UK Government Green Paper: *Building Our Industrial Strategy*

Submission by the Council of Economic Advisers to the First Minister of Scotland, regarding Institutions to Support Patient Capital and Economic Development

Introduction

1. The Council of Economic Advisers (CEA) is an independent advisory group to the First Minister of Scotland. In our role, we provide advice on actions the Scottish Government could take to improve the competitiveness of the Scottish economy, and on actions to tackle inequality. In this regard, we act as a critical friend: challenging the policies of the Scottish Government and putting forward suggestions, which members of the Council believe could make a difference.

2. In our meeting in January this year, we considered a number of issues related to patient capital[1], following a discussion led by Professor Mariana Mazzucato. In particular, our discussion focused on the institutions that support provision of patient capital in Scotland, and the constraints faced by the Scottish Government in supporting development in this area.

3. We recognise that this is a topic where there are interactions across several pillars of the Green Paper, of relevance to a number of facets of the broader productivity and sustainable regional growth agendas. We welcome the recognition within the Green Paper that of the need to increase growth and productivity across the UK. We also welcome the recognition that different parts of the UK face different challenges when it comes to increasing productivity and closing growth gaps – with the implicit recognition that a one-size fits all approach to these challenges is unlikely to be successful. We also welcome the emphasis placed on creating the right institutions to bring together sectors and places, and the need to have the right institutions in place to support growth.

4. With this in mind, we offered to provide an independent submission to the consultation on the Green Paper. Rather than provide a response to each pillar of the UK Government's approach, we have focused on support for patient capital within a devolved context, and the constraints within the current UK institutional arrangements. As such, the views expressed here are those of the Council, rather than of Scottish Ministers.

Scotland's Performance in Business Formation, Scale, Investment, and Infrastructure Investment

5. Issues around patient capital impinge on a number of areas fundamental to long term growth, and the central pillars of the Green Paper, where Scotland's performance lags behind that of the UK:

[1] Patient capital is the name given for long term capital, where investors are willing to forgo shorter term, immediate returns in anticipation of more substantial returns in later periods.

- **Upgrading Infrastructure**: infrastructure quality is generally recognised as a significant impediment to growth in the UK[2], and one which is recognised by the Green Paper. However, there is also evidence that infrastructure expenditure is skewed in the UK towards London and the South East. For instance, expenditure on transport infrastructure in London is over five times greater per head of population than in Scotland.

- **Investing in Science, Research and Innovation**: While Scotland's higher education expenditure on R&D as a proportion of GDP is amongst the highest in the OECD, business expenditure on R&D (BERD) is amongst the lowest, and significantly below the UK rate (with the UK itself having a relatively low rate of BERD as a share of GDP internationally).

- **Supporting Businesses to Start and Grow**: Scotland's *business birth rate* is significantly below that for the UK[3]. Scotland also consistently lags behind UK overall in terms of *high growth enterprises* as a share of the business base[4] - in 2014, 7.2% of the UK business base were high growth firms, compared against 6.7% for Scotland.

  Business investment as a percentage of GDP has fallen over time for Scotland, and has been between 7-8% of GDP since 2003[5], a consistently lower level than that for the UK, whose rate of business investment is itself low by international standards.

6. There is evidence of a persistent funding gap in the provision of microfinance, debt and early stage equity for SMEs, although the precise scale and nature of the funding gap changes over time reflecting two broad factors:

   i. Cyclical gaps in lending that affect a range of SMEs and reflect changes in economic conditions and regulatory requirements; and,
   ii. Long-standing structural gaps that primarily affect certain types of firms (e.g. start-ups, early stage high-growth companies and technology-intensive firms).

7. The annual lending gap in the debt market is estimated to be approximately £470 million annually[6] with specific gaps identified for microfinance, and lending to SMEs in the ranges £20k - £100k and £100k - £1 million. Evidence also suggests there are systemic gaps for SMEs seeking early stage risk capital in amounts up to £10 million.

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[2] See, for instance, the findings of the LSE Growth Commission reports, 2013 and 2017.

[3] The VAT/PAYE registration rate per 10,000 adults for Scotland was 49 in 2015 – compared to a rate of 72 for the UK. The registration rate per 10,000 adults in Scotland has been consistently lower than that for the UK, representing 67% of the UK rate in 2015. (Source: ONS Business Demography, 2015)

[4] ONS defines high growth enterprises as enterprises with average annualised growth greater than 20% per annum, over a three year period. Growth can be measured by the number of employees or by turnover. For this analysis growth has been measured using employment.

