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Market Frameworks for Productive Investment

Necessary but not Sufficient

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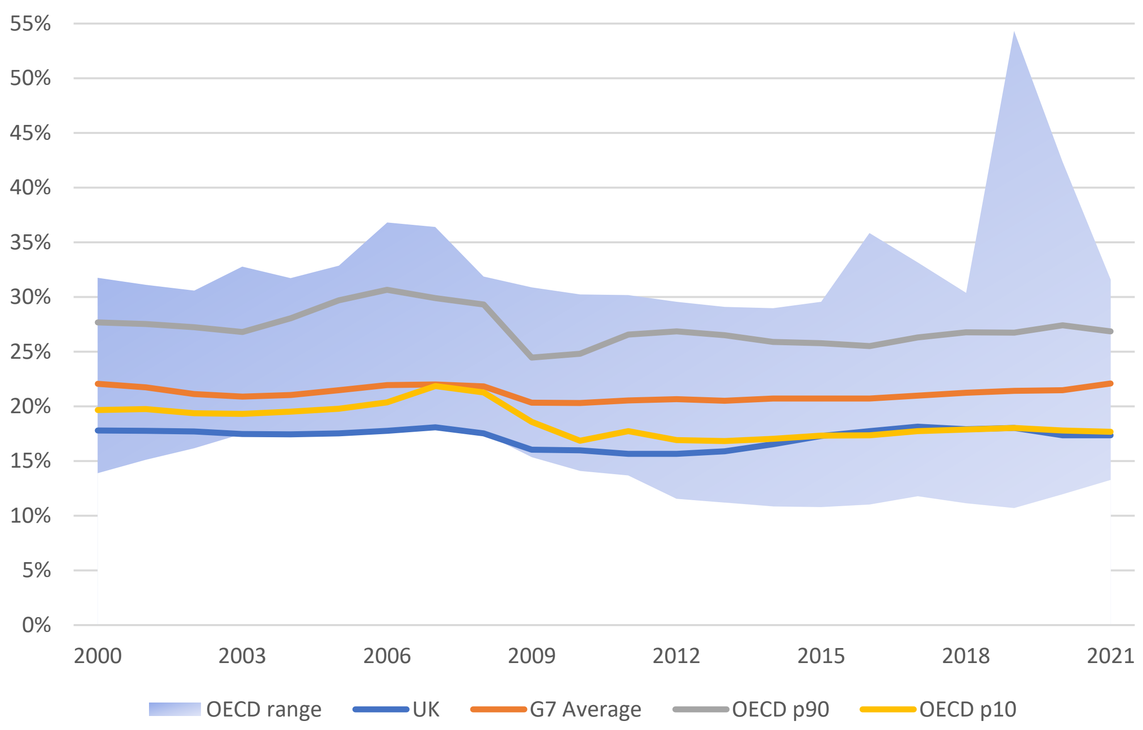
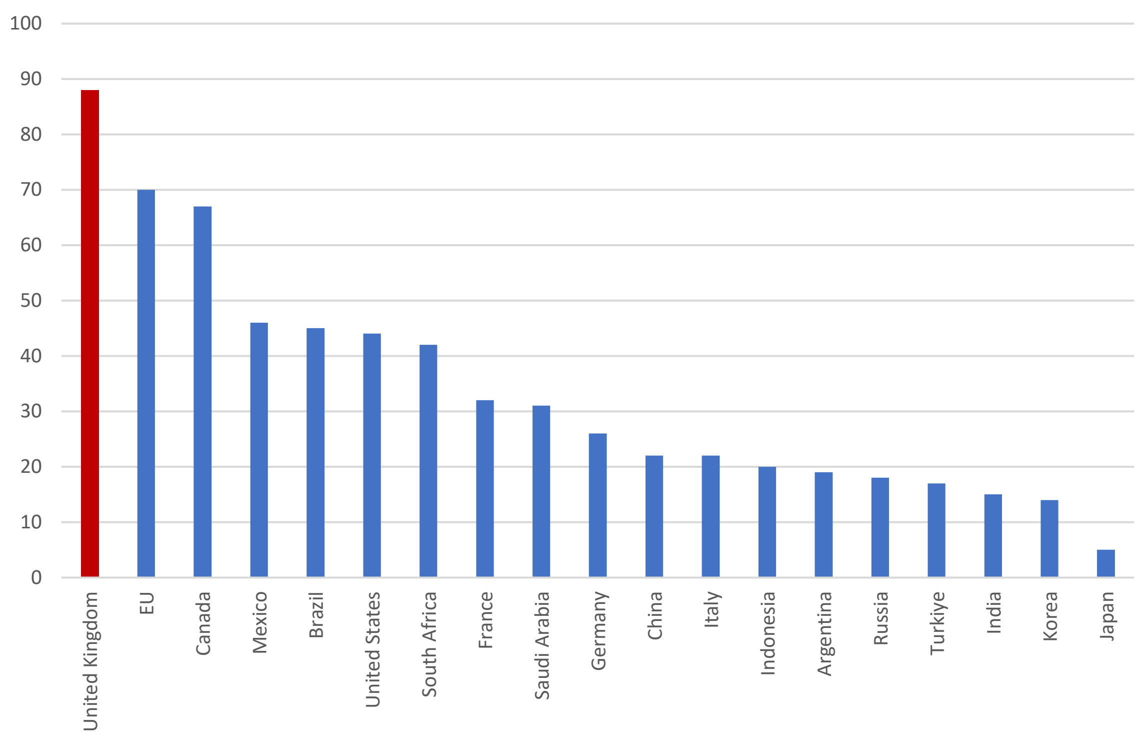
The puzzle – the UK has weak domestic investment but good market frameworks

