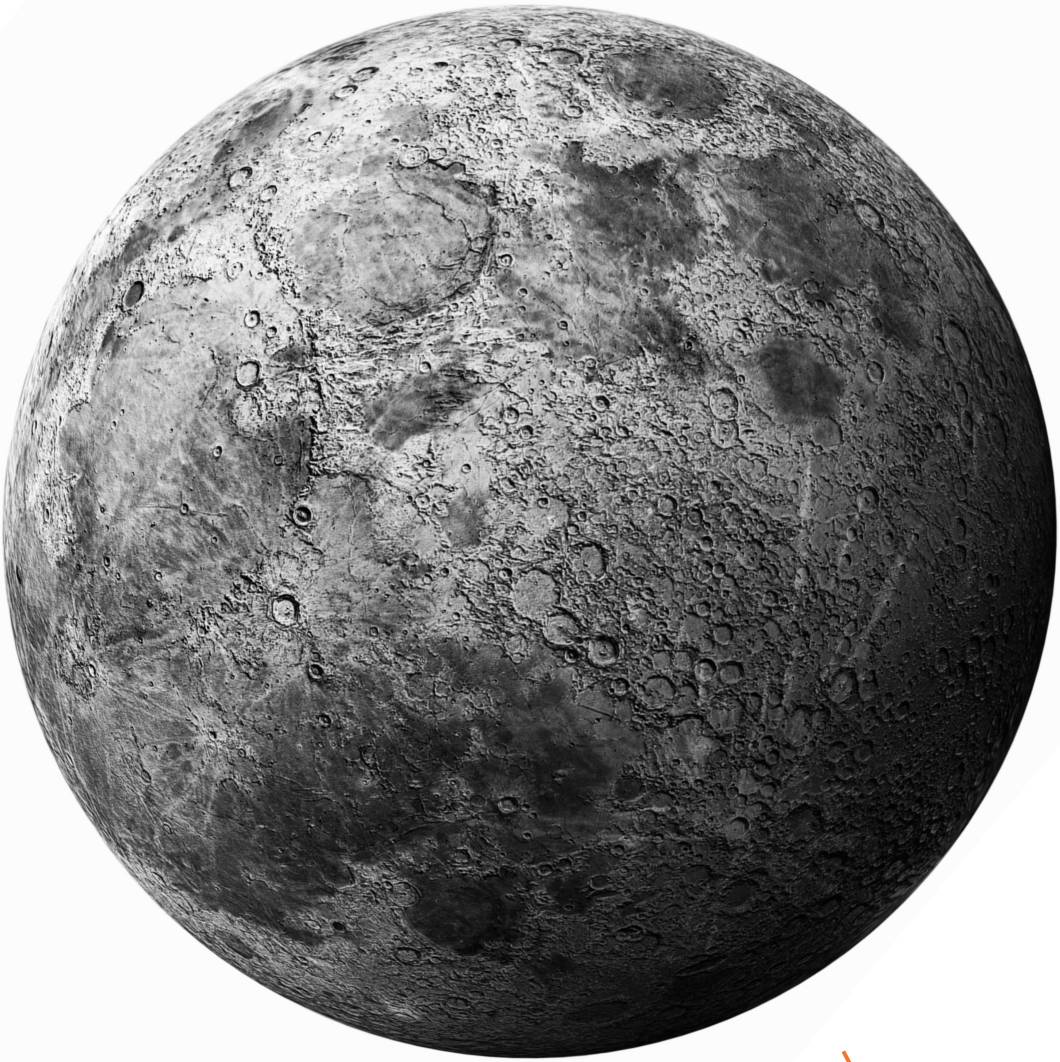

REPORT

SMALL FIRMS, GIANT LEAPS

SMALL BUSINESSES AND THE PATH TO FULL EMPLOYMENT

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ABOUT THE AUTHOR

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All of the views contained in this report are those of the author, and any errors remain his alone.

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CONTENTS

Executive summary 1
From recovery to full employment 1
A new approach: reducing the cost and risk of taking on employees 2
Recommendation one
Business support for new employers and existing micro and small businesses 3
Recommendation two
Retaining and reforming statutory sick pay recovery 4
Recommendation three
Intermediate labour markets in welfare-to-work policy 5
Recommendation four
An occupational benefit insurance scheme for SMEs 6
Conclusion 7

Introduction 8

1. Quantitative evidence on small firms and full employment 9
1.1 Trends in employment by firm size 10
1.2 How have forms of employment varied by firm size? 14
1.3 How do workplace benefits vary by firm size? 20
1.4 Conclusion 21

2. The policy context 23
2.1 How policy influences business hiring 23
2.2 The policy context 26
2.3 What do businesses want? 32
2.4 Conclusion 34

3. A new direction and policy recommendations 36
3.1 Recommendation one
Business support for new employers and existing micro and small businesses 36
3.2 Recommendation two
Retaining and reforming statutory sick pay recovery 39
3.3 Recommendation three
Intermediate labour markets in welfare-to-work policy 41
3.4 Recommendation four
An occupational benefit insurance scheme for SMEs 43
3.5 Conclusion 45

References 47

EXECUTIVE SUMMARY

The jobs recovery is well underway in the UK. This is after a downturn that seriously dampened job creation, but not to the extent expected: compared to the fall in economic output, the fall in employment was not as deep as in many other countries. It is a testament to the flexibility of the UK labour market that employers were able to adjust to weakened demand for their products through means other than laying off workers. Many employers utilised some combination of pay restraint, cutting back on hours, and making greater use of temporary and other atypical contract types, instead of deeper cuts to their overall headcount. These methods of adjustment have come with their own set of issues, including below-inflation pay increases and a rise in underemployment, but the overall resilience of the jobs market in terms of the numbers in work is to be welcomed.

We did see a fall in hiring, however. Adjustments in financial markets meant it was difficult for new and existing small and medium-sized enterprises (SMEs) to access finance in order to grow their business, and weakened overall demand led to an understandable caution within existing firms to expand. This has had an impact on those most likely to both be looking for work and be further from the labour market, most notably the young. And while there has been a remarkable boom in entrepreneurship throughout the nascent recovery, with large numbers of individuals setting up businesses, this has been largely limited to a rise in sole trading as opposed to an increase in the number of new businesses that are also taking on workers: 92 per cent of the growth in new businesses between the start of 2010 and 2013 were among those with either zero or one employee (BIS 2013). The jobs recovery has also seen rises in zero-hours contracts and temporary work. Whether this is a cyclical change or a restructuring of the labour market is still unclear, but it is likely to mean economic insecurity for some workers even as the economy returns to growth.

Small and medium-sized enterprises have contributed enormously to the labour market recovery, accounting for 84 per cent of jobs growth between the start of 2010 and the start of 2013. Overall employment rose by 1.5 million between the start of 2010 and the start of 2013. Of this, 1.2 million was in enterprises with 0–249 employees. Given that they only account for two-thirds of total employment, it is clear that SMEs are disproportionately driving the jobs recovery.

Just as importantly, SMEs have played a disproportionate role in supporting individuals from worklessness into employment. Between 2008 and 2011, 88 per cent of individuals moving from unemployment into employment, and 95 per cent of individuals moving from inactivity into employment found work in either an SME or self-employment. In addition, a greater share of workers in SMEs and self-employment come from groups that face labour market disadvantage, such as the disabled, younger and older workers and those with low levels of educational attainment. This has been linked to the greater informality of employment in SMEs – in contrast to the more uniform recruitment processes in place at larger firms, SMEs are more likely to employ someone who has less experience of work and fewer formalised skills.

From recovery to full employment

As we near the completion of the jobs recovery, we need to look forward and assess the implications of a return to normal in the UK labour market. The working-age employment rate reached 73 per cent in the years leading up to 2007, a level not seen since the early 1970s. But many subgroups in the working-age population nonetheless faced significant barriers to work, having employment rates substantially below the average. These include those with disabilities, older workers, mothers of young children, particular ethnic groups and those with fewer educational qualifications. For some – such as those with work-limiting disabilities, those of Pakistani and Bangladeshi origin and those with no qualifications – employment rates were more than 20 per cent lower than in the wider population both before and after the crisis.

This situation is unsustainable over the medium term, for several reasons. Employment improves the health and mental wellbeing of individuals and can provide a route out of poverty and towards higher living standards. While rates of worklessness were improving in the run-up to the crisis, a significant minority remained economically inactive (over 15 per cent of the working-age population). This damages individuals' employment prospects now and in the future, as human capital erodes and people become increasingly detached from the labour market. Raising the employment rate beyond its pre-crisis level is necessary to reduce structural levels of worklessness and its associated social and economic costs.

Beyond the benefits to individuals, as the labour market begins to tighten it will be essential to make use of the skills of everyone in society in order to support economic growth and raise the productivity of the UK economy. In addition, the changing demographic structure of the UK means individuals will need to stay attached to the labour market for longer in order to save for retirement. Employment opportunities will therefore have to adapt in order to be available to older workers, some of whom will also be living with long-term health conditions.

Also important is the fact that spending on out-of-work benefits will be severely constrained throughout and beyond the next parliament. With all major political parties committed to a programme of deficit reduction, it is unlikely that the value of out-of-work benefits can be maintained without a substantial increase in the number of claimants moving into sustained employment. At the same time, the extra income tax and national insurance revenue generated by a rise in employment will provide much-needed sustainability to the public finances.

IPPR has therefore argued that full employment, defined as an employment rate approaching the best in the OECD (80 per cent) should be an explicit goal of policymakers. This is ambitious but vital, and will require a great deal of innovative policy thinking to tackle the longstanding causes of worklessness, both in general and in terms of the barriers to work faced by particular groups.

This report sets out the role that employers, and SMEs in particular, can play in meeting this long-term challenge for the UK economy, and highlights a public policy approach that can support small businesses in doing this.

A new approach: reducing the cost and risk of taking on employees

With regards to SMEs in a post-crisis labour market, three public policy goals are important.

1. **Increasing the overall scale of job creation.** While this relies in the first instance on a vibrant, growing economy, policymakers should nonetheless be doing their utmost to make it as easy as possible for employers to take on workers. This includes tackling the barriers to becoming an employer. Fewer than 5 per cent of sole traders currently take on an employee in a given year. While we are unlikely to see that proportion increase significantly, even a small rise could have an enormous effect on the overall level of job creation. Similarly, we need to tackle the barriers to employment growth among existing micro and small employers. A small number of existing SMEs currently drive the bulk of job creation in the UK. Helping as many

firms as possible enter a growth trajectory will be crucial in generating jobs and raising the employment rate.

2. **Tackling barriers to hiring those further from the labour market.** Second, employment policy needs to tackle the barriers to hiring those that face disadvantage in the labour market. It has already been shown that small firms provide a disproportionate source of employment for these groups, but as we aim for progressively higher rates of overall employment we will need to increase hiring rates of those even further from the labour market. Taking on many of the individuals within these groups, such as those with few formalised skills, or who have health conditions that give them a higher propensity to experience sickness absence, entails significant risks for employers. And, since the cost and disruption of making an unsuccessful hire are felt more acutely in smaller firms, this is doubly important for SMEs. We therefore need to seek to reduce these risks faced by SMEs as much as is appropriate.
3. **Supporting high-quality employment in SMEs.** Employees in smaller businesses are more likely to class themselves as underemployed than those working in larger firms. In 2013, 7.9 per cent of all employees in micro firms reported they are working part-time because they could not find a full-time position, against only 2.2 per cent in large businesses. In addition, employees in small firms are much less likely to be offered occupational maternity, paternity and sick pay. Over three-quarters of female employees in large firms are eligible for occupational maternity pay, against just 22 per cent in micro firms. And 94 per cent of all employees in large firms are offered occupational sick pay, against 42 per cent of employees in small firms. This does not necessarily reflect explicit choices by small business owners (although reducing hours has been a strategy for many to reduce costs during the recession) so much as the tight cost constraints they face in offering occupational benefits, and the difficulty in adapting workers' employment patterns to fit their hours preferences in a small workplace. This situation puts SMEs on a worse footing when competing for talent in the labour market, and means a large proportion of employees in the UK are unable to access well-paid parental or sick pay.

A new policy approach must also complement the important role that welfare-to-work policy plays in supporting people into jobs, but needs to be more strategic in reducing the substantial cost barriers and risks businesses face when taking on workers, especially those furthest from the labour market. Underlying such an approach would be a reduction in the risks businesses face when hiring without undermining the fundamental rights of employees. With this in mind, there are several changes to business support, statutory benefits and welfare-to-work policy that could be enacted easily to support SME hiring.

Recommendation one
Business support for new employers and existing micro and small businesses

Small businesses face significant costs when they take on their first employee and when they start to grow their business and workforce. In the first instance these include the direct costs that come with starting out as an employer, including purchasing employers' liability insurance, registering for pay-as-you-earn (PAYE) and setting up or outsourcing their payroll. In addition, many small businesses are hampered by a lack of bespoke human resources (HR) advice and guidance. Those not large enough to employ a dedicated HR professional and unable to afford the cost of external support have to navigate through an often complex system of employment law and labour market regulation. Several studies have found that this leads to anxiety among business owners about their legal obligations and compliance and may dampen their hiring behaviour.

Business support policy in England currently comprises a combination of intensive growth coaching aimed at a small number of self-selecting businesses with high-growth ambitions, alongside a much less bespoke offer of information provided online and via a national telephone service to all other firms. This means the vast majority of small businesses have to pay the full cost of any external one-on-one service. This increases the cost of being an employer, and is likely to prevent many sole traders, micro and small businesses from taking on more workers.

In order to tackle these barriers to hiring, the Department for Business, Innovation and Skills should offer micro start-ups (those with fewer than 10 employees and in their first year of trading) a voucher valid for half the cost, up to £1,000, of the support and services needed, such as employers' liability insurance and the services of a payroll bureau. Focusing support on start-ups should make them better able to deal with challenges once open for business, and increase their long-term survival prospects. Existing micro and small businesses (those with up to 20 employees) should be offered a similar voucher, but specifically targeted at HR support such as advice on employment law and HR consultancy services, which would help them to overcome the human resources pressures of business growth. The scheme should be business-led, delivered by the private sector and building on the online marketplace model of the current Growth Vouchers pilot. Vouchers offered through the scheme should only be valid against services bought from approved suppliers, defined as those who are members of professional bodies such as the Chartered Institute of Personnel and Development. This will assist in reassuring business users of the service that the support available is of a high quality.[1]

Recommendation two
Retaining and reforming statutory sick pay recovery

One group that faces substantial labour market barriers is people with work-limiting health conditions or disabilities. Businesses are less likely to hire workers who have not worked for a substantial period for health-related reasons because it is more difficult to assess their potential productivity. They may also perceive them as a more risky hire because of the likelihood that they would have a higher probability of sickness absence while employed. This problem is particularly acute for SMEs; the potential for disruption to the business from employee absence is likely to be greater in smaller businesses. Additionally, given the often lower profit margins at which SMEs operate, the challenge of meeting statutory sick payments is likely to be more acute in small firms.

Up to now, businesses facing a relatively large statutory sick pay liability in a given month (greater than 13 per cent of their NICs liabilities) have been able to get the difference reimbursed from HMRC. Starting in April 2014, however, businesses will no longer be able to recover any of their statutory sick pay payments in this way. While it is being replaced by a new Health and Work Service offering return-to-work support and tax relief on workplace adjustments, this move will nonetheless increase the costs firms face for sick pay, and may lead to reduced hiring of those in these severely disadvantaged labour market groups.

1 Since policy in this area is devolved at the national level, it would be up to the relevant public agencies in Wales, Scotland and Northern Ireland to decide whether to adapt and implement such a policy.

