestimate or overestimate actual growth causing too little or too much investment relative to rational growth expectations. This is important in view of prior studies showing cognitive bias among entrepreneurs in general but a lack of specific evidence regarding the rationality of entrepreneurial investment plans.

To frame the analysis of growth expectations, we present a model of how entrepreneurs learn about growth under rationality and show how cognitive bias affects learning. Under rational Bayesian learning, an entrepreneur's revision of growth expectations depends on new information about growth contained in the 'growth surprise' (i.e., the difference between their actual growth and prior growth expectations) and responds symmetrically to positive and negative growth surprises. However, confirmation bias causes an asymmetric response to positive and negative growth surprises, resulting in biased growth expectations. This bias (if present), which could involve either positivity or negativity bias, leads to suboptimal investment planning involving overinvestment or underinvestment respectively.

Secondly, we test the direct effects of demand and supply-side financing issues ('frictions') on investment plans holding growth expectations constant and indirect effects through growth expectations. Holding growth expectations constant, discouraged and rejected borrowers may experience higher investment costs (due to higher supply-side information costs) directly lowering their likelihood of investment plans relative to otherwise similar 'fully funded' firms which applied for external finance and received the full amount requested. Similarly, controlling for growth expectations, firms with no external-finance needs are less likely to have investment plans (relative to 'fully funded' firms) if their lack of need is a result of experiencing higher investment costs due to owners' debt/control aversion. (By contrast, if the lack of need is because these firms are able to self-finance optimally as opposed to debt/control aversion then, other things equal, they would not be less likely to have investment plans.) In addition, scarring funding experiences among rejected and discouraged borrowers and lower growth ambition among firms with no external-finance needs may have a negative effect on growth expectations and thus reduce investment-plan propensities indirectly via growth expectations.

We use the UK Longitudinal Small Business Survey (LSBS) 2015-2023 to address the following research questions: (i) what are the effects of entrepreneurs' growth expectations on investment plans (including: are growth expectations rational?); and (ii) what are the direct and indirect effects of financing issues on investment plans?

Regarding (i), we find firms that expect to grow are 18.2, 12.2, 21.1, 20.3, 11.9 and 16.3 percentage points more likely to have capital, R&D, product-innovation, process-innovation, leadership-skills, and workforce-skills investment plans respectively than otherwise similar firms which do not expect to grow. These are economically (and statistically) significant increases compared to firms that do not expect to grow, which have probabilities of 19.5, 13.3, 21.3, 19.5, 15.4 and 32.9 percent for the respective investment plans. In terms of rationality, growth expectations (and investment plans) symmetrically adjust downwards following a negative growth surprise and upwards following a positive surprise consistent with rational growth expectations.

Regarding (ii), controlling for growth expectations and firm/industry effects, states of financial rejection and discouragement directly reduce the likelihood of some types of capital-, innovation- and skills-investment plans (consistent with higher information costs). For discouraged borrowers, relative to 'fully funded' firms, the direct reductions in the likelihood of investment plans in fixed capital and leadership development are 8.8 and 8.1 percentage points respectively. For rejected borrowers, the direct reductions for capital investment and workforce-skills development are 9.8 and 23.7 percentage points, respectively. However, a state of no-external finance needs directly and indirectly reduces the likelihood of a wider range of capital-, innovation- and skills-investment plans suggesting demand-side issues (debt/control aversion and low-growth ambition) are more pervasive. The total (direct and indirect) reductions in the likelihood of investment plans for firms with no external-finance needs relative to otherwise similar 'fully funded' firms are 18.2, 16.8, 23.6, 14.6, and 14.9 percentage points for capital, product-innovation, process-innovation, leadership-skills and workforce-skills investment plans respectively. These are economically (and statistically) significant reductions relative to the investment-plan probabilities of 'fully funded' firms, which are 35.4 percent (capital), 36.7 percent (product-innovation), 38.5 percent (process-innovation), 27.9 percent (leadership skills) and 45.9 percent (workforce skills) respectively. Risk aversion results in a 9.8 percentage point reduction in the likelihood of R&D investment plans (against an R&D probability for 'fully funded' firms of 15.1 percent) and a 9.3 percentage point reduction in the probability of process-innovation development plans.

Our findings suggest addressing low-growth expectations is important in view of the significant negative impact on investment plans in general but especially on (productivity-enhancing) innovation activities. However, reflecting rational growth expectations, firms require positive signs of actual growth before revising upwards their growth expectations (and increasing the likelihood of investment plans).

Evidence of supply-side financing issues affecting some types of investment plan among discouraged and rejected borrowers provides support for policies aimed at improving the supply of finance in small-business finance markets. However, the predominant issues across all types of investment plan are on the demand side among firms with no external-finance needs (affecting investment plans both directly and indirectly). Moreover, innovation-investment plans are the most severely affected by demand-side financing issues (debt/control aversion and low-growth ambition). Addressing low-growth ambition among firms with no external-finance needs would help raise growth expectations, reduce debt/control aversion and increase investment propensity.

Additional findings indicate the negative direct effects of financial discouragement and rejection on investment plans (holding growth expectations constant) are greater (in magnitude) for women-led businesses, supporting policies aimed specifically at improving female entrepreneurs' access to finance. Our results also suggest growth expectations among ethnic-minority led businesses are scarred by negative financing experiences (i.e., discouragement and rejection), with an absence of similar scarring effects among businesses with White-British owners, supporting initiatives to increase lending by Community Development Finance Institutions. Finally, firms which export products are more likely to plan for investment, supporting policies aimed at encouraging more small firms to export.



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