The UK has a long history of underperformance on investment compared to its peers, but at the same time we perform extremely well on inward FDI

Gross Fixed Capital Formation (total investment) as % of GDP



FDI/GDP ratio G20 (2022, %)



- The UK routinely ranks in the **bottom 10% of OECD countries for overall investment intensity**
- Our performance improves when we expand the definition of investment to include all '**knowledge assets**', but even then, we are still mid-table

Source: OECD Data

- Since the financial crisis the **UK has consistently attracted more inward FDI from overseas firms than UK companies have invested abroad**
- In 2022 the **UK FDI stock to GDP ratio was 88%, the highest in the G20**

Source: OECD Data

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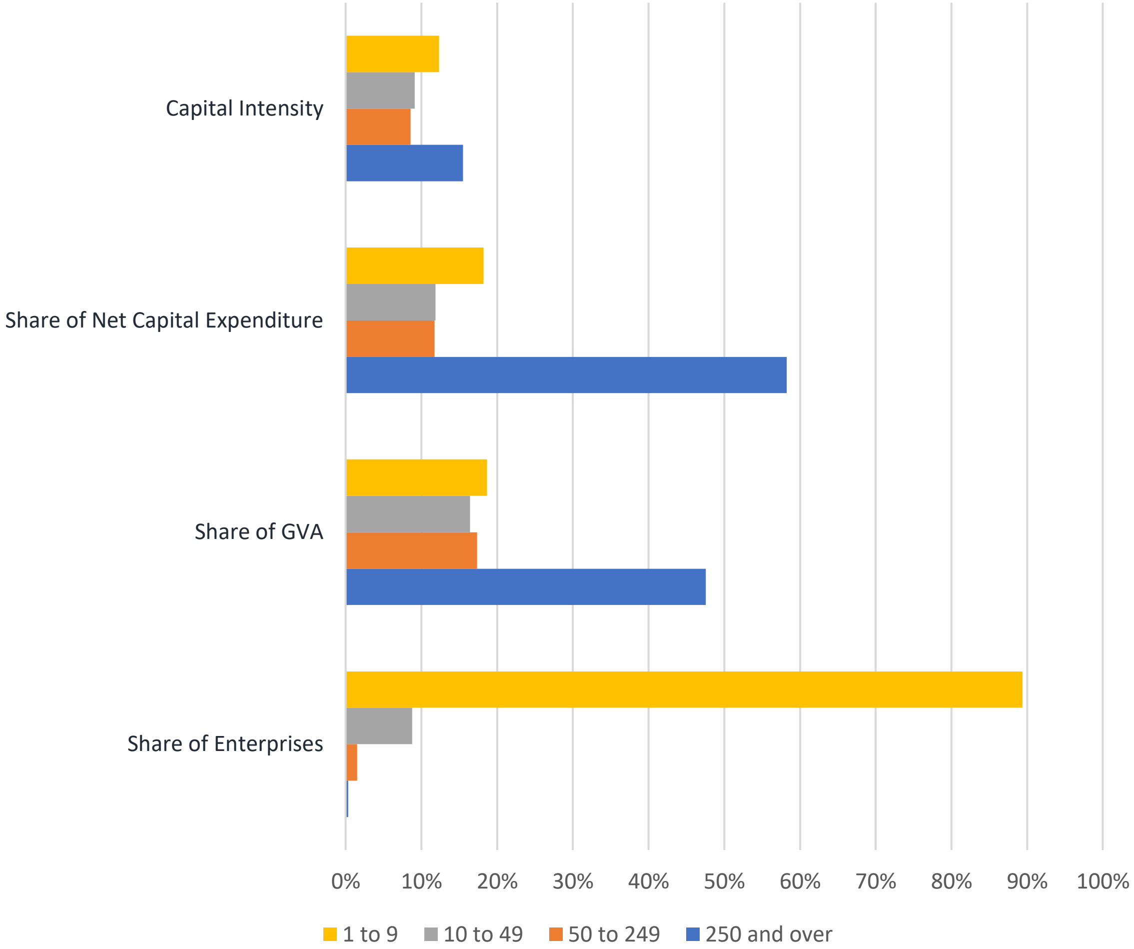
UK business investment is incredibly skewed towards a small number of firms, making very large, ‘lumpy’ investments

- A **tiny proportion of UK firms account for the majority of business investment**
    - Firms with 250+ employees account for just 0.32% of the business population, but 58% of net capital acquisitions*
- **Larger firms also tend to be more investment intensive** than smaller firms
    - Net capital acquisitions as share of GVA is ~15% for large firms, but just ~9% for SMEs (excluding micro firms)
- However, if we look at the population of firms, the **top investors are not the same firms every year**
- **Sector mix is also relatively unimportant** for overall levels of investment

