



# RSA

Action and Research Centre

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## The Second Age of Small

Understanding the  
economic impact of  
micro businesses

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The RSA in  
partnership with

Etsy

## About the RSA

The RSA (Royal Society for the encouragement of Arts, Manufactures and Commerce) believes that everyone should have the freedom and power to turn their ideas into reality – something we call the Power to Create. Through our research and 27,000-strong Fellowship, we seek to realise a society where creative power is distributed, where concentrations of power are confronted, and where creative values are nurtured. The RSA's Action and Research Centre combines practical experimentation with rigorous research to achieve these goals.

## About Etsy

Etsy is a marketplace where people around the world connect, both online and offline, to make, sell and buy unique goods. The heart and soul of Etsy is our global community: the creative entrepreneurs who use Etsy to sell what they make or curate, the shoppers looking for things they can't find anywhere else, the manufacturers who partner with Etsy sellers to help them grow, and the Etsy employees who maintain and nurture our marketplace.

# Executive summary

The UK's micro business population is booming. Defined as firms with 0-9 employees, there are now 5m such businesses in the UK, up from 3.5m in 2000. In contrast, the populations of all other firm sizes have either increased only marginally or fallen over the same period. The result is that micro businesses today account for 33 percent of private sector employment and 19 percent of total output. The RSA has described this trend as the 'second age of small', in reference to the fact that cottage industries were once the norm in pre-industrial Britain.

But is this something we should laud or lament? While the enthusiasm for micro businesses is widespread – stretching throughout politics, media and popular culture – there is still a vocal minority who express disquiet over this economic trend. A key point made by the critics is that large micro business populations are characteristic features of poor countries, not rich ones. Indeed, the developmental economist Simon Kuznets long ago argued that small firms would diminish in number and be replaced by large ones as countries became more prosperous. So is the micro business phenomenon a sign that our economy is going backwards rather forwards?

This report looks more closely at the evidence and concludes that Kuznets and his academic successors have been unfair in their unfavourable appraisal of small firms. This becomes clear when we examine three economic issues in particular:

**Productivity** – Government data shows that the productivity of very large firms (as measured by revenue per worker) is on average more than twice as great as that of micro businesses. However, this analysis does not take into account the high degree of churn within the small firm community, with half of people starting up in business never making it to their third anniversary. Were we to look only at long-standing firms that have found their footing, the overall financial health of the micro business population would look significantly better. Another caveat is that productivity among firms varies enormously by industry. When we exclude sole traders from our analysis, we find that micro businesses have higher productivity levels in nine of the 19 fastest growing industries, scoring particularly well in sectors where relationships are important, such as education, health and social work.

**Innovation** – The latest results of the UK Innovation Survey suggests that small firms struggle to innovate, with just 13 percent engaging in internal R&D compared with 23 percent of large firms. But there is evidence that small firms are more efficient at innovation, meaning they create more innovations for every unit of R&D expenditure as well as extract more financial value from these developments. It is also important to acknowledge that the very nature of innovation is changing. Investment in 'intangible' innovation – the generation of new concepts, designs and experiences – has grown at a much faster rate than spending on tangible innovation since 1990. This is important because micro businesses are arguably better placed to engage in the new kind with its lower resource requirements.

**Employment** – Employment opportunities within micro businesses appear bleak at first sight. Workers tend to be paid less, engage in training less frequently and have fewer protections such as extra maternity pay and extended pension coverage. However, the latest results from the Workplace Employment Relations Study finds that micro business employees are the most satisfied group of workers in the labour market, scoring highest on several indicators such as job control, influence in decision-making, loyalty to the business and even satisfaction with pay. Moreover, micro businesses are more likely to employ individuals on the economic margins, including migrants, disabled people and the recently unemployed.

Whether looking at productivity, innovation or employment, micro businesses clearly fare better than some believe. But even still, we should question the extent to which conventional economic indicators capture their true value. Micro businesses bring colour and diversity to our economy, but this is difficult to articulate through facts and figures. We should also recognise that the people running micro businesses have different objectives, not all of which involve creating a highly efficient and innovative company. One example is of the hundreds of thousands of micro social enterprises that put purpose before profit, or the many over 65s in self-employment who started a business for personal enjoyment rather than financial gain.

The clear message is that the rise of micro businesses is nothing to be feared. Rather, this trend should be taken as the sign of a prosperous nation transitioning into a different kind of economy. While it is true that rates of self-employment are high in poor countries like Greece and Spain, they are also high in rich countries such as New Zealand and Holland. The question is why micro businesses are thriving today, and in particular within the UK. The most obvious reason is the emergence of new technologies. The advent of the internet and the increasing sophistication of computing have dramatically reduced the cost of doing business. Developments in manufacturing and transportation technology also mean it is becoming easier for producers to make and ship products on a smaller scale.

Yet technology is just one among many drivers making micro businesses more viable. Rising skill levels, for example, mean that people have never been better equipped to work for themselves. The proportion of the self-employed workforce with a degree or equivalent has risen from 20 to 28 percent since 2001. Another driver is government policy. Since the early 1980s, every government in the UK has sought to stimulate entrepreneurial activity, including via deregulation drives and tax cuts. Today the UK Corporation Tax rate stands at 21 percent, down from 50 percent in 1980. Changing consumer behaviour is another important factor. Micro businesses thrive in the fast growing industries of education and health, and are arguably better placed to cater to new demands for niche goods and personalised services.

Whether it is the result of new technologies, changing consumer habits or the introduction of pro-business policies, micro businesses are becoming more prominent in our economy. However, this is not to say that large businesses are waning – far from it. Firms with more than 250 employees still account for half of all economic output in the UK. We are seeing

an economy emerge in which the very small and very big – the minnows and the mammoths – are able to live alongside one another for mutual advantage. The Department for Business, Innovation and Skills estimates that over half of SMEs network with large companies, and that a quarter are involved in research and development partnerships.

Our concern is that the balance of power between small and large firms has become skewed in some sectors with the emergence of oligopolies (markets where a handful of firms dominate). According to one study, the top five companies own 89 percent of the market share in airlines, 70 percent in supermarkets, 80 percent in cinema screens and 91 percent in video games. While every industry is different, there is evidence to suggest that oligopolies can have a malign impact on consumers, small suppliers, innovation activity and the political process. This report therefore argues that economists and policymakers need to shift their gaze to what is happening at the larger end of the economic spectrum rather than be preoccupied with the growth of micro businesses.

To be clear, the problem does not lie with large firms per se, but rather the disproportionate control that some have over their markets. The challenge for the government and others is to find the ideal level of concentration that allows for both big and small businesses to flourish for the benefit of consumers, workers and entrepreneurs alike. While policymakers have in the past called for a rebalancing of the economy in terms of sectors, this report finishes by calling for a rebalancing in terms of market concentration. Indeed, it is important to recognise that the economy we live in is not predetermined, but rather a system that can be shaped if there is enough will to do so.

### **Box 1: Five things they don't tell you about micro businesses**

- 1. Micro businesses excel in sectors based on relationships** – Micro businesses (excluding sole traders) are 4 percent more productive than the sector-wide average in human health activities, 20 percent in education and 38 percent in social work.
- 2. A third of microbusinesses consider themselves to be social enterprises** – 33 percent of micro businesses (excluding sole traders) consider themselves to be social enterprises, despite only five percent fitting the official definition.
- 3. Half of micro business owners are in highly skilled occupations** – 47 percent of self-employed workers (ie those running micro businesses) are in highly skilled positions (professional and technical positions) compared with 43 percent of employees.
- 4. Micro business employees are the most satisfied workers** – Micro business employees score highest on most indicators of job satisfaction, including influence over their job, involvement in decision-making and good relations with management.
- 5. Micro businesses are a gateway into the labour market for disadvantaged groups** – The long-term sick, the disabled, migrants and the recently unemployed are all overrepresented in micro businesses. Moreover, many micro business owners say they chose to work for themselves so they can manage a mental or physical condition.

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# Going full circle

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## The new normal

Few economic trends have done more to catch the public imagination than the rise in the number of micro businesses (classed as firms with 0-9 employees). Their number has swelled by over 50 percent in the last 15 years, from 3.5m in 2000 to 5m today.<sup>1</sup> In contrast, the populations of all other firm sizes have either only increased marginally or fallen over the same period (see Figure 1 below). Medium-sized businesses have grown in number by just 17 percent, and there are 6 percent fewer large businesses today than there were at the start of the century. The result is that micro businesses now account for 96 percent of all private sector firms in the UK, 33 percent of employment and 19 percent of revenue. Nor does this expansion show any sign of slowing down. Last year alone, the micro business population grew by 500,000.

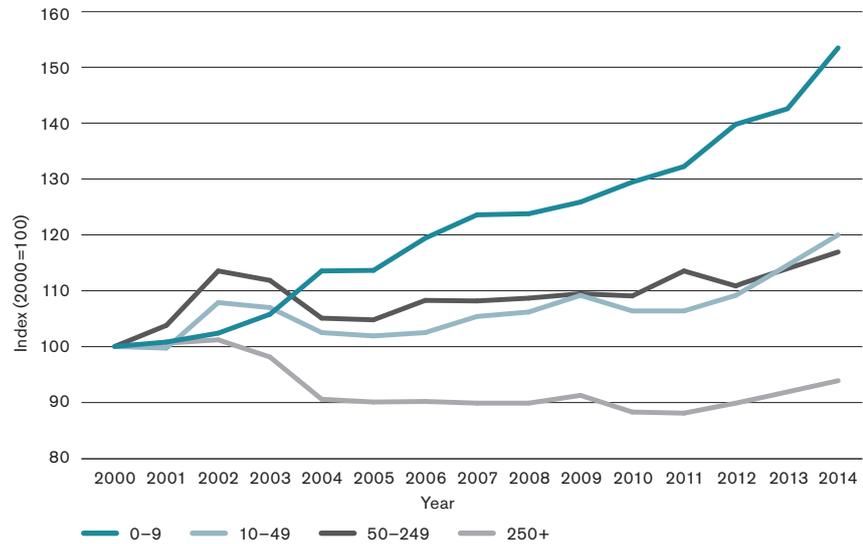
The same story is mirrored in the growth of the self-employed population, almost all of who run micro businesses (see Box 2 below for clarification of definitions). According to the latest government figures, the number of people who work for themselves has grown by 40 percent since 2000, with the result that one in seven of the workforce is now self-employed.<sup>2</sup> In contrast, the number of typical employees increased by just 8 percent over the same period. Some have argued that this boom is simply a response to the downturn that began in 2008, and that once the economy returns to full health the newly self-employed will down tools and move back into conventional jobs, leaving their micro businesses behind them. However, this ignores the fact that the size of this community has grown nearly every year since the turn of the century – long before the financial crisis set in.

These trends have led some to claim that the UK is entering a new era for small businesses. A recent government report by Lord Young, for example, proclaimed this to be a ‘golden age for small firms’, and pointed to the emergence of new technologies and a more promising cultural attitude to entrepreneurship as its foundations.<sup>3</sup> Echoing this sentiment, David Cameron has described small businesses as being ‘the lifeblood of our economy’, while Labour has vowed to ‘unleash the full potential’ of small businesses.<sup>4</sup> The enthusiasm for entrepreneurship is not limited to politicians. According to the latest results from the Global Entrepreneurship Monitor, close to 80 percent of people in the

1. RSA analysis of the Business Population Estimates 2014.
2. RSA analysis of the Labour Force Survey (Sep-Nov 2014).
3. Lord Young (2015) *The Report on Small Firms 2010-2015*.
4. Cameron, D. (2014) Supporting small businesses [Speech] Cabinet Office: 27 January 2014; and Labour (2015) *Labour's plan to back Britain's small businesses* [Press notice] Labour: 15 February 2015.

UK now believe that entrepreneurs have a high level of status and respect in society, while 57 percent think most people see starting a business as a good career choice.<sup>5</sup>

**Figure 1: Increase in the number of businesses by firm size**



Source: Business Population Estimates 2010–14 and BIS SME Statistics 2000–09

### Box 2: A note on definitions

The term 'micro business' has different meanings to different people. For the purposes of our research, we follow the most widely recognised definition as set out by the government's Business Population Estimates programme:<sup>6</sup>

- Micro businesses – 0-9 employees (ie includes one-person businesses)
- Small businesses – 10-49 employees
- Medium businesses – 50-249 employees
- Large businesses – 250-499 employees
- Very large businesses – 500 plus employees

This report is mostly concerned with '**micro businesses**', given their rapid expansion in recent years. We occasionally refer to the term '**small businesses**', but only in its broadest sense rather than the specific definition of a firm with 10-49 employees. We do so because many academics, journalists and politicians continue to use this as a catch-all label for any business that is at the smaller end of the spectrum.

We will also frequently refer to the '**self-employed**' when talking about the people who run micro businesses. By this we mean any individual who works for themselves, whether they are a freelancer, sub-contractor, sole trader or company director. Anyone who runs a micro business is classed as self-employed, regardless of whether or not they employ people or are registered with Companies House.

