Senedd Cymru
Pwyllgor yr Economi, Masnach a Materion Gwledig
Ymchwil a Datblygu
RD02
Ymateb gan: Ffederasiwn y Busnesau Bach Cymru (FSB)

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Welsh Parliament
Economy, Trade, and Rural Affairs Committee
Research and Development
RD02
Evidence from: Federation of Small Businesses Wales (FSB)

Research and Development

Consultation Response: Economy, Trade, and Rural Affairs Committee
FSB Wales
November 2023

About FSB

FSB Wales is the authoritative voice of businesses in Wales. It campaigns for a better social, political, and economic environment in which to work and do business. With a strong grassroots structure, a Wales Policy Unit and dedicated Welsh staff to deal with Welsh institutions, media and politicians, FSB Wales makes its members' voices heard at the heart of the decision-making process.

SMEs form the overwhelming bulk of businesses in Wales. They are grounded and embedded in our communities and provide vital services and amenities, as well as jobs and prosperity. They form the foundation for local economic development and create value within our communities. R&D is important to innovation (including process innovation and growth).

What challenges are Welsh businesses facing in terms of awareness of, and access to, public research and development funding?

It is useful to separate out the discussion between challenges faced by UK businesses (and Welsh businesses as well), and the issues that are more specific to Wales.

UK

The proportion of R&D fiscal support going to UK SMEs is much lower than other OECD countries. In April 2023, the UK Government dramatically cut the R&D Tax Credit Scheme for SMEs.

However, FSB's recent report 'The Tech Tonic' found that:

- The R&D Tax Credit Scheme drove a huge increase in small businesses investing in R&D since 2020.[1]
- FSB research shows 64% of small firms who applied for R&D tax relief in the last three years had improved cashflow for their business, while over a half (55%) increased their investment in R&D.
- Two-fifths have used the tax credits to increase their investment in future projects, and more than a third of recipients say it has led them to undertake projects that would not have happened otherwise.

As such, UK Government cuts to R&D tax relief, even for R&D intensive firms, are self-defeating. This is especially so when countries such as France and the US are going in the opposite direction and where evidence shows it's providing for growth. It is also likely that this is an area that will impact the manufacturing sector disproportionately.

[1] C Russell (FSB: August 2023), 'The Tech Tonic: Shifting the ground on tech adoption and innovation in small businesses', available at https://www.fsb.org.uk/resource-report/the-tech-tonic.html

There has yet to be an official assessment on the impact of R&D tax credits cuts on small firms. The UK Government should publicly publish a review of the impact on the levels of R&D conducted and its impact on SMEs. FSB's recent report 'The Tech Tonic' recommends that at least 10 per cent of the UK's overall R&D budget should be allocated to SMEs.

Previous FSB research [2] has noted the importance of organisational change as an impactful form of 'intra firm' innovation is underlined by the evidence suggesting that of those who innovated, organisational innovation generated the largest impact on sales, which serves as an indicator of the impact of innovation. The table shows that of those who introduced organisational innovation, 76% have increased their sales. Organisational change has been defined as improved methods of organisational structure, work responsibilities and decision making (including a first use of a new system of employee responsibilities, team work and decentralisation, integration or de-integration of teams, education/ training systems). This draws into sharp relief how important effective leadership and management is to deliver impactful change, and the space this allows for innovation among time-poor owner managers in SMEs.

	Organisational	Marketing	Process	Product NTF
Increased sales by up to 10%	29%	29%	27%	32%
Increased sales by up to 20%	26%	22%	25%	23%
Increased sales by up to 50%	11%	9%	10%	9%
Increased sales by more than 50%	4%	4%	6%	4%
Increased sales by 100% or more	6%	5%	7%	4%
No change to sales	13%	13%	15%	14%
Decreased sales by 10% or less	1%	1%	1%	1%
Decreased sales by 11% or more	1%	1%	1%	1%
Don't know / Not sure	10%	16%	9%	14%

Many businesses are not able to access private sector finance to support their innovation. The Welsh Government has a role to play in helping small businesses to reduce the risk attached to innovation and incentivise them to drive improvements. Improving the availability of private sector finance would allow businesses to have the opportunity to apply for credit in order to drive further innovation.

It is clear from our research that most small businesses have not used government support to finance their innovation activity. This suggests that the existing system of government support for innovation is not working as well as it could do, and that what constitutes innovation and its aims remain unclear to SMEs, and businesses may need to rely on private sector finance to support the implementation of innovation. Only 7% of innovators said they did not need Government support because they had access to private sector finance.

Only 10% of innovators accessed Government support to finance innovation. The vast majority of innovating businesses (90%) have not accessed Government support to finance innovation in their business.

[2] https://www.fsb.org.uk/resources-page/innovation-report-final-pdf.html

Considerations around risk are central to innovation. Risk appetite levels therefore are an important metric in subsequent levels of innovation and productivity in Wales. FSB research shows that close to three quarters (71%) of innovators reported that they are willing to experiment with their product, process, organisation or marketing. Their appetite for risk is far higher than those who did not innovate and do not plan to innovate in the next three years (26%).

