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From the Private Secretary

29 November 1982

MEASURES TO ASSIST THE PROVISION OF
FINANCE TO SMALL COMPANIES

The Prime Minister found it helpful to learn, from the Chancellor's minute of 26 November how his ideas are developing about an enterprise package in the next Budget.

Mrs. Thatcher has commented that she is not attracted to proposals for interest rate subsidies. She believes that these would give rise to a bombardment of similar requests for subsidy from other interests. She agrees with the Chancellor that the extension of the start-up scheme along the lines discussed in the minute is to be preferred to the proposal for small firms investment companies.

M. C. SCHOLAR

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PRIME MINISTER

MEASURES TO ASSIST THE PROVISION OF FINANCE TO SMALL COMPANIES
With the help of Nicholas Ridley and John Wakeham, I have been considering a range of options in this area as one component of an enterprise package in the next Budget. I thought you might find it helpful to know the way in which my ideas are developing.

2. We have a number of objectives in this area. To some extent they point in the same direction but it is worth setting them out separately:-

- (a) Increasing investment in productive assets.
- (b) Improving the capitalisation of small firms.
In general small firms rely too much on debt (usually overdraft) and have too little equity. The cash flow pressures of paying interest and repaying debt can threaten the survival of some companies and make others less expansionary minded. Michael Grylls' group is, as you know, very concerned about the inhibiting effects of cash flow pressures.
- (c) Substituting equity finance, or long term loans, for bank borrowings to restrain monetary growth.
- (d) Encouraging wider share ownership and encouraging the risk ethic among investors.
- (e) Helping small firms overcome the problems of their size - and so enabling them to exploit the advantages.



3. With these objectives in mind, we have been examining four main options:-

- extending the Business Start-up Scheme
- interest rate subsidies
- encouraging the conversion of debt into equity
- small firms investment companies (SFICs).

Business Start-Up Scheme

4. There are two main ways in which the Scheme might be extended in coverage, and in time (the present scheme is due to end in April 1984).

Coverage

5. The Scheme is gradually gaining momentum and is widely recognised as innovative and imaginative. Criticism of the restrictions involved is falling away as people come to appreciate the problem on which it is targeted. But doubts are still expressed (e.g. by the CBI) about the limitation to start-ups.

6. I am very attracted to the idea of extending the Scheme from start-ups to existing companies. This would be a major step in itself, and could be consistent with the objectives outlined above - though it could also be quite expensive.

7. Extension raises two key issues: how to define "existing companies", and how to avoid the money going to them at the expense of start-ups.

8. The age of qualifying companies might just extend from "up to 5 years old" to "up to (say) 10 years old". But this is not enough. In extending the Scheme to existing companies, the aim would be to help companies which wish to expand and this bears no necessary relationship to their age.

9. A better starting point is to extend the Scheme generally to all unquoted trading companies. The logic would be that this



was a positive recognition of their lack of access to the Stock Exchange. Some might question the need to extend the net to cover the likes of Lansing Bagnall and Macmillans: if that became a problem we could consider a cut-off point, limited perhaps to size of existing share capital. But there is the precedent of the arrangements for the purchase of own shares - which apply to all unquoted companies.

10. An extension of this sort on the same very generous terms as the existing Scheme could jeopardise the provision of finance to the start-ups. Also, investment in existing companies which have a track record is likely to be less risky than in start-ups. These considerations point to a two rate regime:-

- the existing scheme giving the investor tax relief at marginal rate for investment in start-ups should remain broadly as it is;
- for established companies the investor should get tax relief at either the basic rate only or at (say) half the marginal rate.

There are, of course, numerous important details to be worked out - e.g. the qualifying rules and limits; the precise rate of relief; and the rules for the Approved Funds under an extended Scheme. But, on a first reading, there do not seem to be any insurmountable difficulties.

Timing

11. It follows that the BSS scheme should be extended beyond April 1984. The extension in time - but not in coverage - will be announced in the near future as the prospect of the scheme ending in April 1984 is already said to be inhibiting investment through the scheme.



Interest rate subsidies

12. This is a perennial. one example.

- I don't like this. We should be bombarded with similar requests from other ministers etc

Michael Grylls' latest proposals are

13. In principle most ideas in this area are not attractive. Subsidies encourage companies to borrow more; but they really need to take equity finance rather than debt. In addition subsidies can be very expensive and the result can be high interest rates for those not lucky enough to be in the scheme. Finally subsidies which encourage bank borrowing work against monetary control. The original Grylls proposal fell for these reasons.

