Britain's Investment Gap

Falling Behind

Britain's investment gap

Key findings

This report finds that:

- Britain has an investment gap (relative to the OBR's June 2010 forecasts) of £12.4bn a quarter. Our annual investment gap is £50bn a year.
- Weak investment is a longing running problem for the UK economy.
- So far there is little evidence of rebalancing towards investment.
- Weak investment is adding to the UK's ongoing productivity problem.
- The UK's record on infrastructure investment is especially weak.
- The Government has slashed its own capital spending.
- There are several steps – from establishing a proper British Investment Bank to a more pro-active industrial policy that could be taken now to increase investment.

Introduction

According to most economists the UK faces three major economic issues – a squeeze on real wages and productivity, a chronic trade deficit and weak investment.

Investment has been one of the missing legs of the current recovery. A successful rebalancing of the British economy requires higher investment and exports and a shift away from consumer spending and housing market led growth. The Government's initial economic and fiscal plans were premised on such a rebalancing. As the state cut back its own spending, the theory stated, business would fill the gap as their confidence increased and they engaged in more capital spending.

One and half years into a recovery, and four years after the Chancellor's first Budget, investment remains weak. This report examines recent trends in business investment, public sector investment, infrastructure spending and investment in intangibles. It concludes with some policy suggestions as to how to increase investment across the board.

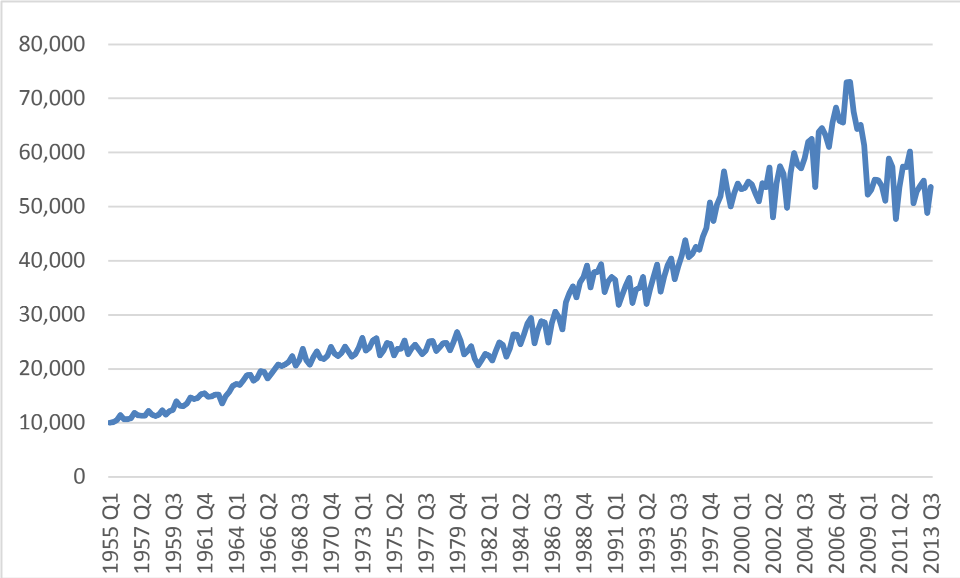
As the ONS have recently noted:

"…the proportion of total expenditure accounted for by spending on investment has fallen from an average of 13.5% in 2007, to an average of 10.9% during 2012 and to 10.4% in Q2 2013: the lowest level recorded since the 1950s. This compares with 14.1% in France, 16.7% in the United States and 17.9% in Canada. Across the G7, investment accounts for an average of 14.6% of Gross Final Expenditure."

Getting investment up to the levels forecast in the June 2010 OBR forecasts would require a quarterly rise in investment of £12.4bn. Closing this investment gap should be a key aim of macroeconomic policy.

Investment

Gross Fixed Capital Formation (£mn)



Gross fixed capital formation (GFCF) is the broadest measure of investment used by economists. It captures private and public sector physical investment in its broadest sense from the building of new homes to offices and from purchasing computers to buying new machinery.

