

Exploring Financial Literacy and UK Small Business Access to Finance

Abstract

Small businesses (SBs) play a vital role in the economic development and cultural diversity of societies in the UK. Despite their significant contributions, SBs often face unique challenges that hinder their growth and sustainability. This paper explores the role of social learning and social capital in improving financial literacy among small business owners. It further examines the multifaceted barriers confronted by small businesses, including social and economic dimensions. Key obstacles include limited access to financial resources, inadequate support networks, and regulatory constraints. Additionally, language barriers and cultural differences further exacerbate these challenges. Using a combination of literature evidence and qualitative interviews with small business owners, this study identifies the critical factors impeding the success of these businesses. The findings underscore the need for targeted policy interventions and support mechanisms tailored to the specific needs of EMBs. By addressing these hindrances, policymakers and stakeholders can foster a more inclusive business environment that leverages the full potential of ethnic minority entrepreneurs. This research aims to contribute to a deeper understanding of the barriers faced by EMBs and to inform strategies that promote their resilience and growth.

Introduction

Small and Medium-sized Businesses (SMEs) are remarkably pivotal to the UK economy. Representing about 90% of businesses and more than 50% of employment in the UK, SMEs are crucial engines for economic growth, innovation, and employment (Brown et al., 2020; Fairlie et al., 2021). Among these enterprises, small businesses (SBs), especially ethnic minority businesses (EMBs), hold a unique and significant position. They represent businesses set up by migrant communities. The importance of ethnic minority businesses (EMB) cannot be underrated because of their contribution to the UK economy. They contribute to the economy by providing employment and acting as a vehicle to alleviate poverty (Sithas and Surangi, 2021; Manzoor et al., 2019; Ram et al., 2017).

Despite their contributions to economic diversity and cultural richness, SBs often face heightened challenges, particularly in accessing finance, with Black-owned businesses applying less (Fairlie et al., 2021). Minority entrepreneurship has been highlighted as a significant segment in entrepreneurship literature, however, more studies are required in this area (Ram et al., 2017). Most researchers emphasise minority entrepreneurship studies from the host country perspective by addressing minorities' psychological traits, cultural backgrounds, motivational factors, constraint factors, resource accessibility, and startup activities (Jones et al., 2012; Roth et al., 2012). However, financial literacy has emerged as a pivotal factor in addressing these challenges. This research paper explores the importance of financial literacy in enhancing the broader SME finance, with a specific focus on ethnic minority businesses, positing that a strong foundation in financial knowledge can significantly impact the financial health and success of these enterprises.

A review of literature

In the modern era, a shift has occurred in the research paradigm to a growing interest in soft issues with a sociological perspective rather than problematic issues with economic perspectives, including minority and non-minority equilibrium, social inequalities, and non-monetary resources such as personal networks (Bates et al., 2018). Therefore, while immigration remains a significant aspect of understanding the increase in EMBs, immigration alone is too broad to account for all the challenges of EMBs. However, small business owners are not often very separate from their businesses. There is a confluence of personal and business attributes. Psychological factors such as impostor syndrome, discouragement, etc., influence business growth aspirations, though they have received little attention and suggest that further research should be done to identify such factors (Ladge et al., 2019).

External finance plays a significant role in the survival and growth of a business. Prior studies maintain that bank lending continues to be a major source of external finance for small and medium-sized businesses (Elam et al., 2019; Abdesamed and Wahab, 2014; Siedschlag et al., 2014). Wang et al. (2020) analysed Bank-SME relationship from 19 European countries using the Market Power Hypothesis (MPH) and Information-based Hypothesis (IBH) to generate findings which, when simplified, suggest that bank competition encourages the supply of credit to SMEs while bank market power at disaggregate levels hinders SMEs' access to finance thus worsens their credit constraint. Their study highlights that SMEs, considered riskier, more informationally opaque, and more dependent on external finance, experience greater unfavourable effects of bank market power. Han et al. (2017); Wang et al. (2020) suggest that theories such as MPH and IBH are not always mutually exclusive. Moreover, Wang et al. (2020) mentioned macroeconomic, firm-level or bank factors are challenging to measure but may affect bank and SME finance.