Taking risks is integral to business success. A breakdown according to business size shows that sole traders are less willing to take risks and experiment with their product, service or business process. If we are to tackle the often referred to 'long tail' of low productivity firms, policymakers need to find a way of reaching the 24% of business owners who state they are unlikely or very unlikely to take a risk and experiment with their product, service or business process. This includes making the issue relevant to them and their business in a time where immediate pressures will often lead to necessarily reactive immediate needs in those businesses that will trump longer term innovation planning.

		Sector				
	Total	Manufacturing	Construction	Wholesale and retail trade	Information and communication	Professional, scientific and technical activities
Appetite for risk	71%	78%	57%	70%	86%	69%
Risk averse	24%	19%	35%	26%	14%	28%
Don't know / Not sure	5%	3%	8%	3%	0%	3%

There is some variance in risk appetite by sector, as highlighted in the table above. Recognising and addressing this barrier to innovation must be a priority for the Welsh Government in the development and implementation of the innovation strategy. Consideration should be given to alleviating these pressures through agencies like Business Wales and the Development Bank of Wales, through advice and financial support services.

Wales

It is well acknowledged that historically Wales has won proportionately less than its fair share of UK R&D funding. Wales spends less than its UK population share (5%) on R&D, and also wins less than its population share of competitive external research and innovation funding (spending 2% on R&D and winning 3% of UK external funding respectively).[3]

The same report finds that Wales has a high impact but small innovation sector. This is a model that fits within what economists have called the 'regional innovation paradox.' This occurs where there is a 'comparatively greater need to spend on innovation in lagging regions' but at the same time 'relatively lower capacity to absorb public funds earmarked for the promotion of innovation and to invest in innovation related activities compared to

[3] https://senedd.wales/media/qrobg4st/21-11-research-and-innovation-in-wales-2021-eng-web.pdf

more advanced regions.'[4] It is important that a levelling up strategic approach look at this issue in the long term and is geared to building capacity in areas such as Wales, and to aid innovation and growth. As such we need to build the capacity within Wales to achieve a long term aim of reaching the target of 2.4% of GDP spend in the UK being on R&D. Interim measures for how to measure that progress (greater networking, more research capacity) within Wales over time, with clear milestones, would be a means towards that.

SMEs' awareness of funding available is an issue. It is likely that this problem in Wales is further hampered due to uncertainty in the current wider post-EU funding environment and confusion on what UK funding applies in Wales. It is plausible that where innovation funding and R&D funding tends to sit with UK bodies that this may mean Welsh firms may miss the opportunities. Certainly, interviews for FSB Wales's recent skills report 'A Skills-Led Economy for Wales' found that many struggled to access support and didn't know where to start.

Innovate UK working across with Welsh Government and Business Wales is a step that helps here, and there needs to be clear coordination with Business Wales, so that the firms themselves don't see the joins between levels of government. While not perfect, Business Wales and Development Bank of Wales are a known brand (far more so than their equivalents elsewhere) and trusted part of the furniture in Wales, and so can form a good starting point for firms to access to – or be reached out to in order to - find innovation and R&D funding.

It is important that Welsh business support institutions' services are retained and resourced properly after 2025 in the Wales funding environment and viewed as a competitive advantage.

As with other digital technologies, smaller firms are reluctant to be first movers, and there is evidence that a divide exists between large and small firms in adopting AI. According to research by McKinsey, across all sectors, larger firms are at least 10% more likely than smaller firms to have adopted at least one AI technology at scale or in a core part of their business. FSB research shows that of those who innovated in the past three years, only 3% have adopted AI.

FSB is concerned that the many firms are not well positioned to take advantage of the unpredictable opportunities that could be afforded by AI, in contrast to scale-ups. While the Welsh Government has placed emphasis on the role of AI and automation over recent years, it must ensure that support services like Business Wales are well placed to advise on adoption by SMEs.

FSB Policy Recommendations

- The UK Government should publicly publish a review of the impact on the levels of R&D conducted and its impact on SMEs, and reconsider its cuts to R&D tax credits
- At least 10 per cent of the UK's overall R&D budget be allocated to SMEs.
- UK and Welsh Governments should look to build capacity for Welsh innovation institutions for the long term, with growing this proportion being a key indicator of success for any 'levelling up' strategy.
- This should be geared toward longer term aim to raise the proportion of R&D spend in Wales relative to other regions over time, so that there is absorptive capacity to use and develop that spend over time.

[4] C Oughton, M Landabaso, K Morgan, 'The Regional Innovation Paradox: Innovation Policy and Industrial Policy' in Journal of Technology Transfer (2002), available at https://www.researchgate.net/publication/5152703_The_Regional_Innovation_Paradox_Innovation_Policy_and_Industrial_Policy

- Funding cycles should be adapted to fit such longer term aims.
- Welsh business support institutions' services are retained and resourced properly after 2025 in the Wales funding environment and viewed as a competitive advantage.

What differences are there between funding for universities and funding for industry innovation? Are there regional disparities in the allocation of funding?