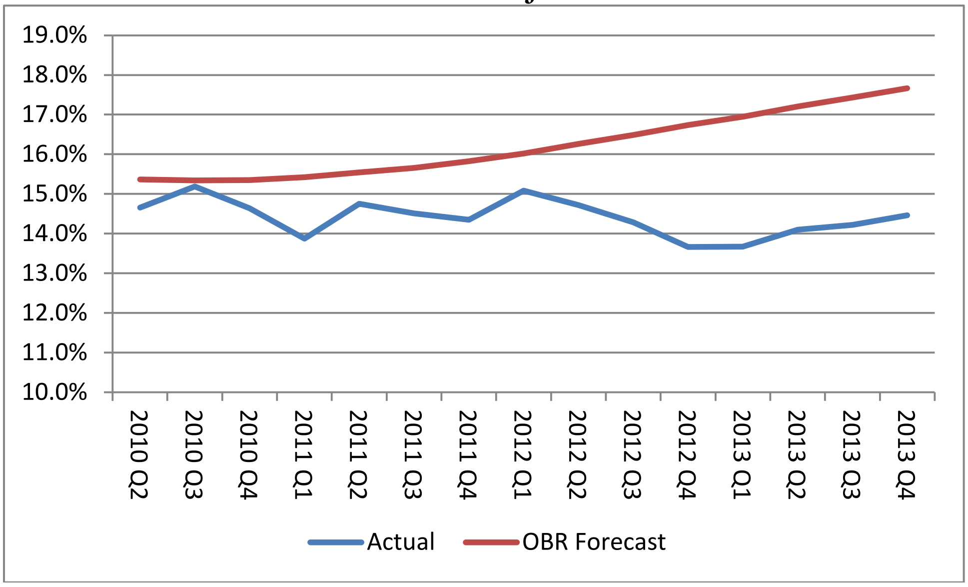
The chart above shows GFCF back to 1955. Two trends are obvious: the broad upswing from the late 1970s until 2008 and the collapse after 2008. GFCF as a share of GDP is now at levels not seen since the 1950s. Whilst the economy has been growing since mid 2012, GFCF has barely budged.

GFCF fell by around £20bn a quarter in 2008-09 – a trend which explains almost all the overall fall in GDP in that period. The financial crisis rapidly became a crisis of the real economy and this manifested itself through falling capital formation.

Since mid 2010 investment has consistently under-performed the Office for Budget Responsibility's forecasts.

Had the economy (and investment) developed as intended, it would now represent almost 18% of GDP as opposed to less than 15%.

Investment as a share of GDP – actual vs June 2010 OBR forecast



Investment & productivity

Weak productivity has been one of the defining trends of the UK's economic experience since 2008. It has fallen by 4.4 per cent since early 2008 and is around 15 per cent below the previous trend.

Back in 2008/09 many expected unemployment to rise by far more than it did. Despite a much more severe recession than in the early 1990s or early 1980, unemployment rose (proportionately) much less than many feared.

Given this one could reasonably expect (and this was certainly the mainstream view amongst economic observers) that any pickup in growth would see weak jobs growth. The logic was that employers had reacted to a downturn in demand by cutting wages and hours rather than staff and so once the upturn came they could simply increase hours and get more output from their workforce rather than hiring new people.

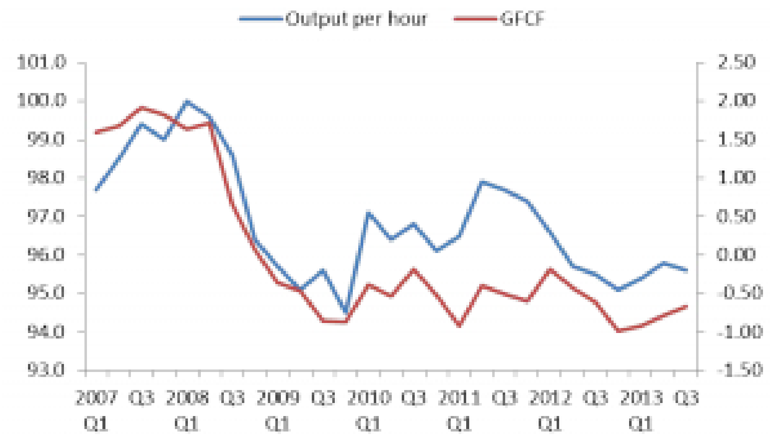
This has not happened – the recovery over the past year has been employment intense.

