

**Small Business  
Failure in Ireland**

**Report to the  
Department of  
Enterprise, Trade and  
Employment**

**June 2001**

# Executive Summary, Conclusions and Recommendations

## 1. Introduction

The Department of Enterprise, Trade and Employment commissioned Fitzpatrick Associates, Economic Consultants, along with Bannock Consulting, London, to undertake a study on the extent and causes of, and appropriate policy responses to, small business failure in Ireland. The study had the following terms of reference:

- *Establish the trend in small business failures over the first five years of their lifetime, by reference to the most recent period for which data is available.*
- *Quantify failures according to size, market, sector, location, type, ie businesses-incorporated, partnerships, sole traders, stage of failure ie 1/3/5 years.*
- *Identify contributory factors to failure from available literature and studies at an EU and US level.*
- *Examine all available data and information on SME failure available in the Irish context.*
- *Consult widely with a range of stakeholders in the Public and Private sectors in Ireland to ascertain causes of failure.*
- *Identify the reasons for business failure in Ireland in a comparative international context.*
- *Identify and assess the impact of business failure on employment, suppliers, customers and the economy;*
- *Identify the current levels of Agency supports in the prevention of business failures.*
- *Review best practice models (EU and elsewhere) designed to reduce levels of business failures.*
- *Arising out of the findings of the study, make such recommendations as may seem appropriate to help reduce the rate and level of business failure.*

This Chapter provides a summary of the study findings, along with its conclusions and recommendations.

## **2. Summary of Findings**

### **2.1 The Causes of Small Business Failure**

#### **2.1.1 International Literature**

Small businesses have a higher chance of failing than do large businesses. Research and statistics generally find this to be the case. However, definitions of failure are critical in evaluating research findings. There is a range of reasons why a business can cease to exist, many of which nobody would interpret as “failure” in the traditional sense. A company which ceases to exist after being bought and subsumed into a larger firm is clearly different from one which becomes insolvent due to declining sales and cost overruns.

The precision required in defining “failures” also needs to be applied to interpreting small business data, as often proxies for failure are adopted, or assumptions are implicitly made about what constitutes a “failure”. Research which is based upon data which clearly defines and records failure and its symptoms will run less risk of diagnosing policy responses which may be unnecessary or irrelevant.

In most literature on the causes of small business failure, a distinction is made between “internal” factors (ie those factors which are unique to the firm in question), and “external” factors (ie factors within the trading environment in which the firm operates). The most commonly found external causes of small business failure include the external price environment and inflation, interest rates, wage costs, declining markets (eg in recessionary periods), tax rates, bad debts and late payment, and market competition.

Internally, much of the research identifies causes which collectively represent “bad management”. A common feature of a small business is the “one person” problem, whereby most if not all of the senior management responsibility is invested in one person who may not have the appropriate range of skills, or may not have the time, to apply them appropriately. In all businesses managerial functions exist in relation to sales, marketing, financial control, resourcing, purchasing, planning, monitoring and many others. Failure can be the result of mismanagement in any one area, therefore often the most frequent causes of failure are weaknesses in the management

functions most frequently neglected. It is unsurprising that research finds internal factors more influential in a typical failure than external ones.

Poor marketing, weak financial control, lack of strategic planning, inadequate liquidity, and a lack of market awareness are commonly identified internal causes of small business failure. Taken further, these can be attributed to personal characteristics of one-person managers, such as their attitudes to risk and control, poor judgement, inexperience or narrow focus.

Another distinction, although one perhaps more in relation to symptoms than causes, is between failures resulting from “over-trading” and from “under-trading”. In the former, a small business may over-extend itself in meeting existing demand for its products or services by perhaps over-borrowing, and may come in to difficulties if orders stagnate. Under-trading is the more straight-forward case of insufficient sales.

Regardless of at what level contributory “factors” are identified, some will be subjective to the situation of a particular small firm (and still be both internal and external), while some will be evident for all small firms operating amongst and competing with larger firms. Diseconomies of scale, for example a lack of capital against which to borrow funds, will effect all small firms, and will place them at a disadvantage to larger businesses.

Of course making distinctions is useful for analytical purposes. Rarely however does a business fail as a result of a single factor, either internal or external. Like business success, failure is often the result of a combination of a number of factors interacting over a sizeable period.

