what works centre for local economic growth

Evidence briefing: Assessing the impact of improving access to debt finance on local economic growth

1. Summary

Business investment is a key driver of productivity and local economic growth. Unless a business can self-fund investment, it will need access to external finance, normally debt finance. Businesses can struggle to access debt finance for a number of reasons including information asymmetries, being assessed as higher risk or a lack of collateral. Depending on the nature of the constraints and the returns to investment, this may mean business investment is below the socially optimal level.

This briefing provides a framework to help policymakers think through some of the local economic impacts of improving business access to debt finance including through community finance institutions (CFIs) that provide funding to businesses. It draws on evaluation evidence on access to finance, community finance, and on other economic theory and evidence.

Key messages

Assessing local economic impacts

Improved access to debt finance

- Interventions must improve access to debt finance or lower borrowing costs for local businesses for there to be local economic impacts.
- Potential local economic impacts will depend on how many businesses experience improved access or lower borrowing costs. Few businesses seek external finance and most that do are successful. Given the need for institutions to be responsible lenders, the proportion of local businesses that might benefit from support could be limited in most cases.
- CFIs may need to build strong relationships with local businesses if they are to improve access to finance.

Establishing type and scale of direct impacts on business outcomes

- Debt finance used for cash flow is, at best, likely to sustain outcomes, whilst funding that is used for business development may improve outcomes.
- Improving access to debt finance may mean some businesses will continue to operate that would not have otherwise survived.

Productivity

- Debt finance used to increase the amount of capital per worker or to deliver organisational change or innovation that improves efficiency has the potential to increase business productivity.
- Consider the profile of supported businesses, how debt finance will be used, and the likelihood and timescales of this leading to productivity improvements when assessing the potential impact on the productivity of supported businesses.

Employment

- Debt finance that is used for business development may lead to employment growth in supported businesses – but not all projects will lead to employment growth. Finance used for cash flow is more likely to sustain current employment levels, if it has any effect on employment.
- Increases in employment in supported businesses may displace employment in other local businesses. Targeting support at tradeable sectors will help minimise displacement but businesses in these sectors may not need support.
- Additional local jobs can also be created if supported businesses develop local supply chains or if those newly employed in the area spend some of their income locally. Understanding supply chains, travel-to-work patterns, and spending patterns will help with assessing how many additional jobs will be created.
- Consider whether additional jobs at supported businesses, displaced jobs, and jobs created as a result of multiplier effects are likely to be filled by local residents. The impact on the local economy will be greater if jobs created (or sustained) are filled by local residents.
- Impacts on employment should be compared to total employment in the area. Unless the programme is large, support is likely to have a modest impact on local employment levels.

Turnover and profits

- There is good evidence that access to debt finance interventions can lead to increased turnover.
- Increased turnover within supported businesses may displace turnover of other businesses, reducing the effect on the local economy.
- Increasing profit margins will depend on the ability to increase turnover, reduce costs or both, alongside the level of competition faced by supported businesses, and the overall state of economy.
- In most cases, it is reasonable to assume that the impacts on profits will be small.

Wages

- In supported businesses, the effect on wages is likely to depend on the effects on productivity, turnover, and profits.
- At the local level, it is unlikely that there will be effects on wages unless supported businesses account for a large proportion of local employment or support leads to a large increase in local employment.

Other income effects

- If supported businesses increase their use of capital assets such as buildings, machinery, data, patents or brands, this will increase the incomes of asset owners. The extent to which this benefits the local economy depends on whether the assets are locally owned.

Assessing wider benefits

- As businesses often play important roles in their communities, improving access to debt finance that strengthens the business base may also have wider benefits.
- Support to social enterprises or community enterprises could have wider social benefits as they play an important role in providing social infrastructure.

Assessing costs

- Consider the potential costs for policymakers and businesses.
- As there are diverse policy options, potential costs for policymakers are highly variable.
- Increased risk and higher costs of borrowing are the main potential costs for businesses.

Monitoring and evaluation

- Use monitoring and evaluation to assess the impact of policies to improve access to debt finance, including supporting CFIs. This will help improve future decision-making.

2. Background

Role of finance

Access to financial services is essential for businesses to operate. For example, businesses need access to banking and processing services to receive payments from customers and pay staff and suppliers.

Business investment – for new premises, equipment, software, to undertake R&D, increase staffing or expand into new markets – often requires outlays up front. Unless the business has sufficient reserves

to self-fund investment, it will need access to external finance.

In 2022, 33 percent of small and medium-sized enterprises (SMEs) used external finance.[1] The most common reason for seeking finance was working capital (53 percent), followed by purchase of fixed assets (27 percent) and to invest in business growth (27 percent). A further 23 percent were seeking finance to deal with recovery from the pandemic.[2] Most external finance is **debt finance** – such as loans, overdrafts, and mortgages – only one percent of SMEs with employees access equity finance.[3]

Access to debt finance

In a recent survey, 16 percent of SMEs with employees and 13 percent of businesses with no employees mentioned 'obtaining finance' as a major obstacle to success.[4,5,6] Why do businesses sometimes struggle to access finance? Information asymmetries – a market failure – are one reason. Financial institutions know less about the business than owners or managers, and this makes it difficult to assess the risk of lending. Information asymmetries are particularly likely if the financial institution has not assessed something similar before – for example, the business is developing a new technology.