Rather than retaining the current system, it should instead be more tightly targeted on those that face the greatest sickness-related hiring risks – those with work-limiting health conditions. In the first instance this should be those moving into work from the employment and support allowance (ESA) claimant group on the Work Programme. Firms should be able to recover 92 per cent of SSP costs for employees who have been hired in this way during their first year of employment. This would substantially reduce the face-value cost of employee absence for this group, while at the same time maintaining an employer stake in supporting them back into employment.

This support should also only be available to small firms, since they face the greatest disruption and therefore hiring risk when taking on a worker more likely to take sickness absence. This would be defined as it is under statutory maternity and paternity pay recovery; those firms with an annual NICs liability of less than £45,000. We estimate that this would cost just over £20 million, substantially less than the £50 million currently spent on statutory sick pay recovery.

Recommendation three
Intermediate labour markets in welfare-to-work policy

There is a growing consensus that the current government's flagship welfare-to-work initiative, the Work Programme, is severely underperforming, particularly for those furthest from the labour market. In the first year of the Work Programme, fewer than 6 per cent of those on the Work Programme via ESA achieved a sustained job outcome of six months.

The failure of the Work Programme to help the most disadvantaged has many causes, including the nature of the contracts drawn up between the Department for Work and Pensions (DWP) and providers, and the structure of payments to providers for achieving job outcomes, which is likely to have led many to offer only minimal levels of support to some claimant groups.

But in addition, the Work Programme does little to reflect the barriers and risks to hiring faced by employers. When the current Work Programme contracts expire in 2015, it is highly likely that they will have to be substantially revised or replaced entirely in order to support those furthest from the labour market. As part of the new system of welfare-to-work support – be it a reformed version of the Work Programme or an entirely different delivery mechanism – more should be done to support the employer's role in generating employment outcomes for participants.

Providers under the next iteration of the Work Programme should be allowed and encouraged to act as a temporary employment agency for claimants in particular groups, securing short-term paid work placements with employers. They would pay claimants directly at the wage paid by the employer, and would receive a job outcome fee when a participant has worked a set number of days within a defined period of time. The structure of their agreement with the DWP would also reflect the periods of down-time between placements, with the focus on providing claimants with valuable experience of the workplace alongside welfare-to-work support. Providers would still be eligible for a job outcome payment should a placement become permanent, and the length of time an individual can remain on the books of the provider would be limited in the same way as the mainstream strand of the Work Programme. Initially this should be targeted just at those in the ESA claimant groups of the Work Programme who face the most significant barriers to work. Policymakers should also consider extending the policy to young benefit claimants, a group which has met the minimum performance targets of the Work Programme but faces higher rates of unemployment than many other labour market groups.

This would have two benefits over the current poor performance of the Work Programme. First, it would de-risk the offer of work for employers, who would face few of the risks, perceived or otherwise, associated with hiring a permanent employee. This would make employers more likely to take on those with health conditions and disabilities. Second, it would give providers and individuals another option should the mainstream offer of support not be appropriate to claimants' circumstances.

Recommendation four
An occupational benefit insurance scheme for SMEs

Employers in smaller firms face significant cost barriers to offering occupational sick, maternity and paternity pay to their employees. This disadvantages small firms in the recruitment market, leads to higher employee turnover, and means many in the UK workforce are only able to access the lower level of statutory benefits. The government currently does little to incentivise or offer support to small firms to move to occupational benefits.

So-called 'group risk' insurance is currently available for employers to purchase privately, offering their employees financial support when they go on long-term sickness absence. But most such schemes are only offered to large employers, or charge much higher premiums to SMEs. If small firms could club together, pooling their risks, it would enable them to access a similar insurance scheme for occupational benefits at a more affordable premium. The key factor preventing firms from grouping together in this way is a problem of coordination – small firms need to have a larger institution around which they can coalesce, which in turn offers them a range of insurance products, paying employees occupational benefits in return for regular monthly premiums paid by employers, the cost of which would be based on their number of employees. This would turn the risk associated with offering a higher level of occupational benefits into a predictable cost that is more easily managed by small employers.

Such schemes should be led by the private sector, modelled in part on the Danish insurance schemes for maternity pay, with employers' associations working with insurers to develop policies to offer to their members. In particular, employer associations such as the Federation of Small Businesses, the British Chambers of Commerce, and sector-specific membership bodies should be talking to insurers to assess the feasibility of setting up such schemes. The government should play only a minimal role in setting up and managing them but should monitor appetite from insurers and employers and, if there are low levels of take-up, take action to incentivise small firms to join and to reduce the price of premiums. For example, payments into the scheme could be tax deductible, exempt from insurance premium tax, or not come within the scope of 'benefits in kind' tax rules. The government could look to inject funds into the scheme or underwrite a small percentage of the risk, to make the scheme's premium cheaper and more attractive to participating businesses, especially in the early phases when participation levels will be low and premiums consequently high.

These recommendations are not exhaustive. Rather, they represent a range of possible public policy options that sit within a broader approach to tackling the barriers to taking on employees. None of the proposals outlined above are likely to come with exorbitant costs to the exchequer. Most either rest on redirecting existing spending, or are likely to cost a similar or smaller amount to items of discretionary spending regularly announced in the budget and autumn statement. In addition, any employment creation generated through these measures would generate extra tax revenue and reduce spending on out-of-work benefits, reducing the net cost further.

Conclusion

We need to be more ambitious about employment in the UK. Simply returning to the pre-recession state of the labour market implies that large parts of the working-age population will still face substantial barriers to work and low levels of employment. For many, this offers little prospect of escaping from poverty or attaining a higher standard of living in an era of constrained welfare spending and limited increases in the value of out-of-work benefits.

The appropriate policy response to this issue is complex, involving tackling the many and varied barriers to work faced by different groups, including those with disabilities, mothers of young children, particular ethnic groups, residents of economically disadvantaged areas and regions, and those making the transition from education to work. However, until now, debates about increasing the employment rate of those further from the labour market have largely neglected the role of employers. Instead we have focused too much on the individual jobseeker, applying greater levels of conditionality to the receipt of out-of-work benefits. This has coincided with institutional innovation in the welfare-to-work system through the Work Programme and its precursor initiatives. While supporting jobseekers through the benefits system and active labour market policy is hugely important, providers face an uphill struggle unless employers are willing to hire jobseekers.

This report sets out a complementary approach that recognises the vital role that businesses, and SMEs in particular, play in job creation, but also the barriers and risks to hiring that they face.

INTRODUCTION

Labour market recovery, at least in quantitative terms, is well under way in the UK. While the employment rate remains below its pre-recession peak, the current rate of jobs growth suggests that at some point in 2014 we will return to the employment rate achieved during the last labour market peak in 2006. This will be a remarkable achievement, given both the scale of job creation involved, and the continuing economic uncertainty in the UK and internationally.

However, the speedy labour market recovery has nonetheless been accompanied by widespread public anxiety about the state of working Britain. There is concern that:

- not everyone in the UK is benefiting, with some, most noticeably younger workers – failing to see their job prospects improve
- real wage growth for those in work has been continually negative since the recession
- the labour market recovery has been characterised by an expansion in part-time work and in atypical work such as temporary employment and zero-hours contracts. While the extent to which this reflects individual preferences is unclear, it has led to some concern that the quality of work may be declining.

In addition, there is a growing consensus that we should be more ambitious for the UK labour market than simply recovering the ground lost in the recession, and look to raise the structural level of employment over the medium and longer term (Dolphin and Lawton 2013). Achieving a consistently higher employment rate than in the recent past will be necessary to sustainably increase living standards and reduce poverty in an era of constrained benefit spending. The implication of a structurally higher employment rate than in the past will involve assisting into jobs many groups that have long faced significant barriers to work and been characterised by low employment rates. This requires a substantial rethink of employment and welfare-to-work policy that moves beyond the methods used in recent years.

The nature of the labour market recovery and the importance of reaching a structurally higher employment rate, have both fostered very lively public debate in the UK. But one dimension that is frequently neglected is how these play out in firms of different sizes. Since employer size is one of the key factors influencing employment characteristics, we should be paying attention to how these patterns might have varied between smaller and larger employers.

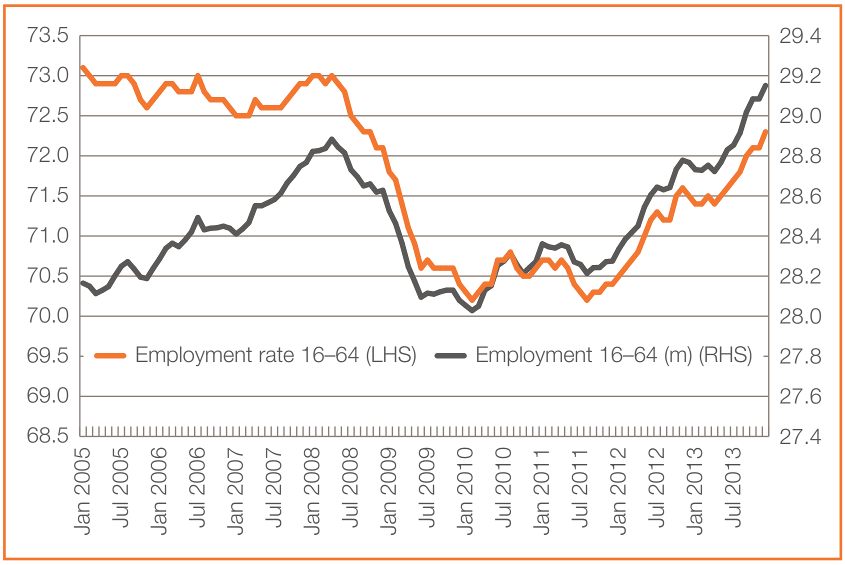
This report seeks to fill this gap. It first sets out key recent developments in the UK labour force, paying particular attention to the contribution of small firms to employment growth. It then discusses the existing policy framework, before setting out a series of recommended policy developments that would help small firms take on even more workers in the future.

1. QUANTITATIVE EVIDENCE ON SMALL FIRMS AND FULL EMPLOYMENT

Employment has held up relatively well since the recession, especially when compared to the much larger fall in output. UK real GDP fell by 7.2 per cent between its peak level at the beginning of 2008 and the trough in Q3 2009. This contrasts with a fall of only 2.3 per cent, or 700,000, in the number of employed persons in the UK. In addition, while GDP remains 2.5 per cent below peak output, the number of employed persons had surpassed its pre-recession level by Q3 2012 (ONS 2014a and 2014b).

But the employment rate, the proportion of working-age people with a job, remains well below its pre-recession level (seefigure 1.1). The economy peaked on this measu=re, at just over 73 per cent, several times in the run-up to the financial crisis, most recently in Q1 2008. Subsequently, it fell to a low of less than 70.5 per cent in Q1 2010 and again in Q3 2011. The recent spurt of job creation has increased the employment rate to 72.3 per cent in the latest data, leaving a gap of just over 0.7 percentage points between the UK labour market's current employment performance and its pre-recession level. Given the size of the working-age population (40.3 million), this means 280,000 more jobs would be needed to fully complete the labour market recovery. Accounting for other factors, including the growing population and the speed of job creation, Plunkett (2013) estimates that the jobs gap may be closer to 850,000.

Figure 1.1
Employment rate (%, LHS) and number employed (millions, RHS) of working-age people (aged 16–64) leading up to and since the recession, January 2005–December 2013



Source: ONS 2014a

The Office of Budget Responsibility (OBR) provides twice-yearly forecasts of the prospects of the UK labour market, and is fairly sceptical about the prospects for the jobs recovery (though its track record in forecasting employment is poor). While the OBR does not provide a forecast of the working-age employment rate, it does forecast growth in overall job numbers and in the employment rate for the total adult population. It estimates that the number of employed adults aged 16 and over will grow by between 200,000 and 300,000 a year in the period 2014–2018 (OBR 2014). This means that the employment rate of the over-16s will be 59.9 per cent in Q1 2019, the end of the OBR's forecast period – 0.4 percentage points below the pre-recession peak of 60.3 per cent in Q1 2008. Given the current size of the jobs gap, and the OBR's weak forecasts for employment growth, it is clear that the labour market recovery is ongoing but far from secure.

Simply returning to the UK's pre-recession employment rate will be far from a success story. In particular, the employment rates for some groups in the population were very low even in the relatively benign years leading up to 2008. Employment rates for older workers have improved slightly by 2013 when compared to 2006 (see tables 1.1a and b), but the gap between them and workers in the middle of their working lives (aged 35–49) has shown little signs of narrowing substantially. Similarly, those with disabilities, low levels of educational attainment, as well as many ethnic minority groups, faced significant labour market disadvantage back in 2006, and there are few signs that their prospects had improved by 2013; in some cases they worsened.

Table 1.1a
Working age (16–64) employment rates (%) by age group and gender

	Total		Male		Female	
Age group	2006	2013	2006	2013	2006	2013
(16–64)	72.8	71.1	78.8	75.8	66.9	66.5
16–17	35.5	21.1	32.4	18.3	38.9	24.0
18–24	65.4	56.6	68.2	57.1	62.6	56.2
25–34	80.1	78.9	88.1	85.6	72.2	71.9
35–49	82.3	81.8	88.7	87.3	76.0	76.4
50–64	64.9	66.9	72.3	72.5	57.7	61.6
65+	6.7	9.3	9.6	12.6	4.5	6.6

Source: IPPR analysis using ONS 2014c

Table 1.1b
Working age (16–64) employment rates (%) by demographic group and individual characteristics

Disability status	2006	2013
DDA* and work-limiting disability	33.1	33.2
DDA disabled	67.7	75.8
Work-limiting disability	67.6	64.4
None of the above	78.1	76.9
Self-reported ethnicity	**2006**	**2013**
White	73.8	72.8
Mixed	64.7	59.0
Indian	68.9	71.4
Pakistani/Bangladeshi	44.5	48.6
Black	62.5	61.1
Other	57.6	55.7
Level of highest qualification	**2006**	**2013**
Degree or equivalent	87.7	83.7
GCE, A level	77.1	73.0
GCSE grades A*–C	74.4	66.4
Other qualifications	71.7	63.3
No qualification	48.5	39.6

Source: IPPR analysis using ONS 2014c
*Note: DDA (Disability Discrimination Act) disability is defined within the 2010 Equality Act as a physical or mental impairment that has a substantial and long-term adverse effect on the ability to carry out day-to-day activity.

1.1 Trends in employment by firm size

Small firms are hugely important both to the UK economy and as a source of employment opportunities for UK workers. The latest business population estimates, calculated by the Department for Business, Innovation and Skills (BIS), show that 46.3 per cent of total UK turnover and 49.6 per cent of employment was concentrated in businesses with fewer than 250 employees. Discounting the public sector, SMEs account for 48.1 per cent of turnover in the private sector economy and 59.3 per cent of employment (BIS 2013).

Defining firm size

In this report we use the standard definition of small and medium-sized enterprises (SMEs) as used by BIS. This divides firms into the following categories according to their number of employees.