### **2.1.2 The Current Causes of Failure in Ireland**

The causes of small business failure in Ireland have not been researched in great depth, nor at any frequency. However available findings suggest that Irish small business failures share many of the characteristics of such failures elsewhere. Among external factors, financial constraints and interest rates have traditionally been attributed, along with exchange rate risk, declining markets and uncompetitive cost environments.

No less importantly, internal managerial weaknesses feature equally regularly in studies, including marketing, sales and particularly export sales, financial planning,

control and monitoring, and insufficient investment. Each has been attributed to the problem in Ireland in the past. More recently, insufficient use of management information systems and information technology have been identified as undermining competitiveness.

However, after a record period of high employment and output growth there is widespread evidence of business failures in Ireland now being caused by factors such as staff resourcing and retention, difficulties in wider resourcing, wage and cost inflation, and the management challenges which accompany a dynamic trading environment. These include factors such as the financing of growth and the attitude to risk, as well as overly burdensome regulations and compliance costs.

## **2.2 Extent of Small Business Failure in Ireland**

Data on small business is poor, in Ireland as well as elsewhere. This probably reflects its short history as a significant specific concern of policy makers in most countries. In the absence of a systematic “register” of small firms, analysis tends to be sub-sectoral, sample-based or based on other data sources which often have quite significant shortcomings.

This study has examined all available Irish data sources which are felt relevant to the analysis of the small business sector. Four key sources emerge as noteworthy, and they reveal a current range of small business “failure” rates between 33% and 41% after five years. Given the diversity of the sources, this proximity is encouraging. Individually, the findings are:

- that approximately 33% of small companies picked up by the Census of Industrial Production had failed after 4 years, with the highest failure rates occurring in years 1 and 4 after set up. This data also suggests that the propensity to fail is highest for the very smallest firms;
- data from the Forfás Business Information System, which covers grant-aided firms in the manufacturing and international service sectors, indicate a failure rate of 37.5% after 5 years. A rate close to the CIP rate, this analysis also suggests rates highest in the first year after establishment. A regional analysis of these data suggests a regional spread of failure rates ranging from a high of 47.7% in the West, as low as 26.1% in the Midlands;

- the VAT register of the Revenue Commissioners shows that 33.4% of companies first registering for VAT in 1994 had de-registered by 1999. While not necessarily a proxy for failure, it is interesting to note the closeness of this to the rates identified above. A quite different regional result emerges, however;
- finally, the employer's register of the Revenue Commissioners shows that 41% of the 11,439 first time "employer" registrants in 1994, had de-registered as such by 1999. Again, there may be many reasons for de-registration from this register. However, the proportion so doing is still notably close to the rates emerging from the other main sources.

### **2.3 The Impacts of Small Business Failure**

Studies in nearly all industrialised economies recognise small business as a key source of employment. Loss of employment is therefore the first serious economic impact of a failure, and this will be most negative where such employment is relied upon – eg where there are few businesses or few alternative opportunities. This becomes a negative macro-economic effect if new firm formation is at a rate below failure, and the population of businesses is declining.

Secondary or multiplier effects of course accompany this primary effect. Bad debts, unpaid creditors and the loss of income to the previous employees all create a trickle of negative impacts arising from the failure. Similarly, there may be sizeable opportunity costs. Where a company fails to realise its potential, that potential in terms of future employment, innovation, and other areas is lost to the economy, and future economic growth potential is constrained. A growing body of evidence exists which suggests small businesses are more innovative than large ones.

Finally, as well as benefiting from steady macro-economic growth and stability, economic research also finds that a healthy small business sector can underpin such growth and stability. In relation to growth, studies have shown that as greater innovators, small enterprises contribute more to the overall innovative process, a process, which as recent history shows, can drive macro growth in its own right. Other research finds that stable growth at the macro-level is strengthened by significant heterogeneity at the micro-level. Economies and industries which are characterised by large numbers of small firms are found to be more reactive, innovative, competitive and less volatile.

The macro-impact of small business failure therefore depends at one level on the rate of business formation, but at another level on which firms are failing. The economic loss of potentially innovative, creative and dynamic small firms is infinitely greater than of those without those qualities.