5. Hart, M. et al. (2015) *Global Entrepreneurship Monitor: United Kingdom 2014 Monitoring Report*. University of Strathclyde and Aston Business School.

6. Department for Business, Innovation and Skills (2014) *Business Population Estimates for the UK and Regions 2014*. London: BIS.

## The retelling of an old tale

While the rise of micro businesses may constitute a significant shift in our economy, it is important to recognise that we have seen this phenomenon before – albeit many years ago and on a much larger scale. Prior to the industrial revolution that began in the early 19th century, the vast majority of people worked on their own account or in small teams of agricultural labourers, and large businesses were few and far between. At the dawn of the 18th century, it is estimated that 75 percent of the population made its living off the land.<sup>7</sup> Small-scale production was even the norm in the relatively sophisticated industries of metal production, lock-making, cobbling and coal mining. There are no available figures for rates of self-employment in the UK prior to the 20th century, but we know that over 60 percent of people in France – a country with a comparable economy – worked for themselves in 1800.<sup>8</sup>

This changed with the emergence of new technologies, which upended traditional working patterns and industries. New methods in agriculture – a sector that had been based on smallholdings for hundreds of years – paved the way for the enclosure of common land into larger plots, such that farming could be done on a much bigger scale. Other industries experienced a similar overhaul. The invention of tools such as the water frame, spinning jenny and flying shuttle allowed for more efficient and large-scale textiles production. These machines, combined with new power sources such as water and steam, led to the creation of the first factories. Richard Arkwright's cotton mills in Nottingham employed nearly 600 people in the 1770s, while James Watt's metal works in Soho had a 1,000 strong workforce – figures that would have been hard to comprehend just a few decades earlier.<sup>9</sup>

If the 18th and 19th centuries were the periods when big was born, the 20th century was the era when big went mainstream. The economist Carlota Perez points to the advent of the 'Age of Oil' as the turning point when the modern day corporation became possible.<sup>10</sup> Oil gave industry both the energy and raw materials it needed to manufacture goods en masse, as well as the fuel necessary to distribute them. No product symbolised this era better than Henry Ford's Model T car, which by 1916 had reached half a million sales and become affordable to the masses. The advent of scientific management in the early 20th century played an equally important role in the scaling up of industrial production. Economists like Ronald Coase wrote extensively about the waste of 'transaction costs' that happen when small firms trade (eg the cost of searching for a product and agreeing a price), and argued that it would be more efficient instead to bring a greater number of activities under the umbrella of a single firm.<sup>11</sup>

7. Kreis, S. (2002) 'Lecture 17: The origins of the industrial revolution in England' in *The History Guide*. Available: <http://www.historyguide.org/intellect/lecture17a.html>

8. Wennekers, S., van Stel, A., Carree, M. and Thurik, R. (2010) 'The relationship between entrepreneurship and economic development: Is it u-shaped?' in *Foundations and trends in Entrepreneurship* Vol 6 (3).

9. White, M. *The Industrial Revolution*. London: The British Library. Available: <http://www.bl.uk/georgian-britain/articles/the-industrial-revolution>

10. Perez, C. (2009) 'Technological revolutions and techno-economic paradigms' in *Technology, Governance and Economic Dynamics* Vol 20.

11. Coase, R. (1937) *The Nature of the Firm*.

As a result of these technological and intellectual forces, big business came to be viewed as the ideal economic unit of production for most of the 20th century. Even Joseph Schumpeter, the founding father of the entrepreneurial movement, eventually believed that economic prosperity lay with large firms. In 1942 he wrote, “What we have got to accept is that the large-scale establishment has come to be the most powerful engine of progress.”<sup>12</sup> Similarly, the economist John Kenneth Galbraith mocked the “no more pleasant fiction than that technological change is the product of the matchless ingenuity of the small man”.<sup>13</sup> These views were vindicated by the fact that the small business population had reduced markedly over the course of the century. In 1965 only 8 percent of the UK population were self-employed, and by the early 1970s only 800,000 micro and small businesses remained.<sup>14</sup> The government’s 1971 Bolton Report went so far as to claim that the small business community was in terminal decline.<sup>15</sup>

### The Second Age of Small?

Yet the Bolton Report’s ominous forecast never came to be. In fact, beginning in the 1970s a collection of dissenting voices began to challenge the intellectual and cultural dominance of the large firm. Perhaps the best known is E. F. Schumacher, who, in his book *Small is Beautiful*, lamented that his generation suffered from “an almost universal idolatry of gigantism”, and instead called for “production by the masses, rather than mass production”.<sup>16</sup> While Schumacher theorised about the economy as a whole, other scholars took on specific issues with empirical studies. In 1979 the economist David Birch published the first of a number of papers supposedly showing the important role that small businesses played in generating employment. In one study, he argued that the smallest firms created close to 90 percent of all jobs in the US between 1981 and 1985.<sup>17</sup> Similarly, the economist David Audretsch wrote extensively in the 1990s defending the capacity of small businesses to innovate.<sup>18</sup>

The findings of these studies in turn fed into politics and government, with several distinct phases of small business policy emerging over the following decades.<sup>19</sup> The 1970s were the ‘policy-off’ period when the state barely had an agenda for enterprise, particularly when compared with the extensive planning in place for large-scale industries. This changed with the arrival of Margaret Thatcher, who saw entrepreneurship as both inherently valuable and critical to moving the UK economy away from manufacturing and towards services. The introduction of the original Enterprise Allowance in the early 1980s, which gave unemployed people a stipend of money to start up in business, was characteristic of the emerging pro-enterprise agenda. Such sentiments grew throughout the 1990s and 2000s, including

12. Schumpeter, J. (1942) *Capitalism, Socialism and Democracy*. New York: Harper and Row.

13. Galbraith, J. K. (1956) *American Capitalism*. Boston: Houghton Mifflin.

14. The self-employment figure is cited in Wennekers, S. van Stel, A., Carree, M. and Thurik, R. (2010) Op cit. The micro and small business figure is cited in Lord Young (2013) *Growing Your Business: A report on growing micro businesses*.

15. Lord Young (2015) Op cit.

16. Schumacher, E. F. (1973) *Small is Beautiful*.

17. Birch, D. L. (1987) *Job creation in America: How our small companies put the most people to work*. New York: Free Press.

18. See for example Audretsch, D. and Acs, Z. (1990) *Innovation and Small Firms*. MIT Press.

19. For more information see Greene, F., Mole, K. and Storey, D. (2004) ‘Does more mean worse? Three decades of enterprise policy in Tees Valley’ in *Urban Studies* Vol. 41 (7).

under New Labour, which saw self-employment as a route into work for marginalised groups such as the disabled. Thus, small businesses were viewed not just as an economic force but also a social one.

The enthusiasm for entrepreneurship today is unparalleled in modern UK history. Most major newspapers have a business section extolling the virtues of entrepreneurship, and it is increasingly the norm for universities to support their graduates into self-employment.<sup>20</sup> The mantle of enterprise has even been taken up by celebrities such as Dr Dre and Ashton Kutcher who have made millions from their own start-ups. Compare this to the general public's growing dissatisfaction with large firms. A recent Populus poll, for example, found that 61 percent of people want the next government to be tougher on 'big business', and that the majority believe the country has more to fear from the actions of big business than trade unions.<sup>21</sup>

### **The purpose of this report**

None of this is to say that micro businesses will come to dominate the economy, nor that most people will move into self-employment. But what is clear is that the UK is witnessing a revival of small firms, in what might be described as the 'second age of small'. The question is whether this is a trend to be lauded or lamented. Previous RSA research has looked at this issue from the perspective of the people directly involved (ie the self-employed), and found that the vast majority are happier at work and more satisfied with their lives overall – despite the multiple hazards involved.<sup>22</sup> But what about the wider economy and society? While self-employment may be a good thing for individuals, does this mean that the UK is better off with more micro businesses? As we shall see, there are still many economists who hold deep reservations about this changing landscape, particularly those on the left of the political spectrum.

The problem with the debate as it stands is that viewpoints tend to be based on hunches or educated guesses rather than detailed research. Few studies have sought to dig deep into the data and look at how micro businesses fare in the real world. In a bid to plug this gap, the RSA in partnership with Etsy has sought to pull together the existing evidence and bolster this with fresh analysis of government datasets. We hope this report adds more nuance to the question of whether it is a good thing to be entering a second age of small, and leaves policymakers and civil servants in particular with a clearer sense of how they should respond. To be clear, this is not an academic exercise. How people perceive of the macro economic and social impact of micro businesses will help to determine the trajectory of government policy in a number of areas, including regeneration, innovation, jobs growth, education and international trade.

20. Only 12 higher education institutions say they provide no opportunities for enterprise learning. See APPG for Micro businesses (2014) *An Education System fit for an Entrepreneur*. London: Parliament.

21. Parker, G. (2014) *Voters turn against big-business culture, claims Populus survey*. London: Financial Times.

22. Delloit, B. and Reed, H. (2015) *Boosting the Living Standards of the Self-employed*. London: RSA.

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# A golden age or false dawn?

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## Caution from Kuznets and co

With all the fanfare surrounding entrepreneurship, it would be easy to believe there is now a consensus that a growing micro business community is good for the UK economy. Such a conclusion, however, would be wrong. While the enthusiasm for micro businesses is widespread – stretching throughout politics, media, education and wider society – there is still a vocal minority which express disquiet over this economic trend, not least within academia. A number of research papers and books have argued that our faith in small firms is misplaced, with titles such as *The Illusions of Entrepreneurship* and *Muppets and Gazelles*.<sup>23</sup> Mainstream economists also harbour doubts. Speaking at our Self-employment Summit at the start of 2015, Will Hutton described the growth in micro businesses as “part of a picture of capitalism that is seriously dysfunctional,” while Vicky Pryce expressed concern that this phenomenon would “put us on a lower productivity path” for the foreseeable future.<sup>24</sup>

A key point made by the critics is that large micro business populations are characteristic features of poor countries, not rich ones. Self-employment rates in Europe are particularly high among the Mediterranean countries, which have relatively low levels of GDP per capita. 37 percent of workers in Greece are self-employed, 25 percent in Italy and 18 percent in Spain.<sup>25</sup> In contrast, the more developed nations of Germany, Sweden and Norway exhibit self-employment rates of 11 percent, 11 percent and 7 percent, respectively.<sup>26</sup> This suggests that a growing number of micro businesses may be indicative of a troubled economy – one that is going backwards rather than forwards. Indeed, the developmental economist Simon Kuznets long ago argued that self-employment rates would fall as countries developed their industrial capacities and improved their GDP per capita.<sup>27</sup>

In this chapter we look at whether Kuznets and his academic successors were correct in their unfavourable appraisal of small firms. Are

23. Shane, S. A. (2008) *The Illusions of Entrepreneurship: The costly myths that entrepreneurs, investors and policymakers live by*. Yale University Press; and Nightingale, P. and Coad, A. (2014) ‘Muppets and Gazelles: political and methodological biases in entrepreneurship research’ in *Industrial and Corporate Change*. Vol 23 (1).

24. Accessible: <https://www.youtube.com/watch?v=19laf7bgn28>

25. RSA analysis of 2013 OECD data. 2013 is the most recent year for which data is available.

26. Ibid.

27. Kuznets, S. (1971) *Economic growth of nations, total output and production structure*. Harvard University Press.

they really inefficient and lightweight? Is it true that they do not have the resources to innovate? And do they only create poor quality jobs? As we shall see, there are many nuances in this debate that are crucial to understanding the bearing micro businesses have on our country’s prosperity, yet which are often overlooked. We begin with an assessment of perhaps the biggest weakness in the UK economy – productivity.

## Productivity

The US economist Paul Krugman once said that “productivity isn’t everything, but in the long run it’s almost everything”.<sup>28</sup> Productivity, in short, is the amount of labour it takes to create a given unit of output, whether that is making a car, sewing a dress or diagnosing a patient. The higher productivity rises, the more output we produce and the more prosperous our society becomes (assuming a reasonable distribution of the proceeds). The problem is that the UK has performed relatively poorly of late on this major economic indicator. According to the Office for Budget Responsibility, productivity in the UK fell during the recession and in 2014 was still 3 percent lower than in 2008.<sup>29</sup> What makes this especially puzzling is that productivity growth in the UK usually picks up shortly after recessions. Even more concerning is that other developed countries have fared much better, such as the US whose overall productivity level in 2014 was 8 percent higher than in 2008 (see Table 1).

