

V. Private investment and innovation⁶

Why private investment and innovation matter

Investment in equipment and new ideas (technological and managerial) are crucial engines of growth. Investing in capital allows existing firms to incorporate new technologies and can be an important part of their strategies to reorganise production processes towards global best practice. The dynamism of innovative new firms which introduce new products and processes is also important for growth via the process of 'creative destruction' that propels economic change.

Fostering a supportive environment for investment and innovation is central to having a dynamic and productive economy. For example, access to finance is essential to support investment, allowing firms to compete effectively in the global marketplace and helping them to anticipate and respond to changing markets and opportunities.

Even though investment and innovation are key processes of the market economy, the policy environment plays an important supporting role. A climate of macroeconomic stability is an important background factor, but many other policies influence investment and innovation, including policies that affect competition, market access, finance, taxation and regulation.

Diagnosis: the problems of private investment and innovation in the UK

As Figure 7 (p.13) shows, UK investment levels as a share of GDP have historically been lower than those of France, Germany and Japan (and similar to the US). The composition of UK investment is also problematic. It is heavily weighted towards property and buildings and much lighter on equipment (which embodies newer technologies). UK intangible investment is also weak in certain areas:

- The UK punches above its weight with a strong science base and an internationally dynamic higher education sector with supporting structures through the 'research excellence framework' administered by HEFCE. Fewer than 4 per cent of the world's researchers are based in the UK yet they manage to produce 6.4 per cent of all scientific articles and receive 10.9 per cent of citations. But commercialisation of their insights and inventions has been historically weak in the UK with lower R&D and patenting intensity than in other major countries. Whereas most countries have been increasing their R&D intensity, the proportion of GDP spent on business R&D declined in the UK after the early 1980s.
- In measures of management quality, the UK is [mediocre](#) by international standards, ranked significantly below the 'premier league' of countries, such as Germany, Japan and the US. This gap matters because recent evidence suggests that about a third of international productivity differences can be attributed to [management](#).

Low investment and innovation generate lower levels of labour productivity or GDP per hour. There has been a longstanding productivity gap between the UK and three close comparators: France, Germany and the US. Despite some progress discussed above, the UK still has substantially lower GDP per hour than these countries.

The long-term capital investment gap in the UK has become more pressing in recent years. In 2012, it was around 15 per cent below its pre-recession peak. Yet large firms seem to be sitting on cash piles indicating they may be held back both by low expected demand and by uncertainty. SMEs have smaller reserves but they may be held back by banks' reluctance to lend while they rebuild their balance sheets.

The other failures of investment that we have highlighted in this report act as a deterrent to private investment. Firms may be discouraged from investing in the UK by a lack of skilled labour. Thus, efforts to increase human capital are likely to provide a boost to investment by firms. Relatively low levels of public investment in infrastructure are a further impediment. So we see increases in private investment

⁶ For a more detailed discussion please see lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/SecretariatPapers/PIInvestment.pdf

“Lasting benefits for investment and innovation could flow from increased competition in retail banking. The direction of travel in recent years has been in the opposite direction.”

as an important further dividend from getting the right skills and infrastructure policies.

But there is a further issue holding back investment and innovation that we believe is equally worrying. There is evidence that UK investment performance has been weakened by a series of problems in the functioning of capital markets.

First, financiers take an excessively short-term outlook when weighing up investment opportunities. Long-term investment is discouraged by investor impatience and a hyper-active mergers and acquisitions market. The 2012 Kay Review concluded that corporate executives and financial intermediaries, such as fund managers and investment analysts, help to generate a short-term approach.

Such 'short-termism' is likely to be particularly acute for funding innovation, which is hard to collateralise and highly risky. Innovation is a public good in terms of the lessons it offers others. The high costs of undertaking due diligence steer private equity investors towards funding a smaller number of larger investments in later stage businesses at the expense of early stage venture capital for SMEs with high growth potential.

Second, a sizeable body of evidence suggests that there is a debt financing gap for younger businesses that lack a track record. The gap arises because of the difficulty that investors have in distinguishing between high- and low-risk entrepreneurs. Younger firms – mainly SMEs – are often the most innovative and hence this capital market failure has long-term growth effects.

