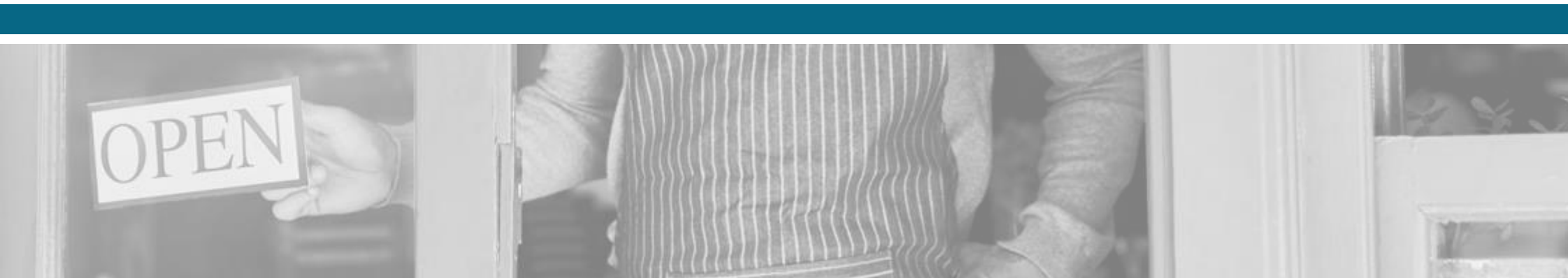


# What should the Government's Net Zero Strategy say about SMEs?



# Overview

This note considers how the Net Zero Strategy can help SMEs overcome the challenges and benefit from the opportunities in transitioning to net zero in three sections:

- **why SMEs matter to NZ**
- **the specific issues the NZ strategy needs to address for SMEs**
- **core elements the NZ needs to address to support SME transition**

The note is based on reviewing recent research on SMEs and NZ and a roundtable<sup>1</sup> with a cross-section of the main business organisations that represent smaller businesses and other organisations with specialist expertise in SMEs and NZ.

1. **The government should have three objectives in addressing SMEs in its Net Zero Strategy:**

- **support SMEs to decarbonise:** achieving net zero depends on SMEs decarbonising
- **support SMEs as the engine for net zero solutions:** capturing the growth and export opportunities that SMEs can offer
- **avoid unintended consequences for SMEs:** they are a vital part of the economy

2. The strategy should recognise SMEs are very diverse and what net zero (hereafter NZ) means depends on their sector, their specific activities, their size and the approach of their managers. But the characteristic that all share, which necessitates a dedicated strategy for SMEs is a lack of scale presenting a specific set of barriers to moving to, and accessing opportunities, from NZ. The strategy should reflect the diversity of their activities, be relevant to SMEs from microbusinesses and sole traders as well as those nearing the SME threshold and also address the capacity constraints they share.



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<sup>1</sup> Participants included representatives from: British Independent Retailers Associations, Federation of Master Builders, Food and Drink Federation, Federation of Small Businesses., Zellar, Supply Chain Sustainability School, Repattern, British Chambers of Commerce, Net Zero Now, University of Oxford, Greater Manchester Combined Authority, Ricardo – AEA. The report was written by Aishwerya Raghav, Megan Wheatley and Ed Lockhart with input from Jill Rutter who also chaired the roundtable.

### 3. The main elements of an effective strategy would then be:

#### To support SMEs to decarbonise Government should:

- **continue to create and support the momentum amongst existing green businesses as well as those who are keen to be early adopters** prepared to differentiate on NZ, kickstarted through the Government's COP26 campaign. This activity should be incentivised through supporting a clear framework for NZ accounting and accreditation, recognition of NZ performance in procurement, and financial support for early adoption.
- **create the frameworks for supporting transition amongst the mainstream of SMEs.** The core NZ strategy will establish the pathway to a net zero economy, setting out a clear timeline for action but Government should also take some specific measures to help SMEs, including:
  - **support industry-led sector-wide NZ plans to enable transition by SMEs within key sectors.** Sector-wide plans provide a shared roadmap for moving to NZ and are a means of collaborating on shared transition challenges within the sector such as ensuring the right skills and training, sufficient scale in supply chains, and engaging with government to identify the barriers that need to be overcome. Government should engage with those creating these standards so that government action can then support the right energy infrastructure, providing incentives and where necessary appropriate financial support. Sector plans provide a potential framework for overcoming SME specific barriers, by providing capacity which SMEs lack, but risk being dominated by larger firms. Both government and sector leaders should ensure that their plans cater for transition by smaller companies as well as the larger players.
  - **partner with key industry and expert bodies in developing a joined-up framework for NZ advice and guidance,** linking into key sources of sector specific and local advice.
  - **develop a fiscal strategy to systematically encourage NZ options.** Key elements could include: maintaining the super-deduction but for qualifying "net zero" investment for a period, ensuring that the business rating system encourages rather than deters low carbon improvements. There should be guarantees on the duration of fiscal incentives to ensure that businesses can incorporate their availability into their plans and that these mesh with the roll-out of critical infrastructure.