**Table 1: Change in productivity among comparable countries (2008-2014)**

UK	France	Germany	US	Canada	Japan
-3%	2%	-2%	8%	5%	0%

Source: Analysis of OECD data by the Office for Budget Responsibility

Theories abound as to the causes of our productivity puzzle.<sup>30</sup> Some believe it is a result of lacklustre business investment, with few firms ploughing money into game changing technologies. Others point the finger at financial institutions, which they consider to have hoarded cash unfairly and thereby prevented businesses from accessing growth capital. What unites these disparate voices is their belief that the solution to our productivity woes lies in large firms, not small ones. The reason is textbook economics: large firms are in theory more productive because they can achieve economies of scale and allow workers to specialise in different roles – something Adam Smith recognised 240 years ago when he used the example of the pin factory. Large businesses are able to bulk buy raw materials, spread the cost of marketing and secure better terms on loan repayments. Economies of scale are thought to be particularly important in sectors like

28. Krugman, P. (1992) *The Age of Diminished Expectations: US economic policy in the 1980s*. MIT Press.

29. Office for Budget Responsibility (2014) *Economic and Fiscal Outlook*. London: OBR.

30. See for example Broughton, N. and Richards, B. (2014) *Growing Businesses*. London: SME.

manufacturing where there are high ‘sunk costs’ that cannot be easily recovered, such as the purchase of heavy machinery.

How much of this theory translates into practice? Straightforward analysis of government data appears to corroborate the view that large firms are more productive than their smaller counterparts. The government’s Business Population Estimates (BPE) show that revenue per employee in very large firms (500 plus employees) is more than twice as great as in micro businesses (see Table 2). Moreover, the productivity of micro businesses has fallen by 17 percent since 2001. The result is that, while micro businesses now make up a greater proportion of the overall business population and employ a greater percentage of the workforce, their total share of economic turnover has remained broadly the same since 2002. In contrast, very large firms are now responsible for 47 percent of overall revenue in the UK, up from 40 percent a decade ago. One prominent economic blogger, Flip Chart Rick, likens the scenario for small firms to a nature documentary, where ‘more and more animals appear, desperate to drink from a shrinking water hole’.<sup>31</sup>

**Table 2: Revenue per employee (£1,000s)**

Micro (0-9)	Small (10-49)	Medium (50-249)	Large (250-499)	Very large (500+)
£79	£135	£155	£193	£185

Source: RSA analysis of the Business Population Estimates 2014

The same story is confirmed by other data. For example, the Labour Force Survey finds that few of the self-employed describe themselves as being the ‘sole director’ of a limited company (9 percent), with the majority using the more humble label of ‘working for themselves’ (65 percent).<sup>32</sup> In fact, most of the self-employed do not employ anyone, and of these only a quarter are registered for VAT.<sup>33</sup> For some, these are clear indications that most micro businesses and the people behind them are inefficient, adding little to the UK’s productive capacity and even acting as a drain on our prosperity. Of course, there will always be a number of high-growth micro businesses that go on to recruit many employees and challenge large firms in their industries, but these are few and far between. The Social Market Foundation estimates that only 3 percent of the UK’s workforce are ‘high-value entrepreneurs’, compared with 7 percent in the US.<sup>34</sup>

Taken together, the impression is that micro businesses are bad for our country’s economic health, and should not be supported by policymakers let alone championed. However, as with other heated debates there is more to it than meets the eye. A more nuanced analysis of the data presents a markedly different picture. The first point to note is that the

31. Toft, S. (2015) *UK Self-employment: success story or basket case?* [blog article] Flip Chart Fairytales, 6 February 2015.

32. RSA analysis of the Labour Force Survey 2015. The LFS survey respondents can select one or more label, including ‘Paid wage or salary by employment agency’, ‘Sole director of own ltd business’, ‘running a business or professional practice’, ‘working for self’ and ‘subcontractor’, among others.

33. RSA analysis of the Business Population Estimates 2014.

34. Broughton, N. and Ussher, K. (2014) *Venturing Forth: Increasing high value entrepreneurship*. London: SME.

method for calculating the revenue of micro businesses has significant shortcomings. The Business Population Estimates draws upon data from the Interdepartmental Business Register (IDBR), which stores up-to-date information on the revenue of micro businesses registered for VAT. This information is also used to estimate the revenue for millions of unregistered businesses. Putting to one side the complications of trying to estimate turnover, the concern is that errors and misreporting on VAT returns may mean we fail to capture the full output of micro businesses. This in turn may lead us to underestimate their productivity. HMRC believes it is owed an extra £12.5bn a year in VAT, the equivalent to 11 percent of the country's VAT liability.<sup>35</sup>

It is also worth recognising the high degree of churn that exists in the micro business community. Many who start up in business will cease trading shortly afterwards, with approximately half dropping out before their third anniversary.<sup>36</sup> The effect of this 'revolving door' phenomenon is likely to bring down average productivity levels for micro businesses, since there will always be a transient cohort who are getting to grips with their market and turning over very little revenue. Were we to concentrate on long-standing firms that have found their footing, the financial health of the micro business population would look better. Indeed, we know from the Understanding Society Survey – which tracks the same respondents over time – that the earnings of the self-employed increase gradually with tenure. People who have worked for themselves for more than four years earn close to 20 percent more than those who have been in business for less than a year.<sup>37</sup> Thus, the productivity of more seasoned micro businesses is likely to be much higher and their overall economic impact more positive.

A third major caveat is that productivity among firms varies enormously by industry. Our analysis of the Business Population Estimates data shows that the average revenue per employee in micro businesses looks more favourable when we look at the **fastest growing sectors** of our economy.<sup>38</sup> When we exclude sole traders (one-person businesses) from the micro business category for the reasons of churn stated above, we find that micro businesses have higher productivity levels than the sector as a whole in nine of the 19 fastest growing sectors, as judged by employment growth between 2010 and 2014.<sup>39</sup> These include office administration, education, health and building services (see Table 7 in the Appendix for the full list). Micro businesses do particularly well in sectors that are bound up in relationships and care. As Table 3 below shows, the productivity of micro businesses in social work is on average 38 percent higher than that for the sector as a whole, while micro businesses in education perform 20 percent better.

Micro businesses do less well when looking at the fastest growing sectors by revenue, but this is because many of these industries involve heavy manufacturing where, unsurprisingly, smaller firms struggle to compete (see Table 8 in the Appendix).

35. HMRC (2014) *Measuring tax gaps 2014 edition: Tax gap estimates for 2012–13*. London: HMRC.

36. Data from Mark Hart's team at Aston University.

37. RSA analysis of the Understanding Society Survey 4 2012/13.

38. RSA analysis of the Business Population Estimates 2014.

39. We have chosen to exclude one-person businesses from our analysis because most of the 'churn' happens among this group. Businesses that reach the stage of employing staff have a lower probability of closure than those who are run by sole traders.

**Table 3: Micro businesses in relational sectors (excluding one-person businesses)<sup>39</sup>**

	Employment growth across whole sector (between 2010 and 2014)	Difference in revenue per employee between micro businesses and sector-wide average
Human health activities	15%	+ 4%
Education	8%	+ 20%
Sports activities	19%	- 1%
Social work activities	39%	+ 38%
Residential care activities	28%	+ 55%
Economy wide	12%	- 31%

Source: RSA analysis of the Business Population Estimates 2014

There is also a geographical element to consider. Evidence shows that small firms are more beneficial than large firms for the local economies in which they operate.<sup>41</sup> This is because their owners are more likely to be situated in the same area, thus keeping money flowing in the surrounding community. In contrast, big firms may extract money by sending profits to shareholders in other parts of the country – something the New Economics Foundation describes as ‘the leaky bucket’ phenomenon.<sup>42</sup> According to the Federation of Small Businesses, every pound spent by a local authority with a local SME generates an additional 63p of benefit for the surrounding community, compared with the 40p generated by large local firms.<sup>43</sup> This is one reason why there are numerous local currencies now in operation – from Brixton to Totnes to Bristol – all of which are geared towards keeping money circulating in the area.

## Innovation

Like productivity, innovation is a key ingredient in creating a healthy economy that can compete on the world stage. For the purposes of this paper, we define innovation as the creation, development and implementation of ideas (a definition endorsed by Nesta, a leading UK authority on innovation). What makes it distinct from general creativity is that the ideas have to be taken up and used, rather than simply remain as ideas. A growing body of evidence indicates that businesses that innovate are more likely to grow (and vice versa), and that spending on innovation is correlated with economic growth.<sup>44</sup> According to Nesta, over 60 percent of productivity growth in the last decade came either directly or indirectly from innovation.<sup>45</sup>

40. We have excluded sole traders (one-person businesses) from the data relating to both micro businesses and the sector as a whole. Were we to include sole traders when calculating the revenue per worker of the latter but not the former, the comparisons would be skewed and micro businesses would look more productive than they in fact are.

41. See for example the New Economics Foundation’s ‘Plugging the Leaks’ project. More information here: <http://www.pluggingtheleaks.org/about/>

42. Ibid.

43. Federation of Small Businesses (2013) *Local Procurement: Making the most of small businesses, one year on*. London: FSB.

44. See Nesta’s research on innovation, for example Nesta (2012) *Plan I: The case for innovation-led growth*. London: Nesta.

45. Ibid.

The concern is that the UK performs poorly on measures of innovation. Investment in innovation fell sharply after the 2008 crash, following an already weak period of innovation spending since 2000.<sup>46</sup> Anecdotal evidence suggests the problem is less to do with invention and more to do with application. For example, while the University of Manchester famously identified a new means of extracting graphene material for commercial use, few UK companies appear to have exploited this technology to create new products.<sup>47</sup> The UK also appears to have a problem of buy-outs, with some of our most innovative firms being taken over and subsumed into international corporations, such as Hewlett Packard's acquisition of the UK software firm Autonomy in 2011, a deal reportedly worth £7.4bn.

**Table 4: Indicators of innovation across different firm sizes**

	10-49 employees	50-99 employees	100-249 employees	250+ employees
Internal R&D	13.2%	19.8%	20.8%	23.3%
External R&D	3.0%	4.7%	5.9%	8.0%
Patents	1.2%	3.3%	3.2%	3.9%
Copyright	1.5%	2.6%	2.5%	3.1%
Trademarks	2.2%	3.6%	4.3%	5.0%

Source: RSA analysis of the UK Innovation Survey 2013

Are micro businesses part of the problem or part of the solution? Mainstream business theory would suggest the former, since it is only large firms that have the resources to invest in research and development (R&D) and the ability to bear the risks involved. Consider the case of the pharmaceuticals industry where it can take as long as 15 years for a drug to go from the lab to the shop floor. The latest results from the UK Innovation Survey suggest there is some truth in the notion that small firms struggle to innovate. Unfortunately, this survey does not collect information on micro businesses, so we must instead look at the next category up – firms with 10-49 employees. Just 13 percent of these have engaged in internal R&D, considerably less than the proportion of the larger firm types (see Table 4 above). Indeed, small businesses score lower on nearly every conventional indicator of innovation activity. Only 1 percent of firms with 10-49 employees say they use patents and just 1.5 percent copyright.

As with productivity, however, the innovation picture is more complicated than it first appears. Look more closely at the data and several caveats come into view. The first is that small businesses appear to be more efficient at innovation, meaning they can create more innovations for every unit of R&D expenditure as well as extract more financial value from these innovations.<sup>48</sup> One indicator of this can be found in the

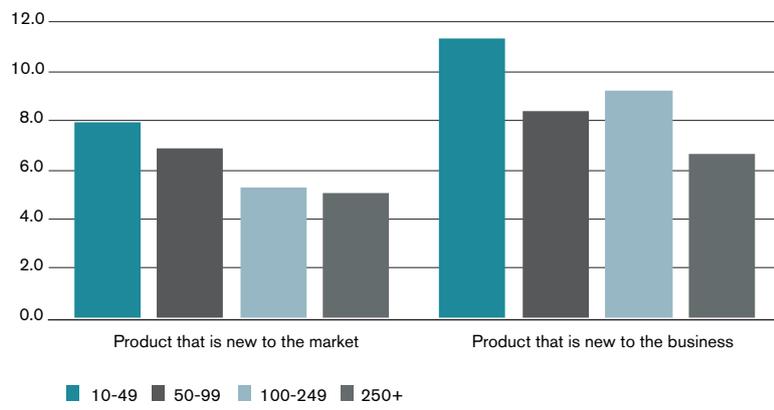
46. Ibid.

47. Chakraborty, A. (2013) *How UK wonder substance graphene can't and won't benefit UK* [article] The Guardian: 3 December 2013.

48. Vossen, R. W. (1998) 'Combining small and large firm advantages in innovation: Theory and examples' in *SOM research report*.

UK Innovation Survey, which shows that the average share of a firm’s revenue that comes from new products is higher in smaller businesses than in firms of larger sizes (see Figure 2 below). This includes products that are wholly new to the market as well as those that are just new to the business. It is unclear why exactly the smallest firms are better at ‘sweating’ innovations, but one theory is that they have greater flexibility to pivot between different strategies, update marketing and rejig structures. In the words of the innovation scholar Frederic Scherer, there are fewer ‘abominable no-men’ that might prevent decisive action being taken.