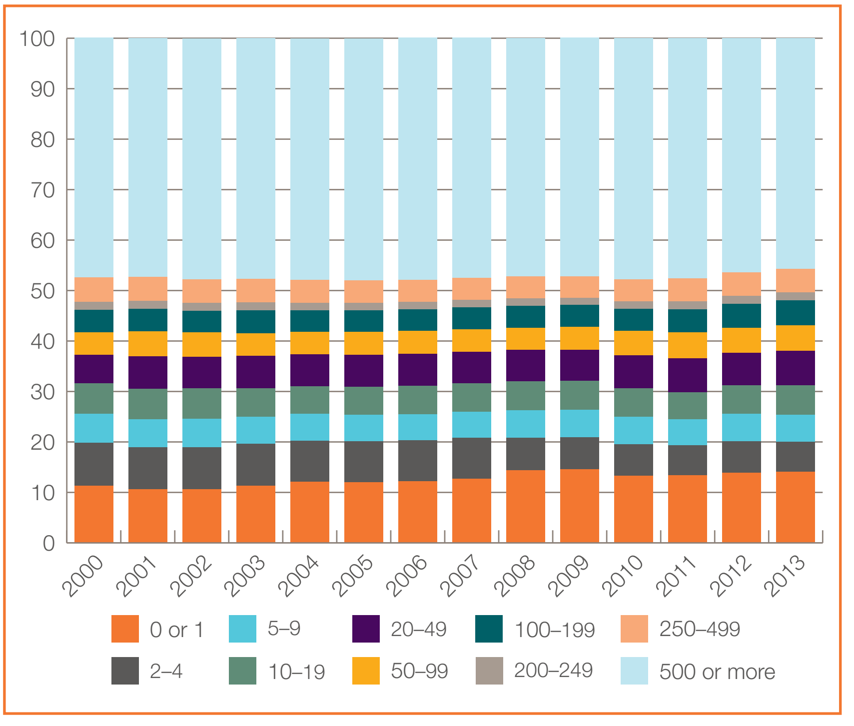
- Sole traders: those with no employees
- Micro firms: 10 or fewer employees
- Small firms: between 11 and 49 employees
- Medium firms: between 50 and 249 employees
- Large firms: 250 or more employees.

In addition, throughout this report we use the terms ‘enterprises’, ‘firms’ and ‘workplaces’ interchangeably. While they do not strictly refer to the same levels of business organisations, they approximate one another sufficiently to make using the terms as equivalents reasonable. The difficulty of accessing enterprise-level data relating to labour market issues means that most of the quantitative analysis contained here is at the firm level.

Figure 1.2 shows how the distribution of employment by firm size has changed over time. Since the recession there have been noticeable increases in the share of employment concentrated in the very smallest businesses, those that are either self-employed/sole traders or that have one employee, although this is partially a continuation of a trend going back to 2001. The share of employees in micro businesses with between two and nine employees has fallen since the recession. The share of employees in small and mid-sized businesses has expanded slightly since the start of the recession, after remaining steady at around 12 per cent and 10.5 per cent respectively since 2000. The largest employers, those with over 250 employees, now employ only 50.5 per cent of those in work, the lowest proportion on record.

Patterns of employment by firm size changed in different ways during the recent recession. The relatively strong performance of UK employment breaks with the experience of past recessions, and can be partially explained by the concept of ‘labour hoarding’: that is, where many firms kept their current workforce employed in order to retain skills and expertise, even as the demand for their products decreased. Research suggests this was especially the case in small and medium-sized firms. Crawford et al (2013) found that enterprises with less than 50 employees that survived the recession experienced a much smaller fall in their number of employees than larger enterprises, achieving partial adjustment through hours and pay instead. Butcher and Bursnall (2013) found a similar result: that the fall in jobs experienced by the UK between 2008 and 2011 was not caused primarily by job losses, which had been a feature of previous recessions, but by lower levels of job creation in new SMEs. The recession was therefore characterised by resilient employment in existing SMEs but limited entry of new firms (although since 2010 there has been a pronounced increase in start-up rates). Aside from the generally poor economic environment in which to set up a new business, this lack of start-ups has also been linked to the cost and availability of finance, which deteriorated in the recession and has limited the ability of many entrepreneurs to start and expand businesses (ibid). Despite these constraints, during the current recovery SMEs and self-employment have been the driving force of jobs growth, accounting for 84 per cent of the growth in private sector employment, 54 per cent of which came from SMEs and 30 per cent from self-employment.[2]

Figure 1.2
Employment distribution by business size (% of total employment), 2000–2013



Source: BIS 2013

Aside from the overall importance of small firms to the UK labour market in quantitative terms, they play a disproportionately large role in supporting workless individuals into employment. Urwin and Buscha (2012) find that, of movements from unemployment into private sector jobs, 88 per cent are into either an SME or self-employment, with 68 per cent of that total being into self-employment (17 per cent), micro (24 per cent) and small businesses (27 per cent). When looking at movements from inactivity the results are even more striking, with SMEs and self-employment accounting for 95 per cent of transitions into the private sector, of which 78 per cent were those into self-employment (19 per cent), micro (29 per cent) and small businesses (30 per cent).[3] The authors argue that this is linked to the relatively informal and flexible employment relationships in SMEs as compared to larger firms. Their argument is that this makes those firms more likely to take on groups facing labour market disadvantage such as the low-skilled or those lacking substantial previous employment experience. But whatever is causing these patterns, it is clearly the case that SMEs and self-employment play a substantially disproportionate role in terms of labour market inclusion.

2 Author's calculations using business population estimates for the start of 2010 and the start of 2013 (BIS 2013).
3 Data refers to Q4 2008 and Q1 2011.

The flip-side to this, however, is the fact that SMEs and self-employment also account for a disproportionate number of moves out of employment and into worklessness. Table 1.2 presents evidence from Q1 2006 to Q1 2008, a period of high employment by historical standards and therefore indicative of how the labour market performs in relatively 'good times'. It shows how moves into and out of employment are distributed across firms of different sizes.

Table 1.2
Flows into and out of private sector employment by firm size, Q1 2006–Q1 2008

	Proportion of moves into work	Proportion of moves out of work
Self-employed	15.8%	17.4%
Micro	28.7%	26.2%
Small	26.4%	26.2%
Medium	16.9%	17.9%
Large	12.2%	12.3%

Source: IPPR calculations using ONS 2014d

Table 1.2 supports the evidence presented in Urwin and Buscha (2012), which found that self-employment and SMEs account for a significant majority of transitions into private sector employment, but also found a similar pattern for moves out of private sector employment and into unemployment and inactivity. Nevertheless, comparing the two figures for each size-class of firms, only micro and small enterprises account for a larger proportion of inflows than of outflows.

The overall dynamic here is hardly surprising. Small firms are more likely to be new, dynamic or growing, and therefore taking on employees. But they are also more likely to cease trading. The death rate of businesses – the number of businesses closing down as a proportion of the total number of active enterprises – is closely related to firm size. Data collected in 2007 found death rates of 13 per cent for those firms with fewer than five employees, 6 per cent for those with 5–9 employees, and 4 per cent for those with 10 or more employees (Eurostat 2014). But the same data also finds that the 'birth rate' of new businesses – the number of business set up as a proportion of the total stock of firms – is also much higher in smaller firms. While many of the employees in firms that are closing are likely to transition successfully into another job, some will move into worklessness, if only for a short period of time.

Since, as noted above, small firms are more likely to take on workers facing labour market disadvantage, we might also expect them to face greater difficulty finding further work when a firm closes, and find it harder to stay in work, and so be more likely to leave employment in general. Both offer partial explanations for the disproportionately high share of employment outflows accounted for by SMEs.

Other research has found that, on balance, small and medium-sized firms drive not only gross but also net employment growth. In an influential study, Anyadike-Danes et al (2009) found that between 2002 and 2008 fewer than 10 per cent of businesses accounted for over half of net jobs growth in the UK.[4] In particular, high-growth firms tripling their headcount from an average of 60 to around 170 employees were found to be the primary drivers of net employment growth – implying that it is firms in the middle of the size distribution that are the most important for medium-term net employment growth. A more recent report from the same authors found that of the 2.61 million

4 The study excluded those firms with fewer than 10 employees.

gross jobs created each year between 1998–2010, start-ups contributed a third and small firms a further 34 per cent (Anyadike-Danes et al 2011).

The key point, however, is that even after accounting for out-flows from employment, at a time of high employment rates, such as in 2006, small firms and self-employment still have a positive role to play in supporting workless individuals into employment. The importance of this should not be underestimated: small firms provide vital experience of employment and skill formation for many individuals who were previously out of work.

Examining how the employment rates of different groups vary between firms of different sizes shows firms of different sizes do not vary systematically in their patterns of hiring individuals facing labour market disadvantage (see table 1.3). Micro firms employ a disproportionate number of disabled, older and low-skilled employees, small firms the young and working-age women, and large firms employees from black, Asian and minority ethnic (BAME) groups.

Table 1.3
Proportion of employees facing labour market disadvantage, by firm size (2013)

	Work-limiting disability	Young (16–24)	Older (50+)	BAME	No qualifications
Micro	8.9%	14.7%	30.4%	10.4%	8.0%
Small	7.6%	16.5%	24.4%	9.0%	5.7%
Medium	7.6%	11.8%	25.1%	9.3%	4.1%
Large	7.3%	7.6%	24.3%	11.9%	3.4%

Source: ONS 2014c

1.2 How have forms of employment varied by firm size?

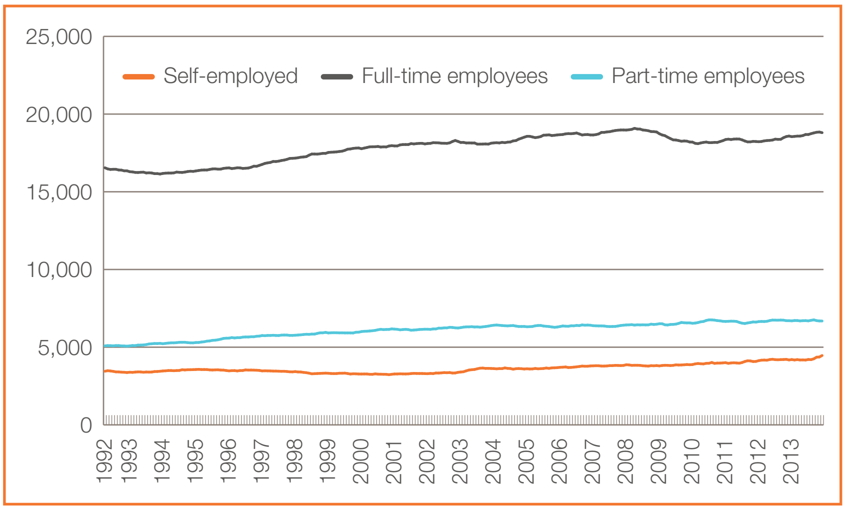
One feature of the labour market in recent years that has generated much public debate is the perceived decline in job quality. While the focus has been in relation to the rise in usage of zero-hours contracts, other 'atypical' forms of employment have also expanded in prevalence in recent years.

Looking at the trends in full-time, part-time and self-employment since the early 1980s, we can discern several interesting trends (see figure 1.3). Full-time employment largely follows the economic cycle, with declines throughout the recessionary period of the early 1990s and in the most recent downturn. Self-employment follows a less discernible counter-cyclical trend, rising in the early 1990s, and then falling back, before increasing before and throughout the recent downturn. While individuals become self-employed for a variety of reasons, rising self-employment during times of weak expansion in the wider labour market is partially caused by individuals setting up on their own as a response to the difficulty of finding work as an employee.

The number of part-time employees appears less tied to the economic cycle, and has been rising steadily throughout the last 30 years. This structural rise in part-time employment could be linked to the increased labour force participation of groups more likely to combine work with family care commitments, particularly mothers. Either way, it is not the case that the economic downturn has caused a surge in the number of part-time employees beyond the trend increase.

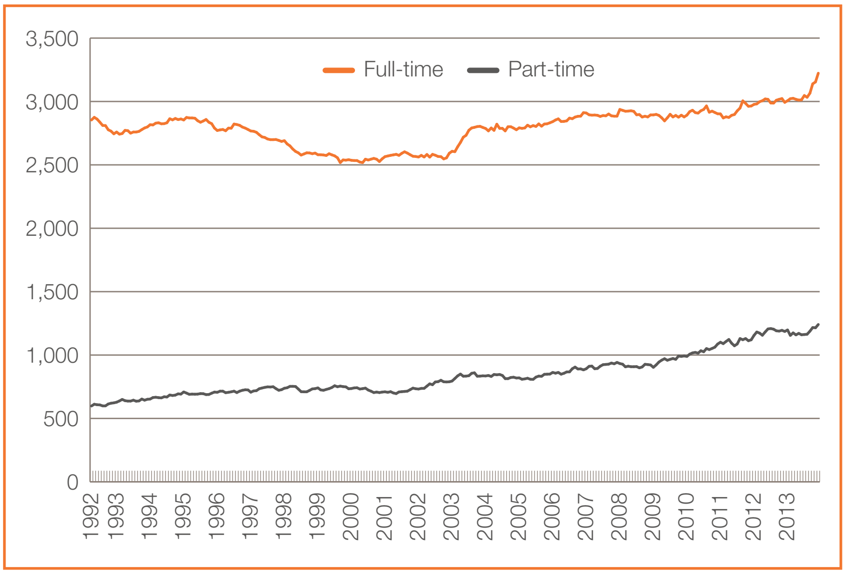
Breaking down the self-employed into part- and full-time (see figure 1.4), we see that almost all the recent increase has been driven by part-time self-employment, which has been growing steadily for the last decade. Increases in full-time self-employment, on the other hand, have been much less pronounced, although it is nonetheless at an all-time high in terms of absolute numbers.

Figure 1.3
Full-time, part-time and self-employment (000s), April 1992–December 2013



Source: ONS 2014a

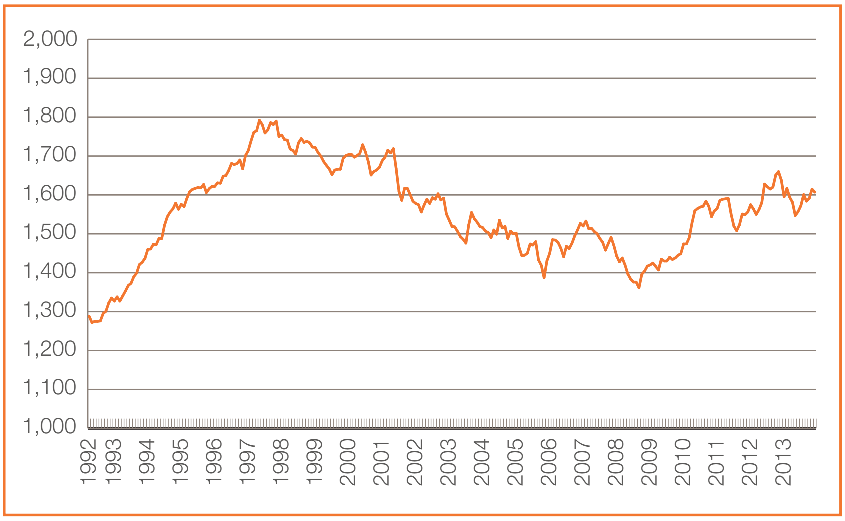
Figure 1.4
Part- and full-time self-employment among the self-employed (000s), April 1992–December 2013



Source: ONS 2014a

Temporary employment, on the other hand, does appear to be strongly linked to the economic cycle. Figure 1.5 shows the number of employees on fixed-term contracts since 1992. Their numbers increased in prevalence through the 1990s until 1997, before steadily declining until the 2008/09 recession when they began to rise again. The link between the performance of the wider economy and temporary employment is unsurprising when we consider that businesses are likely to be more cautious in their hiring during periods of economic uncertainty. This will lead them to increase their usage of fixed-term contracts as a way to limit the risk of an expanding wage bill, or because they do not have sufficient upcoming work to take on a permanent employee. Even so, by 2012 the number of temporary employees was still significantly lower than its previous peak in 1997, suggesting that it is still too early to tell whether the recent increase in their number is anything other than a cyclical development.