Previous studies have mentioned a reluctance from small businesses to apply for bank loans (Brown et al., 2020; Berisha, 2020; Brown and Lee, 2017; Cowling et al., 2016) and the recent UK Finance EMB Finance report (2023) echoed the same. The resulting impact of the reluctance to borrow is evidenced in fewer loan applications (British Business Bank 2020). While many small businesses share similar characteristics, EMBs display more unique ones. The majority of EMB bank loan applicants had 0-9 employees often working alone. The success rates of EMBs with employees were more in line with overall with employees were more in line with SMEs overall (EMB Finance report, 2023).

Given the very limited number of applications made, it is not possible to report on the success rates for many small businesses EMB Finance (2023), particularly EMBs. Moreover, EMB Finance (2023) highlights that EMBs were less likely to report their application outcomes, about half of all applicants ended the process with no facility and indicatively this was more likely to be the case for EMBs; the key reasons for EMB applicants being turned down were poor credit rating/credit issues and affordability. This invigorates the argument for financial literacy as a vehicle to improve access to finance.

Financial literacy, defined as the ability to understand and effectively use various financial skills, including personal financial management, budgeting, and investing, is a critical competency for SME owners and managers (Anshika and Singla, 2022; Simoes Vieira, 2012). For SMEs, financial literacy involves understanding financial statements, cash flow management, investment appraisal, and risk management, among other aspects. The lack of financial literacy among EMB owners often leads to poor financial decision-making, which can impede access to finance, constrain business growth, and increase the risk of business failure.

Access to finance is one of the most significant barriers to the growth and development of small businesses, especially EMBs. Financial institutions often perceive these businesses as high-risk borrowers due to their limited collateral, credit history, and financial management capabilities. This perception is exacerbated by the lack of financial literacy among EMB owners, who may struggle to present viable business plans, maintain accurate financial records, and navigate the complexities of financial products and services. Consequently, improving financial literacy among small business owners can enhance their ability to secure financing by enabling them to better understand and meet the requirements of financial institutions (Anshika and Singla, 2022; Calcagno et al., 2020).

Moreover, financial literacy equips EMB owners with the skills needed to manage their finances more effectively. It helps them make informed decisions about investments, manage cash flow, control costs, and optimise financial performance. This improved financial management can lead to increased profitability, better resilience against economic shocks, and greater opportunities for expansion and innovation. For ethnic minority businesses, financial literacy is not just about accessing finance but also about managing it efficiently to ensure long-term business success and sustainability.

This paper will delve into the various dimensions of financial literacy and its impact on SME finance, with a particular emphasis on small businesses. It will examine the unique challenges small businesses face in accessing finance, the role of financial literacy in mitigating these challenges, and the broader implications for EMB growth and sustainability. By highlighting the critical importance of financial literacy, this research aims to contribute to the ongoing discourse on SME development and provide insights for policymakers, educators, and financial institutions to support financial literacy initiatives tailored to the needs of ethnic minority businesses.

In addition, small businesses have a good representation of females, many of which operate in highly visible sectors such as retailing and catering and have been particularly valued for their role in promoting social cohesion and multiculturalism (Carter et al., 2015). While policy-makers typically regard these as two distinctive groups, policy initiatives have often occurred in tandem (Carter et al., 2015). This was evidenced in the simultaneous establishment, management and reporting of the Ethnic Minority Business Task Force and the Women's Enterprise Task Force (2007–2009). For both groups, the prevailing policy discourse emphasises boosterism (Blackburn and Ram, 2006), an approach underpinned by the view that 'all enterprise is good, more enterprise is better'.

Despite longstanding policy interest, research suggests that attempts to boost ethnic minority and women's (EMW) enterprises have yielded only modest changes in the numbers of diverse business owners (Alexander et al., 2009; Kelley et al., 2011; Marlow et al., 2008; Ram and Jones, 2008). More research needs to be done in this area to boost outcomes for women business owners and the SME sector as a whole.