**Figure 2: Average share of total revenue from product innovation by firm size**



Source: RSA analysis of UK Innovation Survey 2013

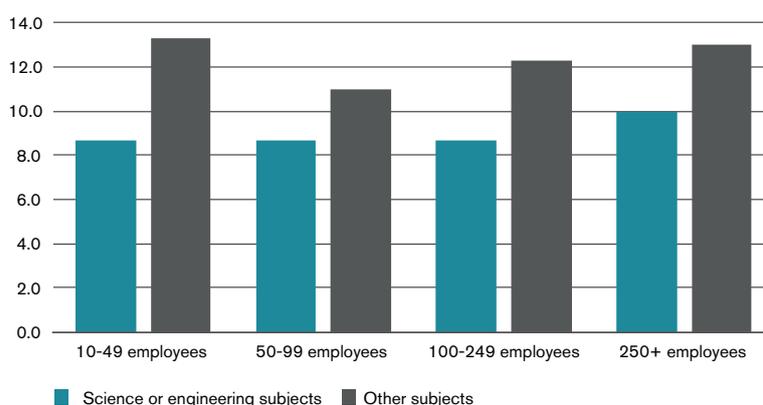
Furthermore, not all innovation has to originate internally within the business. ‘Open innovation’ – so called because it involves firms tapping into the ideas and expertise of other organisations – is often seen as being most useful to large firms like Procter & Gamble, which now aims to source half of its product ideas from the outside world. Yet small firms also benefit significantly from external knowledge. According to the OECD, more than 60 percent of the UK SMEs that engage in innovation cooperate with other firms when doing so.<sup>49</sup> A larger number still are likely to soak up ideas through informal ‘knowledge spillovers’, whether that be via word of mouth or the movement of talented individuals from firm to firm (often from large to small). Indeed, it is a myth that small firms are devoid of highly skilled individuals. The UK Innovation Survey shows that on average they have a higher proportion of graduate employees than larger firms, and have close to the same proportion of employees with a degree in science or engineering (see Figure 3).

To focus only on the quantity of innovation, however, would be to ignore the role that small firms play in generating high quality innovation. According to the US innovation expert Clayton Christensen, large businesses of all kinds face an ‘innovation dilemma’ when it comes to investing in new and disruptive

49. OECD (2014) *Entrepreneurship at a glance 2014*. OECD.

products and services.<sup>50</sup> On the one hand, they want to ensure they are leading the pack in the development of new markets. But on the other, they know that new markets are unlikely to give them the returns they need to sustain their desired rate of growth. This is because ‘disruptive technologies’, such as micro-turbines, distance learning and the internet of things, are initially unattractive to their most profitable and reliable customers. The result is that large organisations typically hold off from entering a new market until it is ‘large enough to be interesting’. In contrast, smaller firms have relatively modest growth targets, meaning they are more likely to invest in disruptive technologies that have low returns at the outset.

**Figure 3: Average proportion of employees that hold a degree or higher, by firm size**



Source: RSA analysis of UK Innovation Survey 2013

Finally, the very nature of ‘innovation’ is changing in a way that may favour smaller businesses. Typically we think of innovation as the development of tangible products – gadgets and devices we can touch and feel. Yet some view intangible innovation as equally, if not more, important.<sup>51</sup> By this we mean the generation of new content, services and experiences, such as a new line of clothing, the redesign of a car, a new music genre or a different approach to personal fitness. Jonathan Haskel at Imperial College London estimates that since 2000, investment in intangible innovations has grown at a faster rate than spending on tangible innovations, partly because of the rise of the service sector where conventional R&D is less common (see Figure 4).<sup>52</sup> Smaller businesses are arguably better placed to engage in intangible innovation, with its lower resource requirements. According to the UK Innovation Survey, they are nearly just as likely as larger firms to be a ‘wider innovator’, meaning they are developing new forms of business structures and marketing concepts.<sup>53</sup>

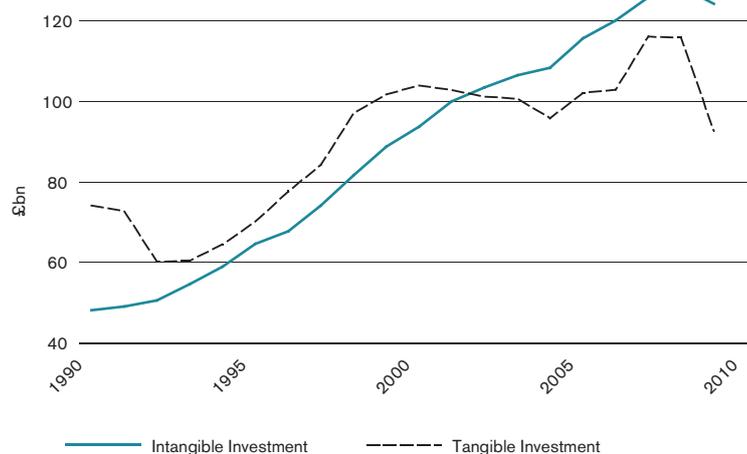
50. Christensen, C. (1997) *Innovator’s Dilemma: When new technologies cause great firms to fail*. Harvard University Press.

51. See for example Stoneman, P. (2007) *An introduction to the definition and measurement of innovation*. London: Nesta.

52. Haskel, J. (2012) *Growth, Innovation and Intangible Investment*. LSE and the Institute for Government.

53. According to the 2013 UK Innovation Survey, 36.2 percent of firms with 10-49 employees are ‘wider innovators’ compared with 38.6 percent of firms with 250+ employees.

**Figure 4: National expenditure on tangible and intangible investment over time**



Source: Haskel, J. (2012) Growth, Innovation and Intangible Investment. LSE.

### Box 3: Three sectors where micro businesses are thriving

Below are three examples of sectors where micro businesses are proving their worth:

**Social work** – Social work encompasses care, counselling and other services aimed at supporting the elderly or disabled in their own home. According to the Business Population Estimates, it is the third fastest growing sector in the UK in terms of overall employment growth.<sup>54</sup> The productivity of micro businesses (excluding one-person businesses) in social work is 38 percent higher than the sector-wide average. They have also been found to provide higher quality care. A forthcoming study by the University of Birmingham shows that micro businesses often deliver more personalised support than larger care firms, in part because they have greater autonomy to vary the service being offered and in part because there is more continuity in the staff that patients see.<sup>55</sup>

**Journalism and media** – The media industry has been transformed by the advent of the internet and proliferation of smart phones, with more people than ever before able to create content and broadcast news stories. The result is that the barriers to running a media business have fallen significantly. There are now more than 28,000 self-employed journalists in the UK, and it is the fastest growing type of self-employed occupation.<sup>56</sup> While some attempt to compete with large newspapers and publishers, the vast majority work with them on a freelance basis. Several platforms like NewsFixed and PayDesk have emerged in recent years to help link suppliers and buyers of media content.

**Construction** – Like any industry associated with property, the construction sector goes through volatile business cycles with extreme booms and busts. Yet this has not prevented some of its smallest firms from thriving. While large businesses are still the most productive, the Business Population Estimates show that the gap between micro businesses (excluding sole traders) and other firm sizes is relatively narrow.<sup>57</sup> For example, very large construction firms (500+ employees) are just 20 percent more productive than micro businesses in this sector.

54. RSA analysis of Business Population Estimates 2014

55. For more information see <http://www.birmingham.ac.uk/research/activity/micro-enterprises/index.aspx>

56. RSA analysis of the Labour Force Survey (Oct-Dec 2014).

57. RSA analysis of Business Population Estimates 2014.

## Employment

The academic David Birch gained considerable attention from his studies in the early 1980s that purportedly showed small firms to be responsible for creating the vast majority of jobs.<sup>58</sup> Indeed, politicians ever since have continued to refer to small businesses as the ‘engines’ of jobs growth, and point to the fact they employ over a third of the private sector workforce as proof.<sup>59</sup>

Yet it was not long after Birch published his first study that his academic peers began to pick holes in the analysis. The main complaint was that, while small firms may create the most jobs in our economy, they are also responsible for destroying the most jobs. This is because of the aforementioned issue of churn, with half of all new businesses folding within three years. More recent analysis by Nesta suggests that it is not small firms that contribute most to job creation but rather young firms that grow rapidly, and only a very small proportion of these. They estimate that 7 percent of businesses accounted for over half of all jobs created between 2007 and 2010.<sup>60</sup> Separate analysis by the Goldman Sachs 10,000 Small Businesses programme pins almost a quarter of the jobs growth in the same period on just 1 percent of all businesses in the UK.<sup>61</sup> While it is true that most of these high-growth young businesses start small, not all small businesses are young.

So should smaller businesses continue to be lauded as job creators? Would it not be better for policymakers to spend their time and energy amplifying the impact of the 7 percent? For some the answer is a resolute yes, since they believe that firms with the highest growth potential can be identified and supported through targeted tax breaks and accelerator programmes. This includes policies like the Enterprise Investment Scheme, Growth Vouchers and the new Help to Grow initiative. Others, however, say it is impossible for the state to pick winners in this way, and that it is better to ‘let a thousand flowers bloom’ in the knowledge that at least some high-growth businesses will emerge. Given the jury is still out on this debate, the least risky approach is to back new business entrants of all kinds. One longitudinal study on firm births and deaths shows that new entrants as a whole tend to add net jobs to the UK economy over time, at least once the initial period of displacing existing firms is over.<sup>62</sup>

As with the discussion on innovation, there is also a qualitative dimension to consider when looking at jobs. On the surface, employment opportunities within small firms appear rather bleak. Wages are on average lower, training is more limited and benefits less generous.<sup>63</sup> For example, micro businesses are less likely to offer additional maternity pay or employer pension contributions beyond their statutory

58. Birch, D. L. (1987) *Job creation in America: How our small companies put the most people to work*. New York: Free Press.

59. According to the Business Population Estimates 2014, businesses with 0-49 employees employ 31 percent of the private sector workforce.

60. See Nesta (2009) *The vital 6 per cent: How high-growth innovative businesses generate prosperity and jobs*. London: Nesta. More recent analysis puts the figure at 7 percent of firms.

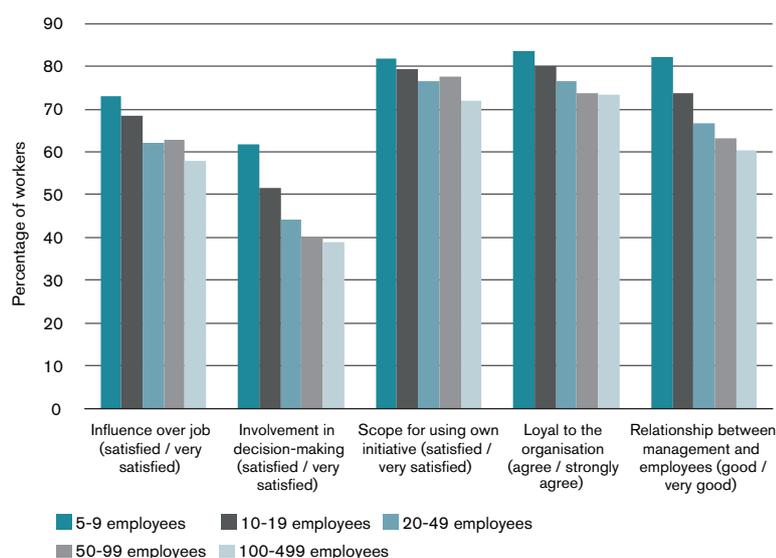
61. Goldman Sachs (2013) *Stimulating small business growth*. Goldman Sachs 10,000 Small Business Programme.

62. Mueller, P. (2008) *The effects of new firm formation on regional development over time: The case of Great Britain*. Max Planck Institute.

63. RSA analysis of the Workplace Employment Relations Study 2011.

obligations. Yet look at **employee satisfaction** rates and the picture flips entirely. The latest results from the Workplace Employment Relations Study shows that micro business employees score notably higher on several measures, including job control, job security, supportive management, involvement in decision-making and general enthusiasm for their work (see Figure 5). The survey also reveals that micro business employees are the group most satisfied with their pay, possibly because there is a narrower pay disparity between staff. A recent study of British firms found that the wage differential between top and bottom earners expands as businesses grow, primarily because the pay of senior managers balloons with firm size.<sup>64</sup>

**Figure 5: Indicators of job quality by firm size**



Source: RSA analysis of Workplace Employment Relations Study 2011

We also need to consider the types of people that micro businesses employ. It is now apparent that small firms play an important role in creating jobs for disadvantaged groups who would have difficulty finding work elsewhere. A study by the Institute of Economic Affairs found that the long-term sick, disabled, migrants and recently unemployed are all over-represented in micro businesses.<sup>65</sup> One potential reason is that smaller firms have greater flexibility to change working practices to accommodate specialist needs. The benefits of flexibility also extend to the owners of micro businesses, not just their employees. Self-employment offers a valuable route into work for people who would struggle to fit into a typical job. We know from the Labour Force Survey, for example, that a higher proportion of the self-employed than employees have a work-limiting health condition (8.5 percent and 5.5 percent respectively).<sup>66</sup> A study by the Work Foundation found that many people choose to work for themselves so they can manage

64. Mueller, H. M., Paige, P. O. and Simintzi, E. (2015) *Wage inequality and firm growth*. NYU Stern School.

65. Urwin, P. (2011) *Self-employment, Small Firms and Enterprise*. London: IEA.

66. RSA analysis of the Labour Force Survey Jul-Sep 2014.

musculoskeletal disorders.<sup>67</sup> Others appear to choose self-employment because it allows them to work whilst coping with a mental illness.<sup>68</sup>

A final point to note is that people may have chosen to start up in business and work for themselves to give them greater freedom to look after loved ones. Our 2014 RSA/Populus survey found that 31 percent of the self-employed think working for themselves is important in allowing them to care for their children, while 37 percent say the same of looking after older relatives.<sup>69</sup> This leads to as much of an economic saving as it does a social benefit. The government spends £14.5bn a year on adult social care in England, while expenditure on pre-primary school care for children amounts to over 1 percent of UK GDP.<sup>70</sup>

#### Box 4: Hidden employment

To employ somebody typically means to recruit them on payroll as a permanent or temporary member of staff. However, many micro businesses choose to employ people on a project-by-project basis. Our 2014 RSA/Populus survey found that 55 percent of the self-employed prefer to work with freelancers for short periods rather than hire them outright. Government surveys are not designed to capture these new methods of recruitment, and may therefore underestimate the impact of micro businesses on job creation.