So we are left with what economists call the productivity puzzle – output is still two per cent below its peak but the number of people in work is higher.

One potential explanation can be found in the weakness of investment.
As the chart below demonstrates, the weakness in output per hour has closely mapped the weakness in GFCF. Intuitively, this makes sense. The weaker GFCF is the smaller will be the amount of capital available to each worker and hence the lower their productivity.

It is unlikely that weak investment can explain the whole of the 'productivity puzzle' but an increase in investment from its current low base would almost certainly feed into an increase in productivity.

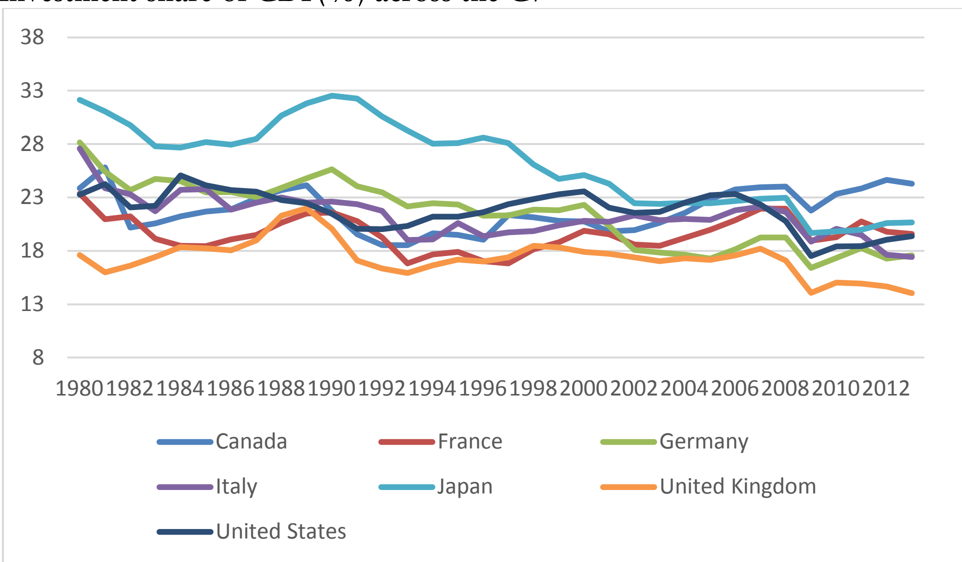
Gross Fixed Capital Formation and productivity (output per hour)



Investment pre-recession

Britain's investment problem pre-dates 2008. The chart below shows investment as a share of GDP across the G7 since 1980. For thirty years UK has always been the least (or second least) investment intense of the major developed economies.

Investment share of GDP(%) across the G7



Before 1980, the difference was even more marked: between 1870 and 1949 the UK typically devoted between seven and nine per cent of GDP to gross fixed domestic investment, while for Canada, France, Germany, Japan and the USA the typical proportion was between 12 and 20 per cent.

In other words the UK has under-invested as compared to our international peers for decades. If there is a 'British disease', it is over-consuming and under-investing in the future.