Businesses may struggle to access finance if they are assessed as higher risk. For example, investing in businesses in sectors with lower survival rates is generally riskier – only 38 percent of retail businesses survive to 5 years after establishment.[7] Survival rates are similar for food and beverage businesses such as cafes and catering businesses (37 percent), worse for couriers (25 percent) and better for accommodation services such as hotels and B&Bs (52 percent), legal and accountancy services or food manufacturers (both 48 percent).

The personal characteristics of the owner such as gender or ethnicity may play a role. Ethnic minority-led businesses are more likely than other businesses to consider applying for finance, to have been rejected for finance once or more in the last ten years, or to have injected personal funds into their business as they felt they had no other options.[8] In some cases, this may be due to a subjective assessment of risks, but in others may reflect discrimination. The balance between these two factors is unclear.

A lack of collateral can also prevent businesses from securing debt finance. Access to collateral is not equally distributed, with median individual wealth £157,000 higher in the South East than the North East, for example.[9] A key driver of this is property – a key source of collateral – with those living in the South East most likely to own property, and those properties having higher values. Other factors that can affect wealth include age, gender, qualification levels, socio-economic group, and disabilities.[10]

Financial institutions assess applications for loans or investment on a commercial basis, selecting those where the risks and returns are most attractive. This can result in business investment being below the socially optimal level, if there are projects that have social and economic benefits that exceed costs – for example bringing jobs to a deprived neighbourhood – but do not meet the criteria of financial institutions.

1 British Business Bank (2023). Small Business Finance Markets 2022/23. Data for Quarter 3 2022.
2 British Business Bank (2023). Small Business Finance Markets 2022/23.
3 Department for Business and Trade (DBT) (2023). Small business survey 2022: businesses with employees.
4 Data on SMEs is used as large businesses are more likely to be able to access finance from mainstream sources, and are therefore less likely to need to use CFIs. In addition, most data relates to SMEs.
5 DBT (2023). Small business survey 2022: businesses with employees.
6 DBT (2023). Small business survey 2022: businesses with no employees.
7 Office for National Statistics (ONS) (2023). Business demography, UK.
8 British Business Bank (2023). Small Business Finance Markets 2022/23.
9 ONS (2022). Distribution of individual total wealth by characteristic in Great Britain: April 2018 to March 2020.
10 ONS (2022). Distribution of individual total wealth by characteristic in Great Britain: April 2018 to March 2020.

Policymakers can improve access to finance in various ways including:

- Supporting businesses to improve financial readiness.
- Directly lending to or investing in businesses.
- Guaranteeing loans provided by commercial lenders.
- Supporting alternative sources of finance to develop, such as business angel networks, and venture capital investors.

This briefing focuses on assessing the potential local economic impact of improving access to debt financing, including by supporting community finance institutions that provide funding to businesses. Interventions aim to help businesses lower borrowing costs or access debt finance that they would not otherwise have been able to access. We refer to both as 'improving access to debt finance'.

This briefing draws on our access to finance evidence review (which also covers other types of finance), a rapid evidence review on community finance, and on other economic evidence and thinking.[11]

Community wealth building approaches can also include efforts to improve access to finance for individuals, and to make greater use of existing local wealth (such as local pension schemes) to stimulate local economic growth. These are not covered in this briefing.

Box 1: Community finance

Examples of community finance institutions (CFIs) include:

- **Credit unions** providing financial services to members. There are around 250 credit unions in the UK with over 2 million members and £4.6 billion in assets. Since 2012, credit unions can provide business loans for SMEs.
- **Mutual banks** providing financial services to their members. Traditionally set up to serve low-income communities, there are currently 43 building societies and 46 friendly societies in the UK.
- **Community development finance institutions** (CDFIs) providing debt finance to businesses and social enterprises that find it difficult to get credit from mainstream lenders. There are around 20 CDFIs in the UK that lend to businesses, plus a number of others that lend to social enterprises.

The main rationale for supporting CFIs is that they will improve access to finance. This is the explicit purpose of CDFIs. Ninety-nine percent of business who took CDFI loans in 2023 had previously been declined by another lender.[12] Many credit unions and mutual banks will also have a goal to improve access to finance for members. As potential credit union and mutual bank borrowers are members, this can help reduce information asymmetries. CFIs may also take different approaches to assessing loan applications than large banks and are often perceived as being more willing to lend. By improving access to finance, CFIs may increase business investment and generate local economic growth.

An additional potential benefit for local economies of supporting CFIs is that profits may be more likely to be retained in the local area. CFIs are more likely to be locally or regionally-based,

11 Many of the studies included in the access to finance review evaluate loan guarantee schemes. Although local policymakers are more likely to pursue other policy approaches these evaluations still provide useful insights as to possible impacts.

