

# Introduction

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Small business, it is often said, is the engine of the economy. In Australia, there are more than two million small to medium-sized enterprises (SME) and one is born every two minutes. They employ more than seven million people and account for more than half of total income for non-financial businesses. But despite, or perhaps because of, their sheer numbers, remarkably little is known about small businesses in Australia. As soon as you look more closely at the sector, you realise that there is a great deal of diversity hiding behind the descriptor 'small business'. Some are hoping to be the next Google or Apple, ready to take over the world and change everything. Others are the outgrowth of their owner's hobby. They have no aspirations to change the world, they are just happy that someone is willing to pay them to do something they love.

Consequently, the firms that make up the sector may have very different needs for funding, may react very differently to the policy environment and, thus, may behave very differently over the economic cycle. For example, while we often hear that small businesses are reliant on banks for business finance, how true is this? Is being on a first name basis with the branch manager, as theories about 'relationship lending' suggest, important? Are other sources of finance, such as trade credit, personal credit cards and mortgages just as useful? Do research and development incentives and tax concessions help to stimulate small business activity? And, most critically, how does the answer depend on whether you want to be the next Google or just have a comfortable life?

The answers to these questions are not of mere academic interest. In the current economic environment, with weak growth and relatively high unemployment, the behaviour of small business could have a large effect on the future path of the economy. There are concerns that the current slow productivity growth, if it continues, will not support the improvements in living standards that we have grown used to. So a surge of hiring, investing and innovating from small business would certainly be welcome. But wishing it will not make it so. Rather, a good understanding of what drives and affects the sector is needed if policies are to be well targeted.

It is to this task of better informing the policy debate that the Bank's annual conference was directed this year. The papers presented at the Conference covered three broad areas: understanding the diversity that exists within the small business sector; examining the different ways that small business finances itself; and looking at innovation in the small business sector and its contribution to overall productivity growth.

The Conference began with an overview of the small business sector in Australia provided through papers by Sam Nicholls and David Orsmond, and Scott Holmes and Dhruva Gupta. Mr Nicholls and Dr Orsmond present information from the Reserve Bank's business liaison program. In addition to providing general information about the sector, they examine the drivers of business decisions to see if there are any differences between small and larger businesses. They find that there is

generally no statistical difference in pricing, employment and investment decisions between small and larger businesses. However, there is some evidence that smaller businesses are less forward looking in their decision-making.

Professor Holmes and Mr Gupta report results from a new survey methodology that they have developed. By asking small businesses to rank the relative importance of different forces affecting their business, the authors categorise businesses into five segments. They hope that this approach can inform more effective policy by recognising the differences between these segments, rather than relying on one-size-fits-all approaches.

A key insight from both these papers is the diversity of the small business sector. There are differences between the self-employed and firms with employees; there are firms that want to grow and others that are quite content doing what they have always done; and there are firms that will succeed, but many that will fail.

The Conference then turned to examining the various forms of finance available to small businesses and how financing conditions affect these firms. Three papers separately addressed intermediated credit, housing equity and trade credit as sources of funding for small business.

Gregory Udell provides a comprehensive overview of what we know and what we don't know about intermediated credit for SMEs. Professor Udell emphasises that, although bank loans are the predominant form of external finance for small business virtually everywhere in the world, they are just one of a number of lending technologies used to finance SMEs. Similarly, many important non-bank financing channels exist. Indeed, Professor Udell argues that the literature may have gone too far in emphasising relationship lending to the detriment of other lending technologies, such as equipment financing and factoring. Professor Udell also provides his view on the 'top 10' areas for further research.

Other than bank credit, the most common form of finance used by small businesses is housing equity. Ellis Connolly, Gianni La Cava and Matthew Read present an examination of the use of housing equity in small business finance in Australia. They also look for evidence of whether higher house prices affect entrepreneurship through a collateral channel. They do this from three perspectives: the lender, the borrower and a combined perspective. The lender's perspective is based on interviews with lending institutions conducted as part of the RBA's business liaison program. They report that, by and large, while housing collateral is not necessary for lenders to grant a loan, in practice, housing collateral is used in the majority of loans. This prevalence reflects a combination of lenders' preference for some security and borrowers' preference for the lower interest rates that are associated with collateralised loans. The borrower's perspective is provided through analysis of household-level data. Using these detailed data the authors find some evidence of a link between higher housing equity and business formation. The last part of the paper, the combined perspective, looks at postcode-level data on house prices and new business registrations. Once again, there is evidence that an increase in house prices is associated with an increase in the company entry rate. In short, housing equity appears to be an important channel of funding used by small businesses in Australia.

The final paper in this set, by Lars Norden and Stefan van Kampen, examines the relationship between trade credit and bank debt. In particular, they find that the relationship varies over the cycle. While trade credit and bank debt appear to substitute for each other during normal times,

during the global financial crisis both contracted together. Thus, they conclude, trade credit has little scope to replace bank debt during credit crunches. Moreover, the authors show that firms with lower credit quality are least able to replace bank debt with trade credit.

The Conference then turned to an investigation of productivity and innovation in small businesses. Alfons Palangkaraya, Thomas Spurling and Elizabeth Webster investigate the effects of innovation on productivity in a sample of 7 000 Australian SMEs. They find that firms that introduce an innovation raise their productivity level by 5 percentage points relative to the industry average over the following four years. Firms that innovate in collaboration with others (e.g. with a university) raise their productivity even further. Given the obvious gains from innovation, the authors wonder why every firm does not innovate. Their answer is that innovation is hard work and, depending on the niche a firm is in, may not be necessary for the firm to meet its objectives. This answer links back to the findings from the papers by Mr Nicholls and Dr Orsmond and Professor Holmes and Mr Gupta and reflects the diversity in the small business sector, both in the level of competition and the objectives of the owners.

The final paper, by Dan Andrews, Chiara Criscuolo, Peter Gal and Carlo Menon, looks at a large cross-country dataset on firm-level labour productivity compiled by the Organisation for Economic Co-operation and Development. They start with the observation that, within countries, productivity is not clustered around the mean but is instead characterised by many below-average performers and a smaller number of star performers. Furthermore, there are large differences across countries. In seeking to explain this observation the authors focus on the efficiency of resource reallocation within a country. Broadly, if underperforming firms limp on rather than close and free up the resources they use for more productive uses, aggregate productivity may be lower. The authors present evidence that indeed shows a correlation between firm entry and exit and aggregate productivity. This fact suggests that the age of a firm is a better indicator of dynamism than size. A corollary is that regulatory policies that focus on the size of an enterprise may be less efficient than policies that focus on age.

The Conference concluded with a panel discussion about the future of small business in Australia led by Michael Schaper. Michael Henderson, Bruce Jeffreys and Kate Carnell offered their insights based on their experiences in the sector. While each participant's experience was different, there were a number of consistent themes. In particular, each highlighted the way the internet has allowed small businesses to both outsource work and reach customers in ways that were previously very difficult. A consequence is that defining businesses by their number of employees – when outsourcing allows small businesses to behave like much larger businesses – may be an increasingly misleading way of categorising businesses.

Overall, the papers presented and the discussion at the Conference made it clear that small business is not well served by clichéd generalisations. Some small businesses hope to be the next Google, but most do not. Some small businesses will grow to become very large businesses, but many will not. Some small businesses rely on bank loans, but many do not. Some policies will help small businesses, but they may not stimulate innovation, entrepreneurship and growth. Thus, it may be best to dispense with the metaphor of small business as the engine of growth, with all parts moving in unison to a single purpose, and start focusing on the nuts and bolts. The papers in this volume make a good contribution to that endeavour.