Investment by Type

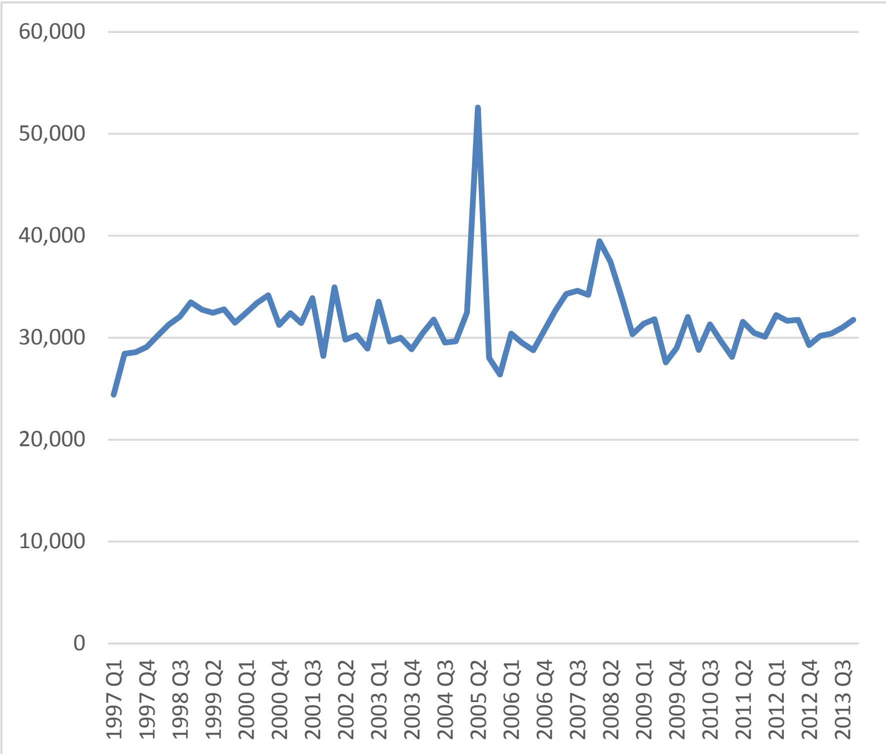
The following sections look in more detail at business investment, public sector investment, infrastructure investment and investment in intangibles.

<u>**Business investment**</u>

Business investment is the core of what most economists regard as 'investment' – the decisions by firms to increase capital expenditure on new plant, equipment and buildings.

To some extent it is business investment which is the real driver of sustainable economic growth – firms choose to reinvest profits (or borrow externally) to increase their productive capacity and expand supply. It is this growth in supply which is the long run motor of economic growth.

Business investment (£mn, real terms)



The chart above shows business investment back to 1997 (the large spike is due to a classification change involving the nuclear industry). The first thing which leaps out of the chart is that (in real terms) business investment grew in the late 1990s and mid 2000s before falling in the recession.

In broad terms business investment has been flat-ish for a decade and a half – and as a share of GDP (which has grown) it has contracted. In other words, British firms are not investing.

Three explanations can be offered for the post-crash failure of business investment to grow.

It may be that faced with weak demand, firms choose not to expand their supply. Given large amounts of spare capacity at many firms this would appear to be a rational decision – although this argument will be harder to sustain as demand returns to the economy.

Equally, weak investment may have reflected weak business confidence. With domestic demand weak and external demand impacted by the Eurocrisis, firms may have been fearful about the future and so reluctant to invest. The returns on investment certainly looked less secure in 2008-2012. Again, though this argument becomes harder to sustain as demand returns.

Finally firms may have been credit-constrained. In particular small to medium sized firms that lack the internal funds to pay for expansion and which are usually bank reliant may have struggled to raise external capital. Bank lending to firms has been contracting since 2009 and this may have decreased investment. Indeed, this problem predates 2008, British banks have always been more comfortable lending against property than for machinery or other business needs.

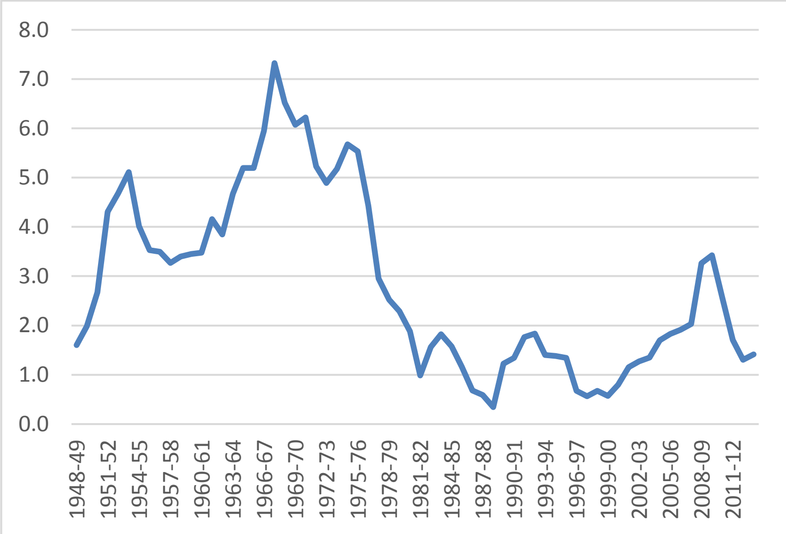
Whatever the explanation for weak investment since 2008, there is clearly a larger problem at work. Business investment lagged economic growth even in the ‘good years’ before the current crisis.