**Taken from The Annual Business Survey, covers Agriculture, Fishing, Production, Construction, Distribution and Non-Financial Service Industries*

Firm Investment and GVA by Size Band (2021)



Source: ONS Annual Business Survey

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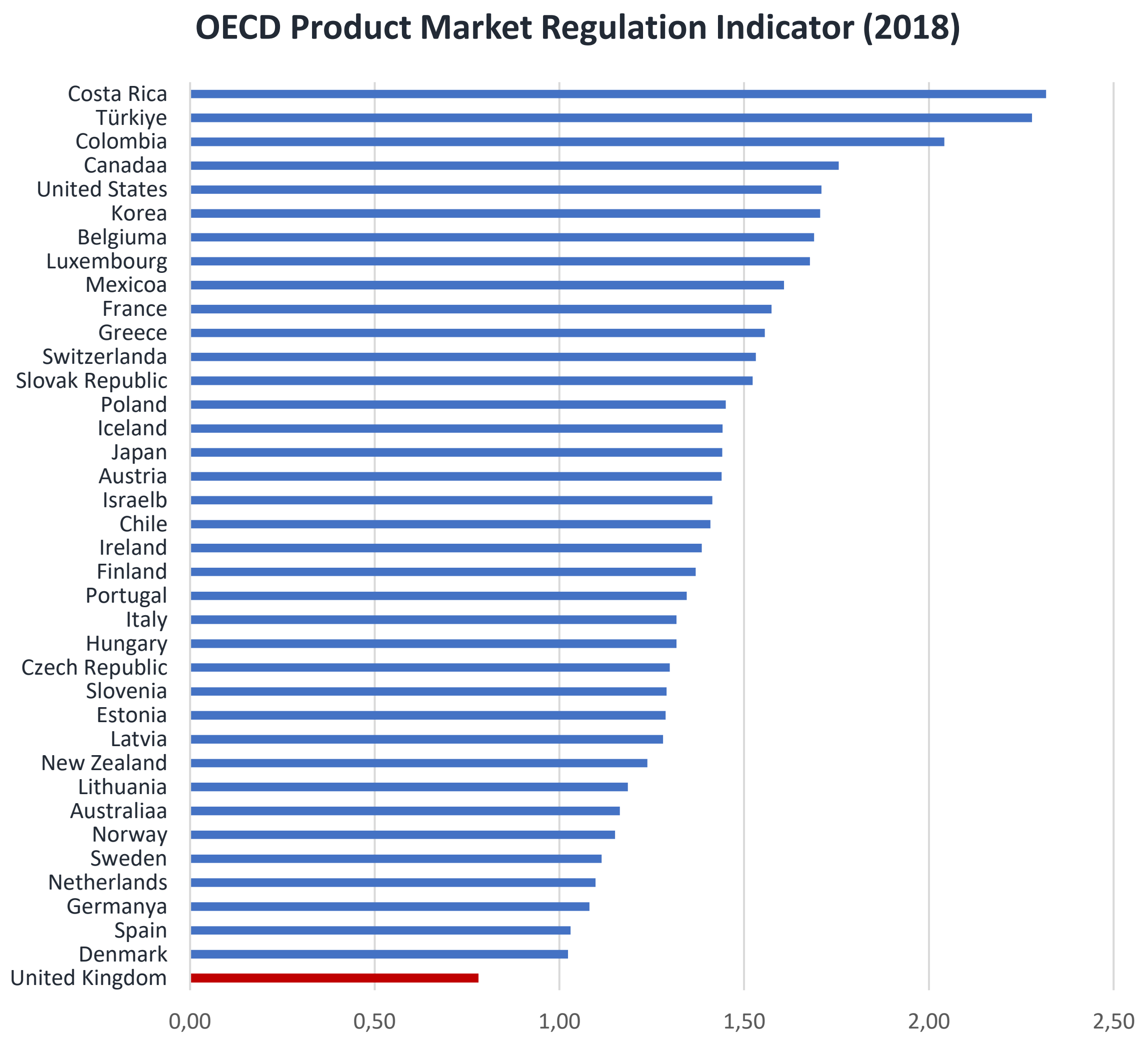
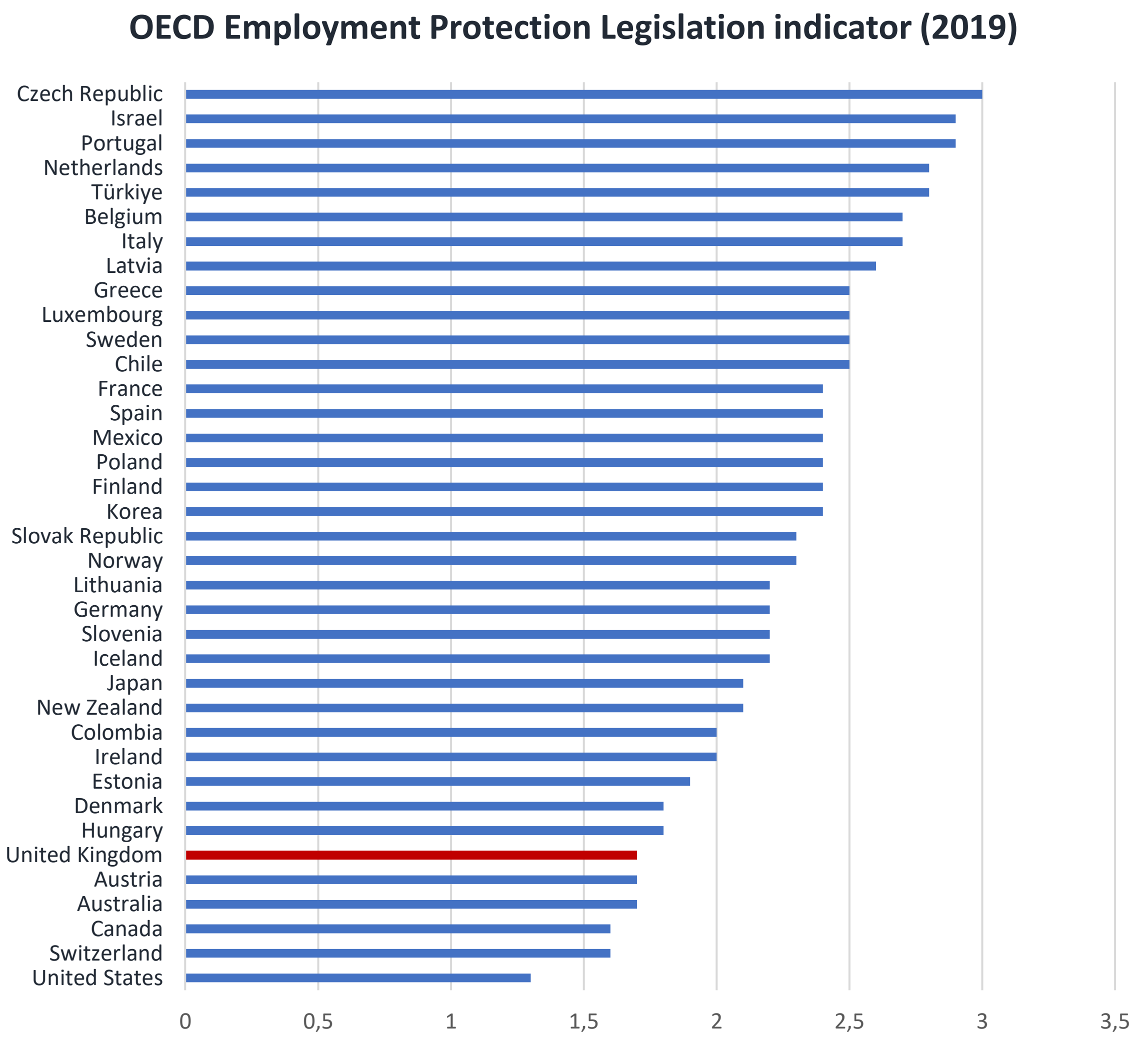
But the UK performs well in terms of having a pro-competition, low burden regulatory regime