12 Responsible Finance (2023). They believed in me. Responsible Finance 2023 Impact Report.

in contrast to large banks that tend to be national or international. They also have organisational structures that are mutual – profits are shared amongst members – or non-profit distributing – profits are reinvested into future loans. For example, CDFIs are social enterprises, and therefore – based on a common definition of social enterprises – must have a clear social or environmental mission, and re-invest or donate at least half of profits or surpluses towards their mission.[13] If CFIs reinvest profits into future lending within the area, the local economy could become less reliant on external providers of finance, providing greater stability in relation to access to finance and local economic growth.

3. Assessing local economic impacts

This section considers the potential local economic impacts of improving access to debt finance for businesses. The section is structured by outcome – covering access to finance, productivity, employment, wages, turnover and profits, and other income effects.

3.1 Improved access to debt finance

For local economies to potentially benefit, interventions must lead to improved access to debt finance (that is, local businesses being better able to access debt finance or lower cost borrowing). Our access to finance evidence review finds that interventions can improve access. Seven studies evaluate the effect of interventions on credit availability, with four finding positive effects and three mixed results. Four studies look at borrowing costs (including three that look at credit availability), with all finding interventions reduce borrowing costs.

The impact on the local economy will depend on how many businesses are affected. Only a small proportion of businesses seek external finance in any given year. In 2022, 11 percent of SMEs with employees had sought external finance in the previous 12 months.[14] The proportions vary by size, with 21 percent of medium-sized businesses (50 to 249 employees) seeking finance, compared to 14 percent of small businesses (10 to 49 employees), 10 percent of micro-businesses (less than 10 employees) and 7 percent of businesses with no employees.[15] In the same survey, 20 percent of SMEs with employees said they were likely to seek external finance in the next three years, with the rates varying from 37 percent in medium-sized businesses to 18 percent in micro-businesses and 11 percent for businesses with no employees.

Most businesses that apply for external finance are successful. Sixty-two percent of applications made by SMEs for external finance between Quarter 3 of 2021 and Quarter 4 of 2022 that had a response by Quarter 4 2022 were successful.[16] Again, there is variation across business size, with 94 percent of medium-sized businesses successful, compared to 87 percent of small businesses, 76 percent of micro-businesses and 56 percent of businesses with no employees.[17]

Reasons given by finance providers to unsuccessful applicants included a lack of track record (17 percent), poor credit rating or credit issues (16 percent), lack of available security (15 percent), provider did not think business could afford it (15 percent), and current business performance (12 percent).[18]

13 https://www.ncvo.org.uk/help-and-guidance/setting-up/understanding-social-enterprise/
14 DBT (2023). Small business survey 2022: businesses with employees.
15 DBT (2023). Small business survey 2022: businesses with no employees.
16 BVA BDRC (2023). SME Finance Monitor Q4 2022.
17 Whilst larger businesses are more likely to apply for finance, the average is strongly affected by profile of businesses, with 76 percent of businesses applying for finance having no employees, and a further 19 percent having between 1 and 9 employees.
18 BVA BDRC (2023). SME Finance Monitor Q4 2022.

Combining data on the proportions of businesses seeking finance and the failure rates with data on the local business base (number of businesses in each size band) will provide a rough estimate of how many businesses could potentially benefit from improved access to finance.[19,20] Consider the failure rate as providing an upper limit on improving access, as not all these businesses will receive loans or other debt finance as the result of policy intervention. Whilst interventions could address many of the issues faced by businesses – for example, offering loan guarantees to offset risks involved in lending to those without collateral – the need for financial institutions to be responsible lenders means not all businesses that are currently unable to access finance will benefit.

Some businesses may be able to access finance but at a high borrowing cost. Some of these may accept the offered finance despite the high cost, others may be offered but decline to take it or be discouraged from applying in the first place. It is difficult to estimate how many businesses are accepting finance at high costs. Local data could help. In the survey, excessive terms and conditions and high costs were the reasons most offers were declined.[21] Combining the rate of declined offers (one percent in the most recent data) with data on the proportion of businesses seeking finance and the size of the local business base could provide a rough estimate of how many businesses have declined offers due to high costs.

In terms of discouraged borrowers, in 2022, 21 percent of businesses that had wanted to apply for finance in the previous 12 months but did not gave 'thought it would be too expensive' as a reason, with 14 percent saying this was the main reason.[22] Combining these rates with the data on the proportion of businesses seeking finance would give an upper bound of the effect of lower borrowing costs on encouraging discouraged borrowers. It might also give an upper bound on the proportion of businesses who are able to access finance but face high borrowing costs.[23]

For both access to finance and cost of borrowing, similar approaches can be taken to calculate the number of potential beneficiaries if the aim is to support specific sectors or types of businesses, such as female- or ethnic minority-owned or at specific stages in the business lifecycle (for example, start-ups). In these cases, the number of businesses will be lower, but the proportion of businesses within the target group that could take advantage of support is likely to be higher.