#### To support SMEs as an engine of NZ innovation, the government should:

- set targets for the proportion of NZ solutions to be supplied by SMEs and provide the support to enable them to supply those solutions. For example, SMEs will play a particularly crucial role in retrofitting the housing stock but will need help with reskilling and training of apprentices if they are to be able to take up the opportunities.
- provide end to end support for SME NZ innovation to enable SMEs to move from product development to market at scale.
- task Innovate UK to prioritise net zero in its work on diffusion and adoption, including working with sector-wide plans to support SMEs to develop the innovations required in key sectors.

#### To avoid unintended consequences for SMEs, the government should:

- **apply an SME test for every NZ policy** to ensure they don't pose specific barriers for SMEs, including the smallest businesses and those in rural areas who are often hardest to reach.

# The contribution of SMEs to net zero

## Section 1: why SMEs matter to net zero

Most businesses in the UK have under 250 employees and thus count as SMEs. There are few reliable estimates for emissions from this sector, though a 2009 study estimated they accounted then for just under half of business energy use. But that figure makes clear that any strategy for business to move to net zero needs to engage those businesses. They also have a potentially important role to play in helping the transition.

The sector itself is hugely varied. It embraces a light manufacturing operation, to a small construction or distribution company, to a restaurant or coffee shop, to a local accounting firm, to one of the UK's 4.6m microbusinesses no employees. SMEs are distributed across sectors and similar challenges and opportunities apply to them as apply to bigger players in those sectors.

For example, in the construction sector SMEs, just as for larger companies, will need to be ready to meet the Future Homes Standard, embrace modern methods of construction, take forward a massive retrofit programme and be ready to service new heating systems in homes and commercial buildings.

Table 1 - Private sector businesses in the UK

Private sector businesses in the UK by number of employees, 2020							
		Businesses 000s	Employment 000s	Turnover £ billions	Businesses %	Employment %	Turnover %
With no employees		4,568	4,966	316	76%	18%	7%
SMEs (0-250 employees)		5,973	16,836	2,270	99.90%	61%	52%
of which:	Micro (0-9 employees)	5,725	9,162	931	96%	33%	21%
	Small (10 - 49 employees)	212	4,140	646	4%	15%	15%
	Medium (50 - 249 employees)	36	3,535	694	1%	13%	16%
Large (250+ employees)		8	10,896	2,077	0%	39%	48%
<b>Total, all businesses</b>		<b>5,981</b>	<b>27,732</b>	<b>4,347</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

Source: House of Commons Library, Briefing paper, 2021

Surveys suggest that there is a lot of enthusiasm from SMEs across the sector to contribute to the goal of net zero, but that many also struggle to understand what net zero means and what the priority actions should be. A [survey by the British Chamber of Commerce](#) in August 2021 noted that around a fifth of businesses did not understand the term net zero - and it is reasonable to assume that figure is higher among SMEs; only 1 in 10 business overall and only 9% of small businesses and 5% of microbusinesses are measuring their carbon footprint. [Surveys done during the pandemic](#) by the BCC suggested that the preoccupation with managing its impact had setback earlier efforts to make progress to net zero.

This finding was confirmed in [research for the Broadway Initiative](#) that characterised SMEs as falling into one of three attitudinal groups:

1. Early adopters, more likely to be in growth/opportunity than survival/debt mode. Some of these will be well established “green businesses” for whom this is core to their business; others will be those who are already getting going.
2. Willing to engage with climate actions, wanting to start or do more but generally not knowing where to start.
3. SMEs who are largely disengaged from net zero beyond complying with regulations, through individual or combined factors such as lack awareness, not believing they can make an impact, not seeing it as relevant to their business, unwilling or unable to commit significant resources or time.