Figure 1.5
People in temporary employment (000s), April 1992–December 2013



Source: ONS 2014a

In terms of firm size, while part-time employment has been increasing in all business sizes, employees in smaller firms are much more likely to be employed on a part-time basis than in large businesses. Over a third of employees in micro businesses are part-time, and around 30 per cent in small firms. This compares to 21 per cent in medium-sized firms and 17.4 per cent in large firms (see table 1.4), with these proportions remaining fairly stable over the last decade.

Table 1.4
Part-time employees as a percentage of all employees by firm size, Q4 2002, 2007, 2010 and 2013

	2002	2007	2010	2013
Micro	35.4	33.6	36.6	36.9
Small	28.7	28.1	31.3	30.3
Medium	19.4	19.8	21.8	21.0
Large	17.1	17.2	17.5	17.4

Source: IPPR calculations using ONS 2014c

No such pattern emerges when looking at the distribution of temporary employment across firms of different sizes. The most recent data from 2013 suggests that micro firms made slightly more use of temporary contracts, with 6.6 per cent of employees being temporary, but this is only slightly higher than in small (5.6 per cent), medium (5.5 per cent) and large (5.8 per cent) (see table 1.5). The proportion of employees in micro firms who are employed on a temporary basis has fallen in the last 10 years.

Table 1.5
Temporary employees as a percentage of all employees by firm size, Q4 2002, 2007, 2010 and 2013

	2002	2007	2010	2013
Micro	7.2	6.4	6.6	6.6
Small	6.6	5.6	6.2	5.6
Medium	5.7	5.3	5.7	5.5
Large	6.6	5.5	5.7	5.8

Source: IPPR calculations using ONS 2014c

One specific contract type that has generated much attention during the labour market recovery is zero-hours contracts. The Labour Force Survey (LFS) finds that around 580,000 individuals worked on zero-hours contracts in Q4 2013, an increase of 330,000 on Q4 2012 (Pyper and McGuiness 2013). Because of the way questions around contract types are asked in the Labour Force Survey, the accuracy of estimates derived from the survey has been questioned. An independent survey of 1,000 employers carried out by the Chartered Institute of Personnel and Development (CIPD) estimated that the true figure may be closer to 1 million, or 3–4 per cent of the workforce. The CIPD found that zero-hours contracts were more widespread among large employers, a quarter of whom used them, than in small businesses, only 11 per cent of which did so. It also found that the voluntary and public sectors were more likely to use zero-hours contracts than the private sector (CIPD 2013). The Office of National Statistics is currently carrying out an employer survey to generate more reliable official statistics on how widespread zero-hours contracts are.

It is difficult to disentangle the extent to which rises in these atypical forms of employment are driven by demand from individuals for particular work patterns, or by demand among businesses for a more flexible workforce. For instance, over recent decades there has been a structural rise in the employment rate of women, driven primarily by mothers moving into work. This has been a key driver of the rise in part-time work, as families fit parental care responsibilities around work. But the cyclical nature of some of these forms of employment, particularly fixed-term contracts, suggests that changes in the extent of their usage may be linked more to business behaviour and the economy than to the preferences of individuals.

One way of assessing the extent to which rises in part-time work and fixed-term contracts are a positive or negative labour market development is to assess individual preferences for these compared to other forms of employment. The Labour Force Survey asks individuals about their working arrangements, including hours of work and contract types, but also asks whether individuals entered into those arrangements out of preference, or because alternative arrangements were not available. In particular, the LFS asks whether any rise in the prevalence of part-time and fixed-term contracts has been accompanied by an increase in the proportion of individuals reporting they would rather be either on a permanent contract or in full-time work.

Table 1.6
Proportion of those employed on a second-choice work arrangement (Q4)

	Employee: second-choice work arrangement (part-time and temporary)	Self-employed	Employee: first-choice work arrangement
1992	4.4%	13.6%	82.0%
1997	4.8%	13.0%	82.2%
2002	3.2%	12.0%	84.8%
2007	3.4%	13.1%	83.5%
2012	5.9%	14.3%	79.7%

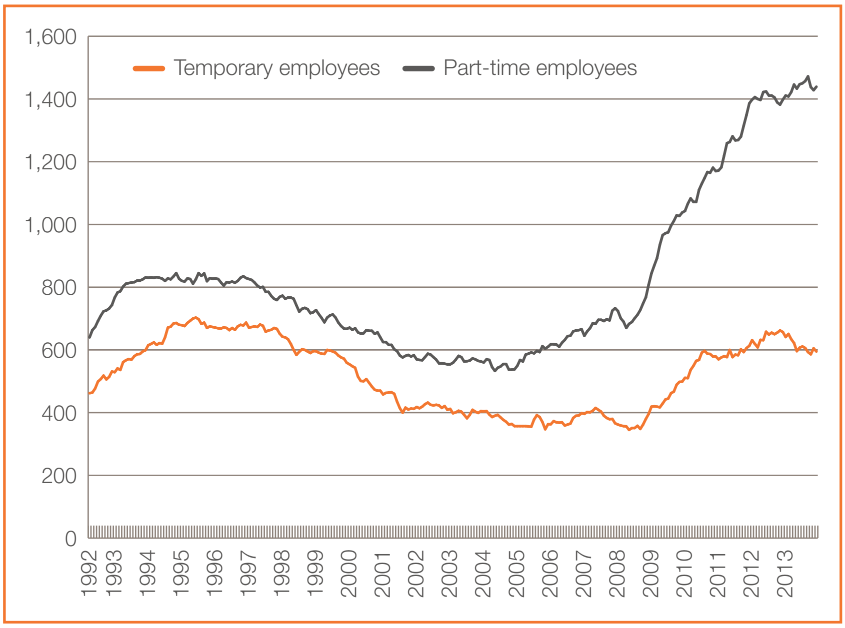
Source: IPPR calculations using ONS 2014c

Table 1.6 shows the proportion of the workforce who are either employed on a full-time and permanent basis, or part-time or temporary but out of preference, and the proportion that are employed either on a part-time or temporary basis but would prefer to be full-time or permanent. It also shows the proportion of the workforce who are self-employed.[5] It reveals that the proportion of individuals not employed on the basis they would prefer has increased dramatically in recent years, from 3.4 per cent in 2007 to 5.9 per cent in 2012. This is higher than during any of the four other sampled years.

5 The Labour Force Survey does not ask the reasons why individuals became self-employed in the same way as it asks about the working arrangements of employees.

Looking at the absolute numbers of individuals employed either on a part-time basis when they would rather work full-time, or on a temporary contract when they would rather be permanent (defined in the following as 'second-choice work arrangements'), we again see a distinct cyclical pattern (see figure 1.6). What is different in this chart is that the most recent labour market downturn has been characterised much more by individuals working in part-time work as a second choice than in the previous downturn in the mid-1990s. The pattern for temporary employment is more in line with the UK's previous experience.

Figure 1.6
Prevalence of part-time and temporary employment as a second-choice work arrangement (000s), April 1992–December 2013



Source: ONS 2014a

Table 1.7 shows how the proportion of employees employed part-time when they would prefer a full-time position varies by firm size. In each of the sampled years, beginning in 2002, smaller firms have had a higher share of employees employed part-time on a second-choice basis. In the most recent data from 2013 this is even more pronounced, with 7.9 per cent of employees in micro business employed part-time as a second-choice arrangement, 5.9 per cent in small businesses, but only 3.6 and 2.2 per cent in medium and large businesses respectively. Not shown below is the distribution for temporary employment on a second-choice basis, which is evenly distributed by firm size.

The more marked rise in part-time employment since 2007 among small firms is likely to be related to the adjustments made during the recession, discussed above. Since small firms were less likely to make redundancies and more likely to manage wage costs through reducing hours, we would expect such an increase. Still, given the consistently higher proportions even back in 2002 and 2007, there are clearly structural reasons why this is the case, which we will come on to discuss later.

Looking at the types of industries and sectors that this group of employees works in reveals that the largest concentration – around 40 per cent of the total – is in distribution and hospitality, which includes retail, hotels and catering businesses, which are large seasonal employers of part-time employees. There is also a substantial minority of around 26 per cent in the public sector, particularly education and health. In terms of occupations, over half are employed in low-skilled occupations. Breaking these down further, 30 per cent are in elementary occupations, 21 per cent in sales and around 13 per cent in care and leisure roles (ONS 2014c). Since these sectors and occupations are characterised by low levels of pay and smaller profit margins for employers, the lack of full-time positions is likely to be even more concerning in terms of living standards and levels of working poverty.

Table 1.7
Proportion of employees employed part-time when they would prefer full-time work (Q4)

	2002	2007	2010	2013
Micro	3.6%	4.0%	6.7%	7.9%
Small	2.2%	2.6%	4.4%	5.9%
Medium	1.4%	1.7%	3.0%	3.6%
Large	1.1%	1.2%	1.9%	2.2%

Source: IPPR calculations using ONS (2014c)

Table 1.8 looks at movements from worklessness into employment in both 2006/07 and in 2012/13, by whether an individual moved into their preferred working arrangement. It shows that, contrary to the pre-recession pattern in which three-quarters of moves into employment were into a first-choice working arrangement, in the current labour market this figure is less than two-thirds (ONS 2014d).

Table 1.8
Movements into employment by work pattern preferences (%), 1006/07–2012/13

	2006/07	2012/13
Part-time/Temporary employee (second-choice work arrangement)	13.72	20.96
Self-employed	10.54	14.85
Employee (first-choice work arrangement)	75.75	64.20

Source: ONS (2014d)

We know little about whether the recent rise in self-employment, particularly part-time self-employment, is a positive or negative trend. On the one hand, it is encouraging that so many individuals have been able to start businesses during a fragile economic recovery. Many of these people may have actively chosen to start a business or turn to freelancing for reasons of income or because of preferences for work autonomy. Added to this, changing business practices and the internet have in many ways made it easier to set up a business than ever before. On the other hand, it is unclear to what extent the rise in self-employment represents a second-choice option for many unable to find work as an employee, as opposed to a genuine resurgence in entrepreneurial zeal. Furthermore, there has been widespread reporting of the phenomenon of 'bogus self-employment', where an individual is an employee in all but name, but is legally classed as a self-employed contractor so that their employer can avoid paying national insurance contributions. This practice has been uncovered in the construction industry (Insley 2012), but it is unclear whether these practices extend to other sectors, as is the overall extent of bogus self-employment within the self-employment figures. Unfortunately there is little readily available data that allows us to separate out the three groups of self-employed individuals.

In terms of occupations, there is a striking difference in the distribution of part-time and full-time self-employment. Around a third of full-time self-employed individuals work in a skilled trade, against only 10 per cent of part-time workers. Part-time self-employment is much more concentrated in low-skilled elementary, sales and care roles.

Looking at the top 10 occupations of both full- and part-time self-employed individuals, we see this pattern clearly (see table 1.9). From the data we see that 440,000 full-time self-employed individuals, or around 15 per cent of the total, work in construction and building trades. Among part-time self-employed individuals, elementary cleaning occupations, hairdressing and teaching combined make up around a quarter of the total. While not exclusively low skilled and low pay, these occupations do tend to command wages towards the low end of the earnings distribution. Many part-time self-employed individuals also have second jobs as employees or in another self-employed occupation to supplement their income.

The recent expansion in self-employment has been mainly driven by increases in part-time employment (see figure 1.4 above). Given the low-skilled, and likely low-pay, nature of much part-time self-employment, this raises concerns over the nature of the recent self-employment boom.

Full-time self-employed		Part-time self-employed	
Construction and building trades	440,000	Elementary cleaning occupations	90,000
Managers and proprietors in other services	220,000	Artistic, literary and media occupations	80,000
Road transport drivers	200,000	Managers and proprietors in other services	70,000
Agricultural and related trades	170,000	Teaching and education	70,000
Artistic, literary and media occupations	150,000	Hairdressers and related	50,000
Building finishing trades	130,000	Road transport drivers	50,000
Information technology and telecommunications	90,000	Agricultural and related trades	50,000
Electrical and electronic trades	90,000	Health professionals	40,000
Functional managers and directors	90,000	Administrative occupations	30,000
Managers and proprietors in hospitality services	80,000	Sports and fitness occupations	30,000

Source: IPPR calculations using ONS (2014c)

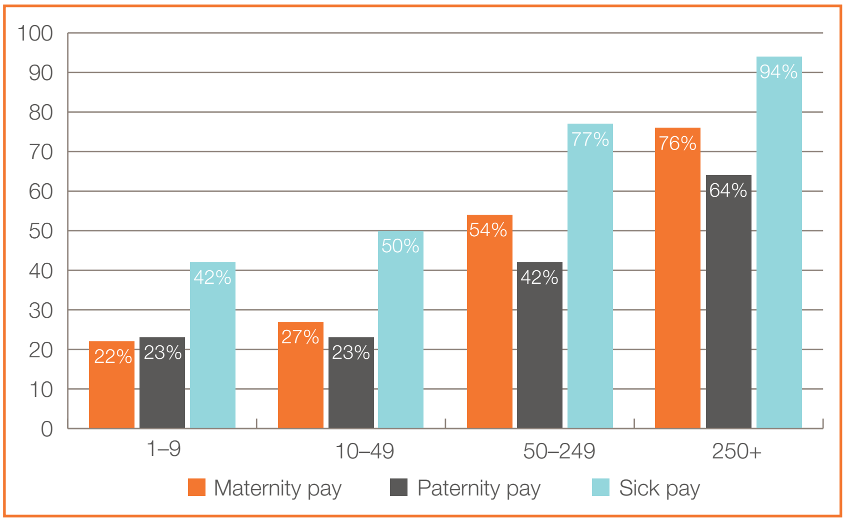
Furthermore, it is worth emphasising that relatively few sole traders take on employees in any given year. Evidence from the longitudinal LFS shows that only 4 per cent of those self-employed who had no employees in Q1 2012 did have employees by Q1 2013. While this may be partially a feature of the current economic climate, in the year to Q1 2008 the proportion taking on employees was only slightly higher, at 5 per cent (ONS 2014d).

1.3 How do workplace benefits vary by firm size?

Another important aspect of employment, which is linked to the issue of job quality, is the level and type of benefits employers offer their staff. We might expect, given the severity of the 2008/09 recession and its impact on business demand and profitability, that some employers will have cut back on offering occupational sick and maternity/paternity pay, as well as occupational pensions and parental leave. Figure 1.7 shows the proportion of employees covered by occupational benefits by size of workplace. It reveals that smaller workplaces are substantially less likely to offer each of the benefits.

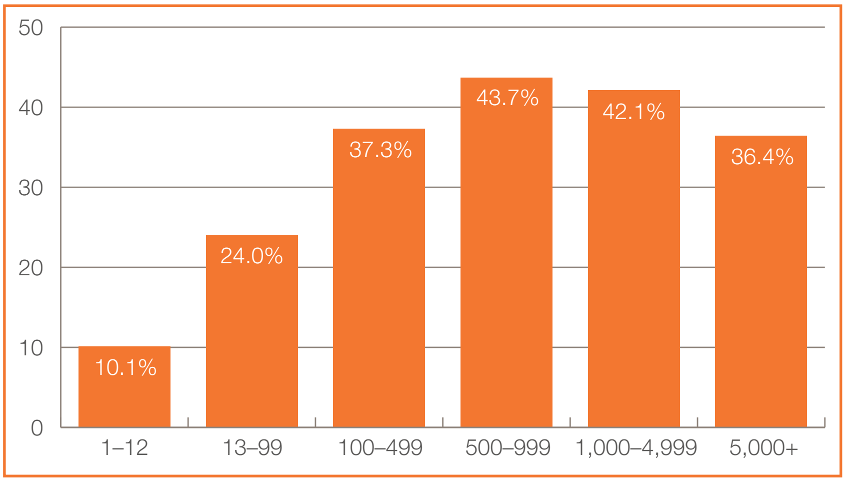
When looking at occupational pensions a similar story emerges, with only around 10 per cent of private sector employees in micro businesses covered by a workplace pension (see figure 1.8). Under existing legislation only firms with more than five employees have to offer staff a workplace pension. Pensions policy is currently undergoing significant reform, and it will soon be mandatory for small and micro employers to automatically opt-in their employees into an occupational pension. This is being phased in gradually, and the evidence surveyed in figure 1.8 predates the implementation of the first wave of the policy.