#### **2.4 International Policy in the Prevention of Small Business Failure**

Most governments adopt a two-tier approach to supporting small businesses, firstly by providing sometimes generous supports to a limited number of high potential firms (a picking winners policy), and secondly by providing much more broad and general supports or a supportive environment for the wider majority of small firms. In the latter case however objectives are often unclear - are policies designed to increase the success of the current population of small businesses, to minimise the number of failures, to maximise the number of successes, to increase the size of the population of businesses and so on. If failures reflect bad original start-ups and are inevitable, then it is rarely a government's policy to artificially lengthen the life-span of what may be ailing and doomed businesses. As high rates of failure often reflect high rates of start-up, it is important that the policy objective be clear.

For the purposes of this study, international policies in the areas of bankruptcy, increasing competitiveness, access to finance, human resources, deregulation and simplification, and competition policy are reviewed in some detail.

The review concludes that the most important policy any government can pursue in order to maximise the number of small businesses that are successful is one which seeks to maintain steady non-inflationary growth in the macro-economy. In so doing they remove the single greatest vulnerability of small businesses – their ability to absorb external shocks. At a more focused level, measures to increase small firm competitiveness through managerial or technological supports have been shown to be necessary and effective in many countries.

With regard to finance, it is considered that easing the cost burden of finance is no longer necessary in most cases, although improving access to finance for higher risk firms can be effectively achieved through targeted interventions. Governments can and do play important roles in improving access to venture capital. Taxation,

regulation and administration are recognised as significant threats to small businesses in most countries, and Government efforts to simplify and minimise the financial and non-financial burdens of these have been shown to be effective.

More recently emerging is the area of competition policy. Evidence of the detrimental effect on small firms of a lax competition policy, particularly with regard to large firms and the banking sector, is now widely recognised. Finally, Governments can take action to alleviate the pressures associated with a booming economy, as has been the case in Ireland for some time. Assistance can be provided in the provision, cost or awareness of land and premises, although very direct subsidisation is usually avoided. Various options exist for Governmental action to alleviate a tight labour market. As well as seeking to attract new labour market entrants, from national or international sources, measures can be taken to ease the regulatory implications of employing people.

### **3. Study Conclusions and Policy Recommendations**

Irish Governments, like most others in western countries, began forming policies aimed at assisting the “small business sector” in its own right within the last thirty years. In that time, but particularly since the late 1980s, the record of successful policy in Ireland is impressive. During that period, a typical small firm was operating in a high taxation, low expenditure and slow-growing and hostile economic environment. Interest rates were significantly higher than today, and exchange rate uncertainty constrained export and high growth potential. Today, Ireland has a fast growing, low interest rate economy. Tax burdens on entrepreneurs have and continue to ease. Finance for small firms is historically cheap and abundantly available, and the venture capital market has widened and become more proactive in favour of small firms. Direct policies have eased regulatory compliance, and euro membership has removed much exchange rate uncertainty for exporters. Falling bad debts of small businesses reported by the major banks is testament to this success.

What the experience has shown however is that policy challenges change rather than disappear. Ireland’s recent years of rapid economic growth, the recent and current diffusion of new technologies across commerce and industry, discernible changes to consumer habits and preferences, and the further internationalisation of

trade all have brought changes to what constitute the required ingredients for small business success and competitiveness.

In trying to define causes of failure, or constraints to success, researchers and policy makers are faced with the problem of differentiating between internal weaknesses and external influences, and also between shocks, short-term pressures and longer-term structural disadvantages. Confusion or misinterpretation of the problem may lead to incorrect or inappropriate policy actions.

While generalising, the factors which currently represent the greatest success challenges for small Irish firms include the tightness of the labour market and wage pressure, rising input costs, internal managerial weaknesses across a host of areas (eg in financial or resourcing decisions), and the ever-present “one person” problems of paperwork, regulatory and taxation compliance.

Having identified the challenges, it is useful to identify their nature before prescribing policy responses. They can be categorised into four areas:

1. immediate “cycle”-related pressures, which result from and accompany the booming economy. Some problems are a direct result of the stage of the business cycle in Ireland;
2. more medium term issues about the pace of economic growth, the risks of over-optimism and the exposure of different groups of firms to any changed external circumstances;
3. the recent and ongoing competitive challenges resulting from e-commerce and information and communications technology; and
4. ongoing and evolutionary challenges which will include the diffusion of “good management practice”, the use of external assistance, the attitude to risk and equity sharing, the regulatory competitiveness of the economy, lending institutions and capital markets, engagement in R&D, and the ease and efficiency of statutory compliance.

Conclusions and policy recommendations are now made according to this categorisation of small business challenges. To begin with, recommendations regarding small business data are made.