Our rapid evidence review on community finance reports findings from two studies that compared lending behaviour of CFIs to mainstream banks, with one study finding CFIs are more likely to lend to small businesses and lend larger amounts to small businesses, and the other that lending is more stable across the business cycle. A third study finds that the relationship with a bank is a more important consideration when businesses seek finance than the type of bank. In the UK, most SMEs seeking finance apply to their main bank or another financial provider they are currently using.[24] Combined, this suggests that CFIs will need to build strong relationships with local businesses if they are to improve access to finance.

19 Data on securing finance also exists for sectors and business age so this could be used as an alternative.
20 A small number of businesses are offered facility but decline to take it. This means the 'failure rate' is slightly lower than one minus the success rate. In this time period, 37 percent of applications were turned down for facility, with rates 44 percent for SMEs with no employees, 21 percent for SMEs with 1 to 9 employees, 12 percent for SMEs with 10 to 49 employees, and 2 percent for SMEs with 50 to 249 employees.
21 BVA BDRC (2023). SME Finance Monitor Q4 2022.
22 BVA BDRC (2023). SME Finance Monitor Q4 2022.
23 For discouraged businesses, this is an upper bound as some businesses are likely to remain discouraged after the intervention reduces borrowing costs. For businesses that have successfully applied for debt finance, this is an upper bound as those businesses were not discouraged by the cost of borrowing.
24 BVA BDRC (2023). SME Finance Monitor Q4 2022.

Key messages

Interventions must improve access to debt finance or lower borrowing costs for local businesses for there to be local economic impacts.

Potential local economic impacts will depend on how many businesses experience improved access or lower borrowing costs. Few businesses seek external finance and most that do are successful. Given the need for institutions to be responsible lenders, the proportion of local businesses that might benefit from support could be limited in most cases.

CFIs may need to build strong relationships with local businesses if they are to improve access to finance.

3.2 Establishing type and scale of direct impacts on business outcomes

The impact of improved access to finance on other outcomes (employment, wages, etc.) will depend on how the funding is used by businesses and the amount of finance received.

In 2022, 69 percent of SMEs who needed funding cited cash flow reasons (most commonly 'working capital to help with cash flow' or 'to cover a short term funding gap'), compared to 36 percent that cited business development reasons (most commonly 'to fund expansion in the UK' or 'invest in new plant, machinery etc.').[25] Funding for cash flow is, at best, likely to sustain current outcomes (for example, help businesses sustain current employment levels), whilst funding for business development has potential to improve outcomes (for example, help businesses grow employment).

Again, business size plays a role, with medium-sized businesses less likely to be seeking funding for cash flow reasons (62 percent) than small and micro-businesses (both 64 percent) and businesses with no employees (70 percent). For business development overall, the variation is from 36 for businesses with no employees to 40 percent for micro-businesses but there are some large variations for specific types of business development (for example, 23 percent of medium-sized businesses needing funding were looking to invest in new plant, machinery, etc. compared to just 14 percent of businesses with no employees). These statistics can help inform calculations in subsequent sections.

Our access to finance evidence review summarises five studies that evaluate the impact of access to debt finance interventions on investment. Only one study finds a positive effect, two mixed effects, and two no effect. Of three studies that look at the effect on assets – which should increase if investment is in productive capacity (for example, new machinery or equipment) – two find positive effects, the other no effect.

The median amount of finance sought by SMEs varies by size – in 2022 it was £375,000 for medium-sized businesses, £100,000 for small businesses and £35,000 for micro-businesses.[26] Whilst small amounts of finance may matter a lot for individual businesses, they are unlikely to have a large impact on local economies unless the projects they invest in have high rates of return. Again, statistics on loan size can help inform calculations in subsequent sections.

It is possible that by providing support, particularly for cash flow, some businesses that would not have otherwise survived will continue to operate. Whether this is a desirable outcome will depend on whether resources (such as capital and labour) could otherwise be redeployed to more economically advantageous activities.

25 BVA BDRC (2023). SME Finance Monitor Q4 2022.
26 DBT (2023). Small business survey 2022: businesses with employees.

Key messages

Debt finance used for cash flow is, at best, likely to sustain outcomes, whilst funding that is used for business development may improve outcomes.

Improving access to debt finance may mean some businesses will continue to operate that would not have otherwise survived.

3.3 Productivity

Will improved access to debt finance increase productivity? None of the studies included in the access to finance evidence review evaluated the impact on productivity, but some assessment of the likelihood of productivity effects can be made by considering the way firms use any additional debt finance.

If debt finance is used to increase the amount of capital per worker (human, physical or intangible – skills, machinery, software, branding, R&D, etc.) or to improve the efficiency with which all inputs are used through organisational change or innovation, it may increase productivity. Finance used for investment is more likely to do this than finance for cash flow. Even when debt finance is used for investment, this will not always increase productivity, as some investments will increase capacity, and others may fail to deliver the expected productivity gains. Some investments will affect productivity immediately (for example, purchasing more efficient machinery) whilst others will take longer (for example, R&D in a more efficient process).