Source: OECD Data

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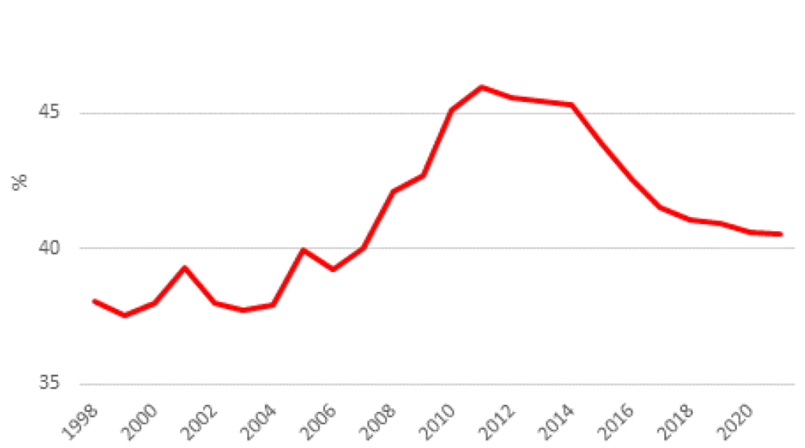
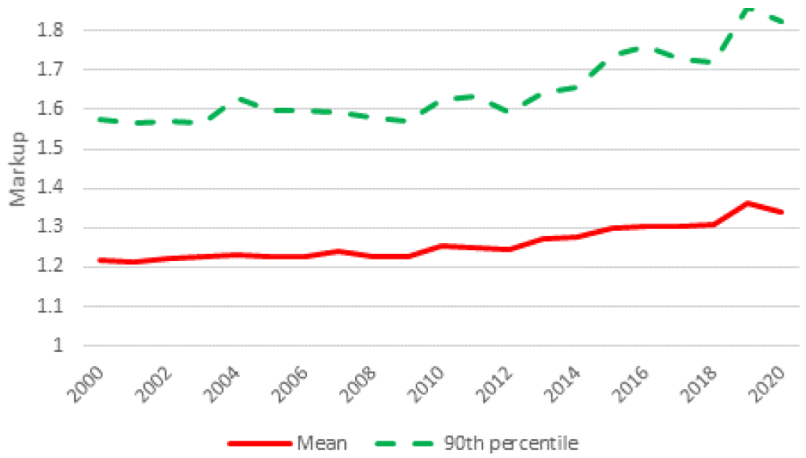
And while there is some evidence of a weakening in competitive forces in the UK, it is not conclusive

