ICAEW
REPRESENTATION 87/23

CALL FOR EVIDENCE: NIESR PRODUCTIVITY COMMISSION

Issued 6 September 2023

ICAEW welcomes the opportunity to respond to the *Call for Evidence: Productivity Commission* published by the National Institute of Economic and Social Research, a copy of which is available from this link.

For questions on this response please contact us at representations@icaew.com quoting REP 87/23.

This response of 6 September 2023 has been prepared with input from Economies, Corporate Finance Faculty, Tax Faculty, Insights, the Business and Industrial Strategy team, and the Practice Committee of ICAEW. ICAEW response has focused on business investment issues within the consultation.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 166,000 chartered accountant members in over 146 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

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The Corporate Finance Faculty is ICAEW's centre of professional expertise in corporate finance. It contributes to policy development and responds to consultations by international organisations, governments, regulators and other professional bodies. The faculty provides a wide range of services, information, guidance, events and media to its members, including its highly regarded magazine *Corporate Financier* and its popular series of best-practice guidelines. The faculty's international network includes member organisations and individuals from major professional services groups, specialist advisory firms, companies, banks and alternative lenders, private equity, venture capital, law firms, brokers, consultants, policymakers and academic experts. More than 40 per cent of the faculty's membership are from beyond ICAEW.

As a leading centre for thought leadership on financial services, the ICAEW Financial Services Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk, auditing and reporting issues facing the financial services sector. The faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

Internationally recognised as a source of expertise, the ICAEW Tax Faculty is a leading authority on taxation and is the voice of tax for ICAEW. It is responsible for making all submissions to the tax authorities on behalf of ICAEW, drawing upon the knowledge and experience of ICAEW's membership. The Tax Faculty's work is directly supported by over 130 active members, many of them well-known names in the tax world, who work across the complete spectrum of tax, both in practice and in business.

The Insights team provide advice and expertise across ICAEW on all aspects of market opinion, research and insight. This includes ICAEW's Business Confidence Monitor 'BCM', one of the largest and most comprehensive quarterly surveys of UK business activity. BCM is based on 1,000 responses per quarter from ICAEW's chartered accountants, senior business professionals in industry and across the economy, covering a comprehensive range of UK sectors, regions and company sizes to ensure a representative picture of the UK economy. BCM includes nearly 30 indicators on business conditions and the health of the UK economy, from the headline business confidence measure to indicators of inflation, wages, labour market and investment.

SUMMARY OF KEY POINTS

- ICAEW's Business Confidence Monitor (BCM) - one of the largest and most comprehensive quarterly surveys of UK business activity - shows that growth in business investment has been particularly lacklustre since the global financial crisis.
- ICAEW's latest BCM covering Q2 2023 shows that growth in capital investment spending has been on a downward trend over the last year and businesses expect to further moderate their capital spending over the next 12 months.
- ICAEW's latest BCM found that access to capital was a growing concern among businesses. In Q2 2023,16% of businesses cited access to finance as a growing challenge, up from 9% in Q2 2022.
- Businesses tend to be more successful with funding applications made via accountants, business advisers or qualified brokers, as these intermediaries have a good understanding of the wider funding marketplace.
- Considerations for Government to improve access to finance for businesses:
    - Explore a new version of the Growth Voucher Scheme that closed to new applications in March 2015. That scheme was successful in helping small businesses access strategic advice around financing
    - Enable larger Start-Up Loans via the British Business Bank (the threshold of £25k is unchanged since the start of the scheme in 2012) and simplification of the guarantee support
    - Signpost sources of trusted business advice such as ICAEW's Find a Chartered Accountant, and point SMEs to Growth Hubs and Chambers of Commerce in SMEs' registered office locations
- When looking to invest, businesses are primarily looking for certainty. This can be at least partially achieved by avoiding changing rates and rules too often.
- The capital allowances system primarily rewards rather than incentivises capital investment because it provides a benefit after the expenditure has been incurred. Incentivisation might be achieved more effectively by providing upfront cash incentives rather than subsequent tax relief.
- Many businesses looking to invest would benefit just as much from simplification of the tax system as they would from being provided with additional tax incentives.
- If the government wishes to incentivise capital investment, it would be most effective if incentives were focused on particular types of expenditure, industry sectors or geographical areas.