The UK performs well in attracting inward investment but performs poorly in creating leading global firms. Productive entrants do not grow to scale nearly as quickly as in the US and this slow 'reallocation' is an important drag on relative productivity. Too often UK firms in high-tech and capital-intensive sectors are acquired by foreign businesses instead of being able to raise growth capital themselves.

Core recommendations on private investment

Addressing these problems is not easy. The Commission welcomes recent short-term measures such as the 'funding for lending' scheme to deal with the lending drought. But this scheme is not designed to deal with structural issues.

One important route with longer lasting benefits could be through spurring increased **competition** in retail banking. The direction of travel in recent years has been in the opposite direction since HBOS was absorbed by Lloyds-TSB in 2008. But there is a mounting case for



formulating a plan to reduce concentration in the retail banking sector. This would be a radical intervention, so before taking the step of referring such a proposal to the new Competition and Markets Authority with a narrow and time-limited remit, we recommend the measures that follow.

Liberalising entry conditions, including speeding up the process for obtaining a banking license, is essential. The OFT has committed to working with the Prudential Regulation Authority to review the application of prudential requirements to ensure that new entrants and smaller banks are not disproportionately affected, for example, by requirements to hold more capital than incumbents. It is important that the process is completed in a timely fashion.

In addition to the recently introduced automatic redirection service, further measures to reduce switching costs across banks are vital, including greater transparency. It should be as easy to transfer a bank account as it has now become to transfer a mobile phone number across operators.

Increased competition in banking would have a variety of benefits. It would encourage banks to seek out profitable lending opportunities more assiduously. It could also stimulate relationship lending as retail banks focus on more mundane finance rather than 'casino' activities. We document these potential benefits in more detail in section 3.3.3 at [lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/SecretariatPapers/PIInvestment.pdf](https://www.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/SecretariatPapers/PIInvestment.pdf).

The Commission supports, with some provisos, current moves towards the creation of a **Business Bank**. At present, the remit of the bank is to deliver the existing programmes of the Department for Business, Innovation and Skills (BIS), with £1 billion (leveraged up to £10 billion) for additional lending to manufacturers, exporters and high-growth

firms. The rationale is that the bank will be able to access funds on more favourable terms than commercial banks (especially those currently saddled with a legacy of poor past investment decisions) and will therefore have a lower cost of capital.

The Business Bank's lower cost of capital and remit to consider social returns would allow it to make loans that would typically be avoided by commercial banks. In particular, it would be able to take a wider economic view of the benefits of investing in certain sectors, including cases where there are potential long-term social returns from developing new technologies. This would mean a particular focus on lending for innovation investments to new and growing firms, which experience the most acute financial market failures and where the externalities will be greatest. Since this would include green technologies, there would be a case for folding the Green Investment Bank into the Business Bank.

The Business Bank should play an important role in creating a corporate bond market for SMEs. This would require a platform for SME loan securitisation along the lines advocated by the 2012 Breedon Review. By removing the requirement for investors to analyse the credit quality of many small issuances from individual SMEs, such a platform would relax SME financing constraints and kick-start institutional investment in these firms.

The Business Bank does carry risks. To be effective, its governance has to be removed from immediate political pressures and it needs to operate on the basis of clearly defined economic objectives. We recommend that it is run by an appointed independent board to oversee operational decisions independently from BIS. It should also operate under a charter that clearly articulates its mission and ensures that the bank is held accountable for delivering that mission.

The proposal for a Business Bank also has to be a long-term commitment supported by cross-party consensus to avoid the perennial process of abolition, reinvention and rebranding that has characterised much government policy in the past. These features are shared with our proposals for infrastructure institutions (including the Infrastructure Bank), but the skills required for the Business Bank are quite distinct so the institutions should be kept separate.

Other policies to support private investment and innovation

Making the financial system more stable

The Commission endorses the Vickers Report on banking regulation and encourages the government to implement both the letter and spirit of its recommendations (Independent Commission on Banking, 2011). Some Commissioners wanted to go further and recommend the structural separation of the investment and retail arms of banks along the lines of the US Glass-Steagall Act. But the consensus was to wait and see how the current set of Vickers and Basel III reforms worked before deciding whether to press ahead with something more radical and potentially disruptive. Although such reforms would help make banking safer and more stable, in the short-term, higher capital requirements will often mean less lending, particularly to risky projects. Recent announcements that suggest a less stringent timetable for implementing the Basel III reforms therefore seem to be a sensible move so long as the delay is not too long.