### Three key take-aways

What have we learned in this chapter? The first conclusion is that **the growth of micro businesses is unlikely to spell negative implications for the UK economy**. On the surface, these firms appear inefficient, incapable of innovation and unable to fully compensate their staff, let alone their owners. Yet look more closely at the data and there is ample evidence that micro businesses make a positive contribution to our economy. For example, they are more productive than the sector-wide average in many of the fastest growing industries, including education, health and social work. They also appear better suited to developing the ‘intangible’ forms of innovation that are becoming more important in our service-led economy. Furthermore, the employees of micro businesses are clearly more satisfied than the workers of other firm sizes, in part because they have greater involvement in decision-making and a stronger relationship with their managers.

The second conclusion is that **we need to appreciate the different purposes of micro businesses**. While some people start up in business to create game changing innovations, others choose to work for themselves for personal enjoyment, or to have the flexibility to look after their relatives. Our segmentation of the self-employed community identified six tribes with very different ambitions, from the Visionaries at one end to

67. Summers, K., Bajorek, Z. and Bevan, S. (2014) *Self-management of chronic musculoskeletal disorders and employment*. London: Work Foundation.

68. According to the Priory Group, over 90 percent of their clients awaiting a mental health diagnosis felt that the stigma around mental health would lead them, or has led them, to consider self-employment. For more information see [www.news.mitrefinch.co.uk/article.aspx?art\\_id=801741326](http://www.news.mitrefinch.co.uk/article.aspx?art_id=801741326)

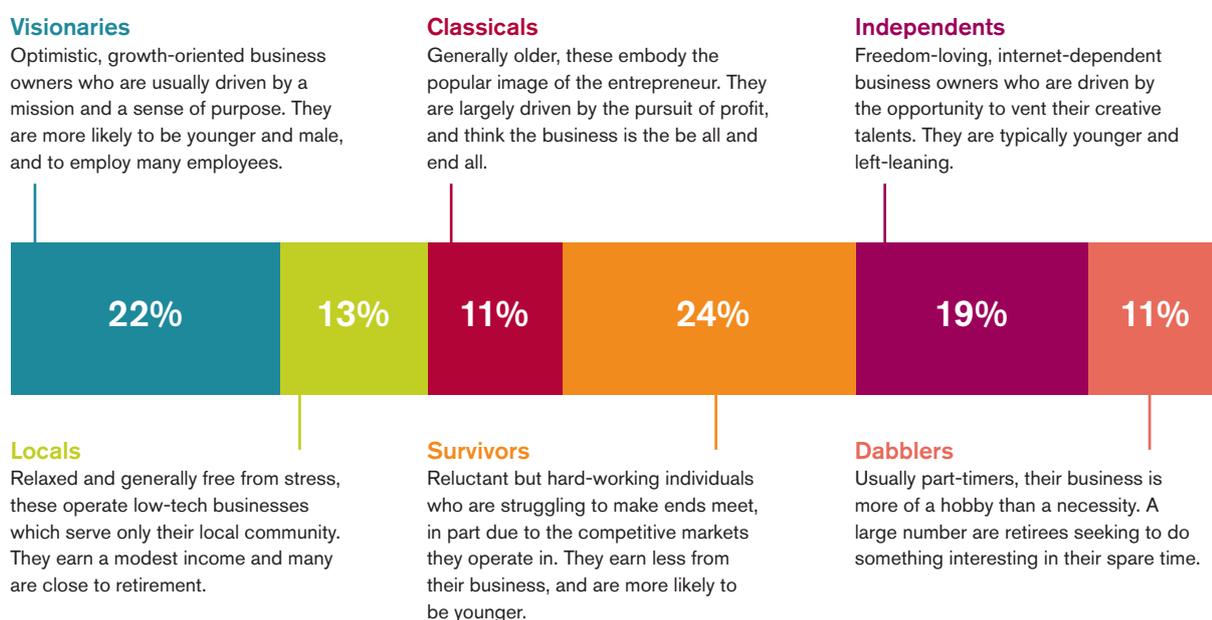
69. Dellot, B. (2014) *Salvation in a Start-up?* London: RSA.

70. The adult social care figure is cited in Dilnot, A. et al. (2011) *Fairer Care Funding*. The child care figure is cited in OECD (2011) *Doing Better for Families*.

the Dabblers at the other (see Figure 6).<sup>71</sup> Therefore in some cases it makes little sense to try and gauge whether a micro business is productive or innovative, given that the owner may not have intended to be either. A good example is the 400,000 over 65s in self-employment, many of whom are running their business solely as a past-time.<sup>72</sup> Another is the thousands of small social enterprises that are putting purpose before profit. According to the government's Small Business Survey, 33 percent of micro businesses (excluding sole traders) consider themselves to be 'social enterprises'.<sup>73</sup>

The third conclusion is that **we require better measurements to make sense of the value of micro businesses**. First and foremost, this means improving existing survey methods so they collect more accurate information. For example, it would be helpful if the Labour Force Survey gathered basic data on the incomes of the self-employed, and if the UK Innovation Survey collected information about the innovation activities of micro businesses. But there is also a wider question as to whether we need to redefine our indicators of economic success. Revenue per employee is a useful way of determining productivity, but on its own fails to capture other important aspects of a healthy economy, such as quality, choice and stability. Would we want doctors or carers to see twice as many people if it meant them being twice as productive? And would it be better to have a high street with just a handful of large chains if it meant prices were marginally cheaper? Economic theory says yes, but human experience tells us otherwise.

**Figure 6: The six tribes of self-employment**



\*Percentages refer to the proportion of the self-employed community who fall into these tribes

Source: This segmentation was created using the results from the 2014 RSA/Populus survey of 1006 self-employed workers. More information can be found in Dellot, B. (2014) *Salvation in a Start-up*. London: RSA.

71. For a more detailed overview of the segmentation see Dellot, B. (2014) Op cit.

72. RSA analysis of the Labour Force Survey 2015.

73. Department for Business, Innovation and Skills (2015) *Small Business Survey 2014: Businesses with employees*. London: BIS.

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# The road to viability

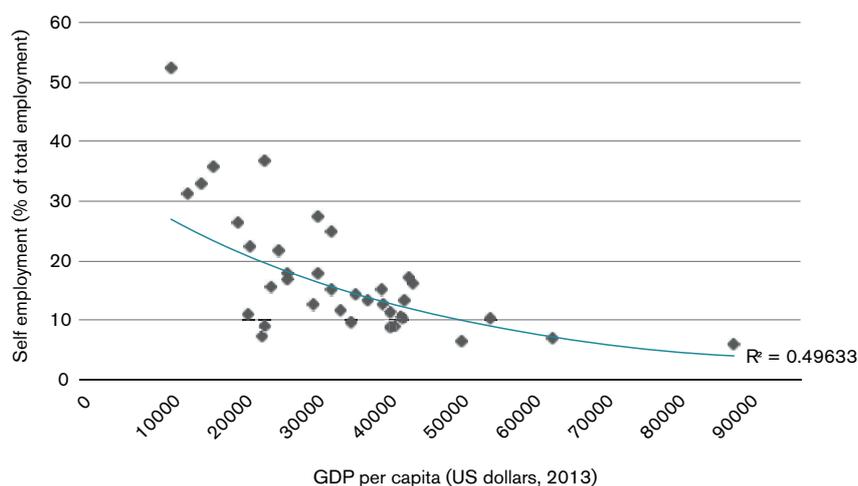
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## Correcting Kuznets

Large numbers of micro businesses are thriving in the UK economy. This begs the question of whether Simon Kuznets was wrong in his belief that small firms would diminish in number as economies became more prosperous. Certainly, a number of modern day economists have drawn this conclusion. The Dutch academic Roy Thurik has argued that there may be a U-shaped relationship between entrepreneurial activity and economic development, such that the prevalence of small firms dips and then grows as GDP per capita increases.<sup>74</sup> In Thurik's view, as countries like the UK become more affluent they gradually transition from a 'managerial' economy to an 'entrepreneurial' one, where the main driver of economic growth derives from smaller economic units rather than large ones. It has also been described as the switch back from a 'Schumpeter Mark II' to a 'Schumpeter Mark I' regime, in which small firms are once again a significant source of innovation.<sup>75</sup>

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**Figure 7: The relationship between self-employment rates and GDP per capita (OECD countries)**



Source: RSA analysis of OECD data

Our own analysis broadly supports this thesis, but reveals a picture that is more complex. When comparing the self-employment rates of different OECD countries by their GDP per capita, we find there is a typical

74. Wennekers, S., van Stel, A., Thurik, R. and Reynolds, P. (2005) *Nascent entrepreneurship and the level of economic development*.

75. Ibid.

curve rather than a U-shaped one (see Figure 7). Here, two main clusters of countries can be observed (if we exclude Norway, Luxembourg and Colombia as outliers). The first group comprises poor and middle-income nations with GDP per capita of between \$12,500 and \$35,000, and with self-employment rates ranging between 7 and 37 percent. This includes Chile, Brazil and Estonia, among others. The second group is made up of richer countries with GDP per capita between \$35,000 and \$57,000, and with a narrower band of self-employment rates stretching from 7 to 17 percent. This group includes the UK, Belgium and France.

What can we conclude from this data? The most obvious finding is that the self-employment rate is on average very high in poor countries, as Kuznets predicted. But the other is that many rich nations also exhibit high rates of self-employment, including New Zealand (15 percent), Ireland (17 percent) and Holland (16 percent). When we look at the fastest growing countries in the OECD, many of these have actually seen their self-employment rates increase, contrary to what Kuznets forecast. In contrast, most of the slowest growing countries (and those in recession) have seen their ratios fall (see Table 5). At the very least, this tells us that the prevalence of micro businesses is not negatively correlated with economic development.

**Table 5: Changes in the self-employment rates of different OECD countries (2000-2013)**

5 fastest growing economies		5 slowest growing economies	
Country	Change in self-employment rate	Country	Change in self-employment rate
Turkey	-15.4%	Greece	-5.1%
Colombia	+0.8%	Italy	-3.49%
Chile	-3.2%	Portugal	-4.3%
Israel	-1.57%	Denmark	-0.1%
Slovakia	+7.6%	Japan	-5.1%

But if small firms are flourishing in some developed economies, why is this the case? And more importantly, why are they thriving in particular within the UK? While it is difficult to identify structural trends as they are unfolding, we have singled out five factors that lie behind the UK's second age of small (see Figure 8). The rest of this chapter examines each of these in turn.

**Figure 8: Five factors fuelling the second age of small**



### Box 5: Measurement mishaps in the US

Despite the widespread assumption that Americans have the greatest entrepreneurial zeal, data from the OECD indicates that, at 6.6 percent, they have one of the lowest self-employment rates in the developed world, behind France, Sweden and even Russia. In fact, the only OECD country where a smaller proportion of people work for themselves is Luxembourg. There is, however, evidence that the OECD may underestimate the level of entrepreneurial activity in the US. For example, the latest findings from the Global Entrepreneurship Monitor reveal that 13 percent of Americans were in the process of starting or running a new business in 2013, the highest rate among the 25 developed countries participating in the survey.<sup>77</sup> While the reasons for these data discrepancies are unclear, they suggest we should be wary of writing off the entrepreneurial spirit of the US.



