Research into the Enterprise Investment Scheme and Venture Capital Trusts

Summary of the report

Prepared for Inland Revenue

by

Nic Boyns, Mark Cox and Rod Spires, of PACEC,

and Professor Alan Hughes, of the Centre for Business Research, University of Cambridge

PACEC
Public and Corporate
Economic Consultants
www.pacec.co.uk

49-53 Regent Street
Cambridge CB2 1AB
Tel: 01223 311649
Fax: 01223 362913

610-611 Linen Hall
162-168 Regent Street
London W1R 5TB
Tel: 020 7734 6699
Fax: 020 7434 0357

e-mail: admin@pacec.co.uk

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Chapter 1: Introduction

The report sets out the results of research into the Enterprise Investment Scheme (EIS) and the Venture Capital Trust (VCT) scheme, undertaken by PACEC for the Inland Revenue.

Both schemes provide tax incentives to individuals to encourage the supply of equity finance to smaller, unquoted, trading companies. The EIS was introduced in January 1994 and the VCT scheme was introduced in April 1995. The former provides reliefs to investors' direct equity holdings in qualifying companies, whereas the latter provides reliefs for indirect portfolio investments administered by professional fund management companies. It is intended that the tax reliefs should encourage investors to increase the supply of finance to companies that might otherwise have difficulties in obtaining it, and that those companies should be able to improve their performance as a result.

A cumulative total of nearly £2.2 billion was invested through the EIS between its launch and tax year 2000/01. The equivalent amount invested through the VCT scheme between its launch and 2000/01 was just over £1.4 billion. The cumulative cost of the EIS to the public purse, in terms of tax forgone, was £750 million to the end of 2000/01. The equivalent for the VCT scheme was £400 million.

The schemes share broad objectives. The **immediate objective** is that the tax incentives provided should improve the post-tax returns for investors, thereby encouraging them to invest more in the companies covered by the schemes. The **intermediate objective** is that the companies should then be enabled to use the funds to improve their performance. The **ultimate objective** is that the UK economy should benefit by having a more competitive small firms sector.

Mirroring the objectives of the schemes, the objectives of the research were to:

1. Provide a quantitative and qualitative analysis of the effects of the schemes on the supply of finance to smaller, higher risk, trading companies;
2. Provide information on how investing companies have used the funds that they have raised through the schemes and on what difference this has made to their financing and performance; and
3. Produce a first evaluation of the wider economic effects of the schemes and their cost-effectiveness.

In order to address the research objectives and the associated issues, a large scale programme of surveys was undertaken. This was informed by a review of the academic literature on small business finance, which was also used to assist the interpretation of the survey results. The main components of the survey programme were:

- Postal surveys of EIS investors, VCT investors and comparable individuals not involved in the schemes. These attracted more than 2,000 responses in total.
- Telephone surveys of companies receiving finance via the EIS or VCT schemes and of comparable companies not associated with either scheme. These involved interviews with more than 1,000 SMEs.
- A telephone survey of accountants, tax consultants, IFAs and others active in providing advice on the schemes to investors and / or companies.

Chapter 2: Literature review

In summary, the review found that the last decade has seen the introduction and reinforcement of a number of related policy initiatives designed to improve the flow of debt and equity finance to smaller, start-up, younger, and high-tech SMEs. This has coincided with an apparent amelioration of reported constraints, arising from financial markets, on the growth and performance characteristics of these firms. However, major areas of uncertainty remain in relation to the impact of particular schemes such as EIS and VCT, on which there is virtually no empirical evidence in the literature. The current research, therefore, fills an important gap in knowledge.

Chapter 3: Characteristics of investors and companies involved in the schemes

The research showed that EIS investors are slightly younger and less likely to be retired than their VCT counterparts. The two groups are similar in terms of their income, but EIS investors are more dispersed than VCT investors in terms of their wealth distribution. The comparison group investors (who were a sample of self-assessment tax payers with similar characteristics to scheme investors in terms of tax liability and income) comprised a greater proportion of females and pre-retirement age people than both of the other groups. Even though they had similar levels of income, the comparison group investors were also markedly less wealthy than both EIS and VCT investors, even though they have similar levels of income.

It was also found that there are two distinct types of EIS investors, and that the two types have different investment patterns from one another. 'Deferral-only' EIS investors (i.e. those attracted into the scheme mainly or solely to access the opportunity to defer their liabilities on other capital gains) tend to invest significantly more than 'mainstream' EIS investors (who are attracted into the scheme for a variety of tax and non-tax reasons).