Businesses supported through access to debt finance interventions are likely to be smaller (as larger businesses will generally be able to access mainstream finance). Smaller businesses are, on average, less productive than larger ones.[27] In addition to better access to finance, other reasons for this include higher levels of human, physical and intangible capital, better management and leadership skills, and being more likely to train staff, innovate and export.[28] Large businesses also benefit from economies of scale and economies of scope, especially in capital-intensive sectors such as manufacturing. There is a weaker relationship between size and productivity in other sectors, for example, with little difference in productivity between large and small firms in the professional, scientific, and technical services sector.[29]

When assessing potential benefits for supported businesses, consider the profile of businesses accessing debt finance, how the finance will be used, and the likelihood and timescales for this leading to productivity improvements. Given the large number of factors, the range of potential productivity improvements for a supported business is likely to be large.

As only a small proportion of businesses are likely to benefit from support and not all will see productivity improvements, it is reasonable to assume that the impacts on business productivity at the area level will be small.

There is no evidence that the source of loans (CFI or mainstream financial institutions) matters for whether there is an impact on productivity.

27 For example, see ONS (2022). Firm-level labour productivity measures from the Annual Business Survey, UK: 1998 to 2019, and Bernick S., Davies, R. and Valero, A. (2017). Industry in Britain – An Atlas. Centre for Economic Performance Special Paper No. 34.

28 For example, see ONS (2021). Management practices in Great Britain: 2016 to 2020 and BEIS (2022). UK Innovation Survey 2021: Report covering the survey period 2018 to 2020.

29 ONS (2022). Firm-level labour productivity measures from the Annual Business Survey, UK: 1998 to 2019.

Key messages

Debt finance used to increase the amount of capital per worker or to deliver organisational change or innovation that improves efficiency has the potential to increase business productivity.

Consider the profile of supported businesses, how debt finance will be used, and the likelihood and timescales of this leading to productivity improvements when assessing the potential impact on the productivity of supported businesses.

3.4 Employment

Direct effects on employment at supported businesses

Will improved access to debt finance increase employment in supported businesses? Most funding is not specifically to expand employment, with just four percent of SMEs who had a need for funding in 2022 giving 'to take on staff' as a reason.[30] Despite this, policies that improve access to debt finance can have an impact on employment within supported businesses. Six studies in our access to finance evidence review evaluated this, with three finding a positive effect on employment, and three finding no effect. This suggests that improved access to debt finance might lead to an increase in employment – but that this is not guaranteed.

One reason for this, as discussed above, is that improved access to debt finance does not always lead to additional loans to targeted businesses or lower borrowing costs. Where programmes improve access to finance, an alternative explanation for the mixed findings on employment is that the effects are likely to depend on the use of the loan. If funding is used to invest it may increase employment but if used for cash flow may only help sustain current employment levels.

Even where funding is used for investment, this may not increase employment if, for example, it is in capital equipment that reduces the need for labour, or to fund a project that does not generate the intended returns. Some investment projects are only likely to affect employment over the long-term.

Whether the supported business is a start-up or existing businesses may also matter. Most businesses employ few people. Across the business base as a whole, the average number of employees is 10. The average is four for businesses employing less than 50 employees.[31] Most start-ups employ no or few employees initially. Research suggests that only 2 percent of start-ups with initial turnover of under £500,000 that survive to their third year grow their turnover to over £1 million. Given average revenue per employee of £190,000 in 2021, this suggests only around 2 percent of start-ups are likely to grow to five or more employees within three years.[32, 33, 34]

Estimates of employment affects should also account for business closure. Across the UK, 12 percent of registered businesses closed in 2022.[35] Closure rates are higher for start-ups, with around 95 percent of new businesses surviving for one year, 75 percent for three years and 40 percent for five years.[36] There is limited evidence to suggest that debt finance has an impact on firm survival. Three

30 BVA BDRC (2023). SME Finance Monitor Q4 2022.
31 ONS (2022). Company turnover and average employee numbers 2021. User request AH1019.
32 Enterprise Research Centre (2019). UK Local Growth Dashboard.
33 Calculation based on data from UK Business: Activity, Size and Location 2021 published by ONS following a user request (AH1019). Please contact What Works Growth if you would more information on this data or on how to request similar data.
34 An alternative approach for converting turnover into employment is to use the 'labour share'. This is discussed in our local procurement briefing.
35 ONS (2023). Business demography, UK.
36 ONS (2023). Business demography, UK.

studies looked at this in our access to finance evidence review, with only one finding positive effects and two finding no effect.

To use these figures to assess likely policy impacts start by trying to understand whether loans will be used for investment or cash flow. Investment projects are more likely to grow employment, whilst funding for cash flow is more likely to sustain current employment levels. Where projects are expected to lead to increased employment, establish baseline employment by considering the type of businesses that will be supported – start-ups or existing businesses – and their employment levels. Combining potential rates of growth with baseline employment levels will give a rough estimate of the number of additional jobs that could be created.