Figure 1.7
Proportion (%) of employees eligible for occupational benefits, by size of workplace, 2011*



Source: IPPR calculations using BIS 2014a
*Note: The question regarding occupational paternity pay was worded differently from those asked about maternity and sick pay. In this table we look only at those businesses that have had a father take up paternity pay, whereas for maternity pay and sick pay it is assumed the benefit is a standard part of the employee benefits package.

Figure 1.8
Proportion (%)of private sector employees with workplace pensions, by size of workplace 2012



Source: ONS 2013

1.4 Conclusion

The resilience of the labour market during the recession and its strong performance over the last year are encouraging. Small firms have been vital in both phases: in retaining their workforce throughout the downturn, and in supporting workless individuals into employment. Small and medium-sized firms and self-employment have accounted for almost four-fifths of the growth in private sector employment since the recession ended. As a result, large firms now account for only 50.5 per cent of total employment – the lowest proportion on record (BIS 2013).

At the same time, a high proportion of the jobs growth post-recession has been in part-time and temporary work, as well as self-employment. While not necessarily a cause for concern, and to some extent a cyclical phenomenon, there have been noticeable increases in the number of individuals not finding their preferred working arrangement as they move from worklessness into employment. 5.9 per cent of the workforce is now working on a part-time basis while wanting to be full-time, or on a temporary contract while wanting permanent employment (or both). Whether this will become a structural feature of the labour market is still uncertain, although the data suggests that the rise in part-time work is a more longstanding change in the UK labour market, pre-dating the recession, than the increase in temporary employment, which only began during the recession.

Going forward, we need to be alert to how jobs growth is distributed between different groups in the labour market, as well as between firms of different sizes. The danger is that large numbers of those furthest away from employment, especially the young and those with disabilities or health conditions, do not benefit from job creation and see their situation improve. The best time to reconfigure policy to support these groups is now, as the economic recovery is starting to gather pace and businesses look to invest and grow.

2. THE POLICY CONTEXT

In order to maximise the ability of small firms to take on employees, we need to gain a better understanding both of what the barriers to hiring might be and any gaps in current policy. This chapter sets out the recent debate on policy to support business hiring in the UK. It starts by providing some background considerations of how businesses make hiring decisions and the various factors that come into play when deciding whether to take on a worker or not. It then sets out how policy has evolved up to now and critically reviews planned policy changes in this area.

In the public debate, supporting business and employment growth are often presented as requiring an unavoidable trade-off between the rights of employees and the need to incentivise firms to hire. This view was put forward most forcefully in the 2012 Beecroft report on employment law, which proposed a wide-ranging deregulation agenda, including the introduction of compensated no-fault dismissal for micro businesses. But the negative reaction to many of Beecroft's recommendations, including from some business groups and from within the Coalition government, suggests there is little appetite for wholesale deregulation of the labour market.

This lack of enthusiasm for further deregulation is also evident in the lukewarm reaction to the chancellor's 'shares for rights' scheme. This scheme, which was announced by George Osborne at the 2012 Conservative party conference and came into force on 1 September 2013, allows firms to offer workers shares in their company if they waive various rights, including to statutory redundancy pay, to request flexible working and to sue for unfair dismissal. But recent reports have suggested that very few firms – perhaps less than a dozen – had enquired about the scheme, mainly because few firms are prepared to share equity.

Nevertheless, there is a debate to be had. Taking on an employee can come with significant costs, uncertainty and risks for businesses, and these are often greater for smaller employers and act as a barrier to hiring. Where possible, policy should be alert to this, and look for ways it can support the diverse SME community by reducing these costs and stimulating demand while safeguarding the rights of employees.

Small businesses are regularly targeted by policy, but often this support is only tangentially related to employment and business hiring. The recent reduction in corporation tax rates aims primarily to increase the viability and profitability of business activity in general, with any effect on job creation a secondary consideration. But other examples – such as the employment allowance, which eases the burden of national insurance contributions on businesses – directly reduce the costs of being an employer and taking on workers.

Other policies seek to support employment from the other side of the equation – by incentivising and assisting jobseekers. Changes to the sanctions and obligations regime governing the benefit system, and to active labour market programmes, aim to activate the supply of labour.

2.1 How policy influences business hiring

Businesses hire workers for a number of reasons. If they experience an increase in demand for their products that cannot be met through their existing workforce, or if they need to replace an employee who is leaving but cannot do so from their current pool of workers, they will have to recruit externally. They may also hire workers in anticipation of a future increase in demand, or to develop capacity in a new area of their business. Some will look to hire workers temporarily, perhaps to replace an employee who is absent for a defined period of time, such as on parental leave, or because they are uncertain about future levels of demand and want to protect against inflation in their overall wage bill.

When businesses look to take on workers, either to replace existing employees permanently and temporarily, or to meet growing demand for their products, they weigh up the relative costs and benefits of doing so. The benefits include the ability to grow their business, increase profits and to prevent disruptions to work arising from an employee leaving.

The costs of hiring can be thought of in two ways. First, in terms of where in the life-course of the employment relationship they fall: the initial finding and recruitment of employees; the ongoing costs of maintaining employees; or any costs that arise when an employee parts company with their employer. A second crucial distinction is between those costs that are predictable to employers, such as wages and salaries, and those that cannot be observed at the point of hiring, and are more likely to be seen as 'risks' associated with employment.

2.1.1 Initial hiring costs

When an employer is looking to take on an employee, they need to spend time on recruitment, drawing up a job description and interviewing potential employees. Depending on the nature of the role, this can take up a significant amount of time, particularly for the smallest businesses which are less likely to have access to human resources (HR) expertise in-house or to be able to afford external advice. Many firms outsource this work to professional consultants.

In addition, if a sole trader is taking on their first employee, they also need to fulfil particular regulatory obligations. These include purchasing employers' liability insurance, registering as an employer and setting up or outsourcing a PAYE payroll system. Firms also have to invest in the initial training of employees, either introducing them to firm-specific processes, or providing more general and occupational skills internally or through paying for external training. It is likely that some sole traders perceive these initial costs to be prohibitively expensive and so do not hire.

Perhaps most importantly, it is difficult for employers to fully assess the 'fit' of a potential employee during the recruitment process. Labour economists have explored this problem in some depth. In a review of the literature, Oyer and Schaeffer (2012) suggest that the key dimensions along which firms look to match a vacancy with a worker are twofold: skills – whether the abilities of the jobseeker are well suited for the role available and can be easily trained in the requirements of the job; and risk – the potential variation in effort and productivity of the jobseeker.

Since the productivity and fit of a potential employee cannot be fully observed, employers have to use what available information they have, such as educational qualifications and references. The current employment status of the jobseeker will also be used, and those that are unemployed or out of work, especially the long-term unemployed, may be perceived by employers as a greater hiring risk. Partly this is related to other characteristics of the unemployed (they tend to have lower educational attainment than the employed, for instance), but being out of work can also act as a negative signal to potential employers in and of itself. Those starting out in their working lives also find getting work more difficult, due to their relative lack of experience compared to older workers. This is part of the reason why youth unemployment tends to be much higher than unemployment rates for other age groups (Thompson 2013).

2.1.2 Maintaining the employment relationship

Beyond the expense associated with setting up as an employer and hiring an individual, there are two further sets of costs inherent in continuing to employ an individual. First, there are the direct costs of paying employees – salaries and wages, and national insurance contributions (NICs). This will soon also include statutory pension contributions. These are largely predictable, although NICs may increase or decrease as a result of policy changes, and any employees on the national minimum wage will see their wages rise with annual up-rating. Currently employers do not pay NICs on the first £148 of an employee's weekly earnings, after which they pay 13.8 per cent on each additional pound. From April 2014, the employment allowance means that firms do not have to pay the first £2,000 of their liability calculated on this basis.

Second, there are less predictable costs that arise when an employee is absent from work. This may be because they go on maternity or paternity leave, or because they are unable to attend work for health-related reasons. If an employer perceives a candidate to have a higher propensity to be absent from work, some may respond by not hiring that individual. Hiring may also entail opportunity costs, for instance where the owner or line manager spends time training up or supporting new employees or gaining an understanding changes to regulations that otherwise would have been spent developing the business in other ways.

Employers also cannot predict with total accuracy the future path of demand for their products. If it is highly uncertain, some may try to mitigate the associated risks by not hiring permanent employees to meet short-term increases in demand, but instead opting to absorb the extra workload in their current workforce, or by hiring someone on a temporary basis. This is probably an important reason for the growing use of temporary contracts during the recent labour market recovery.

2.1.3 Ending the employment relationship

There are many reasons why an employee and employer might end their relationship. But when an employee leaves it can entail significant disruption. If employers perceive that certain individuals are more likely to leave sooner rather than later, they may be less likely to hire them, since this would expose them to the costs of making another appointment.

While in most cases the employment relationship ends amicably, there is also a small chance that an employee may bring their employer to an employment tribunal for an unfair dismissal or another form of litigation such as a discrimination claim. This can lead to a perception of high potential costs to employing a member of staff. In reality, very few employees actually bring cases of unfair dismissal against their employer: in 2011–12 there were 11,200 cases heard at employment tribunals, and less than half were successful and fewer than a quarter resulted in compensation (MoJ 2012). Since April 2012, the time period in employment after which an employee is eligible to bring a case for unfair dismissal against their employer has been doubled to two years, and claimants have become liable for tribunal fees, which is likely to result in a fall in their number. However, defending an employment tribunal can be expensive, as legal fees quickly mount up. When claimants are successful, employment tribunals can result in large costs for businesses – the average award for unfair dismissals in 2011/12 was £9,133, a very large cost for a small employer to have to shoulder (ibid). This is likely to be the reason why the risk of a successful claim, in addition to the chance of other claims such as discrimination (awards for which can be higher than others as they are not subject to a cap), is regularly cited by businesses as a disincentive to hire. Even where unsuccessful, bringing a claim against an employer entails significant disruption and costs to the business. A 2010 survey by the Federation of Small Businesses (FSB) found that the average cost to a business of defending a claim, excluding any award, was £6,900 (FSB 2012).

2.2 The policy context

Most of the costs outlined above are likely to be disproportionately higher for small firms, which helps explain their heightened perception of the costs and risks of hiring. The effect of making a 'wrong' decision will be proportionately much greater than for a large firm. Those costs that are less predictable will be given greater weight in smaller firms, since the cost of an employment tribunal, say, will be substantially higher relative to the size or turnover of the business.

Perhaps because of this, the many areas of policy that try to increase hiring behaviour tend to either target small firms exclusively, or have an emphasis on smaller firms. Broadly they fall into three groups.

2.2.1 Hiring and employment subsidies

Social security contributions make up a significant proportion of the cost of employing workers. In the UK, employer national insurance contributions (NICs) are payable at 13.8 per cent on weekly earnings above the 'secondary threshold', which currently stands at £148. For an individual employee not paying into an occupational pension and earning a median annual salary of £27,000, employers have to pay an additional £2,693 in NICs contributions, meaning that around 9 per cent of staff costs is accounted for by national insurance. Since the government directly controls the national insurance system, changes to how it operates can be used as a way to reduce staff costs for businesses.

As mentioned above, the high proportion of SME employees working part-time partly reflects the lesser ability of small firms to redistribute hours within their workforce. But part-time employment is also incentivised in the structure of employer NICs. An employer can reduce their NICs liability by taking on a greater number of staff at fewer hours, meaning a higher proportion of their total staff wage bill falls under the primary threshold at which they become liable to pay NICs. While again the employment allowance will raise the point at which many employers start paying NICs, it does not solve this problem. Minimising this incentive would require either a flat rate of employer NICs starting from the first pound earned, or a system similar to that which operates in Germany, where social security contributions are higher for the initial portion of earnings (30.99 per cent between €0–450) than for subsequent earnings (19.28 per cent). Moving to either system in the UK would involve putting a significantly greater NICs burden on employers, and is therefore likely to be politically unfeasible.

Between 2010 and September 2013, the current government enacted a regional NICs holiday for new businesses. Employers located outside the greater south east who were in their first year of trading did not have to pay the first £5,000 of their annual NICs liability on their first 10 employees. From April this year, the holiday is being extended nationwide and to all businesses via the employment allowance, although the maximum amount that can be written off is being reduced to £2,000. Small firms will receive the proportionately greatest benefit. As they have a lower NICs liability to begin with, many will not have to pay any NICs at all when the policy is introduced; it will virtually eliminate the annual NICs liability of many micro businesses with employees earning at or near the minimum wage.

The thinking behind both schemes is to make it cheaper for firms to employ staff, and hopefully spur job creation. However, like all such schemes, the employment allowance is likely to have a high deadweight cost. Many firms will not consider taking on more workers when it is introduced, but will nonetheless benefit from it and see a reduction in their NICs liability. The nature of the employment allowance means it is unlikely to generate large net employment growth. It is a 'stock' employment subsidy, reducing the cost of employing all workers. International evidence suggests this will help employers to maintain their current staffing level, preventing job losses, but will be less effective at supporting new hiring and workforce expansion (Silim 2013). Survey evidence gathered by the FSB suggests that just under a third of firms (29 per cent) will use the extra funds generated to increase staff wages, with a similar proportion (28 per cent) using it to take on new staff.

Hiring subsidies, on the other hand, explicitly target new employees. One example of such a subsidy in the UK is the wage incentive component of the current Youth Contract, which offers up to £2,275 to those employers that hire an eligible young person via either Jobcentre Plus or the Work Programme. While an evaluation of the policy found that only 9 per cent of firms have created extra vacancies as a result of the policy, it also concluded that it has helped 'tip the balance' of hiring decisions towards young people, who are more attractive to employers because of the scheme (Jordan et al 2013). Since 16–24-year-olds are one of the more disadvantaged groups in the economically active population, this should be seen as a useful outcome of the policy. However, the scheme has seen very low levels of take-up, with funding available for 160,000 subsidies, but only 4,100 offered since the introduction of the policy (Cominetti 2014). A recent evaluation found that employers had an expectation that claiming the wage incentive would be time-consuming and an administrative burden. While 84 per cent of employers stated that making a claim involved little work, one in four experienced a problem with the process such as delays or receiving incorrect information. The evaluation also found that low levels of awareness of the scheme were one of the key barriers to take-up (Coleman et al 2014). Other wage incentives that are often more generous than the national scheme have been funded in devolved nations and local areas. For instance, Jobs Growth Wales paid the national minimum wage and NICs for employers that took on a young person for six months in a new position of at least 25 hours per week. While yet to be evaluated, the scheme also provided HR support to micro businesses taking part, a promising model that reflects the fact that a monetary incentive alone may not be enough to encourage employers to make use of the incentive.

Employment subsidies such as the employment allowance and the wage incentive in the Youth Contract are expensive, however. The eventual cost of the employment allowance is estimated at £1.75 billion, and the youth contract wage incentive £374 million (HM Treasury 2013 and Cominetti 2014), although there have been problems with underspend. It has been suggested that the scheme has had poor visibility among employers, and that the administrative process of submitting a claim for the incentive is so complicated as to be off-putting to many employers.