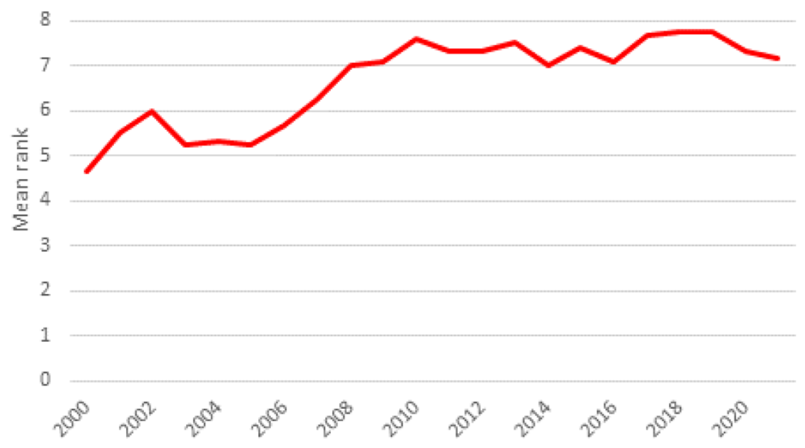
Average market share of the five largest firms in each industry



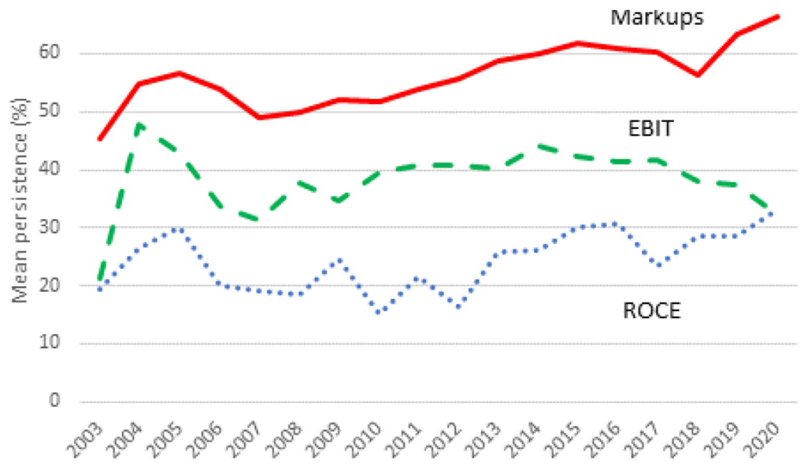
Price-cost markups since 2000



Rank persistence (averaged across industries)



Profit persistence (averaged across industries)



Source: CMA State of Competition, 2022

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So what does this mean for the role of market frameworks in investment?

Although market frameworks are central to making economies work effectively, *in general* they are not directly related to firms' decisions to invest

Reason for investing

Underlying motive

Challenge for competition and regulation policy

To replace existing assets

To expand, become more productive etc.

To adapt to change or seize opportunities

Central to these motives is the expectation of some form of return (financial or otherwise)

The challenge for thinking about the impact of competition and regulatory policy is that for these types 'productive' investment decisions they are **not** the trigger.

To comply with regulation
(or other constraints)

The rationale for these types of investments is more defensive in nature (keep what you have)

Although competition and regulatory policy may be the cause of such investments, the question then is to what extent will these be **productive** investments

There are a variety of external factors which can influence businesses' decisions to invest (and by how much)

Economic Conditions

Uncertainty

High levels of economic uncertainty can significantly reduce investment. Uncertainty makes planning for the future harder and encourages firms to 'wait and see' rather than commit to an investment.

Uncertainty following Global Financial Crisis of 2008 reduced investment across all major advanced economies. Recent developments such as Covid-19 also reduced UK investment (Bloom, 2018).

Weak Demand

Weak consumer demand can encourage businesses to reduce investment because of lower expected rates of return.

There is evidence to suggest that the fall in demand following the Global Financial Crisis, and subsequent austerity policies had a dampening effect on business activity and investment due to weak demand (CEPR, 2021).

Capital 'Shallowing'

A fall in the cost of employment (wages) can cause firms to substitute away from investment towards labour due to hiring costs being relatively cheap.