[5] Scottish Government (2017), *Quarterly National Accounts Scotland*.

[6] 'Ex-ante Assessment of Financial Instruments in Scotland', Scottish Government, 2015 and 'Ex-ante Assessment of the EU SME Initiative', European Commission, December 2013.

8. Evidence also highlights the importance of demand for finance among SMEs, including high growth SMEs, including evidence of some firms that plan on growing being reluctant to use external finance[7]. Some studies also point to high growth SMEs preferring to use internal resources and borrowing rather than equity finance[8], and having a reluctance to use external finance, even to fund growth. The evidence also suggests that aversion to using external finance declines with business size[9]. This is partly attributed to risk aversion, particularly around loss of control, partly to a lack of competition and a resulting service gap on the part of commercial banks. Key reasons cited by Scottish SMEs for not applying for finance include: not wanting to take on additional risk, perceived cost, time/ effort required and anticipated rejection[10].

9. The balance of investment finance across the UK is also skewed by economic geography. Scotland (as well as the North East, South West and Wales) has a higher share of bank lending by both value and volume compared to its share of the business population. Equity investment is concentrated in London and the South East and their share of total equity investment has increased in recent years. London's share of equity investment by both number of deals (48%) and value (59%) is significantly overrepresented when compared to its share of UK businesses (18%).[11]

Government Support for Patient Capital and Investment Finance in Scotland

10. The Scottish Government and its partners undertake a sizeable capital investment programme each year, informed by the Infrastructure Investment Plan. This plan sets out strategic, large scale investments to be taken forward within each sector over the next 20 years.

11. Capital investment is currently funded through a combination of the Scottish Government's capital budget, borrowing powers, revenue funded investment through their Non-Profit Distributing investment programme, Regulatory Asset Base rail enhancements, and capital receipts. Work is also on going to explore approaches to financing infrastructure investment including Tax Incremental Financing and Growth Accelerator schemes, use of guarantees and loans, and equity investments using financial transactions funding. Substantial use has also been made of European funding to support infrastructure development, particularly in more remote parts of Scotland.

12. The Scottish Government and its agencies undertake a range of activities to support access to finance in Scotland. The current approach is based around increasing the level of funding available to SMEs, expanding and deepening financial support and advice for SMEs, and providing easier access for SMEs

[7] Scottish Government (2015), The Market for SME Finance in Scotland.
[8] Brown, R. and Lee, N (2014), Funding Issues Confronting High Growth SMEs in the UK, ICAS, Edinburgh.
[9] SME Finance Monitor, Q4 2016, BDRC Continental: http://bdrc-continental.com/BDRCContinental_SME_Finance_Monitor_Q4_2016_Final.pdf
[10] Small Business Survey 2015.
[11] British Business Bank (2017), Small Business Finance Markets Report 2016/17: http://british-business-bank.co.uk/small-business-finance-markets-report-201617/

seeking finance. This approach includes direct actions by the Scottish Government through the SME Holding Fund to increase the supply of microfinance, debt and equity to SMEs, as well as implementing measures to increase the capacity and capability of Scotland's business angel market. Scottish Enterprise also operates a number of initiatives to directly incentivise business innovation, and commercialise R&D from Scotland's universities and research base.

13. Further important initiatives by Scottish Government include steps to establish a Scottish Growth Scheme, to provide guarantees and loans to young companies seeking to grow, and to firms looking to expand internationally and open new markets.

14. Substantial use has also been made, and continues to be made, of European funding, particularly from the European Regional Development Fund. As things stand, this limits the potential for use of self-funding vehicles, and the extent to which receipts from successful investments can be used to support wider economic development activities. Brexit could have significant implications for support for business development funding (and infrastructure investment) in coming years as EU funding has been an importance source of capital for many business development initiatives.

<u>International Approaches to Patient Capital and Investment Finance</u>

15. International experience suggests that there are a number of approaches to supporting patient capital for business development, and investment finance. In particular, there are a number of examples of public banks and funds currently operating within Europe[12], which operate as cornerstones of industrial policy within those countries. Broad groups include: investment funds, with a remit to assist SME development; public financial institutions, that focus on business development but operate a number of funds; and public banks, who also undertake investments in infrastructure, lend to local authorities, and other operations.