Holding assets for longer

To combat short-termism, the Commission recommends that equity voting rights be linked to investment duration, with rights becoming stronger the longer the holding period. This would follow the spirit of the US Securities and Exchange Commission's proposal for a one-year holding period for shareholders to be able to amend or request an amendment to a firm's governing documents concerning nomination procedures for directors. A concern with this is that it could lead to control by insiders or 'tunnelling' as happens in many Southern European and developing countries. We view this as less likely in the UK with its strong rule of law, protection of minority



investors and transparent contracting environment. But clearly the design of this proposal must be carefully crafted.

Tax policy and innovation

Debt finance is less attractive for an innovative firm than an equity stake because of the inherent riskiness of future revenue streams. Our current tax system creates a bias towards debt and against equity that distorts investment incentives generally and investment in innovation in particular.

Following the recommendations of the 2011 Mirrlees Review, we support the introduction of an ‘allowance for corporate equity’ (ACE). This would offer a tax break on issuing equity to ensure equal treatment of equity- and debt-financed investments. There is a range of options under an ACE for creating a level playing field between debt and equity. Any resulting loss of corporate tax revenue could, in principle, be offset elsewhere in the tax system. For example, the Mirrlees Review proposes using a broad-based tax on consumption rather than increasing the corporate tax rate.

The Mirrlees Review estimates that introducing an ACE could boost investment by around 6.1 per cent and boost GDP by around 1.4 per cent. This is mainly because an ACE lowers the cost of capital. In addition, an ACE would help to rebalance the UK economy away from debt and towards equity finance. A corporate tax system of this kind has now been introduced in several countries. In addition to stimulating investment, an ACE has the potential to increase financial stability by reducing the bias towards debt finance.

The share of GDP devoted to business R&D has been rising in almost all OECD countries since the war, but it started *falling* in the UK in the 1980s. We view the R&D tax credit system introduced in the 2000s as a positive development, which helped to arrest this decline. HM Revenue and Customs defines R&D for tax purposes in a fairly narrow and formal way due to legitimate concerns over tax avoidance. So there needs to be ways of supporting investments in innovation directly without further complicating the tax code. One route is through the Business Bank as it can take a wider view of the social returns to innovative projects. This would help to address weaknesses in the commercialisation of inventions from the science base. The Business Bank could also be permitted to use a variety of venture capital-style financing approaches as well as making standard business loans.

Funding for innovative start-ups often comes from alternative sources, such as venture capital, angel funding and private equity in high-tech sectors. This is welcome and it is well-known that clusters like Silicon Valley have a deep seam of such liquidity. Unfortunately,

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such ‘agglomerations’ of high-tech activity are extremely hard for governments to manufacture, although it can certainly hold them back through onerous regulations. Finance often follows after high-tech clusters have got going due to other factors, such as the presence of world-class universities like Stanford and Berkeley in California’s Bay Area. Finance helps the next stage of development, but it is not the prime mover. Hence, we do not support introducing additional tax breaks for such alternative investments.

Industrial strategy

Since the late 1970s, industry-specific ‘vertical’ policies have been unpopular due to fears that the ambition of ‘picking winners’ turns into an outcome of ‘picking losers’. But some recent successes (such as foreign direct investment in the automotive sector) and the need to generate more green industries have caused a re-think of a more activist industrial strategy. The convening power and coordination role of government can help to bring parties together to recognise and solve problems. So there is a role for strategic thinking, especially as the government touches on almost every industry in some way.

Of course, it is vital that industrial strategy does not divert attention from the importance of ‘horizontal’ policies, such as promoting competition, R&D, infrastructure and skills, which benefit all sectors of the economy. Nevertheless, spotting cases where there is an impediment to the growth of a sector is an important role for the government. Supportive interventions need not take the form of direct subsidies – removing specific regulatory barriers is more important.