Overall, EIS companies are smaller, younger and less likely to be listed on AIM or OFEX than VCT companies, but both groups are equally ambitious to grow. Comparison group companies (who were a group of SMEs with similar characteristics as in-scheme companies in terms of size and sector, and were eligible to use the schemes) are older, less likely to be listed and less growth-orientated than both groups of in-scheme companies.

Reflecting their larger size, VCT companies had raised more finance through their scheme than the EIS companies had. They were also more likely than EIS companies to describe themselves as 'going for growth'. Conversely, they were less likely to be start-ups. High-tech EIS and VCT companies were not found to be greatly different from their conventional technology counterparts, in terms of their background characteristics and financing patterns using the schemes. But they were less likely to describe themselves as mature.

Chapter 4: Effects of the schemes on investors and the supply of finance

This chapter considered a number of questions related to the objective that the schemes should improve the supply of finance to eligible companies:

- **How much of the finance provided through the schemes was additional (i.e. would not have been invested anyway)?** Depending on the scheme and precisely how the calculations are made, it is estimated that between 52% and 87% of the

finance provided through the schemes would not have been invested in small, unquoted companies anyway by those investors, if the schemes had not existed.

- **What features of the schemes encouraged investors to invest? What have been the discouraging features? What have been the relative compliance costs?** Taking all investors together, the single most attractive feature of both schemes is the front end income tax relief. However, secondary attractive features differ according to type of scheme and, to a lesser extent, according to sub-group of investor. The single most unattractive feature is the qualifying period for tax reliefs. Measured in terms of difficulties in understanding and complying with scheme rules, the relative compliance costs of the VCT scheme do not appear to be great, although they are great for a sizeable minority of EIS investors.
- **What has been the impact of changes to scheme rules?** Few EIS investors and a minority of VCT investors claimed to be aware of changes to scheme rules. However, amongst those aware, the effect of the changes has, if anything, made investors more positive in their attitudes towards the investing through the schemes.
- **How do investors plan their exit strategies?** About half of the investors who have given the matter thought are likely to hold on to their scheme shares beyond the end of the qualifying period. However, only just over half of EIS investors, and fewer than four in ten VCT investors, have actually considered the issue.
- **How have rates of return on scheme investments compared with returns on comparable investments?** Post-tax rates of return on EIS investments have compared unfavourably with rates of return on comparable investments, although this is not the case for all sub-groups of investors. On balance, post-tax rates of return on VCT investments have been about the same as those on comparable investments.
- **Would investors invest through the schemes again?** Despite the fact that EIS investors appeared to have had relatively poor experiences of the scheme, more than two-thirds of both groups of investors said that, assuming they had the funds available, they would consider investing through the schemes again.

Chapter 5: Effects of the schemes on companies

In relation to the intermediate objective that schemes should enable companies to improve their performance, the principal findings can be summarised as follows:

- **To what extent have the schemes provided benefits over and above the supply of finance, e.g. increased expertise from investors?** Nearly half of the EIS companies and nearly four in ten VCT companies indicated that using the scheme enabled them to attract investors or fund managers who also provided them with business advice and expertise. This extra support was generally described as extremely or very helpful. There was also evidence to suggest that obtaining finance through the schemes then enables some companies to obtain other external finance, which they had not previously been able to obtain.
- **What has been the impact of the schemes on company performance in terms of profitability, productivity, survival etc.?** Objective econometric analysis of the survey data concluded that use of the schemes had a positive impact on companies' growth. The companies' subjective assessments of the impact of the schemes on a range of performance indicators was also positive, but quantitatively small.
- **How has the impact varied according to type of company (e.g. sector, size)?** Many variations in the survey results according to sub-group of companies were found, although the variations noted did not always have obvious interpretations. Moreover, there was not the same consistent pattern in the variations amongst companies as there was in the variations amongst investors. However, measured in terms of the number of statistically significant survey findings, VCT companies do appear a slightly more homogeneous group than EIS companies.

- **To what extent are the effects and impacts of the schemes on companies additional (i.e. would not have happened in the absence of the schemes)?** The additionality of the supply of EIS and VCT finance to companies was not measured in the same ways as the additionality of the supply of finance from investors was measured, although there were strong suggestions of additionality. Instead, the focus was on the additionality of companies' actions associated with raising finance through the schemes. At first sight, this type of additionality did not appear to be great, but there is reason to believe that simple measurements understate its degree.

It is also worth noting that both sets of companies' implied satisfaction ratings are high and that, consequently, attitudes towards using the schemes again are generally positive. Companies indicating that they are unlikely to use the schemes again, or expressing doubts on the matter, often show signs of having outgrown the schemes.