16. National Promotional Banks (NPBs) are an important policy tool in a number of European countries, offering loans and equity support to SMEs either directly, or in an intermediary capacity, usually via commercial banks (in the form of guarantees) in order to ensure complementarity and avoid duplication of private sector provision. While most NPBs are involved in SME financing and lending, a small number also provide lending for other purposes, such as to local authorities to invest in infrastructure and through public-private partnerships.

[12] 'Business Development Banks and Funds in Europe: Selected Examples', European Policies Research Centre, University of Strathclyde, March 2014. Examples include the *Austria Wirtschaftservice*; France's *Bpifrance*; Germany's *National Kreditanstalst fur Wiederaufbau*; Spain's Instituto de Credito Oficial; the *Vaekstfonden* in Denmark; and the *Strategic Banking Corporation of Ireland*.

17. The importance of NPBs in encouraging and incentivising investment is increasingly widely recognised[13] and a number of countries have established NPBs as a key cornerstone of industrial policy. In exercising their roles, NPB's carry out a variety of economic functions[14]. These include:

- Addressing market failures such as lack of access to finance for SMEs by providing microfinance, debt, guarantee and equity solutions;
- Providing countercyclical financing during periods of economic and financial crisis and catalysing long term finance, for example, the role of Germany's KfW bank in supporting energy investment in recent years;
- Providing long term patient funding for capital projects;
- Targeting investments in high-risk R&D, innovative start-ups, and lengthy innovations, areas that private capital may be too short-termist and risk-averse to venture into;
- Promotion of investments that help address complex societal problems, and providing mission-oriented finance.

18. Within the UK, the British Business Bank (BBB) carries out a number of the functions associated with an NPB. The BBB was formed in 2014 and independently manages the UK Government's access to finance programmes for SMEs within a single commercially-minded institution. It does not finance businesses directly, but instead through its commercial arm, British Business Bank Investments Ltd, makes investments into providers of finance who disburse funds and guarantees to private sector partners, enabling them to finance more smaller businesses (either through debt or equity).

19. In its recent report, the LSE Growth Commission highlighted that, despite the UK financial system's overall strengths, there remain long running issues in both the provision of finance to firms with high growth potential, and for infrastructure projects. In particular, it highlighted the relatively small scale of the BBB's funds available, and the lack of a dedicated infrastructure bank within the UK overall[15].

20. The recent commitments made to expand the BBB, and the BBB's commitment to look to support investment across the UK, are both welcome. However, the Council does not believe that this will be sufficient to address the particular challenges around encouraging investment faced specifically in Scotland or in individual regions within the UK, or to ensure that products provided are particularly tailored to the needs and challenges faced by different parts of the UK. This may particularly be a risk if the approach adopted is one of allocating a quantum of funding to individual regions or nations of the UK. Given the challenges posed by the EU referendum result, and the clear issues for Scotland

[13] European Commission (2015), *Working together for jobs and growth: The role of National Promotional Banks (NPBs) in supporting the Investment Plan for Europe*.
[14] A suggested typology of the roles played by Development banks, and their economic rationale, is found in Mazzucato and Penna (2016), "Beyond market failures: the market creating and shaping roles of state investment banks", Journal of Economic Policy Reform.
[15] LSE Growth Commission (2017), *UK Growth: A New Chapter.* http://www.lse.ac.uk/researchAndExpertise/units/growthCommission/documents/pdf/2017LSEGCReport.pdf

in both of these areas, it is important that Scottish Government has sufficient latitude to investigate how best to deal with these issues.

Constraints on a National Promotional Bank Approach

21. At present, there are a number of constraints that would impinge upon a decision over whether to establish an NPB, many arising as a result of policy choices by the UK Government[16].

22. In most cases, NPBs are financed and supported by the State, which creates a competitive advantage over private market participants. Currently, state aid approval by the European Commission would be required before an NPB could be established, although it is worth noting that the Commission has encouraged and has produced guidance to Member States to set up new NPBs, building on best practices. EU State aid rules are designed to ensure that the interventions of NPBs are well-targeted to remedy market failures and thereby contribute to economic and financial development, while at the same time not distorting markets, crowding out private operators or keeping companies alive that would otherwise have exited the market.