The OECD looks at the population of SMEs [slightly differently](#): from the **eco-innovators** who have new products or services they want to bring to market, or who develop new business processes, through **eco-entrepreneurs** who want seize business opportunities from the green agenda to **eco-adopters** who will comply with new requirements and adapt their business as necessary. The OECD think that the majority of SMEs are in this category. Any strategy for net zero in SMEs needs to take account of these differences.

It also needs to take account of the fact that SMEs are key components in supply chains. This has benefits – it means they can look to the bigger companies they supply as sources of both pressure and advice on the transition to net zero. But it also brings risks, if any strategy depends on SMEs taking a degree of responsibility for the performance of their suppliers. Many reports highlight effective collaboration across supply chains as being important in enabling SMEs to contribute to net zero.

But SMEs also face a distinctive set of challenges in meeting net zero which are a direct consequence of their lack of scale. That means that the government’s strategy on business needs to focus on how government can avoid unnecessary barriers that stand in the way of SMEs changing their operations to deliver net zero and providing support to enable those who are keen to lead to maximise their contribution and pave the way for others to follow. Fully taking account of the SME angle will also avoid potential unintended consequences in terms of erecting new barriers to SME participation and potentially reducing competition and the vibrancy of the sector. Many SMEs have demonstrated their resilience through the pandemic and there is scope for utilising the confidence that is now returning if the right measures are put in place.

This note considers how the Net Zero Strategy can help SMEs overcome the challenges and benefit from the opportunities in transitioning to net zero. It is based on reviewing recent research on SMEs and net zero and a roundtable with a cross-section of the main business organisations that represent smaller businesses and other organisations with specialist expertise in SMEs and net zero.

## Section 2: the specific issues a net zero strategy needs to address for this sector

### 1. Understanding, scope and measurement

Although there is enthusiasm among many in the sector, there is also a lack of understanding. The first is on what both net zero means generally, with the terminology unclear, but also what constitutes being a net zero business. This is a particular problem when the government's focus is getting small businesses to commit to net zero as part of the Race to Zero commitment. Many businesses have taken measures to become 'low carbon', 'green', 'sustainable' or 'resource efficient' for a while and continue to prefer existing terminology while consistent with the journey to net zero.

As outlined above, many small businesses are unclear about how they should measure their emissions and what emissions they are expected to take responsibility for, in particular the extent to which they are supposed to get to grips with so-called scope 3 emissions created in their supply chain.

Many small businesses do not know how to start measuring their own carbon footprint and this is a significant barrier to action. In order to motivate change, particularly in the latter two groups, it may be better to point to where they are wasting energy or resources, incurring additional costs as well as emitting carbon.

Even those that can and are motivated to measure their carbon footprint may face issues if they are expected to take responsibility for total emissions created in the course of doing business. Small businesses tend to be focused on their own operations and lack the information and capability to monitor or influence their supply chain in a way that larger businesses may be expected to do. In some sectors, for example, food and drink, it has been estimated that 90% of emissions are indirect.

### 2. Internal resources and the need to avoid nugatory effort

Time and money are required to research and implement solutions. [Research](#) suggested that these were the dominant barriers to action for SMEs, with financial constraints cited by over 80% of SMEs surveyed and time by over 40%. Small businesses have neither the personnel nor the resources available to their larger counterparts. The smaller the business, the bigger the challenge. Cash flow is a continual concern for small businesses and can mean that even investments with rapid paybacks are not taken. It can also make it harder to bear the costs of competing for funding, or even wait for grants which are paid after the expenditure has been incurred. We heard that SMEs tend to avoid using consultants, instead relying on suppliers to provide solutions, but without independent advice they are put off where there is an upfront cost differential. These pressures have been intensified by the pandemic which has reduced the bandwidth for focussing beyond day-to-day business survival.

One of the consequences of the lack of resources is that small businesses need assurance that there is value in any measures that they take. Before incurring additional expenditure, they need certainty that the spending will prove worthwhile and won't be rendered nugatory by a change of policy direction.

