National Institute of Economic and Social Research

Summary of Evidence Session on Public Investment

25 May 2023

THE PRODUCTIVITY INSTITUTE

PRODUCTIVITY COMMISSION

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This evidence session took place on Thursday 25 May 2023.

The UK Productivity Commission's Commissioners:

- Professor Alan Barrett
- Professor Gillian Bristow
- Professor Jagjit S. Chadha
- Professor Diane Coyle CBE
- Professor Eileen Harkin-Jones OBE
- Dawn Holland
- Rachel Lomax
- Professor Stephen Millard
- Sir Anton Muscatelli
- Professor Adrian Pabst
- Dirk Pilat
- Professor Chris Pissarides
- Professor Bart Van Ark
- Professor Tony Venables
- Professor Jackline Wahba OBE
- Stian Westlake
- Professor Andy Westwood
- Professor Cecilia Wong

Observer:

- Stephen Aldridge

Secretariats

- Max Harvey
- Dr Issam Samiri

The witnesses for this session were:

- Nigel Driffield (Professor of International Business, Warwick Business School (ND))
- Gerald Holtham (Professor of Regional Economy, Cardiff Metropolitan University (GH))
- Jan in't Veld (Head of Sector Model-based Economic Analysis, European Commission (JV))
- Urvashi Parashar (Chief Impact Officer and Chief Economist, UK National Infrstructure Bank (UP))

Opening statements

ND: Academic literature indicates that there is a complementarity, public investment is crowding in private investment; crowding in is back in vogue (US Inflation Reduction Act); the UK needs billions more in investment, probably a ten-fold increase compared with current plans.

GH: The UK needs to provide incentives for investment whilst raising taxes to cope with demographic decline.

JV: Decline in public investment as part of fiscal consolidation post-GFC has been very damaging in the UK and in EU countries; total of 6 per cent of GDP per year needed to boost productivity and facilitate the green transition.

UP: The UK Infrastructure Bank (UKIB) has £22bn for financing and is part of a wider ecosystem which is trying to incentivise the private sector to invest.

SECTION 1: Sizing Public Investment

- Urgent public investment needs in R&D (£4bn), skills, housing (incl. heat pumps) and technology (batteries for electrical vehicles); the principal priorities are energy security and green transition; important synergies between publicly provided R&D and private human capital, especially upskilling for the green transition.
- UK needs much more public investment, minimum 2-3 per cent of GDP per year more; but not just a matter of quantity and scale, also unlocking business investment through tax incentives.
- Increases of public investment through 'distortionary' taxes, for example, increases in corporate taxes tend to have a negative effect on the growth of private investment; better to use other taxes like property taxes, land value taxes or environmental taxes.
- Infrastructure investment will not be the silver bullet, it has to be seen as being part of an ecosystem, but it does have a crucial role to play in reaching net zero and reducing regional inequalities.
- Public investment in general and infrastructure investment in particular have to balance financial returns with demonstrating additionality and ability to crowd in – UKIB does this by (i) commercialising more business modes, (ii) accelerating innovation in technology infrastructure and sectors and (iii) facilitating new investors to enter markets.

SECTION 2: Public Investment in the Priority Regions and Sectors

- The current market failure is that we have whole sectors of the economy which are stuck in a low skill, low productivity equilibrium; public investment needs to be targeted and at scale (for example, West German transfers to the East).
- Reducing regional and sectoral inequalities in productivity requires consistent policy.
- Venture Capital (VC) is a high-risk activity so venture capitalists often do not support businesses for the length of time required but do so for just long enough to attain a quick financial return; VC has retreated from the regions and certain sectors, which public policy needs to reverse.
- Public sector has failed to address this, for example, the British Business Bank focuses investment on businesses seven years or older when the UK lacks funding to grow business after the start-up phase.
- Successful regional and sectoral policies to boost productivity include a focus on interconnectivity between energy systems.
- Labour mobility is important; providing wage subsidies or tax credits for R&D in a country which has a shortage of workers can drive up wages.

- UKIB can take more risks than commercial banks, and they are flexible with the types of investment they make – for example, willing to partner with other investors, which fills a gap in the investment landscape.

SECTION 3: Public Infrastructure Investment

- Public investment in devolved regions did not account for need, just the difference in population, whereas English regions are prioritised by their need. This means that the devolved regions do not receive the funding levels they require.

- The level and scale of private investment required for the green transition are going to be large and far larger than the prior structures would facilitate, and it was an aim of those who decided on UKIB's creation to ensure the benefits would be spread across the UK.

- UKIB is not there to fund, there are other means to gain grants. It is there to finance, stepping in to help the private sector take risks.

- UKIB uses a variety of metrics to measure the effectiveness of its investments, which revolve around their aims of achieving net zero and increasing regional economic growth.

- UKIB uses the usual appraisal processes but considers their mandate and tries to learn from what other public institutions are focused upon and doing, both domestically and internationally. It expects a positive financial return from every investment, but they do consider other benefits of their investment.

SECTION 4: Improving Public Investment

- The UK has both a productivity and a competitiveness problem; to address both requires not just more public investment but also much better policy coordination. South Korea is an example of a country which moved towards a new economic model over the last few decades through a coordinated policy framework.

- Important to bring together the macro and the micro. Make decisions which utilise regional skillsets, for example, producing ceramics in Stoke, for the benefit of the UK when trying to transition the economy to one that is more sustainable.

- Public expenditure needs to increase considerably, even to meet current spending requirements. A lot of public institutions are not being provided with sufficient funding.

- Public agency borrowing, say through issuing their own bonds, should not count towards public sector borrowing and reform the tax system to mobilise more private sector resources.

- Maybe we should be asking a different question to the levels of public expenditure. It should be about what the expenditure would deliver – equipping regions and sectors with the tools to tailor their own support, not purely investing in regions and sectors; regions and sectors have different needs.