23. Regarding the establishment, remit, and capitalisation of new NPBs, recent decisions by the Commission set out how the Commission assesses compatibility with State aid rules. Recent cases include the UK's Green Investment Bank, the BBB, the Portuguese Development Financial Institution, and the Latvian Single Development Institution. In those decisions, great emphasis was placed on the need to ensure that the NPBs in question will focus their operations on sectors where market failures are pervasive and which are thus underserved by commercial finance providers, typically banks, thereby avoiding the risk that those NPBs' lending policy would crowd out private investment.

24. The governance structure underpinning the institution would need to be determined in advance of its establishment. This would include establishing the extent of government control, through the institution’s memorandum, its shareholding structure, initial appointments to the institution’s board and subsequent appointment arrangements, supervision arrangements, and control of financing decisions. These are each important for the delivery of the institution’s objectives.

25. Ownership and control are also key determinants in deciding whether a national promotional bank would be public or private sector. Sectoral classifications for national accounts purposes would follow on from any assessment of ownership, governance and control arrangements. In the UK, this decision would be made by ONS, who would decide on whether the body sits within the public sector (either as a non-departmental public body or a public financial corporation) or within the private sector (based on criteria set out in ESA10 and the accompanying Manual for Government Deficit and Debt). The decision made by

[16] A helpful overview of the constraints present in a devolved administration context is provided by the New Economics Foundation’s publication, *Blueprint for a Scottish National Investment Bank*. http://allofusfirst.org/tasks/render/file/?fileID=3B9725EA-E444-5C6C-D28A3B3E27195B57

ONS could constrain the activities of the bank as a result of the impact on public finances and the budgeting arrangements that are determined by that classification decision.

26. Under current budgeting rules, the outcome of the classification process would dictate the budgetary treatment of a NPB and may also place significant constraints on the degree of financial manoeuvrability that the organisation could deploy. For instance:

    - **Private Sector Classification:** Initial and any subsequent capitalisation of an NPB by government would score against public sector budgets. Subsequent transactions of the body would not impact on public finances. However, there would be no on-going public sector control and therefore limited scope to meet future policy imperatives.

    - **Public Sector Classification – Public Corporation:** Initial and any subsequent classification would score against public sector budgets. Running costs and other transactions would not impact on public sector budgets and the body would have the ability to carry forward and deploy reserves without incurring the need for government budgetary cover. External Borrowing would score against government capital budgets and public sector net debt.

    - **Public Sector Classification - Central Government:** Loans made by the NPB would score as they were issued. Running costs and other transactions would fail to be recorded directly against public sector budgets. There would also be limited ability to carry forward and deploy significant reserves.

27. HM Treasury could offer additional flexibility in the budgeting arrangements of a new NPB, to allow better alignment of policy priorities with and budgeting treatment with a publicly classified body. We note that there are recent examples of where HM Treasury has granted exemptions to rules around in-year funding and recycling of funds, although we recognise that these have been the subject of detailed legal and financial negotiation. However, we would suggest that it is important to recognise the challenges for economic development outlined earlier, and that the potential loss of access to EU funding for business development and infrastructure projects post-Brexit has the potential to significantly impact on efforts to support and encourage long-term investment.

28. Given these challenges, the Council believes that a more flexible approach should be supported, and that there is a strong economic and urgent strategic case for reviewing the arrangements affecting the potential establishment and operation of vehicles to support investment and deployment of patient capital, of the sort that already exist in most major European economies.

Recommendation

29. The Council would suggest that, in taking forward the White Paper on industrial strategy, the UK Government consider the important role of National Investment or Promotional Banks in providing patient, long term capital. These institutions are present in a number of other European economies, and form cornerstone

institutions in the delivery of long term investment to support economic development.

30. We also suggest that these institutions could play a useful complementary role to that already played by the BBB at a UK level, or within a devolved context, in order to reflect and address specific needs or issues faced by different parts of the UK. Within this latter context, and given the important role they can play, we believe there is a strong case for reviewing the arrangements that would influence their establishment, operation, and ability to provide a range of patient capital, including microfinance, loans, equity and guarantees.

31. Finally, we would emphasise that such a change would be crucial to underpinning the wider aspirations for industrial strategy set out in the Green Paper.

Council of Economic Advisers
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