### 3. Accounting and accreditation

SMEs lack the internal resources and know how to undertake proper due diligence on other companies or products to ensure that their claims to be “net zero” are robust. They are thus very dependent on the existence of reliable external accreditation to ensure that they can be guaranteed that claims are verified. Small businesses themselves need access to simple and inexpensive certification if it is not to prove a barrier to either claims for themselves or their products to be net zero.

A recent evidence review by Blundel and Hampton<sup>2</sup> described the problems SMEs can face: “For green start-ups and other businesses wishing to promote the environmental benefits of their products and services, it can be difficult to choose between a plethora of environmental accreditations and guidelines, and any accreditation represents an additional cost and bureaucracy for a small business – led by industry associations, local area networks, or government. They continued: “Another hindrance for SMEs is the difficulty and expense associated with proving the environmental benefits of their eco-innovations. Scientifically rigorous life-cycle-assessments (LCAs) and organisational carbon footprints can be expensive and time-consuming undertakings. ”

### 4. Capabilities and skills

Allied to the lack of resources is a lack of access to internal expertise – which is another contrast to larger businesses that often can have dedicated sustainability/health, safety environment teams. Managers in smaller business don’t have the knowledge to know where to begin.

There is a different challenge where businesses need new skills to benefit from the opportunities of net zero. In the construction industry, for example, training is needed in the building sector to meet net zero standards. The problem for small businesses is that they may lack the funding to pay for courses for their employees and may not be able to carry the costs of giving employees the necessary time off to retrain.

### 5. Domestic competition and international competitiveness

Small businesses are concerned that their lack of buying power may mean they cannot access new technologies at prices that mean they are able to compete with bigger players who may use their purchasing clout to corner the market – which could risk their long-term viability. They are also concerned that larger companies may overlook them as potential suppliers of net zero technology.

Another worry is their ability to compete with overseas competitors who may not face the same prices if the move to net zero imposes additional costs.

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<sup>2</sup> Blundel R and Hampton S: Eco Innovation and Green Start Ups: an evidence review, forthcoming

## **6. Inappropriate or inconsistent policies**

Small businesses already feel badly burned by changes in policy direction – whether its changes in subsidy amounts/rules or termination of programmes. Short lead times make it hard for small businesses to build capacity to enter the new markets created by net zero and the risk of cancellation makes them wary of investing to meet new opportunities. The termination of the Green Homes Grant programme is the most recent example of a programme that was ended before it really geared up. This means SMEs put a huge premium on policy certainty and policies being introduced with sufficient lead times to build capacity.

## **7. Ensuring policies work for rural areas**

Most businesses in rural areas are SMEs and any net zero strategy needs to take into account their particular needs. One is that, compared to businesses based in urban areas, they are particularly dependent on private transport - both for their employees who may not have public transport options available to come to work, to service their clients and to allow customers to come to them. That means that as the switchover to EVs happens, they may be particularly dependent on the availability of public charging infrastructure

## **8. Timescales and priorities**

Businesses need clarity on what they are expected to do by when, and what changes are happening that they need to be prepared for. 2050 is too distant to be a meaningful date for smaller businesses which make decisions on shorter time horizons. Businesses also need to understand what they need to prioritise so that they concentrate on changes they need to make and that will make the biggest difference.

## **9. Tailoring for early adopters**

Different categories of SMEs require different approaches. There is no point in trying to support all SMEs – there isn't the capacity to do this. In order to move quickly, priority should be given to those who are willing to change, and willing to pay for something. The government could explore ways in which to encourage more businesses to become early adopters. The learnings from the early adopters will help to normalize behaviours and encourage others. There is value in building momentum. Very small SMEs have needs more aligned to households. This changes when SMEs get to the first layer of management

## **10. Participation in Government consultations**

The FDF survey finds that only 6% members constantly participate in government policy consultations which is an important mechanism in defining the policy frameworks to decarbonise industry. The SMEs lack the bandwidth to participate in government consultations. This means that their specific needs risk being overlooked when policies are being developed.



# Section 3: enabling SMEs to meet net zero objectives

## 1. Creating and supporting momentum amongst the early adopters

Surveys suggest that SMEs recognise the need to act on climate change– and a belief that it brings opportunities and business benefits. One is simply in terms of attracting and retaining employees who want to work for businesses that are part of the effort to create a net zero economy. They also understand the potential importance in terms of attracting and retaining customers.

