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Analysis

UK Business Investment Continues to Lag Behind Competitors

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

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Abstract

UK business investment is poor and has been for decades, doing untold damage to productivity and limiting the economy's growth. Unfortunately, successive governments have failed to understand the broad range of conditions necessary to encourage entrepreneurs to commit to investment, opting instead to focus almost exclusively on offering tax breaks. In this article, the author looks at the numbers and what more needs to be done to turn round the UK's investment performance.

Introduction – the hard facts

According to data analysts CEIC Data, investment represented 18.9% of our GDP in September 2023[1]. That placed us 87th out of 116 countries who publish this data, ahead of a variety of nations including a significant number in the midst of armed conflicts, civil wars and political turmoil, but well behind all of our major competitors.

Most of this is business investment, which accounts for about 13% of GDP and which has come far lower than other developed economies for decades. On average, it has been 36% lower than other members of the G7 since 1990 according to a report[2] published in 2023 by The International Monetary Fund (IMF).

Looking in particular at recent disruptions caused by Brexit, the pandemic and the invasion of Ukraine, the IMF analysis also confirmed that in real-terms, business investment in the UK was marginally lower by the end of 2022 than it was in 2016. By comparison, the other G7 economies have achieved a 14% increase on average over this period.

This decline was dominated by a fall in investment in equipment and machinery, including information and communications technology equipment. This fell from around 8% of Gross Domestic Product (GDP) in 1987-97 to less than 4% from 2009 onwards, the lowest share in the G7.

Additionally, the share of Research & Development (R&D) expenditure over the past thirty years has been falling in the UK and is now below 2% of GDP. Data suggest that UK R&D spending is relatively low compared with other G7 countries. For example, Japan spends 3.5% of its income on R&D, while Germany and the United States spend approximately 2.8%.

Why business investment matters

The causal link between business investment and GDP growth is a given among economists, though putting hard numbers on it can be difficult. The UK government's Plan for Growth from 2021 refers to a study[3], which implies that a 10% increase in infrastructure capital spending leads to an increase in GDP in the range between 1% and 2%.

Other academic research has found that the elasticity of GDP in relation to the stock of capital in an economy is between 0.2 and 0.3, so that a 10% rise in the UK's capital stock would raise GDP by between 2% and 3%.

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Given that the latest predictions from the respected EY Item Club and IMF call for a rise in UK GDP of 0.9% and 0.5% respectively for 2024, we are in serious need of a rapid improvement in business investment levels. To put this in context, the 30-year trend since 1993 shows that the UK economy has grown by an average of 2.1% per year over that period.

Why do entrepreneurs invest?

Amid all the academic debate and behavioural analysis, three fundamental factors lie behind positive investment decision-making:

- Confidence;
- Natural instinct to grow a business; and
- Understanding that all businesses eventually wither and die without ongoing investment.

Those may be the primary drivers, but what business owners and managers also need are a broad range of pre-requisite conditions and incentives. The problem is that successive governments stretching back decades seem to be hung up on just one sort of incentive and have consistently failed to listen to the business community about what really matters to them.

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The government is obsessed with tax incentives and targeted grants

The independent thinktank, the Institute for Government reported recently that current government thinking is that tax incentives supported by a stable economy are the major influences on entrepreneurs. There is also a less significant but regular flow of high profile, one-off targeted financial support for certain major projects, such as the building of the new all-electric mini by BMW at Cowley, or the modernization of the iconic Port Talbot steel works.

The National Audit Office reported[4] in January 2024 that it had identified 39 different ongoing tax incentive schemes aimed at encouraging business investment activity, of which it was able to identify a cost of £16.6 billion for the 29 schemes it could quantify. Unfortunately, there is no comprehensive data available on the economic or social benefits these schemes generate, although the UK is not alone in flying blind on tax incentives. Few governments around the world carry out any serious analysis; cynics might suggest that this is because politicians know they won't like the answers they would get.

What is on the incentive's agenda of business leaders?

Ask entrepreneurs what creates the right conditions for signing off on an investment project and a rather broader view emerges. Tax incentives like the previous 130% 'super deduction' for capital expenditure and its replacement by 'full expensing' are welcome, but rarely come anywhere near the top of business leaders' shopping lists.

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Other factors come above tax breaks, notably:

- the availability of sufficient skilled labour;
- the existence of effective local transport and other infrastructure, and access to affordable housing;
- cost of borrowing and access to finance; and
- the degree and nature of regulation.

Above all else, what makes businesses invest is a tolerable level of economic and political certainty, or at least the absence of too much uncertainty.

Policy uncertainty

Endless policy change is an important factor in creating commercial short-termism and putting up unnecessary barriers to investment. Setting aside the structural distortion of Brexit, there have been decades of regular changes in official thinking on key topics such as industrial strategy, regional policy, business advice, skills development and so much more.

There is no more graphic illustration of these shifting policy sands than the saga of the northern legs of the embattled HS2 rail project. Never mind what the postponement of bringing the line into Euston until the 2040s at the earliest has done to the thriving business community of an entire neighbourhood close to the station. The major damage is becoming clearer as the impact of cancelling any

works north of Birmingham on the 'levelling up' agenda unfolds, especially the lost opportunity urgently to improve the pitiful transport infrastructure in the North of England.

Government capital spending budgets have been raised, slashed, and raised once more. Policy on business taxation seems to shift almost with every Budget. Capital allowances, the treatment of small businesses, dividend taxation and capital gains taxes have all been 'reformed' at one time or another. Changes to local planning regimes pile opacity on complexity, while the inability of local authorities to fund adequate resources for the system generates a downward spiral of gross inefficiency. The housebuilding and renewable energy sectors are understandably bewildered.

Borrowing aversion among SMEs

SMEs are responsible for close to half of UK business investment. The British Venture Capital Association[5] surveyed smaller businesses in 2023 about their borrowing habits and was startled to find that almost half of their respondents described themselves as "permanent non-borrowers", while 75% confirmed that they would rather have a lower rate of growth if it meant that they could fund the expansion of the company from their own resources, rather than loading extra debt onto their already fragile balance sheets.

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Nevertheless, our recent research[6] into the finances of consumer-facing sectors such as retail and hospitality showed that borrowing by smaller businesses had already increased by a factor of two or three times during Covid as they took up Bounce Back Loans and other facilities provided by the government designed to help them get through the pandemic. The understandable instinct of these companies will be to focus on repaying these loans, rather than ramping up their borrowings, especially now that interest rates are so sharply higher.

What hope is there for any meaningful a rise in business investment?

At first glance, the prospects might be described as 'mixed' at best and in reality, 'poor' on the basis of the prevailing short term economic and political environment. Nevertheless, not investing at all is a doomsday option for those who run businesses, which will lead eventually to their extinction. The bigger issue is not the basic ongoing investment in preserving the fabric of a commercial enterprise, it's persuading risk-averse, hard-pressed entrepreneurs to commit to the type of capex that grows a business and most importantly of all, improves its productivity.

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