Chapter 6: The role of advisors

The findings from advisors were, by and large, consistent with the findings from investors and companies. But, focusing on instances where the results from the survey of advisors conflicted with equivalent results from the surveys of investors and companies, the main findings of this chapter can be summarised as follows:

- Advisors perceive the attractions of the schemes to investors in broadly the same way that investors themselves perceive them. But they tend to under-estimate the importance of loss relief to EIS investors, and of tax-free dividends and the portfolio nature of the scheme to VCT investors.
- Advisors think that the VCT scheme is the more difficult of the two to understand, but the investors implied the opposite.
- Advisors' perceptions of rates of return on VCT investments (compared to rates of return on other investments) were similar to VCT investors' own perceptions, but they over-estimated comparative rates of return on EIS investments.
- The advisors also under-estimated the extent to which VCT companies are able to satisfy their objectives in being involved in the scheme.
- Overall, the advisors' attitudes towards using the schemes again in the future were more positive than those of the companies.

Chapter 7: The wider economic effects of the schemes

The overall conclusion drawn from this chapter is that there are wider benefits associated with the schemes and that any wider disbenefits do not appear to be great. The other key findings are that:

- The rationale for the schemes was valid during the period considered by this research.
- The schemes do not play a major role in the overall supply of funds to SMEs, but they play a significant and growing role in the supply of private equity funds in the UK.
- The schemes appear to be reasonably effective in targeting the companies for which they were intended.
- The schemes are associated with important supply-side gains, a substantial proportion of which are additional (i.e. would not accrue anyway).
- The substitution and displacement effects associated with the schemes appear to be moderate.

Chapter 8: Overall conclusions on the effectiveness and cost-effectiveness of the schemes

Assessing the effectiveness and cost-effectiveness of the schemes proved to be hazardous, and it was necessary to attach caveats to many of the cost and effect estimates. In the absence of performance targets and external benchmarks, the report compares the two schemes with one another, even though they operate under different rules and aim to address different needs. Nonetheless, the key conclusions may be summarised as follows:

- **Effectiveness of the Enterprise Investment Scheme**. Because more than half of the monies invested would not have been invested by those same investors in the absence of the scheme, the EIS is adjudged to have satisfied its immediate objective to an extent. The additionality of finance through the EIS has been lower than through the VCT scheme partly because the EIS scheme has attracted a significant minority of investors who would probably have invested anyway to support friends and acquaintances. Concerning the intermediate objective, it was found that EIS companies were changed and affected positively in a range of ways as a result of the scheme; and that many of them would not have taken alternative action to secure the same benefits, if they hadn't been able to use the scheme. As a result of the changes and effects reported, there were moderate improvements in company performance for a sizeable minority of firms. It was also found that the effects of the EIS on firms were of the sort that would lead to competitiveness improvements, rather than short-term, one-off, gains. There were also positive spill-over effects into the wider economy, and any negative internal and external effects appeared to be moderate. Thus, it is concluded that the EIS has gone some way towards satisfying its ultimate objective.
- **Effectiveness of the Venture Capital Trusts scheme**. The large majority of the monies invested would not have been invested by those same investors in the absence of the scheme. The VCT scheme is, therefore, adjudged to have satisfied its immediate objective to a large extent, although some companies invested in could have got the finance from elsewhere. Despite the differences between the schemes in terms of the ways firms used the finance raised, the effect of the VCT scheme on company performance was not greatly different from the effect of the EIS. Consequently, it is concluded that the VCT scheme has been fairly effective in relation to its intermediate objective. There was little to distinguish between the two schemes in terms of their effects on small firm competitiveness and the UK economy. Thus, it is concluded that the VCT scheme has also gone some way towards satisfying its ultimate objective.
- **Cost-effectiveness of the Enterprise Investment Scheme**. The estimated cost of the EIS in terms of tax forgone has been 55-66 pence for every additional £1 invested through it. In relation to the effects of the scheme on company performance, it was shown that for every £1 million in tax forgone EIS companies are estimated, amongst other things, to have increased their sales turnover by £3.3 million and have increased their employment by 65 jobs. However, without external benchmarks, it is difficult to say how good a performance this represents.
- **Cost-effectiveness of the Venture Capital Trusts scheme**. The equivalent data for the VCT scheme implied that its estimated cost in terms of tax forgone has been 33-41 pence for every additional £1 invested. The VCT scheme seems to be significantly more cost-effective than the EIS, but the respective estimates relate to the amount of money invested through the schemes, rather than to the amounts supplied immediately to small firms. Conversely, it was also shown that the VCT scheme appeared to be less cost-effective than the EIS in terms of its effects on company performance (for every £1 million in tax forgone, VCT companies are estimated, amongst other things, to have increased their sales turnover by £0.6 million and have increased their employment by 9 jobs). However, it was also cautioned that the data were likely to have exaggerated the cost-effectiveness of the EIS relative to that of the VCT.