Displacement and crowding-out

Increased employment in supported businesses may result in displacement. Displacement occurs when higher employment at a business results in lower employment at other businesses, for example, because customers switch from an existing business. When assessing local impacts, a key consideration is whether employment at supported businesses is due to displacement from other local businesses. This is more likely for less unique goods and services, for goods and services sold primarily in local markets, or when competitors are based in the same area. For these reasons, non-tradeable sectors – such as retail and hospitality – are much more susceptible to local displacement than tradeable sectors.[37]

Targeting support at businesses in tradeable sectors, especially those serving international markets, will minimise displacement. However, these are the businesses that tend to already be best served by mainstream financial providers. Where support is offered to non-tradeable businesses, unless there is evidence that the supported organisation fills an unmet need, adjust employment estimates downwards when moving from direct jobs to total local jobs to account for displacement. The scale of displacement will depend in part on the geography considered, with displacement more likely the larger the geography area (for example, is more likely across a region than within a local authority).

Scottish Enterprise recommend using the location of the business's competitors and the state of the market to calculate the likely scale of displacement.[38] For example, if all competitors are judged to be based in the same area, then the displacement would be put at 100 percent assuming the market is broadly stable.

This figure can then be adjusted if the market is experiencing growth or decline. If the market is growing strongly for instance, Scottish Enterprise suggest an adjustment of 0.5 could be made to account for this, reducing the displacement percentage to 50 percent. When making these kinds of adjustments be careful to consider the question of deadweight – the amount of employment growth that would have occurred in the absence of any policy support. While displacement may be smaller in growing markets, deadweight will tend to be larger.

Estimating the total impact on jobs

When a policy results in net additional jobs in an area – that is, additional jobs at supported businesses exceed displacement – this can have further impacts on local employment.

One mechanism for this is through supply chains. For example, if expanded employment means more purchases from a local supplier, this will increase revenues and may lead to the supplier increasing employment.

Additional local jobs can also be created if those newly employed in the area spend some of their

37 For more information on non-tradeable and tradeable sectors, see https://whatworksgrowth.org/insights/understanding-tradable-non-tradable-sectors/

38 Scottish Enterprise (2014). Scottish Enterprise Impact Appraisal and Evaluation Guidance.

income locally. For example, increased local employment is likely to increase demand for goods and services on the local high street, creating more retail and hospitality jobs. Local jobs created in this way tend to be in non-tradeable sectors, which means they need to be done locally, either because they require face-to-face interaction (as with health care, education, and hospitality) or because local production overcomes substantial 'transaction costs' related to distance (like in local food delivery and perishable goods).

The same mechanisms operate where support sustains employment, as this prevents wider negative impacts on supply chains and local spend from job losses.

An employment 'multiplier' can be used to calculate the total number of jobs created when a policy results in net additional jobs in an area. There are several ways to estimate the multiplier. Evidence reviewed for the What Works Growth local multipliers toolkit suggests that the multiplier for private sector jobs is around 1.3. This means that, on average, for each net additional private sector job created (i.e. direct employment net of displacement) 1.3 additional private sector jobs will be created indirectly, with 0.4 jobs created through the supply chain and 0.9 from increased demand from income spent locally.

The Office for National Statistics (ONS) uses a different method, known as input-output analysis, to estimate the multiplier for different sectors. The ONS figures suggest that each net additional job creates 0.7 private sector jobs in the supply chain (but provides no estimate for the jobs created through increased incomes).

The 0.7 to 1.3 figures are averages. The employment multiplier could be larger or smaller than this, depending on:

- The extent to which businesses use local suppliers: the more they use them, the more jobs should be created in the local supply chain.
- Where new employees will work, live, and spend their income. This will affect the extent to which increased demand for goods and services occurs within the local area.

Understanding supply chains, travel-to-work patterns, and spending patterns will help with assessment of the extent to which support will feed through into employment. This is discussed in more detail in our public sector relocations briefing.

Our access to finance evidence review includes three evaluations that look at the overall effect on local employment. Two find positive effects, and one mixed effects (with positive effects on employment growth in the short-term but no effect after two years). New business starts are a key source of job creation, so debt finance could potentially contribute to job creation if it helps increase business starts. The evidence review identifies four studies that evaluate the impact of policies to improve access to debt finance on business starts. Only one study finds positive effects, with one finding mixed effects, and two no effects.

Whilst there is no evidence that suggests that the source of loans (CFI or mainstream financial institutions) has an impact on employment outcomes, there is some limited evidence that employment is more stable in areas where a larger proportion of deposits are held by CFIs. However, as this finding comes from a country where CFIs account for a large proportion of local banking services, it may not be transferable to the UK.

Who benefits?

Consider whether additional jobs at supported businesses, displaced jobs at other firms and any jobs created as a result of multiplier effects are likely to be filled by local residents. The higher or more specialised the skills required, the greater the likelihood that roles will be filled by those living

outside the area. If jobs are filled by local residents, they are more likely to spend their wages locally, increasing the benefit to the local area.