Theoretical Background

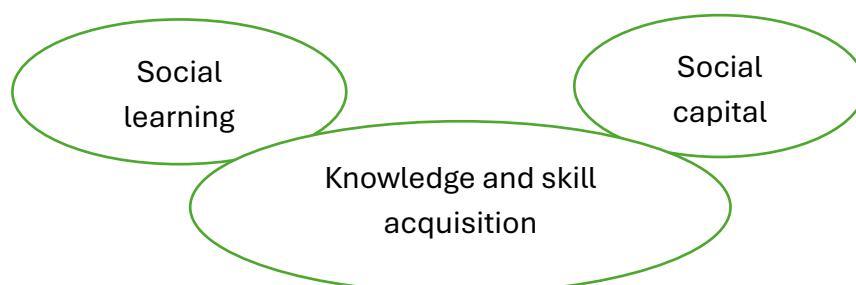
Chia et al. (2021) highlighted the importance of not solely relying on a single theory to offer an explanation for complex issues. Instead, to consider integrating different relevant theories as they did by integrating social exchange, social capital and social learning to provide a comprehensive understanding. Hence, in this paper, social learning and social capital are integrated to develop a framework for understanding the complexities of EMB owners' financing access and financial literacy.

Social Learning reinforces the argument that how people acquire information or new skills is often from their social context (Resnick, 2012; Taghipoorreynh and Run, 2016; Wang et al., 2017). **Social Capital Theory**

Social capital refers to the communal property developed through civic engagement, associational membership, high trust, reliability and reciprocity within a social network (Cooke and Wills, 1999). For businesses, it develops from the business owners' relationships within their network (Owusu et al., 2017). For many EMB owners, social capital is an asset in the form of family, friends, and associates who can usually be called upon during a crisis or leveraged for material gain (Emeson, 2024; Woolcock, 2000). Communities enriched with great social networks are better positioned to withstand poverty and vulnerability (Moser 1996; Narayan 1997), access finance, and take advantage of new opportunities (Isham 1999).

However, trust plays a significant role in taking advantage of the resources within the community. In social sciences, trust is seen as a form of relational dependency. Trust in word-of-mouth, key opinion leaders/endorsers, is a salient factor on which consumption-related knowledge and information depends. Gambetta (1998), Ring and Van De Ven (1994, 1998), Putnam (1993, 1995), and Kramer et al. (1996) all demonstrated that a high level of trust in relationships translated to a greater willingness to engage in social exchanges, particularly cooperative interactions.

Social identification: As an essential part of the cognitive dimension of the social capital theory, social identification has been studied by scholars Bagozzi and Dholakia [2002], Dholakia et al. [2004], and Chiu et al. [2006]. Their research shows that when individuals identify with a group, they concern themselves with the group's collective goal and this, in turn, opens up more opportunities for exchanges. Social identification also amplifies their anticipation regarding the value of knowledge exchange and combination.



Data and Methodology

This study explores the interconnectedness of financial literacy and access to finance by exploring firm characteristics, business owner perspectives and bank loan applications. Due to the complex and exploratory nature of this study, a mixed method is used (Bryman and Bell, 2015). Most of the quantitative data is drawn from industry-based reports and qualitative data is from interviews. Using the UK Finance Reports, we extract relevant data on lending to SMEs. We look at Business Finance 2024 Q3, Q2, Q1 and Ethnic Minority Business Report 2023 to capture any ethnic-based variations. We also gather rich data from the experiences of small business owners through semi-structured interviews (Tracy 2020; Bryman and Bell, 2015). Twenty purposefully selected SB owners.

Preliminary Findings and Discussion

Key findings

Metric	EMBs (%)	SME Overall (%)
Young Businesses ≤ 5 years old	59	30
'Ambitious Risk Takers'	57	27
Profitable Businesses	56	75
Use of External Finance	37	37
Concerned About Debt Repayment	35	17
Planning to Grow	61	43
Planning to Apply for Finance	16	8

Financial literacy alone does not solve the access to finance problem for EMBs, however, improving it can lead to an increase in the willingness to access finance.

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