Do the research interests of universities and industry differ and, if so, what actions can be taken and by who to ensure the interests of both sectors are catered for?

How can universities and businesses better interact and collaborate with each other?

The interests and needs of universities and industry may often be different and they may have different priorities, but they are not necessarily in opposition, as long as this is dealt with strategically, with awareness of what each part brings, and where they add value in partnership.

What is important is that the funding structure and conditionalities for anchor institutions to act as a central point of contact and convening point to ensure that SMEs are communicated to, engaged and brought into projects. This should sit alongside other measures for impact such as aims to develop spin off start-ups because of innovation projects that impact the wider economy. This is a matter of ensuring the impact and focus of the universities are properly monitored and assessed, including its role in facilitating and shepherding networks and relationship building within the small business community.

Within general funding systems, SMEs are disadvantaged by their size and capacity so have relatively less time to find and work the system with tight funding cycles. Universities will be better resourced and will be more focused on such 'project funding.' This doesn't mean that they have to necessarily be in competition, but it may be that there needs to be more impetus to ensure Universities build networks and engagement and relationships over the long term (and not as one off consultation events or for projects, but to ensure a legacy of a business community network), so that there is an ongoing process of relationship building between anchor institutions and SMEs. This should be an important measure of success for funding for R&D and innovation, as with any other funding.

SMEs are a vital part of the entrepreneurial ecosystem in developing the economic off shoots and bringing to market innovation products and processes. Firms are better able to bridge that divide better than many universities might do for themselves. So, a systemic approach is to ensure all partners are equally important in the decision making and project development.

The weaknesses of Wales's research and development in terms of size (where it is there it has impact), suggest the priority needs to be on building and expanding those networks, and ensuring we build the capacity for Wales to better win and utilise funding available.

Dissemination of process innovation too (e.g., Food sector in mid and west Wales) balanced with building networks. Product innovation is important, but impact needs to understand that process innovation (that is, changes to ways of working, or machinery

used to build efficiency or diversify what a firm can do) is likely to have more impact on business performance among micro and smaller businesses in many sectors.

There are some clear communication issues for policymakers to consider – in particular how we define innovation, which impacts on our strategic aims. Innovation shouldn't necessarily be seen as making radical market disrupting changes or 'shiny new products'. Smaller incremental changes are just as instrumental for innovation and productivity and can be spurred by changing trends and wider policies across government and markets. These 'new to firm' innovations are critical for improving aggregate productivity in Wales, particularly for SMEs. These changes can often be as simple as the adoption of digital technologies such as bespoke software packages for accountancy, HR-related functions or the adoption of cloud computing services. The innovation strategy must account for this important nuance.

With SMEs being disproportionately the economy in some areas, this is particularly so for rural SMEs, and so for innovation in sectors in those areas (e.g. food, agriculture), but remains vital in all areas to ensure that innovation builds capacity and capabilities across all firms and all locations, and is not skewed towards large businesses and organisations.

FSB Wales's new Skills report 'A Skills-Led Economy for Wales' found that SMEs' relationship with educational institutions tended to be ad-hoc and based on personal relationships, and that the onus seems to largely be on SMEs to find the institutions rather than the other way around, despite institutions having a greater level of resource than SMEs. This makes relationships fragmentary, disparate, and dependent on individuals. This supports the idea that a more systemic approach to bringing SMEs in would bring greater dividends.

How effective is Welsh Government's Innovation Strategy likely to be in supporting research, development and innovation in Wales?

The Innovation Strategy has the potential for impact if it drives activity that builds SMEs to innovate for future trends. As such, implementation and the institutional capacity to do so will be crucial. The document remains light on detail around the next steps – although the development of an action plan has been indicated.

The impact, therefore, depends on its implementation and any allocated funding activity that surrounds it. If this effort is done effectively the potential impacts on sales and productivity growth for the business and wider economy would be substantial.

The innovation strategy details some positive and encouraging sentiments, but its protracted form creates a lack of clarity and direction. The document would benefit from a more refined and intentional approach that accounts for the immediate context, future aspirations and – crucially – the levers of the Welsh Government to achieve it.

Progress made in respect of the Welsh Government response to the Fifth Senedd report on 'Research and Innovation in Wales'.

It would be useful to check on progress on Welsh Government's statement on **recommendation 1** following its rejection that it would 'take this recommendation into consideration as we continue to work on the draft vision for the new Commission for Tertiary Education and Research'. With CTER now going into operation and taking on fuller

functions next year, understanding how Wales can measure progress on developing its research capacity and links across business and education should be an important area to scrutinise, and to check on delivery.

Checking on this progress, and **Recommendation 2** on the strategy for CETR to develop its strategy beyond education institutions to business community will be important.

Similarly, **Recommendation 6** understanding whether the mid-level posts have proven to influence over investment decisions in London would be useful, and whether this should be reviewed should be revisited.

Recommendation 9 is key to extending networks and building capacity as outlined in the above evidence. Learning from the impact is also important tin this regard. It would also be useful to understand if the transition from HEFCW to CTER has disrupted these funding streams, the effect it may have had, and how this will be addressed next year when CTER takes on operations in full.