### People

Why are more people starting up in business? One reason lies in changing values. The American sociologist Ronald Inglehart argues that, since the 1970s, many developed countries have seen a gradual shift away from ‘materialist values’ – where people mainly prize possessions and material objects – towards ‘post-materialist values’ – where people place greater emphasis on self-expression and autonomy.<sup>77</sup> Demographic shifts are also part of the explanation. Close to 30 percent of people are now over the age of retirement and many of these are choosing to start up in business, often in a bid to top up their pension. 40 percent of all over 65s still at work are in self-employment.<sup>78</sup> Also important is the UK’s recent baby boom, with 2012 seeing the highest number of births in over 40 years.<sup>79</sup> The result is a new wave of parents seeking more flexible forms of working and ways to save on childcare costs.<sup>80</sup> Then there is the trend of a high and sustained level of immigration, important because migrants are twice as likely as natives to start up in business.<sup>81</sup>

Yet neither a change in mindsets nor demographic shifts help to explain why micro businesses have become more viable in the UK – only why people are starting them. However, one by-product of these trends is that more highly educated people are moving into self-employment, bringing with them the competencies necessary to run an effective business. According to the Labour Force Survey, the proportion of the self-employed workforce with no qualifications has fallen from 14 to 8 percent since 2001, while the proportion with a degree or equivalent has risen from 20 to 28 percent.<sup>82</sup> The same picture is mirrored in the data on occupational changes, with the biggest increases in self-employment

76. Global Entrepreneurship Monitor (2014) *2013 United States Report*. Babson College.

77. Inglehart, R. F. (2008) ‘Changing values among western publics from 1970 to 2006’ in *West European Politics*, 31(1–2): 130–146.

78. RSA analysis of the Labour Force Survey (Oct-Dec 2014). The figure is 14 percent for 18–64 year-olds.

79. Allen, K. and Warrell, H. (2013) *Baby boom drives UK population growth* [article] *Financial Times*: 8 August 2013.

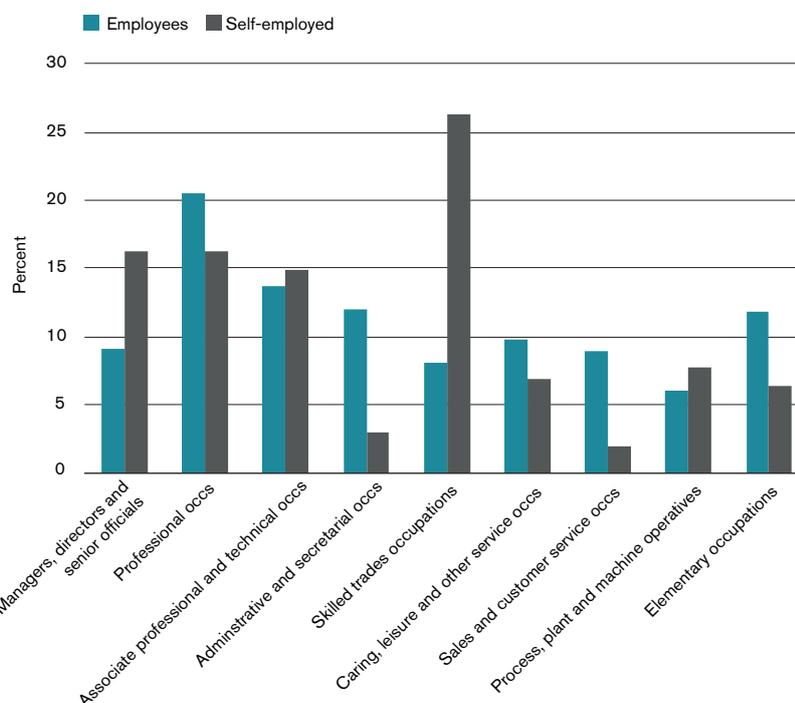
80. A survey undertaken by NatCen in partnership with the Joseph Rowntree Foundation in 2003 found that 47 percent of self-employed mothers said that the cost of childcare was one of the main reasons for deciding to work for themselves. Bell, A. and La Valle, I. (2003) *Combining self-employment and family life*. York: JRF.

81. Levie, J. and Hart, M. (2014) *GEM UK 2012 Report*. Global Entrepreneurship Monitor.

82. RSA analysis of the Labour Force Survey (Jul-Sep 2014).

between 2008 and 2013 being seen in ‘professional’ occupations, one of the highest skilled labour groups.<sup>83</sup> Today, 47 percent of the UK’s self-employed workers are in highly skilled positions, compared with 43 percent of employees (see Figure 9 below).<sup>84</sup> This is clearly at odds with the conventional portrayal of micro businesses as being a refuge for ‘odd-jobbers’.<sup>85</sup>

**Figure 9: Proportion of workers in different occupational groups**



Source: RSA analysis of Labour Force Survey (2013-14)

Moreover, thanks to the internet and its multiple platforms, more people have the opportunity to learn about the world of business, often free of charge. The number of ‘Massive Open Online Courses’ (MOOCs) has swelled to over 10,000, with business and management being two of the most popular subjects.<sup>86</sup> The most sought after course in 2014 was one run by Coursera called ‘Developing Innovative Ideas for New Companies’.<sup>87</sup> Yet MOOCs are just one part of internet-powered knowledge sharing. Online forums, for example, are used by thousands on a daily basis to informally share business insights. A case in point is Etsy, which has its own chat rooms where sellers can exchange information on everything from how to photograph their products to where they can find reputable suppliers.<sup>88</sup> Those selling through online platforms are also

83. RSA analysis of the Labour Force Survey (Jul-Sep 2014). For more information see Dellot, B. (2014) Op cit.

84. Highly skilled positions encompass three occupational groups: managers, directors and senior officials; professional occupations; and associate professional and technical occupations.

85. Philpott, J. (2012) *The rise in self-employment*. London: CIPD.

86. For a good source of information on MOOCs see <http://www.moocs.co/>

87. Shah, D. (2014) *MOOCs in 2014: Breaking down the numbers* [article] edSurge: 26 December 2014.

88. Dellot, B. (2014) *Breaking the Mould*. London: RSA.

exposed to rich ‘feedback loops’, such as customer reviews and a steady stream of data showing who is buying their products, as well as where and when.



## Government

Just as people and their skillsets have changed, so too has government policy. Since the late 1970s, successive governments have championed the cause of small businesses and sought to make their life easier – including by paring back red tape. Only recently, the government promised to scrap 3,000 regulations, and is currently considering whether the self-employed should be exempt from key health and safety rules altogether.<sup>89</sup> As a result of these and other moves, today the UK is ranked eighth place on the World Bank’s Ease of Doing Business table, and ninth place on the World Economic Forum’s Global Competitiveness Index.<sup>90</sup>

Successive governments have also supported micro businesses through significant tax cuts. In 1980, the UK’s corporation tax rate was levied at just over 50 percent of business profits. Yet today it stands at only 21 percent, one of the most competitive rates among developed nations. The current government has also introduced a number of tax breaks specifically for employers, such as the new Employment Allowance that effectively writes off the first £2,000 that employers have to pay in National Insurance for their workers. On top of this are targeted tax breaks aimed at high-growth firms, such as the Seed Enterprise Investment Scheme (SEIS), which allows investors in small businesses to claim tax relief on their investments. Of course, it is a matter of debate as to whether such tax breaks are justified, with Mariana Mazzucato among others arguing that they are excessive.<sup>91</sup> But the central point is that the gradual shift towards a low-tax economy has created a more favourable operating environment for micro businesses.

On top of tax cuts and deregulation drives, the government has also presided over a burgeoning ecosystem of enterprise support schemes. One study by the Federation of Small Businesses identified close to 900 public sector initiatives in place.<sup>92</sup> Some of these, like Growth Accelerator, are designed to help firms scale up quickly and export abroad, while others, such as the New Enterprise Allowance, are geared towards helping everyday business owners make a living. There are also many support schemes that exist beyond the realms of the government, such as those run by universities, FE colleges, housing associations, libraries and charities like the Prince’s Trust and UnLtd. Although there are valid concerns regarding the overcrowded nature of this support ecosystem, a recent review of the evidence suggests that most initiatives have a positive impact on the business performance of participants.<sup>93</sup>

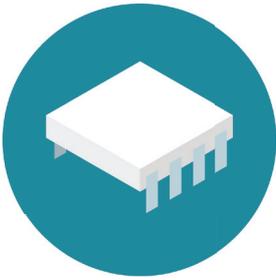
89. For more information see <http://www.hse.gov.uk/consult/condocs/cd273.htm>

90. See <http://www.doingbusiness.org/rankings> and <http://www.weforum.org/reports/global-competitiveness-report-2014-2015>

91. Mazzucato, M. (2013) *The Entrepreneurial State: Debunking Public vs. Private Sector Myths*. Anthem Press.

92. Federation of Small Businesses (2013) *Enterprise 2050: Getting UK enterprise policy right*. London: FSB.

93. What Works Centre for Local Economic Growth (2014) *Evidence Review: Business Advice*. London: What Works Centre.



## Technology

While government efforts may wax and wane depending on who is in power, the impact of ever improving technologies on the world of business is relentless – not least ICT. The price of high quality computing, storage and internet bandwidth has plummeted, bringing down with it the cost of doing business. Whereas 20 years ago it may have been necessary to have a shop to stock and sell goods, today all that is required by many people is a laptop, basic computing skills and an internet connection, if only to get going. The internet and its related platforms have also diminished running costs by introducing ‘plug and play’ models where people pay for every *unit* of goods or service used. Examples include paying per call made on Skype, per advert clicked on Google, and even per hour of manpower bought on freelancing sites like People Per Hour and Upwork. The result has been to reduce the ‘minimum efficient scale’ in a number of industries, allowing micro businesses to thrive alongside larger firms.

Another significant effect of the internet has been to open up global markets to fledgling business owners. This has been particularly important to businesses catering to niche tastes, which can only survive by tapping into ‘diffused demand’. Etsy, for example, plays host to thousands of thriving niche shops – specialising in everything from vintage women’s wear to Dutch furniture – that would struggle to survive on the high street. The platform is one of a number of so-called ‘sharing economy’ marketplaces that make it relatively simple for people to sweat their assets, whether that is renting out a spare bedroom (through Airbnb), leasing their driveway (through JustPark) or lending money to others (through Zopa). Airbnb reports that a typical host in London earns US\$4,600 a year renting out a spare room.<sup>94</sup> The key point is that these platforms level the playing field between individuals and large corporates by connecting anyone who has with anyone who wants. Today an Airbnb host can compete with a hotel chain, an Uber driver with a taxi firm and a peer money lender with a retail bank.

This helps explain why a third of the respondents to our 2014 RSA/Populus survey said they would not have been able to start their business were it not for the internet, while a third said they could have done but it would have been less successful.<sup>95</sup> Yet technological progress encompasses more than just computing and the internet. Small players in the manufacturing industry are beginning to feel the benefit of new machines that allow for smaller batch runs, whether in shoe making, clothing or ceramics. 3D printers now cost as little as £350 and can be accessed in the growing number of maker spaces across the UK (over 95 at last count).<sup>96</sup> But the most important changes are happening in existing factories and supply chains. Thanks to ever more sophisticated machinery, suppliers in developing countries can now cater to the bite-sized demands of micro businesses in the UK.<sup>97</sup> Just as scale has become less important in services, so too is it becoming less pivotal in manufacturing.

94. Airbnb has conducted its own studies of its economic impact in several different cities. For more information see <http://blog.airbnb.com/economic-impact-airbnb/>

95. Dellot, B. (2014) Op cit.

96. Sleigh, A., Stewart, H. and Stokes, K. (2015) *Open dataset of UK makerspaces*. London: Nesta.

97. Hagel, J. et al. (2014) *The hero’s journey through the landscape of the future*. Deloitte.

The other area being transformed by technology is transport. While the advent of computing and new types of machinery are well documented, we often fail to notice the dramatic changes being wrought in shipping. According to research by Moisés Naim, the cost of transporting a ton of cargo today is ten times lower than in the 1950s, thanks in large part to the spread of containerisation.<sup>98</sup> The shipping that takes place within countries has also become faster and cheaper. FedEx started the trend when it offered overnight delivery services in the 1970s, but new players continue to emerge in the shipping business, including Google (through Google Express) and Uber (through Uber Cargo). As a consequence, it has never been cheaper or easier for a small firm to ship raw materials and distribute their products. Moreover, reductions in the cost of flying mean that business owners themselves are more able to move from place to place, meeting clients and promoting their services.



### Consumers

Several changes in consumer behaviour have benefited micro businesses. First and foremost, the UK economy continues to shift away from manufacturing and towards services. Almost all of the jobs created in the last decade have been in the services industries, with the result that they now employ 75 percent of the workforce.<sup>99</sup> This is important partly because the barriers to entry are lower in the service sectors, but also because many services are grounded in relationships and the provision of experiences, which small firms are arguably better able to deliver.<sup>100</sup> Micro businesses have relatively high productivity levels in sectors like health, education and social work - all of which are deeply rooted in care and trust. With the exception of education, most of these ‘relational’ industries are also growing at pace. Between 2010 and 2014, the number of people employed in human health grew by 15 percent, in social work by 39 percent and in sports activities by 19 percent, relative to a 12 percent growth in employment across the whole economy (see Table 6).

**Table 6: Employment growth in relational sectors (2010-14)**

Human health activities	Education	Sports activities	Social work	Residential care	Economy-wide
15%	8%	19%	39%	28%	12%

Source: RSA analysis of the Business Population Estimates 2014

The importance of relationships is not limited to the usual ‘relational’ industries. An increasing number of businesses across the economy now seek to forge close bonds with their customers. According to the business

98. Naim, M. (2013) *The End of Power*. Basic Books.

99. RSA analysis of Business Population Estimates 2014. We have classed all industries as services bar those relating to manufacturing, agriculture, energy extraction, logging, construction, and waste and water treatment.