Comparing the skills requirements of jobs affected to the skills of local residents, and analysing existing commuting patterns will help calculate the spatial distribution of employment effects. Training programmes may help ensure that local people benefit from jobs created.

Relative impact on employment

Impacts on employment should be compared to total employment in the area. The working age population of the median sized English local authority is 83,600 (North Hertfordshire), which means improved access to debt finance would need to create 836 net additional jobs to increase the employment rate by one percentage point (or sustain the same number of net additional jobs to prevent the employment rate falling by one percentage point).[39] The equivalent figures for the largest (Birmingham) and smallest (Rutland) local authorities are 7,398 and 197 net additional jobs. Given that the average number of employees in businesses with less than 50 employees is four, and the potential for displacement, large numbers of businesses would need to be supported to achieve a modest percentage change in local employment.

Key messages

Debt finance that is used for business development may lead to employment growth in supported businesses – but not all projects will lead to employment growth. Finance used for cash flow is more likely to sustain current employment levels, if it has any effect on employment.

Increases in employment in supported businesses may displace employment in other local businesses. Targeting support at tradeable sectors will help minimise displacement but businesses in these sectors may not need support.

Additional local jobs can also be created if supported businesses develop local supply chains or if those newly employed in the area spend some of their income locally. Understanding supply chains, travel-to-work patterns, and spending patterns will help with assessing how many additional jobs will be created.

Consider whether additional jobs at supported businesses, displaced jobs, and jobs created as a result of multiplier effects are likely to be filled by local residents. The impact on the local economy will be greater if jobs created (or sustained) are filled by local residents.

Impacts on employment should be compared to total employment in the area. Unless the programme is large, support is likely to have a modest impact on local employment levels.

3.5 Turnover and profits

Will improved access to debt finance increase business turnover or profits? The evidence on turnover from our access to finance evidence review is broadly positive, with four out of six studies finding a positive effect, one no effect, and one a negative effect.

An increase in turnover may be a precursor to other changes. For example, securing finance for new equipment can enable a business to increase output, increasing turnover, which may in turn lead to an increase in employment, wages, or profits.

As with employment, and as discussed in detail in Section 3.4, increased turnover in supported

39 ONS (2022). Estimates of the population for the UK, England, Wales, Scotland and Northern Ireland.

businesses may displace turnover of other businesses. Account for displacement when moving from business effects to local effects.

Business profits are turnover (revenues) minus costs. Debt finance can improve profits if it increases turnover, decreases costs or both. As access to debt finance can have positive effect on turnover, there is potential for increased profits if costs remain the same or decrease. Four studies in the access to finance evidence review evaluate the impact on profits and the findings are mixed, with two studies finding positive effects and two no effects. One of the studies in the evidence review finds both turnover and costs increase resulting in no overall effect on profits.

Ability to increase profit margins will depend on the level of competition faced by supported businesses and the overall state of economy. One of the studies in the evidence review that finds no effect on profits evaluates an intervention introduced during a period of economic crisis, when profits were under pressure.

As previously discussed, businesses benefiting from access to finance interventions are more likely to be small. Profit rates differ by business size – but the differences are relatively small with 79 percent of micro-businesses (with between one and nine employees) making a profit in the last financial year, compared to 81 percent of small businesses (10 to 49 employees) and 83 percent of medium businesses (50 to 249 employees).[40] This suggests that the size profile of supported businesses is unlikely to affect whether there is an increase in profits – but other business characteristics (such as sector) may matter.

Consider the extent to which debt finance is likely to increase turnover, reduce costs or both when assessing potential benefits for supported businesses. This should consider the overall state of economy, the degree of competition in the markets supported businesses operate within, and the scope for displacement. In the absence of further evidence, it is reasonable to assume that the impacts on profits will be small.

If access to debt finance interventions support locally owned businesses, and increased profits are distributed to owners, this will benefit the local economy. As the amounts distributed to each individual become larger, the proportion spent locally is likely to decrease as profits are more likely to be taxed (or taxed at a higher rate), more likely to be saved or invested, and less likely to be spent on goods and services produced locally.

There is no evidence that suggests that the type of financial institution providing finance affects turnover or profits, so calculations of the impact of improved access to finance on turnover and profits should not be adjusted in cases where finance is being provided by a CFI.

Key messages

There is good evidence that access to debt finance interventions can lead to increased turnover.

Increased turnover within supported businesses may displace turnover of other businesses, reducing the effect on the local economy.

Increasing profit margins will depend on the ability to increase turnover, reduce costs or both, alongside the level of competition faced by supported businesses, and the overall state of economy.

In most cases, it is reasonable to assume that the impacts on profits will be small.

40 DBT (2023). Small business survey 2022.

3.6 Wages

Will improved access to debt finance increase wages? The evidence from our access to finance evidence review is mixed, with four out of eight studies finding a positive effect, one finding mixed effects, two no effect and one a negative effect.