Employers are also required to pay the national minimum wage (NMW) to employees. At the time of its introduction in 1997, there was concern that the NMW might have a negative impact on employment at the bottom-end of the labour market, pricing low-paid workers out of a job. However, the evaluations carried out for the Low Pay Commission, the body formed to monitor and propose the NMW each year, have found little evidence of any such effect (Bryan et al 2012). There is some evidence that up-rating of the value of the NMW may have increased employee retention, but only in particular years for some groups, and also some evidence that it may reduce hours worked per week for young people (ibid). Even so, part of the remit of the Low Pay Commission is to consider any potential employment impact when they set the NMW annually. No doubt, this will be an important factor in judging the merit of the call from George Osborne for the minimum wage to increase to £7 by 2015/16, especially given analysis by HM Treasury which suggested such a move could cost an estimated 14,000 jobs by 2018–19 (BIS 2014b).

2.2.2 Cost recovery for employee absence

Employees are eligible for a variety of statutory benefits and rights, paid for by their employer. In particular, statutory sick, maternity and paternity pay all require employers to continue paying their employees during periods of absence from work. Statutory sick pay (SSP) is payable from the fourth day of illness for those earning more than £109 a week (the lower earnings limit for national insurance), and can be claimed for up to 28 weeks. Statutory maternity pay (SMP) is payable for 39 weeks following childbirth: the first six weeks at 90 per cent of an employee's average weekly earnings, followed by the lower rate of £136.78 or 90 per cent of earnings for the remainder, although many employees return to work before that time. Ordinary statutory paternity pay (OSPP) is paid similarly at £136.78 or 90 per cent of earnings, but for 2 weeks. Families with a father and mother both eligible can share a proportion of their entitled parental leave, meaning fathers can be eligible for additional statutory paternity pay covering a greater number of weeks. From April 2015, this will be replaced by a new Shared Parental Leave and Pay scheme, which is designed to give parents more flexibility over when they take parental leave.

These costs are directly payable by employers, but they are able to recover some of their costs from HMRC. This is important since in the absence of any recovery system, employers may be concerned about hiring people who they anticipate might take one of these temporary leaves of absence. The ensuing costs of having to meet statutory payments, as well as hiring a replacement or absorbing the extra workload, might lead some employers to reduce hiring in general or to discriminate against particular groups.

The system of recovering SMP and OSPP involves employers calculating how much SMP they are liable for in the relevant tax year. The amount they can recover depends on their size: those with an annual NICs liability of less than £45,000 can recover 103 per cent of their SMP payments, those with a liability greater than £45,000 can recover 92 per cent.

The system of recovering SSP, the 'percentage threshold scheme' (PTS), works differently. Firms that have an SSP liability greater than 13 per cent of their total class 1 NICs liability in a particular month are able to recover the amount of SSP they pay in excess of 13 per cent. This system is being abolished, however. From March 2014 employers will no longer be able to recover SSP, which is being replaced by a new Health and Work Service. The aim of the service is to provide employers with free advice to adjust their workplace to facilitate a quicker return to work for employees who are absent because of sickness. In addition, after four weeks of absence employees may be referred to an occupational health professional, who will draw up a return-to-work plan to be shared with the employee and employer and identify relevant workplace adjustments needed. There is also a tax exemption being introduced for payments of up to £500 per employee on expenditure recommended by occupational health specialists to facilitate a return to work.

The ability to recover SSP is essential to mitigate against the extra risk inherent in hiring some groups of workers. While the Health and Work Service is likely to help many employees with health conditions return to work quicker, it is unclear whether it will be sufficient as a replacement for SSP recovery. It is also the case that none of the statutory recovery systems fully compensate employers for the costs of employee absence. SSP recovery only reimburses employers for the amount payable above 13 per cent of their NICs liability. While SMP and OSPP recovery do offer 103 per cent for smaller businesses, which covers salaries and national insurance, they do not reflect the extra costs that may be incurred if the employer hires a temporary replacement to cover maternity leave.

In addition, many firms offer greater than the statutory amounts for these benefits. Whether or not an employee is eligible for occupational levels of sick, maternity and paternity pay is closely linked to the size of their employer. As noted in the first chapter of this report, only 22 per cent of employees in micro firms received occupational maternity pay – substantially lower than the 76 per cent of employees in large businesses who do (IPPR calculations using BIS 2014a). Occupational sick pay is also more likely to be offered by large employers, 94 per cent of whom provide sick pay above the statutory amount, versus 42 per cent of micro and small employers (ibid). It is likely these large inequalities in access to occupational benefits are related to the tighter cost constraints operating on smaller businesses, with many unable to offer more generous benefits.

2.2.3 Business support

A wide variety of business support services are available to employers, both in the private sector and funded or provided by the state. This ranges from professional accountancy, legal and HR advice, to the provision of ongoing administrative functions such as payroll services. These are important to small firms for several reasons – many firms are too small to be able to hire professionals to do this work in-house, and so either have to purchase it externally or not access such support. In addition, it is likely that many new firms wish to access such support in order to gain more clarity about their responsibilities as an employer, or to ease anxieties they might have about their legal responsibilities as they grow their business and take on more workers.

But smaller firms are less likely to access business support and assistance. One survey carried out for BIS found that 57 per cent of medium-sized business sought external assistance, against 39 per cent of micro businesses (North et al 2011). The authors also found that there are substantial levels of latent demand for business support: around 23 per cent of SME employers had either seriously considered using assistance, faced challenges in their business they were unable to completely deal with, or were only partly meeting their need through their current usage. Exploring why this might be the case, they found that uncertainty over the benefits versus the costs of support, a lack of trust over whether external organisations would understand their business, and concern over whether the appropriate assistance could be accessed were the key reasons for not using business support.

Some of the concerns many in the small business community have about employment regulation might be ameliorated by a better business support offer for SMEs. While employment regulation in the UK is low by international standards, what regulations the UK does enforce tend to have a disproportionately large impact on the smallest firms. Small firms tend to lack a qualified HR function, and therefore have a more informal relationship with their employees. While this can be beneficial, it leads to uncertainty among small employers around compliance, and anxiety around regulatory changes, which can have a dampening effect on hiring behaviour.

Recent research published by BIS, based on interviews with 30 employers about their perceptions of labour market regulation, found that much of the perceived impact among small firms may be due to the relatively informal way they manage staff (Jordan et al 2013). Among larger employers, written employment policies are more common and therefore they are more confident that they are complying with regulations, with the opposite often true in small firms. Many small firms value this informality, since they believe it promotes a better working relationship with staff, and can also have a positive impact on the hiring of disadvantaged groups, since small firms are less likely to require detailed formal evidence for the job, such as educational qualifications and gapless CVs, and do not have as complex hiring procedures as larger firms. But this informality, the study revealed, can also generate anxiety and uncertainty among small firms about their own compliance, and makes it more difficult to manage disciplinary and grievance situations in the absence of formal workplace procedures (ibid).

It is therefore vital that small employers are able to access support to develop written employment policies, and that basic HR support and training are accessible with the benefits clearly communicated to small firms. While a range of information is available online, businesses without a dedicated HR function – and therefore access to support through organisations such as the CIPD – find it difficult to navigate and apply in practice.

A recent report published by FSB Scotland suggests that attitudes towards regulation are influenced by the provision of guidance. Often, legal guidance can overemphasise the risks of noncompliance with regulatory requirements, but when impartial quality advice is offered to employers it can address misconceptions. This underlines the importance of disseminating and communicating advice and guidance in a way that employers understand and trust (FSB Scotland 2012).

This implies that, rather than deregulation, what might be needed by firms more is greater access to basic HR expertise, facilitating greater adoption of HR systems within SME workplaces. Indeed, the BIS report concludes that there are drawbacks to further deregulation, not least since it will increase the perception among employers that employment law is a rapidly changing area and therefore increase their anxiety around compliance (Jordan et al 2013).

In the past, some aspects of business advice and guidance were directly provided by the state. The Business Link network of local and regional offices, established in the 1990s and reconfigured several times since, sought to provide businesses in England, and SMEs in particular, with a mixture of advice and signposting to other services alongside more intensive ongoing support targeted at those businesses with growth ambitions. One estimate found that Business Link reached more than 30 per cent of businesses between 1997 and 2002. Evaluations of the programme have found a significant employment impact of firms engaging with Business Link support. One such study found that Business Link generated approximately 23,000 additional jobs in 2004/05 (Mole et al 2008). In 2011 the current government removed funding for the regional network of Business Link offices, delivered at that time through regional development agencies. It was replaced by a website and telephone service, initially on a dedicated Business Link website but subsequently moved to the gov.uk website.

This website aims primarily to offer businesses information, rather than any bespoke or face-to-face services. For instance, in 2013, the government launched an online toolkit aimed at sole traders contemplating their first hire. It lists the 10 things a prospective employer needs to do when taking on staff for the first time. While some of these tasks are fairly straightforward – ensuring that you pay the national minimum wage, for instance – others are more opaque, such as the distinction between employment status and contract type. While the toolkit is adequate at providing information, it does little to change the actual administrative burden faced by employers, and assumes that all prospective employers need the same information, as it does not provide a bespoke service. They still have to engage with a number of different organisations, including HMRC to register as an employer, and a private insurer to purchase employers' liability insurance. In addition, employers have to be set up on the PAYE system to record employee earnings and start to pay employer NICs.

More intensive support is still available, but it is much more tightly targeted than in the past. The Business Coaching for Growth programme connects SMEs with growth ambitions with a 'growth manager' who supports the employer to identify barriers to their expansion. They can then access match-funding for leadership training, peer networks, and master classes covering topics such as access to finance and innovation. There is a small charge for employers wanting to attend, and eligibility is contingent on an assessment of firms' growth potential. This form of intensive and targeted support closely follows international best practice, in that it depends on self-selection of participants, shared learning and leadership development. Nonetheless, the removal of face-to-face guidance and support available to all firms, as provided by Business Link's earlier incarnation, means the majority of SMEs are unable to access government-sponsored business support.[6]

The Cabinet Office's Nudge Unit, in partnership with the Department for Business, Innovation and Skills and a private contractor, are currently carrying out a randomised control trial of a new way of providing business support. The Growth Vouchers programme works by sending out information packs to a random sample of SMEs. Half of the firms contacted receive a link to information such as that held on gov.uk. The other half receive a voucher that can be used in an online marketplace to purchase strategic advice in a number of areas, including support from HR professionals on employing staff. The voucher will cover half the cost up to a maximum of £2,000. The purpose of the trial is to compare the subsequent growth performance of the two groups on a variety of metrics to see if the voucher has a positive impact.[7]

The scheme solves one of the key issues with business support services – suppliers of the service can also sign up to the marketplace and receive vouchers as part of their payment, so long as they are a full member of a relevant trade body and meet a minimum standards requirement. This provides users of the service with a quality assurance mechanism, not always available if they were to seek advice independently, and should make them more likely to use the service than they otherwise would be.

6 It is important to note that, since business support is a devolved area of policy, this discussion only refers to England. In Wales, for instance, Business Wales continues to provide a service similar to the earlier iteration of Business Link.

7 The scheme is running for two years and £30 million of government funding has been provided. More information is available at http://marketplace.enterprisenation.com/

2.2.4 Supply-side policies

In addition to influencing employers' demand for workers through the above, policy is changing rapidly in terms of the obligations it places on recipients of out-of-work benefits to find employment and participate in welfare-to-work programmes.

The welfare system is evolving in the UK, with implications for worklessness and employment; the introduction of Universal Credit in particular is intended to increase work incentives for those out of work, although some will see their work incentives reduced. At the same time there has also been a succession of above-inflation increases in the value of the personal allowance – the amount of income someone can earn before they start paying income tax – which have also had the effect of increasing work incentives. The ending of incapacity benefit and movement of its claimants to employment support allowance (ESA) is also seeing more of the workless population brought into back-to-work support and labour market activation. Given that many of these changes are either still being rolled out or are very recent, it is too early to assess the impact they may have had on employment.

These changes have been accompanied by the introduction of the Work Programme, which pays private and voluntary sector contractors to offer job-search assistance to the long-term unemployed. They then receive an outcome payment dependent on whether they manage to support individuals into sustainable employment.

The performance of the Work Programme to date, however, has been poor, especially for some of its client groups. It underperformed severely in its first year. Throughout year two, performance improved for some client groups, before levelling off in the case of adult JSA claimants and starting to worsen again for youth JSA claimants. The performance of the Work Programme for ESA claimants remained very weak, with less than 6 per cent of starters securing a job outcome (Inclusion 2014).

One other area of the tax and benefit system that has had a noticeable impact on labour supply has been pensions reform, in particular the staged rise in the state pension age for women from 60 to 65. One study found that the move from 60 to 61 alone raised female employment rates among 60-year-olds by 7.3 percentage points, and among their male partners by 4.2 percentage points (Cribb et al 2013).

2.3 What do businesses want?

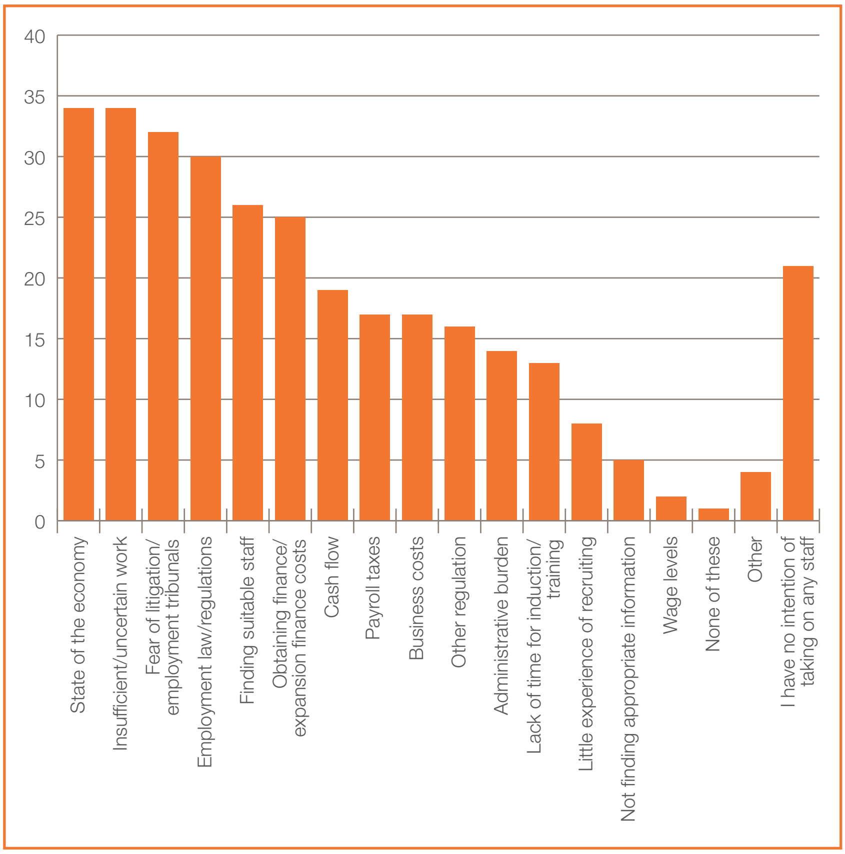
The preceding sections have shown the ways in which policy can have an impact on employment costs, but has said little about what businesses themselves perceive to be the barriers to hiring. It is vital to understand these perceptions since they tell us where policy can have the biggest effect.