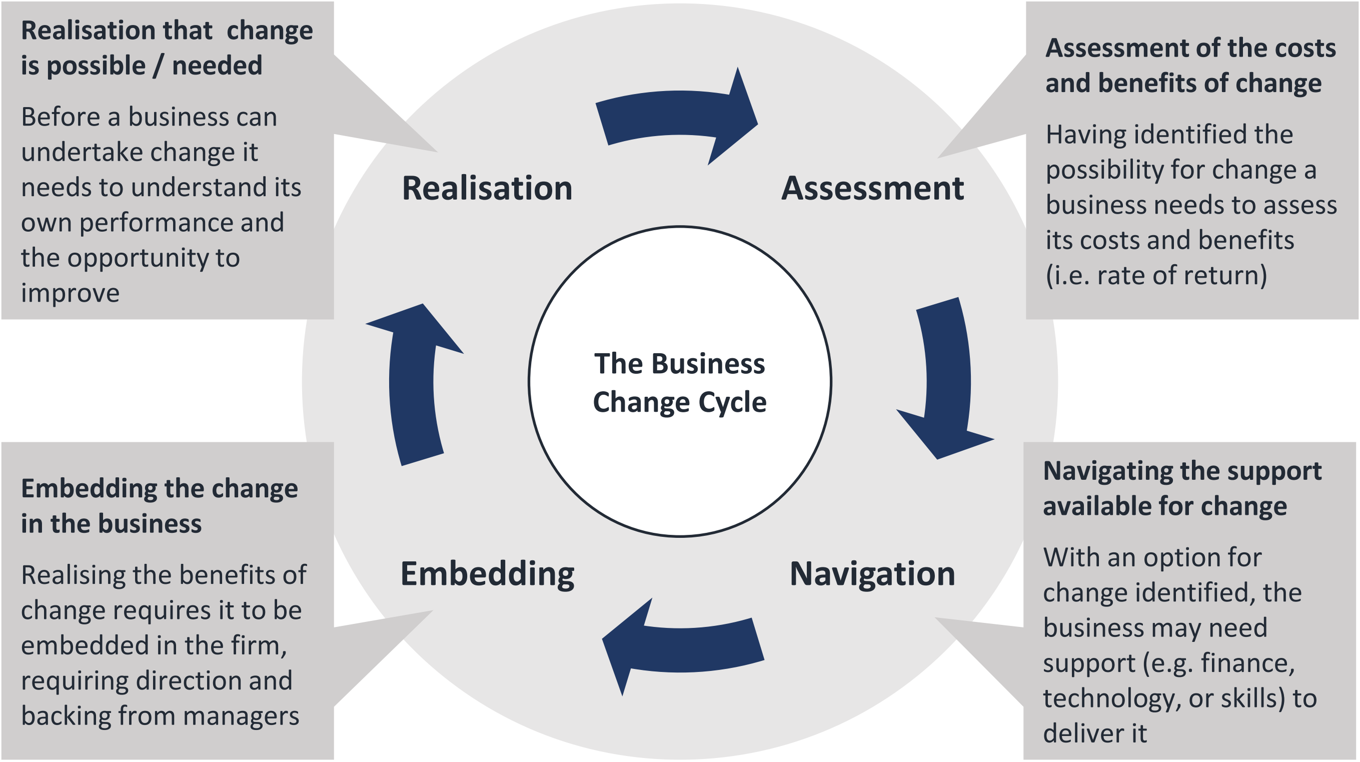
In countries with flexible labour markets like the UK, scaling production up / down via hiring and firing is easier than via investment – making it an attractive option during periods of increased uncertainty (NIESR, 2019).

Trade Openness

Increases in trade frictions have a negative impact on investment due to higher costs of doing business, which lower the rate of return. Businesses will also be impacted by knock-on effects as a result of changes in the exchange rate, inflation, financing conditions, and consumption.

The Bank of England Decision Maker Panel Survey found that due to trade frictions more businesses expected to reduce their investment than increase it (NIESR, 2019).

But given the high level of heterogeneity in firm investment behaviour, **the most important drivers and barriers to investment decisions probably sit within firms themselves**



Source: BIS – Business Productivity Review (2013)

- **How firms make decisions** is a key driver of investment
- The **complexity and volatility** of external factors make investment decisions difficult
  - Business will find it hard to predict and understand future impacts (e.g. AI and automation, consumer demand, Net Zero, geopolitical instability, policy changes, macroeconomic conditions, etc.)
- **Small barriers at each stage of businesses decision processes** may cumulate into large effects
- Barriers are likely to **vary by the type of firm:**
  - **Large firms** – less likely to face barriers such as access to finance given greater internal capacity / resources (but may have high internal hurdle rates if competing against other projects)
  - **Foreign firms** – although more likely to be large, their lack of local knowledge may make it harder for them to assess / navigate opportunities
  - **SMEs** – More likely to face barriers at all stages of the decision process
- Or **vary by the type of investment**
  - e.g. even large firms may struggle to deliver investment in AI due to a lack of the right expertise