100. Research by Vodafone found that more than half of small businesses said their ability to be nimble in tailoring services to clients was crucial in competing with larger firms. Vodafone (2011) *Working smarter to succeed*.

strategist Nicholas Lovell, relationships are becoming a focal point for winning competitive advantage. As he puts it: “In the commodity era of limited availability, we asked ‘Can I get it?’ In the goods era of manufactured products, we asked ‘How much does it cost?’ In the service era of quality, we asked ‘Is it any good?’ Now that we can get great products cheaply whenever we want, we have started asking a new question: ‘How will it make me feel?’”<sup>101</sup> This trend could be advantageous for micro businesses, which are arguably better at relating to customers and satiating their appetite for a more personal touch.<sup>102</sup> Lawrence Katz, a scholar at Harvard, predicts that a new class of self-employed ‘artisan’ workers will emerge in the future to respond to these changing consumer desires – from empathetic care givers to attentive personal trainers to diligent academic tutors.<sup>103</sup>

Yet it is not just how micro businesses deliver their products and services that give them an advantage, it is also *what* they deliver. One of the most significant trends in consumer behaviour is the growing appetite for niche products that satisfy specific tastes. This may be a result of the internet enabling people to more easily identify the goods and services they like, whether that is jumpers made from a particular type of Shetland wool, or original recordings of 1960s folk and blues music. Alongside niche goods, there also appears to be increasing demand for tailored goods that are made to order. One indicator of this can be seen in the growing popularity of Etsy, over 70 percent of whose sellers say offering bespoke products is an important part of their offer.<sup>104</sup> While it is debatable whether large firms can meet these changing consumer demands, it is likely that the nimble nature of micro businesses makes them better placed to respond.



## Corporations

A discussion about the viability of micro businesses would not be complete without looking at the changing nature of large firms. The bottom line is that today’s corporations are facing fierce competition, in part because lower barriers to entry have led to an influx of rivals, but also because globalisation has opened up domestic markets to international contenders. Another problem is that consumers have become less loyal, which in turn has shortened product life cycles. Whereas companies could once rely on products to be in high demand for at least a decade, today the average product lifecycle is closer to three years.<sup>105</sup> This phenomenon is not limited to the UK. Among the top 100 US companies in the Fortune 500 listing of 2010, only 66 were survivors from the 2000 list.<sup>106</sup> Thirty-six of the 500 had yet to be born. As we shall see in the next chapter, this does not mean the large business community as a whole is losing market power, but rather that individual firms are struggling to retain their grip.

101. Lovell, N. (2013) *The Curve: From Freeloaders to Superfans*. Portfolio Penguin.

102. Vodafone (2011) Op cit.

103. Larry Katz cited in *The Economist* (2011) *The Return of Artisanal Employment* [article] 31 October 2011.

104. Dellot, B. (2014) Op cit.

105. Deloitte (2014) Op cit.

106. Naim, M. (2013) Op cit.

In response to diminishing returns and market volatility, some corporations have sought to shore up their power and expand their revenue base through mergers (an issue we will explore in the next chapter). Many others, however, have chosen to cut costs by outsourcing work to smaller contractors. This helps to explain the growth of freelancing websites like Odesk (now known as Upwork) and People per Hour. The former has 9m registered freelancers worldwide and hosts 3m jobs annually.<sup>107</sup> Indeed, results from the Labour Force Survey show that the biggest increase in self-employment since 2005 has been among those describing themselves as ‘freelancers’.<sup>108</sup> Nowhere has the trend towards outsourcing been as closely observed as in the field of research and development. In pharmaceuticals, for example, most market leaders now have close relationships with smaller contract research organisations (CROs). According to Deloitte, CROs today account for 10 percent of pharmaceutical research, and its market is expected to grow substantially over the coming years.<sup>109</sup>

However, not all outsourcing has been driven by financial imperatives. Many large firms work with smaller businesses primarily because they provide higher quality services and products than their in-house teams.<sup>110</sup> These partnerships were prevented from forming 20 or 30 years ago because of the high transaction costs involved – namely the time and effort required to identify outside talent. But the advent of new technologies has reduced these costs and diminished the importance of Coase’s Law, which stated that it was cheaper to keep production under one roof. Large businesses now adhere to what has been called Joy’s Law, named after Sun Microsystems co-founder Bill Joy, who said that “no matter who you are, the smartest people work for someone else”.<sup>111</sup> Joy’s Law, which advocates using contractors and outsourcing work, has gained the upper hand because our economy is more characterised by uncertainty and increasingly powered by knowledge, which is distributed across a multitude of economic actors.

107. See <https://www.upwork.com/about/>

108. D’Arcy, C. and Gardiner, L. (2014) *Just the Job – Or a working compromise?* London: Resolution Foundation.

109. Deloitte (2014) Op cit.

110. Harvard Business Review (2015) *Holistic Talent Supply Chain Management*. HBR.

111. For more information see [http://en.wikipedia.org/wiki/Joy%27s\\_Law\\_%28management%29](http://en.wikipedia.org/wiki/Joy%27s_Law_%28management%29)

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# Adjusting our Gaze

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## A tale of the mammoth and the minnow

So far we have shown that micro businesses are a powerful force in our economy. Not only are they increasing in number, they are also outperforming larger competitors in a number of industries. Their growth is a signal of economic prosperity rather than economic frailty. However, this does not mean that big business is waning – far from it. The self-employed still only make up 15 percent of the workforce, and micro businesses just 19 percent of private sector revenue. In contrast, large firms (those with over 250 employees) represent half of all economic output.<sup>112</sup> In certain sectors, it is obvious that large firms are the main players and will continue to be so for the foreseeable future. This is particularly true of manufacturing industries with high barriers to entry. In the manufacture of motor vehicles, for example, large firms account for 83 percent of revenue and 56 percent of employees.<sup>113</sup>

The truth is that large firms are just as relevant as they have ever been, but the difference is that the space has now opened up for small firms to complement their activities. Indeed, small does not necessarily have to come at the expense of big, or vice versa. Collaboration between large corporates and smaller entities has flourished in recent years. In the last chapter we drew attention to the increasing tendency of big businesses to use consultants, partly in a bid to cut costs but also to tap into the wealth of expertise beyond their office doors and factory gates. According to a recent report from the Department for Business, Innovation and Skills, over half of the SMEs they surveyed said they networked with large companies, while a quarter were involved in research and development partnerships.<sup>114</sup> Almost 15 percent were in formal joint ventures with large firms. Virtually every major corporation has small firms built into their supply chain. Microsoft, for example, works with 750,000 small companies around the world.<sup>115</sup>

Firms of different sizes have always collaborated in some form of another. What makes today different is that small firms and large firms are taking on polar opposite but complementary roles – something that has been described as ‘barbellisation’. Research by Deloitte suggests that a new economic landscape is beginning to emerge in which ‘a relatively few, large concentrated players will provide infrastructure, platforms and

112. According to the Business Population Estimates 2014, firms with 250+ employees account for 53 percent of total private sector output.

113. RSA analysis of Business Population Estimates 2014.

114. Jamieson, D. et al. (2012) *Large Businesses and SMEs: Exploring how SMEs interact with large businesses*. ORC International and BIS.

115. The Economist (2009) *Global Heroes* [article] 12 March 2009.

services that support many fragmented, niche players'.<sup>116</sup> In practice, this means 'mammoths' supporting 'minnows' in areas such as transport (eg Uber), manufacturing equipment (eg Flextronics), accounting (eg Sage) and workspace (eg Reed). In other cases, large players will not provide services per se but rather play the role of connector. One example is PCH International, which connects product designers with other companies that can manufacture, package and ship their goods.

### The rise of oligopolies

The interdependence of large firms and small firms is indisputable. However, not all markets exhibit benevolent relationships. If there is an economic trend that is stronger than that of the micro business boom, it is the rise of oligopolies, a type of market structure where a few firms are responsible for most economic output. A recent report by the Centre for Policy Studies revealed that just a handful of firms dominate several markets in the UK economy.<sup>117</sup> The top five companies own 99 percent of the market share in search engines, while the figure is 89 percent in airlines, 85 percent in banking and 70 percent in supermarkets. Some of these industries are prone to 'natural' oligopolies because the nature of the goods or service means it would be difficult for more than one provider to operate. Many other industries, however, show an uncharacteristic degree of concentration. 80 percent of the UK cinema screens market is controlled by the top five businesses, while this is true of 91 percent of the video games industry.<sup>118</sup>

This trend is not limited to the UK. In global industries as diverse as computer processors (Intel), diamonds (De Beers) and crop seed protection (Du Pont), oligopolistic power is alive and well.<sup>119</sup> Increasingly, we are also seeing a handful of firms wield what is called 'monopsonistic' power, which enables them to dictate prices to suppliers, not just to consumers. A good example is of supermarkets in the UK and major corporates such as Walmart in the US, which dominate their markets to the extent that they can effectively set the prices of agricultural products from their farmers. Nor does this phenomenon show any signs of abating. Since 1980, the GDP share of the 1,000 largest firms in the OECD has risen from 31 to 72 percent.<sup>120</sup> Several recent mergers serve to illustrate this trend, such as the decision this year to merge Heinz and the Kraft Foods Group into a single firm, making it the fifth largest food company in the world.

Oligopolies are nothing new, of course. During the aftermath of the Great Depression in the 1930s, many economists blamed capitalism's woes on the emergence of very large firms wielding excessive market power. Even before then, Joseph Schumpeter expressed his concern that the age of 'competitive' capitalism of the 19th century was being usurped by the 'trusified' capitalism of the 20th.<sup>121</sup> But since then oligopolies have only taken on greater significance. In theory, globalisation should have injected much

116. Deloitte (2014) Op cit.

117. Saatchi, M. (2014) *The Road from Serfdom*. London: Centre for Policy Studies.

118. Ibid.

119. Naim, M. (2013) Op cit.

120. Mulgan, G. (2013) *The Locust and the Bee*. Princeton University Press.

121. Schumpeter, J. (1928) 'The Instability of Capitalism' in *The Economic Journal*.

needed competition into markets. Yet the reality is that many big companies simply got bigger and turned into multinational corporations (MNCs).<sup>122</sup>

### Why care about concentration?

There are several reasons why this trend should concern us:

- **Consumers** – Businesses in concentrated markets are thought to charge consumers more than businesses in fragmented ones. This is not always the case, as has been shown by the price wars between major supermarkets. But in sectors like banking and energy, there is evidence that consolidation can lead to a worse deal for consumers.<sup>123</sup> It is almost 15 years since the Cruickshank inquiry into British Banking found evidence of excessive prices and profits among the major UK banks, but reports of dubious activities continue to emerge.<sup>124</sup>
- **Suppliers** – Oligopolies can wield just as much power over their suppliers as their customers, with some dictating unfair prices and payment terms. This problem of ‘monopsony’ appears to be common in the supermarket industry, where at least 1,400 suppliers are thought to be at risk of imminent collapse as a result of pressure from above.<sup>125</sup> In the short-term this may benefit consumers if it results in lower shelf prices, but in the long-run suppliers could be pushed out of existence, leading to job losses, less choice for consumers and more instability in supply chains.
- **Innovation** – Joseph Schumpeter believed that firms with monopolistic power would innovate to keep their competitors at bay.<sup>126</sup> But experience tells us that some businesses find less reputable ways to maintain market power. Long-standing firms in both the credit card and airline industries, for example, have been accused several times of attempting to prevent new businesses from entering their markets.<sup>127</sup> Another concern is that large firms have a tendency to fixate on ‘shareholder maximisation’, which often involves spending money on share buy backs that could have otherwise been channelled into R&D.<sup>128</sup>
- **Politics** – There is evidence to suggest that some oligopolistic firms use their resources to lobby heavily in areas such as regulation, taxation, public sector contracting and state subsidies.<sup>129</sup>

122. Dawd, D. (2000) *Capitalism and its Economics*. Pluto Press.

123. The energy regulator Ofgem, for example, triggered an investigation into the big six energy firms in response to concerns that customers were being overcharged. Macalister, T. and Farrell, S. (2014) *Big six energy suppliers could be broken up after Ofgem triggers full investigation* [article] *The Guardian*: 27 March 2014.

124. Cruickshank, D. (2000) *Competition in UK Banking*.

125. Smithers, R. (2015) *UK supermarkets dupe shoppers out of hundreds of millions, says Which?* [article] *The Guardian*: 21 April 2015.

126. Lynn, B. (2010) *Who broke America's jobs machine?* *Washington Monthly*.

127. Wu, T. (2013) *The Oligopoly Problem* [article] *The New Yorker*: 15 April 2013.

128. Share buy backs involve a company repurchasing its own stock. For more information see *The Economist* (2014) *The repurchase revolution* [article] 13 September 2014.