Figure 2.1 shows the results of a survey carried out in June 2013 by the Federation of Small Businesses. The survey asked respondents what barriers they face to taking on staff. The most frequently cited barrier is concerns about future demand for the company's product, whether expressed as a general concern about the economy or a specific concern about the company's workload and income. This is perhaps unsurprising, given the still nascent economic recovery. This is followed by worries about the cost of taking on more workers and administrative and regulatory concerns.

Almost a third of firms say they cannot expand their workforce due to a lack of suitable staff in the jobs market, which suggests – given there are almost 2.5 million unemployed people looking for work in the UK – a serious skills mismatch between demand and supply.

The FSB survey also found that the fear of litigation was perceived as a more significant barrier to hiring by employers than wage levels, the administrative burden of hiring and lack of time to induct staff. Clearly, many employers do factor in the high potential costs of any litigation when they are considering hiring, despite the low risk of such an outcome.

Figure 2.1
Barriers to taking on more staff among FSB members*



Source: Data from an original survey conducted by the Federation of Small Businesses for this report in June 2013.
*Note: The precise question asked was: 'With regard to your future employment intentions, which of the following are barriers to taking on more staff, if any?' The 'business costs' option was presented with the examples of utilities, fuels and business rates.

If future demand for their products is the main factor holding back greater recruitment by small firms, there is likely to be a limit in the short term on the effectiveness of measures designed to make it easier for small firms to hire more staff. Although the most recent economic news has been more positive, until there is greater certainty about the outlook for demand in the UK – and in the UK's key export markets, in particular the rest of Europe – many small businesses are likely to opt for a safety-first approach that involves careful control of costs and maximising their flexibility, for example by making greater use of temporary and part-time contracts.

However, the FSB's survey shows that other factors matter too – and they will become increasingly important when the economic recovery eventually takes a firmer hold. Given the time needed to implement structural changes in markets, these factors need to be addressed sooner rather than later.

In order to gauge where the government might best direct its efforts, the FSB's survey also asked small firms how helpful a number of policies would be in encouraging them to take on more staff. The results are summarised in table 2.1, which shows that the strong preference was for measures to reduce the costs of employment, either through a tax break or a wage subsidy, though there was also strong support for help to reduce the risk of employing additional workers. Interestingly, there was less widespread support for help with employment tribunals, with less than half of small firms saying this would be helpful in encouraging them to take on more staff, although relatively high levels of support for temporary exemptions from aspects of employment law suggests that understanding and complying with regulations remain a concern for small firms.

Table 2.1
Percentage of firms which said that particular measures would be very or quite helpful in encouraging them to take on more staff*

A tax break	82%
The state taking on the liability of an employee going off on long-term sick in the first one/two years of their employment	79%
A wage subsidy scheme	78%
Temporary exemption from some employment legislation	75%
Easier access to information and advice	58%
Wider use of work trials	57%
Reduced interest payments on loans	50%
Another organisation directly employing the employee (e.g. local authority or training provider)	50%
Introducing a fast-track process for small businesses at employment tribunals	46%
One-to-one support for recruitment and assimilating new workers	34%
A body that provides micro firms and the self-employed with HR, administrative and back-office functions	33%
Applications for public sector contracts from firms that have a good record of employing young people and apprentices being looked on more favourably	31%

Source: Data from an original survey conducted by the Federation of Small Businesses for this report in June 2013.
*Note: The precise question was: 'How helpful would each of the following be in encouraging you to take on additional staff?', and respondents were given the option of replying: 'very helpful', 'quite helpful', 'quite unhelpful', 'not at all helpful' and 'unsure'.

2.4 Conclusion

Labour market policy in the UK in recent years has focused on trying to reduce the direct costs of hiring and ongoing employment, in combination with greater activation of the labour supply through changes to the tax and benefit system. There has also been some deregulation of the labour market, such as the extension to two years from one of the period before which employees are able to bring an unfair dismissal claim against their employer. And business support policy is changing in important ways as well, with the ending of a universal service in England delivered in local areas and regions (Business Link) and the introduction of highly targeted support (growth vouchers) alongside free-to-access information provided online.

In some areas policies are moving in opposite directions. The ending of SSP recovery, while being replaced with another measure designed to support the labour market attachment of workers with health conditions, nonetheless runs the risk of making it more difficult for those individuals to find work. This comes at a time when more and more oworkers with health conditions are in the workforce, because of changes to disability benefits and lengthening working lives.

Looking forward, policy to encourage hiring needs to develop a greater understanding of the predictable and unpredictable costs faced by businesses as they make hiring decisions, and reflect the particular challenges faced by small business in this regard.

3. A NEW DIRECTION AND POLICY RECOMMENDATIONS

Due to the longstanding barriers to work faced by many in the labour market, there is a strong case for broadening the set of policy levers available to encourage business hiring. Policy also needs to be responsive to the barriers that businesses of different sizes face when recruiting, particularly when hiring those further from the labour market. There are three key priorities in this regard.

1. **Increasing the overall scale of job creation.** While this relies in the first instance on a vibrant, growing economy, policymakers should nonetheless be doing their utmost to make it as easy as possible for employers to take on workers. This includes tackling the barriers to becoming an employer. Even a small rise in the number of sole traders taking on employees could have an enormous effect on the overall level of job creation. Similarly, we need to tackle the barriers to employment growth among existing micro and small employers. A small number of existing SMEs currently drive the bulk of job creation in the UK. Helping as many firms as possible enter a growth trajectory will be crucial in generating jobs and raising the employment rate.
2. **Tackling barriers to hiring those further from the labour market.** Second, we need to tackle the barriers to hiring those that face disadvantage in the labour market. It has already been shown that small firms provide a disproportionate source of employment for these groups, but as we aim for progressively higher rates of overall employment, we will need to increase hiring rates of those even further from the labour market. Taking on many of the individuals within these groups, such as those with few formalised skills, or that have health conditions that give them a higher propensity to experience sickness absence, entails significant risks for employers. And, since the cost and disruption of making an unsuccessful hire are felt more acutely in smaller firms, this is doubly important for SMEs. We therefore need to seek to either reduce these risks, or turn them into more predictable and transparent costs for employers.
3. **Supporting high-quality employment in SMEs.** While there can be many benefits to working in a small firm, we should look to where small businesses can be supported to improve their offer and ensure their workplaces are attractive places to work, both for current and prospective employees. The issues faced by small business in this regard do not necessarily reflect explicit choices by business owners, so much as the tight cost constraints they face in offering occupational benefits, and the difficulty in adapting employment patterns to fit staff preferences in a small workplace. This situation puts SMEs on a worse footing when competing for talent in the labour market, and means a large proportion of employees in the UK are unable to access well-paid parental or sick pay.

This chapter sets out several ideas that could be introduced or reconfigured in order to meet these objectives. This is not intended to be an exhaustive list of potential ways forward in this area, but rather to show practical examples of where this approach can be applied in order to encourage and target hiring among small businesses.

3.1 Recommendation one
Business support for new employers and existing micro and small businesses

Micro and small firms need a better business support offer. The government's current policy has an explicit focus on a small number of businesses on a high-growth trajectory. It is important to support this group, since they generate a significant proportion of net jobs growth. But we should not overlook the need for one-on-one support for other small businesses.

The lack of an offer of support to tackle hiring barriers for the vast majority of SMEs means many small business owners are likely either to be making do with what expertise they have in these areas, or refraining from hiring. Those not large enough to employ a dedicated HR professional, and unable to afford the cost of external support, have to navigate through an often complex system of employment law and labour market regulation. This is often difficult to interpret, increasing anxiety among small business owners about taking on workers.

In particular, there are two groups of firms that would benefit in terms of their hiring activity from a better business support offer.

New employers: start-ups face a variety of regulatory hurdles to taking on their first employee, detailed above. Some of these, such as registering as an employer and providing employees with a written statement of employment, do not involve any direct costs, but are nevertheless time-consuming for business owners. Others, such as buying employers' liability insurance and purchasing and setting up or outsourcing payroll, do involve up-front costs. This group of employers needs support, both before and after their first hire, to reduce any up-front costs, as well as offering bespoke guidance to demystify the process of becoming an employer.

Existing small businesses without a dedicated HR function: businesses that are not big enough to employ a dedicated human resources officer but are looking to expand their headcount encounter many difficulties along the way. The burden of a non-expert, usually the business owner, taking on all HR duties when they lack expertise can lead to anxiety about whether they are complying with regulation, following management and HR best practice, and offering the appropriate contracts, terms and conditions to their employees. This group of employers would benefit from support to access bespoke, professional HR advice and support, as well as training in managing people in a productive way that is also compliant with their legal obligations.

In order to meet the needs of these two groups of employers, the government should subsidise private-sector-led business support through a voucher scheme. This would operate similarly to the Growth Vouchers programme currently being piloted. It would offer small businesses up to 50 per cent funding on the costs of a defined range of employment-related services, purchased on an online marketplace and up the value of £1,000. Compared to a service directly commissioned by the state, such as the pre-2010 iteration of Business Link, the online marketplace through which the growth voucher is delivered enables businesses to access high-quality private sector support, while minimising the administrative burden on the public sector. Dependent upon the outcome of its evaluation, BIS should seek to more tightly target the range of support on offer, to employers with less than 20 employees and to new employers.

The support on offer should be separated into two schemes, each covering one of the above groups, and the range of support on offer should be more tightly targeted to focus specifically on issues related to employment and HR. In the following sections we explore some of the services that could be offered to new and existing small business employers.

3.1.1 New employers

Payroll software or payroll services: Most employers make use of a payroll bureau to process their employees PAYE and payslips.

Employers' liability insurance: Employers have a regulatory obligation to purchase employers' liability insurance, imposing a necessary cost on small businesses. By making the voucher redeemable against insurance, the cost of the first year of being an employer can be substantially reduced.

One-on-one HR support: Financial assistance with direct costs should be packaged with professional support that goes through the process of setting up as an employer step by step, delivered over the phone or in person. This would include drawing up terms of employment, registering as an employer, choosing employers' liability insurance, applying for a DBS check and other requirements. This could also be combined with a basic level of HR training for the employer to take forward into their new role.

3.1.2 Existing firms with fewer than 20 employees

Training: Knowledge of HR and people management is often lacking among many small businesses, which ultimately can contribute to problems in the employment relationship later on. HR training can help prevent this and ensure employers get the most out of their staff, boosting capacity, productivity and employee satisfaction.

One-on-one HR support: As businesses grow it becomes increasingly important that they put in place clear and legally compliant procedures. Therefore, also available should be professional bespoke support for specific aspects of HR, such as developing grievance procedures, contracts, staff handbooks and absence management guidelines.

It is likely there are other areas of HR and employment support that could be offered through such a scheme as well. The £1,000 on offer would be sufficient to cover a large part of a year's worth of HR support costs as well as training. As a guide, CIPD offers training courses on managing staff and key areas of employment legislation to non-HR professionals for just over £600, and HR support and outsourcing services, while varying considerably, can be found for between £100 and £200 per month. The cost of employers' liability insurance depends on the number of employees and the nature of the business' activity, but for a business with fewer than 10 employees would cost anything between as little as £20 and as much as £200 per month. The current Growth Vouchers pilot has used match-funding, with employers having to pay an equal amount to the proportion of the voucher used. While co-funding should be considered under this proposed scheme, full match-funding between employers and the state is likely to reduce the level of take-up for the policy and should be avoided if possible.

One criticism levelled at current and previous business support policy is that there have been very low levels of take-up among the target group of employers. This stems from several issues. First, a lack of awareness of the support that is on offer, and second, the fact that employers have little way of knowing how useful the available services would be to their business. Finally, accessing the services can be seen by businesses as overly complicated, hence any new voucher scheme must be easy to use with as low a level of administrative burden as possible.

There are a number of ways to tackle lack of awareness through a small business voucher scheme. New employers can be signposted to the availability of support via the gov.uk new employers website,[8] and potentially through the insurers they are required to interact with when purchasing liability insurance. For existing small businesses, membership bodies such as the British Chambers of Commerce (BCC)

8 https://www.gov.uk/employing-staff

and the Federation of Small Businesses (FSB) could be involved in the design and running of the scheme, as well as promoting it to their members.

In order to reassure potential and existing small employers that the services on offer are of a sufficient standard, only members of professional bodies or service providers already used and approved by business groups such as the FSB and BCC should be eligible to receive a voucher as co-payment for their services, in a similar way to the Growth Vouchers pilot. For instance, only members of the CIPD should be able to offer HR advice through the scheme.

The way the support is packaged will also be crucial, particularly for new employers. As discussed, there are other products and services which most new businesses need that should be available to purchase using the voucher. These include some of the costs associated with taking on a first employee, such as purchasing employers' liability insurance, as well as ongoing support functions such as outsourced payroll services. These types of services are not particularly expensive, but making new employers seek them out themselves adds a further layer of complexity to the process of becoming an employer. Ultimately, they should be packaged with professional support that goes step through the process of setting up as an employer by step, delivered over the phone or in person.

How much would this cost? Business demography data from Eurostat shows that between 170,000 and 250,000 businesses with 1–9 employees are set up every year in the UK (Eurostat 2014).[9] Providing them all with a voucher valued at £2,000 would therefore cost between £340 million and £500 million, assuming both 100 per cent take-up and that each business uses the full value of the voucher. In addition, there are just over 5 million existing businesses with between one and 19 employees. Offering a £2,000 voucher to these groups is therefore likely to be prohibitively costly. Ultimately the costs of such a scheme would be highly dependent on the level of take-up, with the likelihood being that many small businesses would prefer not to use the 50 per cent discount on HR support offered by a voucher. Still, one way to limit the cost would be to tightly target the existing small firms voucher to those that are growing in terms of headcount. This is the group of businesses most in need of extra HR support. This could be done by offering the voucher to those that have expanded their total payroll by greater than a defined amount over the past year. Alternatively, the cost could be limited by adjusting the value of the voucher for this group to, say, £500. However this is done, implementation of the policy should pay close attention to the results of the current Growth Voucher pilot, in order to gauge the level of appetite among small businesses for business support delivered in this way, and the expected fiscal implications of the policy.

Since business support policy is devolved, it would be up to the relevant public agencies in Wales, Scotland and Northern Ireland whether to adapt and implement such a policy.

3.2 Recommendation two
Retaining and reforming statutory sick pay recovery

The ending of statutory sick pay recovery via the percentage threshold scheme is likely to increase the risk of hiring employees with health conditions or work-limiting disabilities. This will be particularly acute in smaller firms. The new Health and Work Service is likely to help some employees return to work after health-related absences, but will do little for the many workless individuals looking to move into employment.

9 Data refers to 2004–2010.

Rather than simply keeping the current system of statutory sick pay recovery intact, it should be reformed so that it is targeted at those who face the greatest health-related barriers to work. This could be done by limiting statutory sick pay recovery to individuals moving into work from ESA. Those with work-limiting disabilities and health conditions face very low rates of employment, and the ESA segment of the Work Programme has performed very poorly in generating employment for this group, with only 5 per cent of participants achieving a job outcome over the life of the programme (Inclusion 2014). This is well below both minimum performance levels and targets, and is undoubtedly a contributing factor to the very low employment rate for this group in the working-age population.

SSP recovery should also be restricted to smaller firms, defined as those that are currently eligible for the higher rate of SMP recovery – businesses with an annual NICs liability of less than £45,000. This would ensure that support is targeted at those firms facing the greatest risk when hiring from this pool of workers; larger workplaces face significantly less disruption when an employee takes illness-related absence, being better able to redistribute their workforce to take account of unplanned leave. The narrower margins and tighter cashflow constraints in the smallest firms mean many find it difficult.