One potential explanation is short-termism in management. As managers have become more concerned with managing their share price (and their own remuneration has become more tied to it), there has been a tendency to favour short- term profits over longer term investment. Dividend payments and share buybacks have gained favour over capital spending as a use of profits.

Given the longer term trends at work it is hard to conclude that the recent return to growth will see a surge in business investment. Whilst business capital spending probably will pick up in the short run (especially as delayed projects are given the go ahead) there is still a significant longer term issue to be dealt with.

Public investment

Public Sector Net Investment (% GDP)



The chart above shows public sector net investment as a share of GDP back to 1948. This is net investment – so is a measure of total government investment spending minus the deprecation of existing assets.

The numbers for the 1940s, 50s, 60s and 70s contain investment that nowadays would be counted as business investment. As the government still owned large capital-intense industries (rail, coal, steel, etc) then one would expect public sector investment to be higher over those periods.

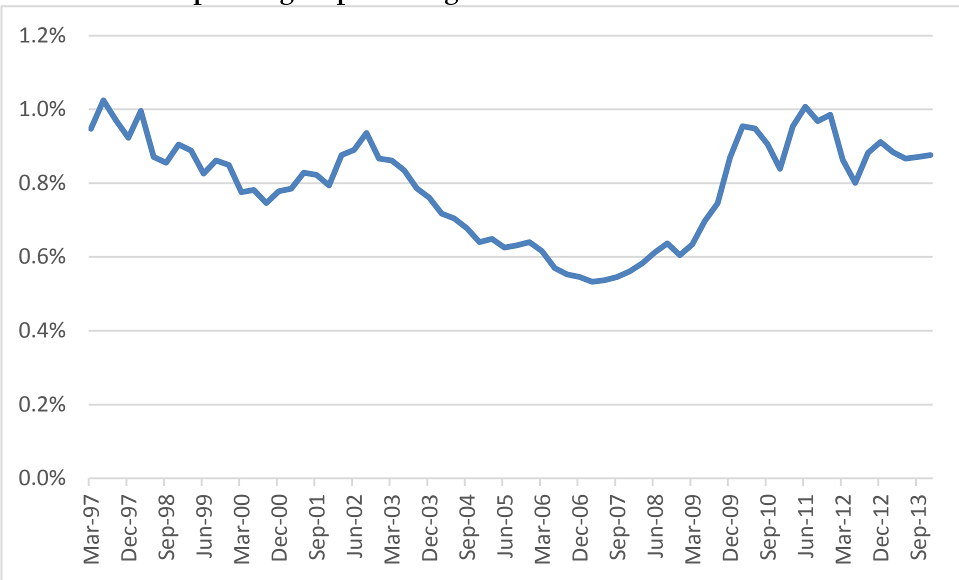
Post-privatisation in the 1980s a few trends are visible. Public investment fell throughout the 1990s during the Clarke fiscal consolidation and then rose steadily under Labour. It rose sharply after 2008 as capital spending was brought forward as a stimulus measure and has fallen sharply under the Coalition.

Capital spending has been cut by almost 50% since June 2010 despite later attempts to talk up small switches of current to capital spend.

The Labour government increased capital spending on schools, hospitals and other public services after a decade and half of apparent under-investment – although improvements in infrastructure were less significant.

Infrastructure

Infrastructure spending as percentage of GDP



Infrastructure spending in the UK (as share of GDP) fell from 2002 until the crisis when the last government's fiscal stimulus began to increase it. It has been broadly flat since 2010.