Beyond that SMEs point to their ability to be nimble with the right backing and support and see opportunities to share best practice and are keen to work with government to address the barriers to progress. They are also critical to the widespread adoption, as Blundel and Hampton noted that where solutions already exist “the further diffusion of eco-innovations often depends on how far ‘middle actors’, such as equipment manufacturers, merchants and installers, are able to reconfigure themselves in order to increase the scale and scope of their service delivery (Parag and Janda, 2014; Killip et al., 2020).”

The Government’s approach to SMEs has so far focussed on its SME campaign which is effective in helping to create early momentum and helping to define pathways for decarbonisation. To further encourage ‘early adopters’ the government could:

- facilitate and support collaborative action to simplify the framework for accounting and accreditation for Net Zero – and make it (and the language used) readily accessible to all SMEs including the smallest
- build on its approach to procurement of low carbon products and services, ensuring it is designed to be SME friendly - see ‘Government procurement’ below.
- maintain the super-deduction, but for qualifying “net zero” investment- see ‘Investment and incentives’ below.

Government should also continue to monitor the commitments made, identifying any barriers to converting commitments into emissions reductions.

A mix of a framework for demonstrating differentiated performance and the right technical know-how may be enough to motivate early adopters. However, there are likely to be limits to the number of SMEs who choose to differentiate through early adoption of carbon emissions, voluntarily. It is also questionable whether an approach based on detailed and costly measurement of carbon emissions is the most effective - or efficient way - to decarbonise the mainstream of SMEs. The majority may be more likely to transition in response to a clear regulatory framework, with deadlines for phase-out that reflect technology availability, supported by incentives and financial support where affordability is a barrier. Amongst other benefits of encouraging early adopters is to help establish the pathway and regulatory frameworks required to move the mainstream.

## 2. Sector-wide plans as a mechanism to support SME transition

Sectoral industry groups are starting to develop [sector-wide net zero plans](#), based on the groupings into which businesses organise themselves reflecting the common activities they undertake and challenges they face. These plans, which commonly consist of emission reduction targets and milestones, roadmaps with the enabling steps required to meet them and implementation arrangements, provide a tailored framework to support effective and smooth transition for all businesses within a sector. These plans need to be based on and compatible with the Government's overall Net Zero strategy and its 'policy domain' sector strategies - such as the Transport Decarbonisation Plan, Industrial Decarbonisation Strategy and hydrogen strategy.

Sector-wide plans provide a framework for collaborative action to address the set of challenges implicit in moving to Net Zero including: right skills and training, supply chains, infrastructure, incentives and finance, all tailored to the specific challenge in the sector. By providing central capacity sector plans help overcome capacity constraints of SMEs.

Sector-wide plans offer the opportunity to provide tailored support for the SMEs within each sector, providing central capacity to develop the transition strategy and templates that SMEs need and to overcome common barriers for all SMEs within the sector, including those identified in section 2 above. Conversely, without specifically recognising and addressing the needs of SMEs, there's a risk that the development of these roadmaps will be dominated by and biased towards the larger companies who have greater resources to prepare for changes needed.

**Government should therefore work with these sector groups to ensure that each of these roadmaps is grounded in an understanding of the needs of the whole of the sector, and specifically addresses the barriers facing SMEs.** For example, MHCLG, BEIS and Defra have worked in partnership with the Future Homes Task Force to specify the Future Homes Hub with a specific mandate to support the transition of smaller developers. **Government should identify which SME sectors are most important from a net zero perspective - for example selecting sectors like construction, agriculture, manufacturing, retail and hospitality would quickly cover a substantial proportion if not majority of relevant SMEs.**

The end point should be clarity for SMEs on what they are expected to do, by when and that the barriers for SMEs are systematically overcome. While some barriers for SMEs may be identifiable upfront, it will be essential to have an ongoing mechanism to identify and overcome barriers as they arise.

Collaboration will be an important element in enabling SMEs to achieve net zero at least cost. That may be collaboration along supply chains, but some SMEs may want to learn from what early adopters have done. That learning might be facilitated by trade associations or by local enterprise partnerships.