14. One of his latest proposals is a little better. We have been examining a variant along the following lines:-

- restricted to small firms; (~~OR~~ unquoted companies)
- restricted to medium and long term finance;
- the finance being provided by intermediaries subject to their normal criteria;
- the intermediaries raising the finance by issuing bonds (rather than through monetary expansion);
- the interest rate charged to the small firms being subsidised. This subsidy would represent public expenditure.

15. While this seems to be the best approach, it is a fairly major step. It would help small firms if they used the cheap finance to replace bank loans. It might encourage marginal investment. But it is a pretty indiscriminate subsidy. It encourages debt, not equity. The cost would be hard to control. There is an obvious danger that the pressure that would build up to make it available to all firms, not just the small (however defined), with consequent damage to monetary policy, and interest rates.

16. With this latter point in mind, and to encourage equity, one possibility would be to make the scheme available only to unquoted companies which had also raised equity finance. This might be on



the basis of £1 of subsidised credit for every £1 new equity. This would tend to concentrate the new loans on expansion situations, where new equity was being raised (including under extended BSS scheme above). It would do so without worsening the gearing.

17. I have asked officials to work up a scheme of the sort outlined above, with a possible equity link. It merits further consideration.

Debt-Equity conversion

18. A direct way of improving companies' balance sheets would be to encourage banks to turn their loans (and overdrafts) into equity.

19. There are of course prudential limits on how far the banks should go in this direction. Moreover, in rescue cases banks can normally already write down outstanding debt for tax purposes, and further encouragement to the banks would probably have to take the form of even wider tax concessions. There are obvious difficulties in providing banks, or all people, with another new tax shelter. But at the same time debt-equity conversion schemes may offer one effective means of helping companies on the brink of liquidation due to the burden of interest payments on their short term debt. Any practicable tax shelter proposals to this end would clearly be worth looking at closely. Such a scheme might be linked to the BSS/Subsidised loans scheme discussed above, to persuade banks first to convert to equity and then sell the equity to private shareholders.

20. The Bank of England have been asked for a note on their views of the scope for useful action here.

Small Firms investment companies (SFICs)

21. As you know Patrick Jenkin, John MacGregor and the CBI are keen on SFICs. Nicholas Ridley, John Wakeham and I do not fully share their enthusiasm.



22. In principle, we think our aim should be to encourage the individual investor to take a direct stake in companies. The balance has been tilted too far in the direction of channelling savings through institutions, and, in the end, the SFIC is another institution. There is a risk that investors would be no more conscious of the links between their investment in a SFIC and the small companies it invests in, than in the link between their premiums on a life policy and the insurance company's investment in equities, or their superannuation contributions and the pension fund's investment policy.


23. The new Approved Funds under the BSS, like Electra and Basildon, are to be preferred on these grounds because they act solely as managers and nominees for their clients. The investor remains the direct owner of the portfolio of shares invested on his behalf in the small companies.

24. I would like to see more "brokerage" activity aimed at bringing companies and investors together. But this does not require SFICs. Local Enterprise Agencies would be more appropriate. Nicholas Ridley will be discussing this with DOI, and possibly DOT, Ministers in the context of extending the Start-Up Scheme.

✓ 25. Overall I consider the extension of the Start-Up Scheme along the lines discussed above is to be preferred to SFICs. But equally it would be premature to dismiss the SFICs idea entirely, and we will leave it on the table as work progresses.

26. In summary the position we have got to is:-

✓ (a) work is pressing ahead on extending the coverage of the Start-Up Scheme;

(b)  further consideration is to be given to a limited interest rate subsidy scheme, whether linked to the Business Start-Up Scheme as extended, or not;



- (c) in the light of the Bank's views on debt-equity conversion we shall examine any specific proposals to emerge which appear worth pursuing, in the context of (a) and (b) above;

- (d) the need to encourage local enterprise agencies to undertake a more active brokerage role is to be pursued with the appropriate Ministers in other Departments.

27. It therefore seems likely that I will be able to include something quite substantial in this area in the Budget as one element of an enterprise package.

G.H.

26 November 1982