Despite a large increase in public sector net investment between the late 1990s and the late 2000s it remained weak – suggesting that public investment was concentrated on public services rather than economic infrastructure such as energy and transport.

The current government have set out an ambitious National Infrastructure Plan with some £500bn of projects. However there has been little progress (as is clear in the chart above) in achieving this.

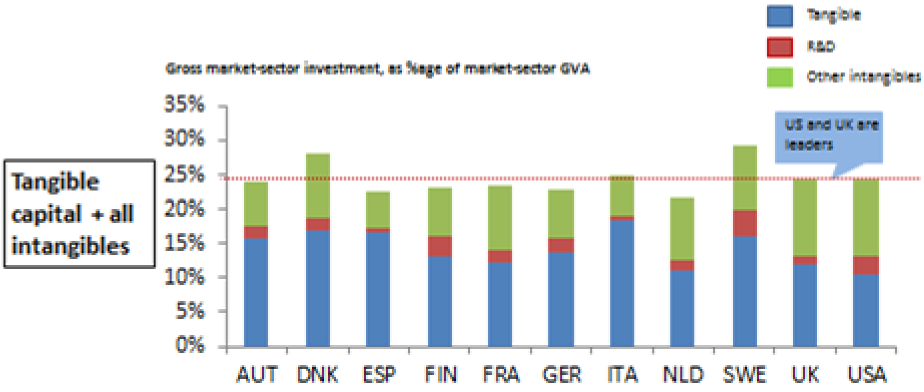
Partially the reasons are the same as those for poor business investment - credit constraints, confidence and short-termism – but there may also be difficulties around the plan. Credit constraints are likely to be an especially large factor with large debt-financed projects.

The Government has taken steps to use its own balance sheet to guarantee infrastructure financing but again progress since this announcement in 2012 has been slow.

Whilst Government has committed around £50bn to guarantee infrastructure projects, up to £130bn is available as guarantees to residential mortgages through the Help to Buy scheme.

Intangibles

Investment including intangibles



The preceding analysis has concentrated on physical investment. Some economists argue that if investment in intangibles is included then the UK's position looks less bad.

Intangible investment represents business spending on non-physical property. Prominent examples are investments in software and in areas such as branding. Whilst most conventional economists consider a firm spending on marketing as a form of consumption, it can be argued that it should be seen as investment in future sales growth.

It is certainly true that including intangibles (as in the above chart) makes the UK (and US) look comparatively better – on the widest measure only Denmark and Sweden have higher investment.

In any service based economy one would expect higher investment in intangibles but there are two problems with this approach. First such investments are harder to measure and secondly – given recent productivity performance – such investments seem less effective at increasing growth. Indeed if the UK's investment has indeed been much higher than many estimate due to areas such as software and branding, then questions can be raised about the return on that investment given the poor economic performance of the last few years.

Policies to boost investment

The TUC believes that there are a number of actions that can be taken now to address the UK's immediate and longer term investment needs, and in Budget 2014 calls on the government to:

- reinstate a far higher proportion of recent capital spending cuts than are currently planned;
- support locally-led investment and regeneration models to maximise the regional benefits of HS2;
- increase the scope of the UK Guarantees scheme to match the scale of the Help to Buy initiative;

- reverse planned corporation tax reductions (with the rate set to fall from its current 22% to 20% by April 2015), reinvesting the money in capital allowances;
- widen the remit of the British Business Bank to enable it to focus lending on high-growth small businesses and infrastructure projects;
- provide the British Business Bank with an increased capital base and with the power to borrow from the capital markets;
- increase the capitalisation of the Green Investment Bank allowing it to issue green bonds;
- expand its remit to include community energy projects, home energy efficiency schemes and significant major infrastructure investments;
- develop proposals to establish a network of regional development banks;
- maintain financial support for local government home-building and lift the borrowing caps that apply local authorities;
- signal the government's intention to commit to a full scale carbon sequestration programme for power and industry, focussed on CCS pipeline and storage infrastructure in key industrial regions;
- reduce the interest rate payable on Green Deal loans, providing a new role for the Green Investment Bank following the example of the KfW bank in Germany.