Underpinning new thinking on industrial strategy should be a view of where the UK has some actual or latent comparative advantage. For such sectors or firms so identified, it must then be considered whether these are areas of global growth. This means taking an appropriately dynamic perspective. For example, investment in low-carbon technologies is likely to be an important area in the future. We recommend a tight focus on what factors inhibit the growth of such sectors and what policies could encourage their growth.

Moreover, it is important that this thinking is conducted transparently with the supporting analysis subject to independent scrutiny.

One example of how highly focused government intervention can help would be the relaxing of severe planning restrictions that are inhibiting the expansion of high-tech clusters in some parts of the country (such as Cambridge and Oxford) where the UK has strong comparative advantage in its universities. Planning restrictions on housing for workers, land use restrictions and slow roll-out of ultra-fast broadband are particular constraints on these dense centres of new economic activity. The infrastructure institutions we propose should help, but additional political attention needs to be focused on relaxing regulations that are impeding growth. Other examples are management training in the creative sectors; visa restrictions harming universities; and the prevarication over expanding airport runway capacity that harms our comparative advantage in international business services.

What kind of institutions can help to develop and deliver a better industrial strategy? We recommend creating an independent National Growth Council, which brings together expertise across all disciplines to review relevant evidence and to recommend growth-enhancing policy reforms that could be subject to rigorous evaluation. This body should also challenge government on why successful policies are not introduced and/or why unsuccessful ones are not closed down. The Council would work with BIS on formulating the evidence base needed to underpin an industrial strategy.

The lending strategies of the Business Bank and the Infrastructure Bank should be supportive of this type of industrial strategy. This could be important for industries where there is good evidence that access to finance is holding back investment and innovation. This is particularly true where large upfront investments are needed in an emerging area, such as developing low-carbon technologies.

Policies to improve management quality

Policies should be pursued that encourage good management practices. High levels of competition, meritocratic appointment of chief executives, proper management training and foreign direct investment all lead to improved management performance. Since management matters so much for growth are there more directed policies to improve it? Business education is growing in importance so we should be wary of stifling the growth of the sector with tough immigration controls that make it hard to recruit overseas faculty and students. There is also evidence that family-run businesses suffer from managerial deficits, so targeted support for management training could be useful for this group. The inheritance tax regime, which allows tax breaks on passing business assets between generations, should also be re-evaluated as it discourages reallocation of assets away from family ownership.

Why have problems with private investment persisted?

The thrust of financial policy prior to the crisis was generally *laissez-faire*. Charmed by the success of the City, politicians of all stripes lined up behind 'light-touch' regulation. More conservatively run financial institutions, such as building societies, were demutualised to take advantage of market opportunities that were otherwise denied to them. The need for government-led solutions, especially in an area like finance, went distinctly against the grain. Moreover, the concentration of the UK banking sector was often thought to be a source of stability, especially when protection for depositors was quite limited. The success of the City allowed senior financiers to speak with an authority that limited government interference in the activities of the sector. In contrast, our view is that correcting market failures is a pro-market intervention.

The evidence for both rich and poor countries that greater competition in banking (and in other sectors) improves productivity, management and innovation seems to have had little impact on UK policy thinking. The UK's retail banking system is extremely concentrated and attempts to promote more competition have floundered. In 2010, the four largest banks accounted for 85 per cent of SME current accounts (Independent Commission on Banking, 2011).

The UK is also unusual in not having a publicly supported bank to promote lending to small and new businesses. For example, the US has the Small Business Administration, which provided more than \$30 billion in lending to over 60,000 small businesses in 2011. The UK has instead relied on private commercial banking to provide finance to SMEs and commercial lenders rightly look at business funding in terms of profitable opportunities. But if competition is weak, then the high profits of the banks will result in otherwise commercially viable lending opportunities being overlooked.

Summary on private investment and innovation

Low levels of private investment and innovation in the UK are a reflection of capital market failures. Over-reliance on bank finance along with problems of bank concentration and short-termism are constraining firm growth, especially of dynamic and innovative SMEs. We propose increasing retail banking competition and developing a strategy for a Business Bank to deal with these issues. We have also proposed a range of complementary reforms to support private investment and innovation.