In supported businesses, the effect on wages is likely to depend on the effects on productivity, turnover, and profits. As outlined in Section 3.3 and 3.5, not all debt finance will lead to improvements in productivity, or higher turnover and profits. Improvements from improved productivity will not always translate into higher wages. For example, they could be used to increase profits instead benefiting owners over workers.

As larger businesses are more likely to be able to access mainstream finance, access to finance interventions will generally support smaller businesses. Wages in smaller businesses tend to be lower than in larger firms – sometimes referred to as the 'firm-size premium'. This is discussed in more detail in our briefing on plural and local ownership. Again, understanding how debt finance will be used, alongside the profile of supported businesses will help in estimating the likely impact on wages at the business level.

Turning to local area effects, these could come about in two ways. If supported businesses account for a large proportion of local employment, and wages have increased, this will have an effect on average wages at the local level. However, as supported businesses are most likely to be small, this is unlikely. Alternatively, if debt finance leads to an increase in net employment (direct and indirect jobs, minus displaced jobs) this could affect local wages, as these reflect overall labour supply and demand in the area. However, unless the change in employment is large relative to the overall size of the local labour market, it is unlikely that there will be effects on wages. In most cases, the change in jobs is likely to be small relative to the overall labour market, so it is reasonable to assume that there will be no effect on local wages. One potential exception is if the jobs are in specialised labour markets, when wages for those specialist skills may increase. However, as this only affects a small part of the labour market, the overall impact is still likely to be limited. In most cases, assume there will be no effect on local wages.

There is no evidence that the source of loans (CFI or mainstream financial institutions) has an impact on wages.

Key messages

In supported businesses, the effect on wages is likely to depend on the effects on productivity, turnover, and profits. At the local level, it is unlikely that there will be effects on wages unless supported businesses account for a large proportion of local employment or support leads to a large increase in local employment.

3.7 Other income effects

Will improved access to debt finance have other local income effects? Support to businesses could also impact the local economy through the 'capital share' – the proportion of the additional revenues that go to owners of capital assets such as buildings, machinery, data, patents or brands. For example, if a business uses debt finance to rent additional office space, some of the additional revenue will go to the owner of the building. Data on the capital share can be used to calculate the potential scale of these impacts. Again, geography matters and the extent to which these increased

returns remain in the local area depends on whether owners of capital assets are based locally.

Where lenders are local (for example, a locally-based CFI or direct lending by the local or combined authority), repaid funds (principal and interest) can be reinvested, either into future lending or (in the case of local authorities, other activities).

Key messages

If supported businesses increase their use of capital assets such as buildings, machinery, data, patents or brands, this will increase the incomes of asset owners. The extent to which this benefits the local economy depends on whether the assets are locally owned.

4. Assessing wider benefits

Improving access to debt finance that strengthens the local business base may also have wider benefits. For example, local businesses often sponsor local events and groups which may increase people's sense of belonging, ownership, empowerment, and pride in an area. More generally, increasing local employment and wealth has the potential to create more social cohesion, a sense of belonging, and feeling more connected to and proud of their community and area.

One other potential wider benefit from CFIs may come if they are more likely to provide support for social enterprises or community enterprises than mainstream financial institutions. Social enterprises trade primarily to support a social or environmental mission, and community enterprises are usually set up to benefit a community. Both types of enterprise can play an important role in providing social infrastructure within a local area. Our briefing on plural and local ownership provides more information on assessing the impacts of supporting plural ownership.

However, in most cases, these benefits are likely to be small and difficult to measure.

Key messages

As businesses often play important roles in their communities, improving access to debt finance that strengthens the business base may also have wider benefits.

Support to social enterprises or community enterprises could have wider social benefits as they play an important role in providing social infrastructure.

5. Assessing costs

Consider the potential costs for policymakers and businesses.

The main cost for policymakers will be the provision of support to improve access to debt finance. As set out earlier, there are diverse policy options – including supporting businesses to improve their financial readiness, providing loans, guaranteeing loans, and supporting alternative sources of finance to develop – so potential costs are highly variable. Support should reflect the nature of the problem that the policy is seeking to address.

The main costs to businesses come from taking on risk and the need to service debt. This is a particular worry for interventions that offer higher cost borrowing to business that would otherwise be unable to access debt financing. This will happen, for example, if the (lower quality) profile of lenders

(with higher potential default rates) has to be reflected in the cost of loans provided by an intervention.

Key messages

Consider the potential costs for policymakers and businesses.

As there are diverse policy options, potential costs for policymakers are highly variable.

Increased risk and higher costs of borrowing are the main potential costs for businesses.

6. Monitoring and evaluation.

This briefing provides a framework to help policymakers assess the benefits and costs of policies to improve access to debt finance, including supporting CFIs. Collecting monitoring data and, where possible, undertaking evaluation of the impact of the policy interventions will help assess impacts and increase the data and evidence available to inform future decisions.

Key messages

Use monitoring and evaluation to assess the impact of policies to improve access to debt finance, including supporting CFIs. This will help improve future decision-making.

what works centre for
local economic growth

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