### ***Small Business Data Sources***

A clear conclusion of this study is the inadequacy of small business data upon which analysis, research and monitoring can be based. The next sections discuss in turn how small business success can be maximised through policy action. However, unless there can be systematic monitoring, analysis and measurement of the sector in question and its dynamics, any policy initiative will not be open to evaluation or appraisal, and runs the risk of being incorrectly prescribed to begin with.

It is our understanding that the CSO, in developing the new “Business Register”, is hoping to radically improve small business statistics in Ireland. Certainly, having the CSO as the main source of policy data for this sector will be an improvement on the current position. It will be important however that those with policy responsibility for the small business sector ensure that what is proposed meets their sector definition and policy analysis requirements. From a policy analysis and research perspective, improvements ought, in our view, to meet the following requirements:

- data needs to be comprehensive, covering with absolute confidence, the entire range of business sectors;
- data needs to be reliable;
- data needs to be timely and produced periodically with minimum gaps between observations, so that trend analyses can effectively be undertaken;
- data needs to be detailed. While the range of variables recorded in the Census of Industrial Production stands as a good example of what is possible for a specific sector, aspects of small firm competitiveness (which present challenges to quantitative researchers and statistic gatherers), have been highlighted in the Annual Competitiveness Report and include:
  - technological competence, marketing knowledge and product innovation;
  - levels of co-operative networking; and
  - innovative capacity.

### ***Cycle-related Pressures***

Ireland’s current economic boom began in the early 1990s, and for a number of years now, skill shortages and more recently general labour shortages have been becoming more and more prevalent. This has become a serious problem for small firms, and probably represents their greatest current challenge. Unable to compete with the remunerative capacity and flexibility of larger firms, small businesses not

only cannot attract sufficient workers, but have difficulty retaining existing staff in an increasingly competitive labour market. Continuation of this trend may lead to structural imbalances in Irish employment, in which various pools of labour remain beyond the reach of small indigenous firms, or where highly-skilled or experienced staff become “price-setters”. As in the case of any product or service market, the small business sector is first to feel the pinch of excess power being exploited in the labour market.

In order to minimise the threat of this labour market pressure on the sector, Government policy should maximise the flow of new labour market entrants from various sources. This should be based on labour market needs assessment which appropriately considers the skill needs of the economy, but also the competitive position of the jobs market. Further measures to ease mobility within the job market, for example through the speeding up of the procedures for gaining work permits, will also assist the labour market’s more competitive and smooth functioning. Such measures should ease labour mobility, increase labour supply, and constrain unnecessary wage pressure which is becoming widely evident and threatening.

A second symptom of the booming economy which is presenting difficulties is the supply of land, space and serviced premises. Like the housing market, the industrial, retail and commercial property markets have been experiencing supply shortages and resulting price inflation in recent years. While EU policy may not advocate direct subsidisation of rent for certain sectors, again measures should be taken to ensure the smooth functioning of the property market. Increases in the supply of commercial and retail space are coming through, but should be hastened to minimise further rent inflation. Specific initiatives should be taken to provide advisory and informational services to small firms requiring suitable accommodation. In the longer term, the reasons behind the supply un-responsiveness of the Irish residential and commercial property markets should be identified and rectified.

Finally, and much more recently, Irish inflation has reached discomfiting levels. Regardless of its temporary nature or the reasons behind it, small firms are being hit. Uncertainty in future price levels, input cost increases and inflation induced wage pressure in small firms will undoubtedly be the early losses of competitiveness brought by rapidly increasing general price levels. Government options for controlling inflation are much more limited since entering EMU, but remain nonetheless.

Perhaps most importantly, ensuring sufficient competition across and within all sectors and removing artificial or unnecessary supply constraints in markets where the public sector has a role to play should become a policy priority.

In addressing management skills necessary to overcome these problems, training programmes should continuously be needs-based, provide appropriate HR best practice, and new and creative remunerative packaging should be explored and encouraged where it adds to labour competition. Small business networking arrangements and experience sharing can play an effective role in disseminating good practice in these areas. In this context, we would support any widening of the “skillnets” programme, which may follow its current evaluation.