### 3. Information and advice

A big area for every sector roadmap and more generally SME transition will be how to make core 'how to' information available to smaller businesses. Bankers for Net Zero in [their report](#) on mainstreaming net zero, reflecting on Broadway Initiative research concluded:

*[R]ecent survey data indicates that a majority of SMEs do not know where to turn for information or advice on how to get to net zero. The issue is not an absence of sources for this information and advice: there are many places an SME could turn for help on how to decarbonise – and the list is growing fast. Instead, the three important hurdles to overcome are:*

- **Low awareness of what's available:** *the fact that 71% of SMEs could not recommend a single web source for help on getting to net zero is an indication of just how much awareness raising is needed.*
- **Confusion and overwhelm:** *for those SMEs that have looked for help and advice on decarbonising, the experience can be frustrating due to the sheer number of different information sources and solution providers to choose from. For SMEs with limited knowledge and time, the need to sift through so many options and the difficulty of making an informed judgment about which information sources to trust and which solution providers are right for them is a barrier to action.*
- **A fragmented landscape:** *though there are many providers of information and advice on aspects of the decarbonisation journey for SMEs, few (if any) cover the full spectrum of support most SMEs will need. In particular, advice on how to measure and reduce carbon footprint is often disconnected from information on how to fund or finance such reductions, leading many SMEs to conclude (often incorrectly) that investments in lowering emissions are too expensive for them.*

The gap identified both by Broadway Initiative and Bankers for Net Zero is for a central service that gives users easy access to trustworthy advice free at the point of use, ideally supplemented with face-to-face site specific advice. The trade associations and energy networks have therefore started to work together to develop this service under the Zero Carbon Business partnership.

**Government is not necessarily best placed to provide advice directly, however, it does have an important role in making its own rules and services easy to understand and access and to support the development of an appropriate framework for advice including the standards and principles to ensure the places SMEs go for advice are high quality.**

## 4. Skills and training.

While these resources can help guide businesses to identify the steps they can take to move towards net zero, they do not address the specific gaps that will emerge.

In July the Government published the [report of the Green Jobs Taskforce](#) which set out recommendations on how to address the [new skills](#) required in a net zero economy, and how to help the transition for people employed in high carbon sectors. That report identified a lot of new skills needed across the energy sector, but it also focussed on the demands facing the construction sector, in meeting the Future Homes Standard and in delivering the major retrofit programme that will be required, a demand that includes the need for project managers for retrofit, and the changes that will be required to manage the transition to EVs, both in terms of ability to install EV charging points and to change to servicing electric vehicles (which the report raises potential safety concerns). There are also potential white-collar skills gaps in areas such as green finance.

Many of the recommendations focus on skills providers and on potential trainees. But the report is very quiet on the particular challenges facing SMEs in retraining their current workforces to allow them to benefit from the new opportunities offered and to avoid being caught out by the transition (EVs for instance are expected to require much less servicing than ICE vehicles). It appears to place the burden on bigger industry players to ensure that their supply chain is prepared (Recommendation 13 reproduced right).

That is welcome, but not all SMEs are part of identifiable supply chains with clear contractual relationships with larger companies, so it is important that as well as giving clarity on timelines, strategies **commit to measures to make the necessary training available and affordable to SMEs**. SMEs should also be able to benefit from any initiatives such as Green Apprenticeships if the government decides to take up that recommendation.

The recommendation in the first bullet of the Green Job's Taskforce recommendation 13 is consistent with the proposal at 2 above that sector-wide plans are an important mechanism to support SME transition.

### Recommendation 13

Employers and sector bodies should set out business and skills plans for the net zero transition, engaging unions and workers.

- Sector industry bodies should bring together large and small employers to develop skills strategies for the entire sector that tackle skills transition in their supply chains and the communities in which companies operate, involving workers and unions.
- Larger employers can support green skills transitions in smaller employers, where possible and relevant through measures including:
  - By setting Science Based Targets, in line with United Nation's *Race to Zero*, and how they intend to meet those decarbonisation goals;
  - Initiating dialogue with supply chain companies on future skills needs;
  - Transferring unused apprenticeship levy funding;
  - Opening up inhouse skills programmes to supply chain employees, or beyond, to residents local to a project;
  - Incorporating skills collaboration into their procurement processes; and
  - A transition to a net zero emissions business model.

