National Institute of Economic and Social Research

Summary of the Evidence Session on The Underperformance of Business Investment

26 January 2023

THE PRODUCTIVITY INSTITUTE

PRODUCTIVITY COMMISSION

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This evidence session took place on **Thursday 26 January 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:

- Andy King (Member of the Budget Responsibility Committee, OBR).
- Frances Haque (Chief Economist, Santander).
- John Llewellyn (Consultant – formerly of University of Cambridge, OECD and Lehman Brothers).
- Martin Sartorius (Principal Economist, CBI).

Introductions and Sizing Business Investment:

- It was accepted by witnesses that the **UK has seen poor productivity growth**, especially relative to comparable economies.
- Despite this, there was some resistance to this proposition, with one witness commenting that they were unsure if the UK should be expecting increased productivity levels and that it is important to reassess the accuracy of the way productivity is measured.
- Correspondingly, it was agreed by all witnesses that **business investment levels have been low in the UK relative to comparable economies** and that this has been a longstanding issue, with the UK having been towards the bottom of the OECD league tables for a number of years.
- One witness expressed **puzzlement at the UK's low business investment levels**, given its relatively low headline corporation tax rate.
- In terms of **increasing business investment**, witnesses commented that there are **no simple answers and that the future may remain bleak** due to **increased energy costs**, **increased**

financing costs, and **labour shortages**. Additionally, **Brexit** was noted as a reason the UK may remain a less desirable place for businesses to invest relative to comparable economies.

- Despite this, the witnesses did identify **some positives**:
  - Investment may increase with the green transition.
  - Some sectors may be more resilient, particularly manufacturing. The witness commented that this is likely due to a distinct boost to plant and machinery investment intentions and an increase in demand for goods since the pandemic.
- **Possible reasons were offered to help explain** why the UK is experiencing low levels of business investment:
  - Witnesses commented on **the importance of policy consistency and direction** because policy uncertainty is likely to be a factor in deterring business investment. Notably, Brexit came up as a particular source of uncertainty over recent years.
  - Some witnesses commented that **the planning regime is a likely reason** for low business investment levels as it currently slows things down, is costly and comes with many uncertainties.
  - One witness mentioned that the **UK's sectoral composition of output** and that the service industries tend to be less capital-intensive than manufacturing sectors might explain, in part, the lower investment rates in the country.
  - Another witness commented that **current low corporate borrowing levels may be contributing** to the low levels of business investment.
- There was also particular focus given to **SMEs and the greater difficulty they have in accessing finance and their reluctance to invest**. One witness commented that this may be due to SMEs focusing on reducing their debt post-pandemic.

Intangibles and Business Investment:

- Witnesses perceived investment in **intangible assets to be just as important as investment in tangible assets**.
- **More investment in intangible assets** is expected in some sectors, especially in relation to the use of big data.
- However, **questions remain around what classifies as an intangible asset**.
- Additionally, one witness commented that it may be **harder to secure finance to fund investments in intangible assets than tangible assets**, and that it may be **more difficult to use intangible assets than tangible assets as collateral** to secure lending.

Financing Business Investment:

- Witnesses discussed barriers to financing business investments:
  - **The size of a company**:
    All witnesses conversed about large companies having more scope to attain and choose forms of finance. They noted that it is harder for SMEs to secure financing because:
    - Banks can be reluctant to lend to SMEs, often due to them perceiving SMEs as higher risk endeavours. As a result, …

        - SMEs often face higher financing costs.
        - SMEs are expected to provide a greater level of information before accessing new financing.
        - SMEs often must provide more collateral to secure loans and are subject to stricter loan covenants.
    - SMEs often do not possess the same financial skills as their larger competitors. As a result, they may not be as aware of the different forms of finance available to them.
  - **The age of a company**:
    One witness commented that their experience with banks had demonstrated that banks are reluctant to show interest in a company until that company has been operating for a length of time the bank deems sufficient.
  - **The region a company operates within**:
    One witness mentioned that localised banking expertise might be lacking, thus increasing regional disparities in access to finance.
- One witness commented that more entrepreneurial local governments may help to reduce the regional financing gap.
- Another witness mentioned that UK firms may be too focused on short-term financial gains, which may harm long-term investments.

Policy and Business Investment:

- All witnesses agreed that the **public sector plays an important role in helping to crowd-in private investment**.
- One witness also commented that the **UK benefits from flexible product and labour markets and from a good competition regime**, helping to make it an attractive economy in which to invest.
- However, witnesses commented that **public investment has had and can have its issues**:
  - One witness noted that there are certain public investment projects which have **cost and time overruns**.
  - Additionally, another witness commented regarding public-private initiatives that they had perceived a **prioritisation to provide shareholders with their dividends** rather than ensuring initiatives were delivered most effectively and appropriately for the public's long-term benefit.
- Furthermore, one witness mentioned that **reductions in public investment in the UK** in the mid to late nineties and after the global financial crisis, which were considerable relative to comparable economies, **will have had a negative impact upon business investment and growth**.
- Witnesses then discussed **how policy could be improved**. Notably:
  - **Policy could be more consistent and provide direction for business investment**. With government aims constantly changing, along with ministers repeatedly changing outside of election cycles, this can contribute to slow progress with public investment projects and project overruns.
  - It would be **helpful if the public sector could intervene to de-risk and encourage investment in growing markets**, for example in green technology.
  - **The government can also help to clarify where investment needs to be directed**, which may not require them to invest to crowd-in private investment.
  - **Economic policy could be more competitive to attract business investment ahead of other leading economies**.

    - **The UK should ensure it has an adequate competition policy**.
- Witnesses also conversed about **successful public-private investment initiatives**:
    - One witness commented that the **European Bank for Reconstruction and Development (EBRD)** had been successful at effectively targeting joined up public-private investment, financing investment which the private sector would have unlikely undertaken. To assess the macroeconomic impacts of its interventions, the Bank included macroeconomists on panels responsible for allocating financing. The witness considered this to be integral to the Bank's success.
    - Another witness praised the **UK's Covid-19 vaccine creation and subsequent production** as an example of a successful public-private initiative.
- Witnesses specifically discussed the **British Business Bank**, commenting that beyond the issue of its size, independent scrutiny is required to ensure that its medium and long-term strategies are adequate, particularly regarding closing the SME financing gap.