129. Harvey, D. (2014) *Seventeen contradictions of capitalism*. Profile Books.

According to a report by Transparency International, the UK has the third biggest lobbying industry in the world, valued at £2bn.<sup>130</sup> An in-depth study of the North Sea oil industry, for example, found there to be an ‘unholy alliance’ between major energy firms and policymakers in Whitehall, which meant that smaller oil businesses lost out on lucrative drilling contracts.<sup>131</sup>

- **Instability** – Concentrated markets may be more prone to instability. The failure of a very large business is likely to have greater ramifications than the closure of multiple small ones – particularly if the firm is intimately connected with other businesses, as many banks are. A 2011 study by the Swiss Federal Institute of Technology found deep linkages between transnational corporations, with a ‘super entity’ controlling more than 40 percent of the total wealth in the network. The fallout would be very severe were one of these to collapse, and as we have seen there is no such thing as too big to fail.

Not everyone believes that oligopolies present a threat. Columbia University law professor, Michael Heller, argues that a high concentration of ownership in markets can be more conducive to innovation and economic growth, since it allows for more decisive action to be taken.<sup>132</sup> Likewise, the entrepreneur Peter Thiel says that oligopolies are good for society because they have a wider latitude to be socially conscious and ‘can afford to think about things other than making money’.<sup>133</sup> But Heller, Thiel and others like them are clearly in the minority.

### Unanswered questions

The UK’s economic landscape is undergoing a notable change, with both very small and very large firms becoming more prominent. While there is concern among some that micro businesses are out of their depth, our analysis shows that in many markets they are in fact thriving, whether that is in health, education or management consultancy. Rather than fret over their rise, we should instead pay attention to what is happening at the larger end of the business spectrum where oligopolies are becoming more commonplace. From supermarkets to banking to cinemas, there are few sectors that have not seen a consolidation of market power.

To be clear, the problem here is not in the size of firms per se, but rather in the proportionate control that some have over their markets. The challenge for the government and others is to find the ideal level of concentration which allows for both big and small businesses to flourish for the benefit of consumers, workers and entrepreneurs alike. Just as policymakers have a clear goal of rebalancing the economy in terms of sectors, so too should they strive to rebalance the economy in terms of market concentration. While it is beyond

130. Transparency International UK (2015) *Lifting the Lid on Lobbying: The hidden exercise of power and influence in the UK*.

131. Collingridge, D. et al. (1994) ‘Inflexibility in the development of North Sea oil’ in *Technological forecasting and Social change* Vol. 45 (2).

132. Heller, M. (2010) *The Gridlock Economy: How too much ownership wrecks markets, stops innovation and costs lives*. Basic Books.

133. Thiel, P. (2014) *Competition is for Losers* [article] The Wall Street Journal: 12 September 2014.

the scope of this paper to lay out detailed recommendations as to how this could be achieved, we finish by presenting a number of important questions for further enquiry:

### **1. What is the ideal level of concentration?**

How concentrated do we want our economy to be? The public debate about market power has tended to skim over this question, with policymakers presenting only vague aspirations such as to have ‘more small businesses’ or ‘greater checks and controls’ on large firms. The Conservative manifesto, for example, included a commitment that 600,000 businesses be created every year, yet there were no specific targets relating to market concentration.<sup>134</sup> The Liberal Democrat manifesto did include a goal that 30 percent of the household energy market be supplied by alternatives to the ‘big six’, but this appeared arbitrary and without a clear rationale.<sup>135</sup> Part of the problem is that policymakers do not have enough evidence – either from academic studies or government datasets – to make informed decisions. The Business Population Estimates contain very little information on the extent of consolidation in different industries. Another problem is the dearth of media coverage on the issue of oligopolies, which in turn prevents a rich public debate from taking shape. The recent £10bn merger of O2 and Three received scant attention in the mainstream press, despite the fact that the two firms would together control 40 percent of the mobile network market.

### **2. What is the future of competition policy?**

There are several schools of thought on how to approach oligopolies. The most extreme says they should be broken up, as some have argued of RBS. Another argues we should accept oligopolies in principle but put clear limits on the power of very large firms. A good example is Labour’s pre-election commitment to freeze energy prices and put a cap on rail fare rises. Yet it is clear that neither of these approaches have been entirely successful. The former is too politically unpalatable while the latter is deemed by some as economically impractical. Thus, there is a need for fresh thinking in this area. We should explore, for example, whether there is any mileage in the idea of social licensing, whereby large incumbents would be obliged to pay into a support fund that is directly used to stimulate new entrants in their markets.<sup>136</sup> We should also consider what might be done to better support suppliers, for example by loosening controls on ‘resale price maintenance’ (RPM).<sup>137</sup> Another idea worth considering is a statutory obligation for merging firms to follow through with promises made during a bidding process (eg around job retention and investment). A speedy commission on market power could explore new ideas such as these.

<sup>134</sup>. Conservative Party (2015) *Our Small Business Manifesto*.

<sup>135</sup>. Liberal Democrats (2015) *Manifesto 2015*.

<sup>136</sup>. Advocated in Leaver, A. and Williams, K. (2014) *After the 30-year experiment: The future of the ‘foundational economy’* [article] *Juncture*: 5 December 2014.

<sup>137</sup>. Resale price maintenance involves distributors (the middle-men) selling a product at a pre-agreed price. The aim is to create a flourishing market of suppliers and to avoid a situation where one undercuts the others and comes to dominate the market. The French government recently acted upon the principles of RPM by preventing Amazon from selling books below their list price.

### 3. How should we treat sharing economy platforms?

The rise of sharing economy platforms has been spectacular. Airbnb, which did not exist eight years ago, has a million listings – more than any of the world’s largest hotel groups.<sup>138</sup> Uber, which was founded in 2009, now operates in 200 cities and is expected to generate \$10bn in revenue by the end of 2015.<sup>139</sup> These platforms present new challenges to the way we think about market power. On the one hand, they are opening up opportunities for hundreds of thousands of micro businesses by helping them more easily connect with potential customers. On the other, they often act as gatekeepers that determine the terms and conditions upon which these micro businesses trade, including the prices they can set. Another problem is that some appear to be unfairly sidestepping tax and regulation at the expense of their users and the government. Uber, for example, treats their drivers as self-employed workers, meaning they miss out on key benefits while the government loses out on employer National Insurance contributions. As sharing economy platforms take centre stage in their respective industries, it is important we build up a regulatory framework that manages these risks.

### 4. What can we do to help small firms scale up?

As this report has revealed, the number of businesses being started every year has grown substantially over the last decade, and many of these are proving to have a positive impact on our economy. Yet we have to acknowledge that without support these firms will never be able to wrestle significant market share away from oligopolistic firms. A key challenge is that relatively few micro businesses scale up. According to the Social Market Foundation, just 3 percent of the UK’s workforce are ‘high value entrepreneurs’, compared with 7 percent in the US.<sup>140</sup> We need to do more to understand why this is the case. Access to finance is almost certainly a barrier to growth, but there is evidence to suggest that lacklustre management skills are also a major and often overlooked obstacle. Psychological barriers, too, are likely to be holding people back from growing their business, as a recent RSA report has argued.<sup>141</sup> Another consideration is the ‘acqui-hire’ trend, which involves large firms buying out smaller businesses for their talent. In 2014 alone Google reportedly acquired 29 smaller tech companies.<sup>142</sup> More research is needed to understand the positive and negative implications of this phenomenon.

### 5. Who owns the data?

Many large technology companies have built their business models around the collection and monetisation of personal data. Social network platforms could not exist without harvesting this information to improve the targeting of their adverts, whilst sharing economy platforms rely

138. Mudallal, Z. (2015) *Airbnb will soon be booking more rooms than the world’s largest hotel chains* [article] Quartz: 20 January 2015.

139. Shontell, A. (2014) *Uber is generating a staggering amount of revenue* [article] Business Insider UK: 15 November 2014.

140. Broughton, N. and Ussher, K. (2014) *Op cit.*

141. Delloit, B. (2014) *Everyday Employers*. London: RSA.

142. Burke, J. (2014) *Have job, will buy your firm: Tech’s ‘acqui-hire’ trend* [article] CNBC: 9 November 2014.

on the collection of data to seamlessly link buyers and sellers, whether that is Uber drivers with passengers or Airbnb hosts with guests. While these business models are legitimate, the concern is that some technology companies have been left unchallenged because data is difficult, if not impossible, for individuals to carry from platform to platform. Evgeny Morozov argues that one of the best ways to inject competition into the technology sector would be to allow individuals to move, for example, their browsing history, online reputation and information about social connections. But this in turn would require people to own their personal data, or at least to have a say in how it is stored and used. Any attempts to rebalance the economy, particularly one that is increasingly digitalised, must grapple with emergent questions around data control.

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# Conclusion

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We began this report by asking whether micro businesses are a drain on the UK economy as many perceive them to be. On the surface, the answer is yes. A cursory analysis of the data reveals that small businesses are on average less productive, produce fewer innovations, and do not create the high-paying jobs that large businesses often can. Yet look closer at the evidence and a more nuanced picture comes into view. For example, micro businesses exhibit relatively high levels of productivity in some of the fastest growing industries, including health, education and media production. Likewise, our analysis suggests that micro businesses may fare better at ‘intangible innovation’, otherwise known as the generation of new concepts, designs and experiences. In employment, too, there are signs that small firms are proving their worth. The employees of micro businesses score the highest on measures of job control, supportive management and general enthusiasm for their work.

None of this is to say that micro businesses are ‘better’ than large firms. Rather, it is to emphasise that they are playing an increasingly important role in our economy. The question is why now, when small firms have always existed in some form or another. Our research identifies several factors behind their increasing viability, from the spread of new technologies, to changing consumer habits, to the introduction of pro-business policies. While some of these are widely acknowledged, such as the effect of the internet in diminishing the costs of doing business, a number have yet to be fully recognised. The fact that we have a more educated workforce, for example, means a growing number of people are equipped with the necessary skills to work for themselves. Another factor often overlooked is that the UK economy continues to shift away from manufacturing and towards services, where micro businesses are more viable. This is particularly true of the booming ‘relational industries’ of health, education and care, all of which are bound up in trust and a personal touch.

Taken together, our research questions the preoccupation with small firms and their apparent negative impact on the economy. Indeed, our focus instead should be on what is happening at the larger end of the economic spectrum, where a handful of very large firms have emerged wielding excessive market power. From supermarkets to telecoms to cinemas, there are few sectors that have not experienced the malign impact of oligopolies. To be clear, the problem here is not in the size of firms per se, but rather in the proportionate control that some have over their markets. The challenge is to find an ideal level of concentration that allows for both big and small businesses to flourish for the benefit of consumers, workers and entrepreneurs alike. We finish this report not with a series of speculative policy proposals but rather a number of key questions, the answers to which would lay the groundwork for further action.

# Appendix

**Table 7: Fastest growing sectors by employment \***

20 fastest growing sectors by EMPLOYMENT (2010-14)	Revenue per employee (£1,000s)	
	Micro businesses	Sector-wide average
Food and beverage service activities	37	38
Retail trade, except motor vehicles	94	118
Social work activities	45	33
Services to buildings and landscape activities	61	36
Residential care activities	53	34
Computer programming and consultancy	77	151
Office admin and support activities	132	115
Education	62	51
Human health activities	57	55
Personal service activities	42	49
Other professional, scientific and technical	79	95
Activities of head office, management consultancy	111	160
Legal and accounting activities	65	86
Real estate activities	110	106
Sports activities and recreation	51	51
Warehousing and support services	225	176
Architectural and engineering activities	84	125
Activities auxiliary to financial services and activities	Insufficient information available	
Crop and animal production	95	100
Wholesale and retail trade of motor vehicles	138	287

Source: RSA analysis of Business Population Estimates (2010-14)

**Table 8: Fastest growing sectors by revenue \***

20 fastest growing sectors by REVENUE (2010-14)	Revenue per employee (£1,000s)	
	Micro businesses	Sector-wide average
Electricity, gas	717	853
Gambling activities	118	802
Activities of head office, management consultancy	111	160
Retail trade, except motor vehicles	94	118
Computer programming and consultancy	77	151
Manufacture of food products	99	209
Office admin and support activities	132	115
Coke and refined petroleum products	Insufficient information available	
Services to buildings and landscape activities	61	36
Warehousing and support services	225	176
Manufacture of motor vehicles	97	416
Manufacture of other transport	156	224
Food and beverage service activities	37	38
Scientific R&D	106	319
Wholesale and retail trade and repair of motor vehicles	138	287
Crop and animal production	95	100
Legal and accounting activities	65	86
Air transport	Insufficient information available	
Manufacture of machinery and equipment	93	205
Motion pictures, television and video game production	166	215

Source: RSA analysis of Business Population Estimates (2010-14)

\* We have excluded sole traders (one-person businesses) when analysing the productivity of both micro businesses and the sector as a whole. Were we to include sole traders when calculating the revenue per worker of the latter but not the former, the comparisons would be skewed and micro businesses would look more productive than they in fact are.

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