## 5. Investment and incentives

Net zero will require businesses to change some of the basics about the way they do business. At the very least they may need to convert the way they heat their premises and change the vehicles they use for transport. For some, information and advice will be enough, and their choices and options will be very similar to those facing households. But financial support will encourage more to make the changes early and may be needed to overcome financial barriers.

The pandemic has left many SMEs with a [big burden of debt](#). That means they may be more reluctant to take on more debt than they would have been pre-pandemic. SMEs prefer grants and these can be offered upfront to encourage early adopters, with a clear signal that regulation will come later. Those early adopters can help normalise new ways of doing business (and potentially yield learning to be shared and ease the transition for other businesses). But grants need to be accessible and application processes should not place an unnecessary burden on SMEs.

Even grants can place a cash flow burden if they are only available retrospectively. So, government should consider the case for making a proportion of grants available before expenditure is incurred with subsequent tranches paid when milestones are achieved. Where government cannot afford to provide grants, interest free loans can offer an alternative. Loans should be repaid over a period that exceeds the payback based on cost savings, and include a 12-month delayed payment start, thereby making it cost neutral or positive to the business. Loans would ideally be linked to the provision of face-to-face support (mentioned earlier) to identify suitable opportunities to invest and prioritise options based on contribution to carbon reduction and payback. It may also be possible to link the loan scheme to environmental testing in some way to ensure there has been a degree of technology verification (accepting that application will determine the true benefit).

Unsecured loans under the Green Deal were a failure. The Scottish government offers homeowners interest free loans to finance energy efficiency improvements with repayments over 20 years against an equity stake in the property. The loan is only paid back when the property is sold. A similar scheme could be developed for small businesses. However, many SMEs do not own their own premises and investment in energy efficiency will depend on their landlords: they will depend on those landlords making the necessary investments which government may need to introduce regulations to require them to do, though there would need to be a mechanism to support them to work collaboratively with tenants.

The government also needs to address the perverse incentive of the impact of investment in low carbon enhancements to buildings on business rates. Business rates are paid by all businesses, irrespective of their profitability or cash flow, and therefore can place a significant burden on SMEs when their liquidity is under strain. A [report by the CBI and Avison Young](#) in November 2020 identified the barriers that the business rates system places to investment in some improvements - while installation of microgeneration is specifically exempted, investment in modern air conditioning or LED lighting which would reduce energy use could lead to higher assessed rateable value and thus a higher rates bill well before the investment started to pay back.

**The government should therefore ensure that the business rating system encourages rather than deters low carbon improvements.** The CBI report suggested a delay before any enhanced rateable value took effect as well as regularly updating the list of green technologies which are not deemed to add to a premises rateable value.

Governments can go further and In order to boost the recovery from the pandemic, the government has introduced a time limited [“super-deduction”](#) which allows companies to claim up to 130 per cent of any qualifying investment in the year it invests against its tax bill. There is no “green conditionality” and the relief is due to be phased out at the end of March 2023. In order to help business adapt to the costs of net zero, which is a major concern for many SMEs, **government could maintain the super-deduction, but for qualifying “net zero” investment for a period, say to 2030.** Like any tax relief this would only benefit taxpaying companies, but it would incentivise early adoption of net zero technology and give a signal to suppliers that this was a market that the government was willing to support. As currently constructed the super-deduction is not available to sole traders.

The government announced in the Budget that it would review the operation of the R and D tax credit including [R and D tax relief for SMEs](#). This is seen as a key plank in the government’s new [Innovation Strategy](#) published in July. It is [consulting](#) on whether to merge the specific SME relief into the more general scheme and whether the scheme can be redesigned to better encourage investment with social value eg green technology. **It is important that at least the current level of incentives for SMEs to invest in the development of net zero technologies are maintained.**

One distinguishing feature of SMEs compared to larger businesses is that many are not registered for VAT. That means that they cannot reclaim VAT they pay, and thus are subject to the same VAT distortions as private consumers. So any moves by government to green the VAT system by removing some of the current anomalies (e.g. on repairs and renovation vs new build), would also affect these SMEs costs directly.