We recommend that the amount that smaller firms can recover should be increased to 92 per cent of SSP costs (the same proportion as SMP recovery for larger firms). This would substantially reduce the costs of sick pay for this group, and therefore the perceived risk of hiring individuals from ESA. Keeping the proportion of costs recoverable at 92 per cent (below the 103 per cent available to smaller businesses through SMP recovery) is likely to be appropriate. Refunding more than 100 per cent of costs mean that the employer had little financial incentive to support an employee on sickness absence back into work. However, if 7 per cent of the costs of SSP were to fall on the employer, they would retain a direct interest in this facilitating process.

While it is difficult to generate costings for this new system since it rests upon the small in-flows into employment of a narrowly defined group of welfare participants, it is possible to derive a rough estimate. We propose limiting SSP recovery to ESA claimants in their first year of employment. The government review of sickness absence carried out by Dame Carol Black estimated that approximately 31 per cent of ESA claimants were in work 12–15 months later (Black 2011). Therefore, based on the 1.87 million ESA claimants in the latest data referring to August 2013 (DWP 2014), we could expect around 673,000 to be in work 12–15 months afterwards (in September–November 2014). The same study found that around a fifth of those in work 12–15 months after claiming ESA were on sick leave. Assuming that this proportion holds true for the subsequent three-quarters, this implies an estimated 440,000 spells of sickness absence per year accounted for by ESA claimants. Based on the average length of sickness absence spells calculated by the Health and Safety Executive (5.02 days) (Reetoo et al 2009), and the fact that statutory sick pay is only payable after the third day's absence, we could expect close to 900,000 days, or 180,000 weeks, of sickness absence annually accounted for by recent ESA claimants. In practice, we would expect recent ESA claimants to experience longer than average sickness absence spells. The same study estimates that around 5 per cent of absence spells are longer than 20 days, with an average length of 52 days (Reetoo et al 2009). If we assumed that 20 per cent of ESA claimants absent from work have a longer spell of absence lasting an average of 52 days, this would imply 5 million days, or 1 million weeks, of absence eligible for SSP recovery. With SSP payable at £86.70 a week, and 92 per cent recoverable, this would result in a liability to the state of £80 million.

By limiting eligibility to firms with a NICs liability of less than £45,000, this figure would be reduced. As a rough guide, around 29 per cent of employees work for employers with fewer than 50 employees. Scaling the above costing down by this proportion gives us an estimate of the total fiscal liability under this system of SSP recovery of around £23.2 million per year. Compared to estimates of the cost of the abolished SSP recovery scheme – £49m (Browne and Hood 2012) – this is highly affordable.

Clearly we would hope that changing the structure of SSP recovery in this way would bring about a noticeable change in behaviour among small employers, increasing their hiring of individuals with health-related and disability conditions. This would be likely to increase the cost of the policy, but would also generate extra revenue to the exchequer through reduced spending on out-of-work benefits and greater tax and national insurance revenue. We are unable to model behavioural assumptions of this kind here, so the figure presented above should be considered indicative of the cost based solely on current patterns of sickness absence and employment.

3.3 Recommendation three
Intermediate labour markets in welfare-to-work policy

The risks confronting small employers when hiring the long-term unemployed are undoubtedly a factor driving the poor performance of the Work Programme to date, and the low employment rates for particular groups in general. To remedy this, supporting the long-term unemployed into work by reducing the risks of hiring for employers, we should make more use of temporary agency models of welfare-to-work support, involving providers acting as employment agencies to take on and secure work placements for long-term unemployed jobseekers.

This should be modelled on past and current 'intermediate labour market' (ILM) schemes. The idea underpinning ILMs is to provide a way for those jobseekers furthest from the labour market to gain experience of work and employability skills without imposing any obligation on individual employers to engage them on a permanent basis.

In their review of international ILMs, Finn and Simmonds (2003) highlight four key features of the model: engaging with clients who face severe labour market disadvantage; an offer of paid work on a short-term contract; an accompanying offer of training and personnel support; and a variety of sources of funding for the schemes. A contemporary example of such a scheme is the Apprenticeship Training Agencies (ATAs), who act as employers of apprentices and find placements within host employers, who then pay a fee to the ATA. Where a host employer is no longer able to keep an apprentice on, it is the ATA's responsibility to find a new placement. The network of ATAs were set up to address some of the specific costs and risks faced by employers, particularly SMEs, when taking on an apprentice, including uncertainty over whether sufficient work will be available, and apprehension on the part of employers about whether they have the capacity to deliver a full apprenticeship. An evaluation of ATAs found that many host employers were already looking to hire apprentices permanently, but the involvement of ATAs was crucial for them to avoid the risks of employment and solve capacity issues regarding the administrative burden of employment (Turner 2011).

Evaluations of similar models used in the UK and internationally have broadly shown that ILMs generate significant employment outcomes. Marshall and Macfarlane (2000) look primarily at ILMs that place participants in third sector social enterprises and charities, a group with similar characteristics as SMEs, and emphasises the importance of tightly targeting the support offered on the needs of both the individual and for each client group. This suggests that the client group format of the Work Programme should be carried over into the proposed ILM system, with differential payments for each group.

The advantage of such an approach is that it substantially reduces the risks faced by employers when taking on long-term unemployed workers. As explored elsewhere in this report, it is difficult for employers to gauge the potential productivity of prospective employees, especially those who have been out of work for long periods of time. This means employers are, other things being equal, more likely to hire an individual closer to the labour market. Offering temporary posts for a defined period of time can get around this issue, as it entails a significantly lower risk to the employer than a permanent hire, as well as taking away the risk and costs of sickness absence, holiday pay and other statutory costs, as well as much of the administrative burden of employment.

The current contract cycle of the Work Programme comes to an end in 2015. Given its poor performance, there is a high likelihood of either substantial changes to the design of the programme, or its replacement by a new institutional structure for delivering welfare-to-work support. Either way, an intermediate labour market component should be promoted within the next iteration of welfare-to-work support in the UK.

This could either be used as an option for all claimants, or only for those in particular claimant groups. Initially, it should be targeted at those in the ESA claimant group, who have seen the worst outcomes in the Work Programme, as well as facing the greatest labour market barriers in general.

How would an ILM component to the Work Programme work? At the point at which an eligible claimant moves into the Work Programme, their benefits advisers would work in conjunction with the relevant provider delivering welfare-to-work support to see if a temporary agency scheme would be an appropriate route for them alongside or instead of the core offer of support.

The agency/provider would function as the employer of claimants and secure them temporary work placements. Providers should try to place people into private sector businesses or, if that is not possible, into work with a social or community benefit. Employers would pay participants directly at least the national minimum wage for each hour worked, as well as any national insurance payable. During any spells when there are insufficient placements available, they would complement paid work with personalised employment support and training, and claimants would continue to be eligible for ESA. Providers would not charge employers an agency fee, as is the case in private sector temporary work agencies. They would receive funding along the lines of the Work Programme, with the Department for Work and Pensions offering a job outcome fee after a period of time if the individual has either worked a specified number of days over a qualifying period, or progressed on to a permanent job. Unlike the Work Programme, it would not be expected that participants work consecutive days in order to receive an outcome payment, but instead the proportion of days that must be worked to be eligible for the final payment would be specified within contracts. Should a participant transition into a permanent job, the normal rules for receiving a job outcome payment would apply.

The idea for the scheme is not to replace the Work Programme, but to provide more flexibility to providers to adapt their support offer to fit the needs of individual claimants. In terms of commissioning, it would work similarly to the Work Programme, by not being overly prescriptive about the nature of the support provided, instead issuing guidelines and minimum standards to those providing the service. There are a variety of options as to who could actually deliver the service, including private and third-sector providers, local authorities or jobcentres themselves, but it is likely this would be dependent on how mainstream pathways of support are defined and delivered post-2015.

The young – another group that has seen very poor labour market performance over recent years – are also likely to benefit from an intermediate labour market option within the welfare-to-work system, since their relative lack of labour market experience makes them a more risky hire for employers. But the Work Programme performance data for young jobseeker's allowance (JSA) claimants shows that it is achieving its minimum performance levels for this group (Inclusion 2014). In addition, IPPR has argued that unemployed young people should be taken out of JSA entirely, and all young people not in education, employment or training instead offered a 'youth allowance'. This would be means-tested on parental income up to the age of 21, and could be claimed during both job search and during further education training (Cooke 2013). It would take young people out of the Work Programme and into their own separate benefit system more appropriate to young people's needs. Still, depending on how welfare-to-work policy for the young evolves, an intermediate labour market component should be considered as part of either the successor to the Work Programme or a separate youth welfare system.

How would this be funded? Given the very poor performance of the Work Programme to date, particularly for those in the ESA claimant group, the majority of any additional funding should come from current underspend on the gap between the target performance for the Work Programme and what it has actually attained. Nonetheless, it is likely that sustainment payments and the cost per job outcome would have to be higher to account for the extra administrative work involved with providing an intermediate labour market solution. This should be carefully considered when Work Programme contracts come up for renewal. Beyond that, it is difficult to predict how successful such an ILM model would be in terms of job outcomes, and therefore what the total public spending implications are. We would hope it would be substantially more successful than the current iteration of the Work Programme, with more outcome fees awarded.

3.4 Recommendation four
An occupational benefit insurance scheme for SMEs

Many small employers would like to offer occupational benefits to their employees, but are unable to do so because of the additional cost. This results in employees in small firms being significantly less likely to have access to occupational benefits than those working for larger employers. Small firms' difficulties in providing occupational benefits put them at a disadvantage in the recruitment market, where they are pitted against larger businesses better positioned to provide these benefits. In addition, the low level of occupational benefits coverage among SMEs may be linked to the relatively high levels of employee turnover in small firms, having an impact on the overall high levels of churn seen in the UK labour market.

A case can be made for aiding small employers to turn the risks associated with offering a higher level of benefits to their staff into a more predictable cost. One way would be through an insurance scheme, which would involve employers paying a regular premium in return for timely payments of occupational maternity, paternity and sick pay if they are needed. A private market for such schemes does already exist in the UK, known as 'group risk' provision, normally used to offer employees income replacement should they become ill for a substantial period of time, but the evidence suggests that such schemes are aimed primarily at large corporates: premiums reduce significantly as the size of the scheme in terms of number of employees increases, and many insurers will only offer policies covering 250 employees or more.

Danish collective maternity pay insurance

In 2004, the Danish government, employer associations and unions reached a collective agreement to offer a higher level of occupational maternity pay and leave to Danish workers. The scheme is compulsory, requiring employers to pay an annual contribution based on the number of employees and their hours of work. Employer associations are in the most part free to set the amount of contribution, subject to minimum amounts set by central government.

When a member of staff goes on maternity leave, the employer is required to pay 36 weeks of maternity leave at normal pay, higher than the 22 weeks under statutory maternity pay. They are then reimbursed from the scheme for the difference between the statutory and normal pay amounts, subject to an hourly pay ceiling set by each employer association, with the central government specifying a minimum amount. Those businesses that are not a member of an employer association are covered by a similar national fund, with the required contributions and reimbursement amounts set centrally.

The scheme works by increasing the level of maternity benefits received by employers, but pooling the additional financial risk between all businesses. Since membership is mandatory, the financial impact of having an employee go on maternity leave is therefore shared between all members of the scheme. While this involves a transfer of resources between those employers in sectors with relatively fewer female employees, it reduces for all businesses the uncertain costs of offering greater maternity benefits. Insurers are able to charge low premiums because the administrative costs of engaging with a large number of very small schemes is reduced. Instead, they only have to work with a small number of employer associations.

Indeed, the impetus for the scheme was a desire on the part of unions to equalise the costs of maternity pay between employers, with a particular emphasis on alleviating costs for small businesses. This was intended to reduce discrimination in the labour market on the basis of age and gender, with the risk of employee absence reduced substantially for employers.

The combined payments of small firms therefore need to be pooled together. In Denmark, where such a scheme exists, firms that are members of employer associations pay quarterly premiums into a collective fund which then administers the payment of these benefits. Employer associations in the UK that currently offer other services to members such as legal advice and training should be encouraged to provide something similar offering occupational benefits insurance. Each employer association should be free to engage private sector insurers to provide a scheme that covers occupational maternity, paternity and sick pay and offer this service to their members. This would give small employers that pay regular premiums a simple to use way of offering high-quality occupational benefits to their staff, removing the uncertainty and variation associated with the provision of workplace benefits. In addition, by pooling together many employers, the cost per employer is likely to be reduced significantly compared to current private sector group risk provision. As well as leading to greater equality in access to occupational benefits among employees of different firm sizes, offering the scheme through employer associations would also have the advantage of encouraging more employers to join, increasing membership rates.

We do, however, have to be aware of the adverse selection risks associated with insurance schemes, which can lead to an uneven distribution of firms entering. The danger is that firms more likely to make a claim from the scheme are also more likely to join, which would greatly increase the premiums charged. For occupational sick pay, this can be partly mitigated by the insurer administering the scheme, since they would have an incentive to provide occupational health services to employers to limit absence. Many group risk providers currently provide such services. It is likely that this would have to be provided via the employer association, many of whom already provide similar insurance services in other areas, such as employers' liability insurance and goods and contents insurance.

Another way to solve this issue would be to make membership of the scheme compulsory. This is unlikely to be politically feasible, however, and in any case the extra costs this entails should not be forced onto employers, increasing their costs of hiring and employment involuntarily. Instead the cost of premiums negotiated, and the characteristics of firms who join the scheme, should be closely monitored by employer associations and the state, to see whether this is occurring and if any further action is needed.

While such schemes would be best led and provided by employer associations, there are things the state could do to create incentives for firms to join. For example, payments by employers into the scheme could be tax-deductible, or be eligible for targeted tax relief, such as not being subject to insurance premium tax or treated as a 'benefit in kind'. The state could also play a role by helping with the administrative costs of setting up a collective insurance scheme, while it could likewise part fund the scheme alongside the private sector, or underwrite a small percentage of the risk to make the scheme's premium cheaper. This would help to make the scheme more attractive to employers, especially in the early phase of such schemes when participation levels will be low and premiums consequently high.

3.5 Conclusion

As we move into fully fledged economic recovery, we need to make sure that that we maximise the ability of businesses to hire, and that all groups in the population stand to benefit from the jobs created. This report has set out several examples of how policy can better target hiring among small businesses and more disadvantaged jobseekers.

A new vision of business support policy: moving away from state-led business support and highly targeted growth coaching towards a private-sector-led offer to employers that demystifies the employment relationship, increases their capacity to manage staff, and provides financial assistance to overcome the costs of becoming an employer.

Reforming SSP recovery: the state should take on a greater liability for SSP, but only for those that face substantial barriers to work. Covering 92 per cent of SSP costs incurred by small firms for those moving off ESA will substantially reduce the costs of taking on workers with disabilities and long-term health conditions.

Making use of intermediate labour markets in welfare-to-work policy: by acting as a temporary agency for ESA and young JSA claimants, welfare-to-work providers can offer those furthest from the labour market vital integration into the workplace. At the same time this will reduce the risks faced by employers in hiring individuals from these groups.

An insurance scheme for occupational benefits: in order to support small firms in the recruitment market, as well as widen access to occupational benefits among workers, employer associations should offer insurance schemes to their members that pay out a given level of occupational maternity, paternity and sick pay to those that join the scheme.

None of the proposals outlined above are likely to come with exorbitant costs to the exchequer. Most either rest on redirecting existing spending, or are likely to involve costs similar to or smaller than those of items of discretionary spending that are regularly announced in the budget and autumn statement. These recommendations are not exhaustive. Rather, they represent a range of possible public policy options that sit within a broader approach to tackling the barriers to taking on employees, and they seek to maximise the role of small businesses in providing work for the most disadvantaged groups in the labour market and, as a result, in delivering full employment.

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