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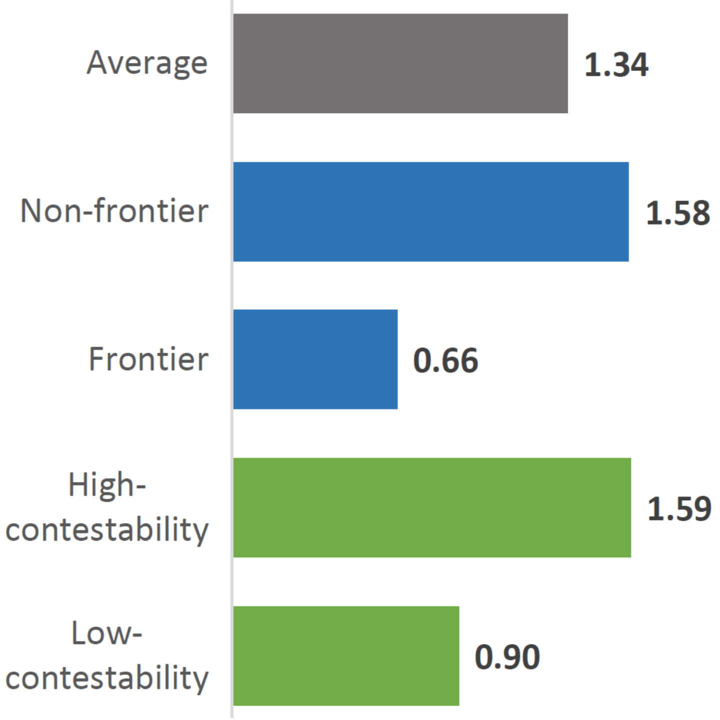
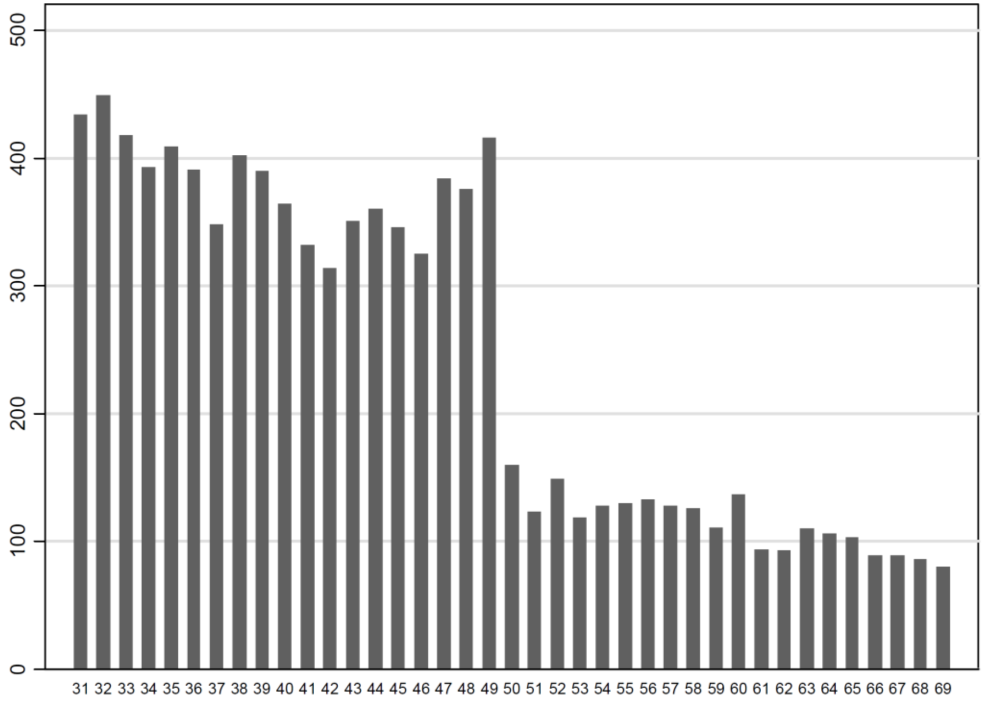
So, what is the role for market frameworks? – firstly, good market frameworks can ensure that firms who want to grow are not impeded from doing so

Firm-level employment growth (percentage points) after a 10% productivity increase



Number of Firms by employment size in France



- Recent work by the OECD (2023) shows that the ability of a firm to expand – either in their domestic market, or into foreign markets – is a key enabler of firm growth following productivity enhancing investments
- Conversely, Gariciano et al (2013) show that size related thresholds for regulations can distort patters of firm growth, with significant implications for productivity, wages and GDP

Secondly, we need to make sure that market frameworks do not inadvertently distort investment decisions *within* firms

It is often argued that publicly listing on the stock exchange reduces investment through excessive dividends, because shareholders are short-termist, or executives reduce investment to boost share price and hence also their pay.

But DBT commissioned analysis suggests that this not the case (or at least the evidence for this is very weak).