## 6. Government procurement

In June 2021 the government [announced](#) that all bidders for government contracts worth more than £ 5m would be required both to have committed to net zero by 2050 and have produced a carbon reduction plan covering scope 1-3 emissions. But ministers also promised that the new requirements would “not be overly burdensome” for SMEs. Despite that commitment the [procurement policy note](#) issued to departmental and arm’s length body procurement teams alongside the announcement contains no specific guidance on how they apply to SMEs.

That contract threshold probably excludes most (though not all) SMEs. However, Government still needs to monitor the impact of this requirement to ensure that it does not prove too onerous for SMEs and exclude them from government contracts, and if there is evidence that it does consider either reducing the requirement (for example to looking at scope 1 and 2 emissions which SMEs find easier to measure) or making it easier for SMEs to conform with the requirements. Public authorities should look to examples of best practice on how to structure tender processes to ensure SMEs can participate.

The government should also consider how to use its buying power to drive markets for new products and technologies and give clear indications of future purchasing needs to give SMEs the opportunity to enter the market. That should extend beyond central government purchasing to clear net zero purchasing strategies to the wider public sector, including local government.

## 7. Supporting innovation and diffusion of new products and processes

The government needs to remove or reduce barriers to successful innovation by SMEs. Innovation is a process that can start with an idea, needs to turn into a prototype that can be demonstrated to potential customers, and then sufficient finance to scale up and serve a new market. The economy will benefit when the new technology is more widely adopted.

There are a lot of pockets of support for net zero innovation potentially available to SMEs (nationally through Innovate UK and the Catapults, but also locally through some of the LEPs or private platforms) but in some cases there may be barriers to accessing that support - if for example funding requires a lot of preparation with no guarantee of success, or grants are paid well after spending is incurred, or projects “go stale” while waiting for funding to be agreed. Even if the early stage of development attracts support, there may be less help available with the process of commercialisation - the stages that are critical in taking a new product to market. As part of its wider approach to both net zero and innovation, **the government needs to ensure that it is easy for SMEs to access end-to-end support to enable them to commercialise innovations.**

If an SME brings a new product or process to market, its ability to sell may depend on its ability to get its innovation recognised. As noted above the process of certification, which helps distinguish genuine innovations from “greenwashed” products is hard to navigate and potentially costly. This could be made much simpler if there was a clear and easy, and relatively low-cost process for getting an “authoritative kitemark” that would be widely recognised and accepted. Any innovation that has achieved such a kitemark could be subject to preferential treatment through the loan scheme. This could be through extended loan terms or a grant contribution to the loan of x%. If additional technology performance reporting is included in the loan process this could provide the evidence base for wider promotion and adoption.

Economic transformation depends on diffusion and adoption of new ways of doing business. The government’s recent Innovation Strategy notes that there can be high barriers to adoption of new technologies, but reports very successful preliminary results from its Made Smarter North West pilot which aimed to boost the take-up of digital technology by SMEs and where the evaluation suggested it led, among other positive results, to 25% reporting a reduction in carbon emissions. Government should make clear that greater weight should be given to net zero in the selection of which projects its innovation bodies should support and **Innovate UK should prioritise net zero in its work to promote diffusion and adoption.**

Sector-wide Net Zero plans (referenced at 2 above) provide a framework for transition within sectors, sending signals about what innovations will be needed when. Innovate UK and other innovation bodies should work with sector industry bodies to support SMEs to meet these opportunities.

One way of spurring diffusion is through collaboration along a supply chain with an “anchor firm” helping its suppliers and customers adopt new technologies. There are other examples of effective collaboration - either through “twinning” with like businesses or transferring best practice across sectors.



## 8. A stable, predictable and coherent policy environment

The overriding demand from SMEs is that the government provides a clear direction and that policies are well thought through, timelines take account of implementation lags and capacity constraints and that there are no more of the sorts of U-turns or direction changes that have been seen in the past that undermine the value of earlier actions and inhibit future action.

Policies need to take proper account of business timelines, give adequate advance warning of future changes and the different strategies produced across government need to make sense when joined up. They need to be signalled and communicated well in advance.

Policies also need to be coherent and all facing in the same direction and apply at national and local level. This ranges from procurement to planning to ensuring that all government business funding reflects its net zero objectives. And they need to be anchored in a clear vision of what a net zero economy looks like, so that businesses know where they need to be heading.