### ***Medium-term Challenges***

Taking a slightly longer timeframe into view, there are other policy concerns worthy of equal consideration. Since about 1993 Ireland’s economy has been booming by both historical and international standards. Our data suggests that about 33-41% of small firms fail within their first five years. Therefore we can predict that a small proportion of small firms which will exist in the upcoming years will have experience of operating outside “boom” conditions. This represents a concern in any circumstances. The capacity to absorb negative shocks, or even declining markets, will neither have been called upon nor tested in a majority of Irish small firms. Indeed, arguably the very pace of recent economic expansion and output growth has been so pronounced as to have ensured an across-the-board level of success, on foot of excess demand in all areas. Many of today’s small businesses may not have survived even slightly more restrained market conditions.

This leads to a concern of vulnerability. While currently expanding and succeeding, the small firm sector has rarely before enjoyed a benign set of circumstances which prevailed over such a long period. Overenthusiasm, expansionary risk taking and unwarranted optimism, though difficult to quantify, is a likely characteristic of many firms today. Their ability to adapt to negatively changing circumstances is a key long-term test of the health of small businesses, and one which hasn’t been examined for some time in Ireland. In designing education, training and consultancy supports for small businesses over the coming years, Government should seek to ensure there are rational expectations, appropriate planning and contingency planning, and minimal over-exuberance which the current environment will stimulate.

### ***New Technology***

Maximising the rate at which small firms learn about, adopt and fully exploit new methods of doing business for their own benefit will be an ongoing policy objective of most Governments. The emergence of the internet, e-commerce and wider developments in information and communications technology represent a wide and rapid change in traditional business methods, the full implications of which are far from clear. What is clear is that such developments are rapidly changing the criteria for business success, as well as widening the fundamental potential of any business by exponentially increasing the size of potential markets.

Given their size disadvantage, small firms have unsurprisingly been slower to engage with this shift, and international research finds consistent differences between small and large firms with respect to investment in this area. The extent to which business competitiveness depends crucially on both an understanding of new technology and its potential uses and benefits is difficult to overstate. Good business planning in all sectors will be based upon it to a large degree. Governmental policy must ensure that Irish small firms invest in and exploit new technology on an ongoing basis, but also continuously learn and understand how such developments affect the competitive position of their products, processes and services.

### ***Longer-term Considerations***

Finally, some weaknesses in Irish small firms are more long-term in both their nature and in their solution. In practically all countries, there is recognition that small firms lack managerial proficiency and experience. Given that many small firms are first time enterprises of first time entrepreneurs, this is almost true by definition. It is nevertheless often the cause of failure. Ireland has not been slow to provide and encourage the use of external managerial support, training and consultancy to small firms to assist managerial functioning and effectiveness. Over the long term this challenge will remain, although its priorities will reflect circumstances at any particular time. To ensure the effectiveness of future policies, good practice in small firm management training needs assessment should be defined, policy adaptability and comprehensiveness should be maximised, policy or agency confusion either at the end of the deliverer or receiver should be minimised, and attitudinal constraints to external managerial support should be addressed. Early education will have a part to play. Increasingly Governments are including education in the area of enterprise within standard secondary syllabuses.

The importance and potential benefit of encouraging widespread engagement in research and development by all firms has never been greater. While the availability of “off-the-shelf” technologies has never been greater and more progressive, fundamental product and process innovation at the level of the individual firm is likely to increase its already significant influence on success. The process of continuously ensuring its greatest level among small firms must remain an ongoing Governmental policy objective, and experience and information sharing among firms again may offer an effective vehicle upon which good practice can be diffused.

As the elements and implications of Governmental regulatory compliance will change over time, so will the need to minimise their negative bureaucratic burden on small firms. The Irish Government should assess new regulatory requirements in terms of their burden on small firms, and minimise these burdens should they arise. More urgently however much could be done to reduce regulatory burdens already, through, for example, the sharing and pooling of information by relevant State bodies, and the use of “one stop shops” for regulatory compliance between the State and small firms. Despite the problem, experience has shown that policies have not been particularly successful in this area across countries.

The final recommendation relates to the macro-economy. Small businesses rely on, but also contribute to, a stable and steadily growing macro-economy. As a more exposed sector, small firms are the first to suffer from macro imbalances such as supply and demand inequities (eg in the labour market), rapidly growing or declining markets, price, interest rate or exchange rate shocks, or uncompetitive or monopolistic markets. Policies which seek to maintain stable and sustainable economic growth, maximise innovation and process change, and maximise the competitiveness of markets and their efficient functioning will in the longer term lead to the highest number of self-sustaining, progressive and successful small firms.