This is an interesting example of where our prior assumptions about the distorting effects of corporate governance rules may be wrong

Company Status

Compared to privately owned firms, publicly listed companies:

- **Invest up to 1% more of their assets in R&D**
- Invest up to 1.2% less of their assets in plant and machinery

Share Repurchases

Between 2007-2017:

- **No relationship between share repurchases by UK firms and their investment**
- Instead, a lack of perceived investment opportunities drove share repurchases

Executive Pay

- Incentive schemes do affect CEO effort, **but CEOs do not generally change investment rates to boost pay**
- It is rare that investments substantially influence firm outcomes enough to affect whether performance targets are achieved

Hurdle Rates

- Evidence suggests that average hurdle rates used by firms exceed the cost of capital
- But according to Bank of England analysis, some businesses demand a lower return than the cost of capital

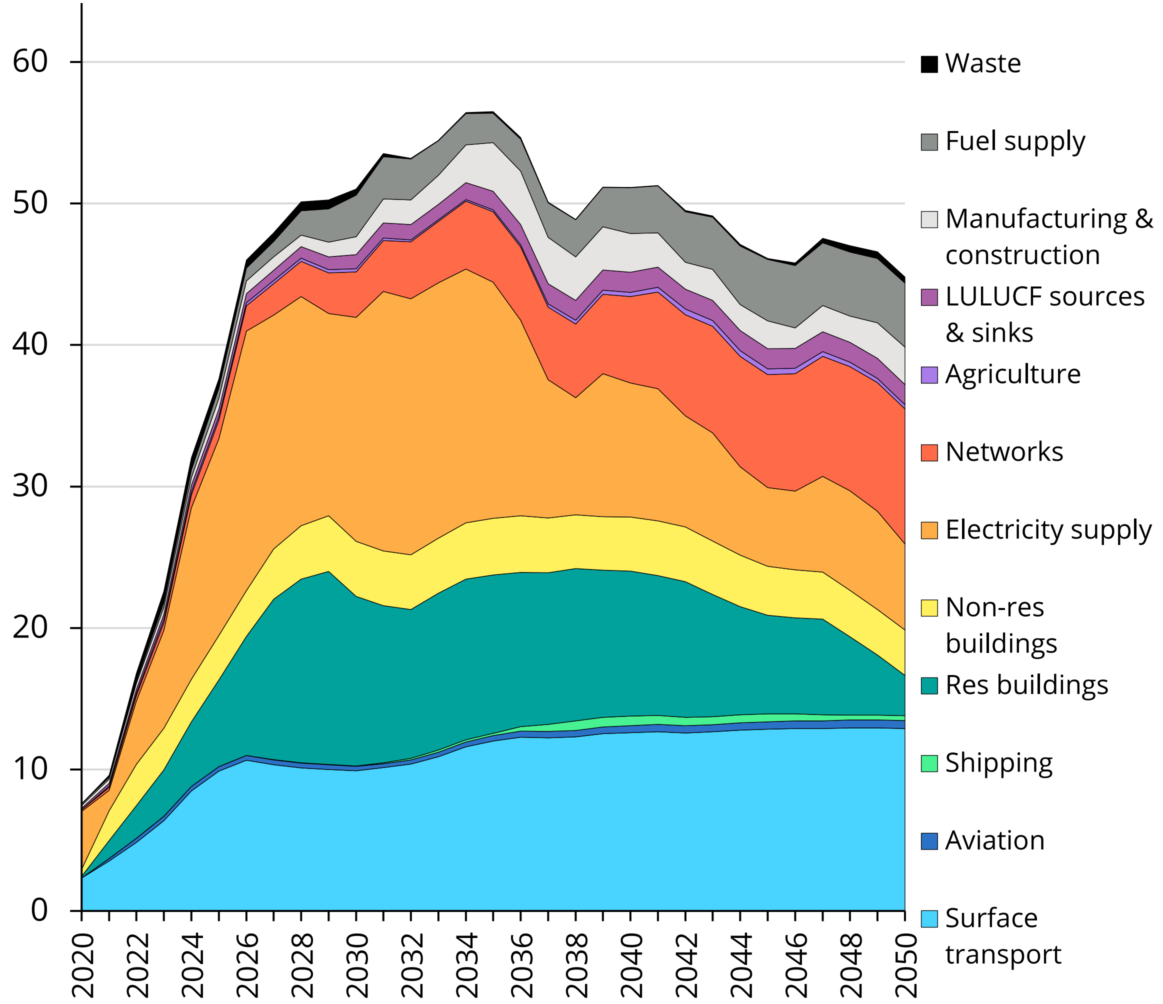
Thirdly, market frameworks can be used to *direct* investment towards activities which align better with our policy goals (e.g. Net Zero)

- Delivering Net Zero has (rightly) been identified as a major investment challenge
    - In the UK capital investment must ramp up to around 2-3 times larger per year through the late 2020s and 2030s

- While some of this is entirely new capital stock to meet new demands, a significant part is about changing the composition of our capital stock towards lower carbon options

- Regulation plays an important part in the process by helping direct investment into the development, diffusion and adoption of the types of technologies we need

CCC estimated additional capital investment requirement (£bn per year)



Putting it all together

Summing up – Market frameworks are very important, but when it comes to investment – they are necessary but not sufficient

- Competition and regulatory frameworks can have powerful impacts on firm behaviour – and are central to making modern market economies work effectively

- But, *in general*, they do not directly affect firms' decisions to invest

- However, they can be important enablers of factors that do matter e.g.
  - Ensuring that firms who want to invest to grow can do so
  - Not creating perverse incentives for business decision makers
  - Help direct investment towards technologies and solutions which align with our wider objectives