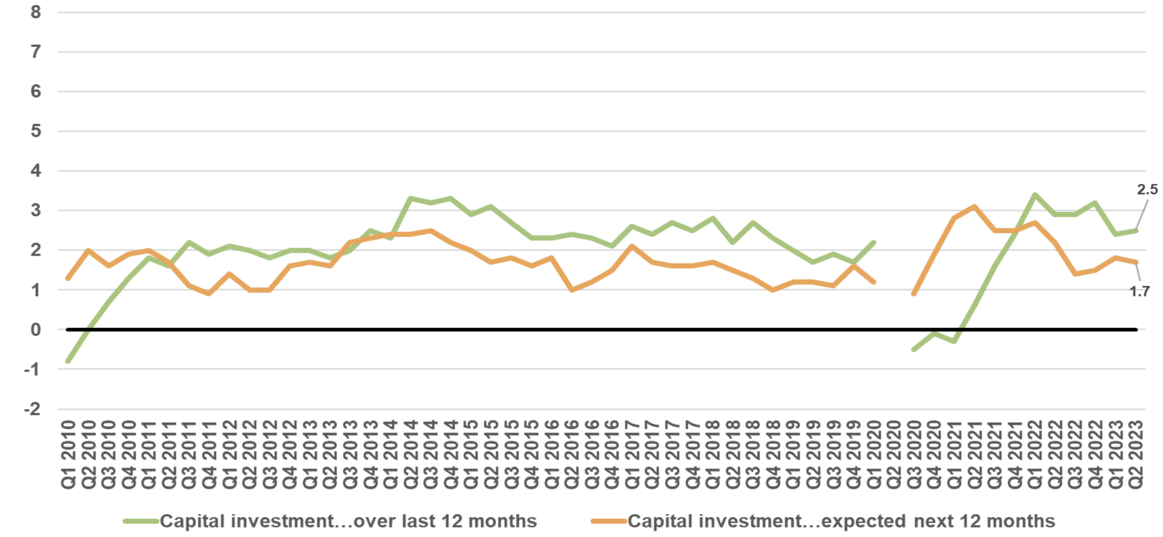
SIZING BUSINESS INVESTMENT SHORTAGES

1. ICAEW's Business Confidence Monitor (BCM) - one of the largest and most comprehensive quarterly surveys of UK business activity - which shows that growth in business investment has been particularly lacklustre since the global financial crisis (GFC).

2. From 2004 to mid-2007, average annual growth in capital investment as measured by ICAEW's BCM stood at 2.8%, in the three and half years that followed it fell to 0.7% and over the full 15 years since it has averaged just 1.8%. The picture varies greatly across sectors, investment growth in the property sector, for instance, stood at 4.5% pre GFC, in the immediate aftermath it fell to 0.3% and over all the years since it has only recovered to 2.5%. This story ties in with the slowdown in productivity that the UK has experienced ever since the GFC. Although there has been some degree of recovery, the ground lost in the late 2000s has never been fully regained, and the later shocks of Brexit, Covid-19 and the Russia-Ukraine war have only compounded this.

3. ICAEW's latest BCM covering Q2 2023 (fieldwork period between 27 March and 23 June 2023) that growth in capital investment spending has been on a downward trend over the last year, dropping from 2.9% annual growth in Q2 2022 to 2.5% in Q2 2023 (see Chart 1).

Chart 1: Capital Investment, annual percentage change, over the last 12 months and for the next 12 months

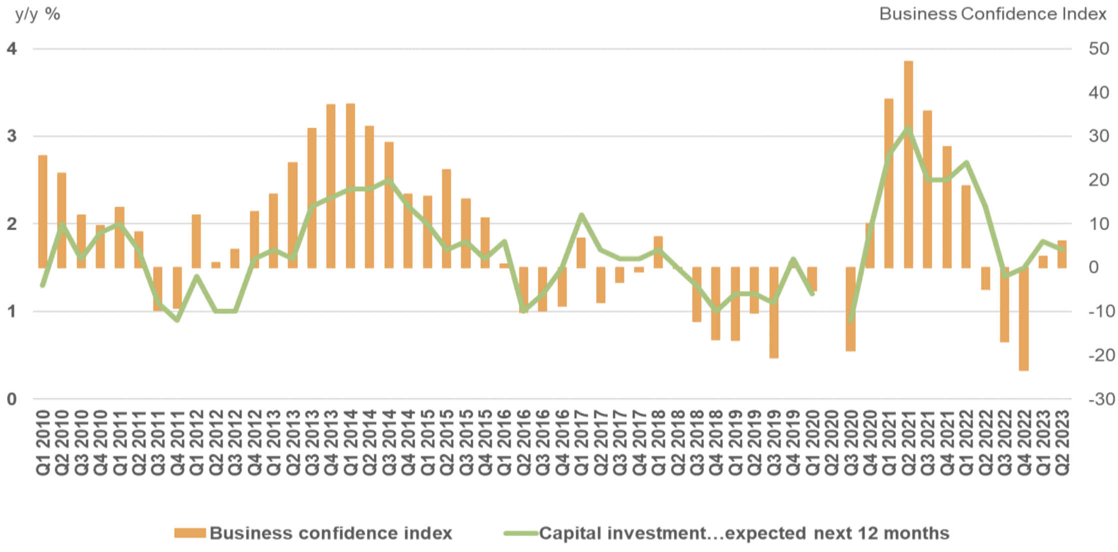


* = data unavailable for Q2 2020

Source: ICAEW BCM

Annual growth in staff development budgets from fell 2.4% to 1.9% and research and development budgets dropped from 2.4% to 1.6% over the same period. This reflects slowdowns in profits and domestic sales and a lack of clear upward momentum in business confidence (see Chart 2).

Chart 2: ICAEW Business Confidence Index (How would you describe your confidence in the economic prospects facing your organisation over the next 12 months, compared to the previous 12 months?) and Capital Investment expected over the next 12 months, annual percentage change*



* = data unavailable for Q2 2020

Source: ICAEW BCM

Alongside this, there has also been an upward trend in the proportion of businesses operating below capacity, which means that fewer businesses need to invest to meet existing or future demand.

4. Looking ahead, businesses expect to further moderate their increase in capital spending, with growth averaging 1.7% in the year to Q2 2024 – down from 2.5% reported in Q2 2023. Businesses are not, however, expecting to see further cuts in their R&D budgets. However, at 1.6%, the growth in these is far from rapid.

FINANCING BUSINESS INVESTMENT

5. ICAEW's Business Confidence Monitor (BCM) for Q2 2023 found that bank charges and access to capital were growing challenges. In Q2 2023,16% of businesses cited access to finance as a growing challenge, up from 9% in Q2 2022. Similarly, 19% of businesses highlighted bank charges as a greater concern in Q2 2023, up from 11% in the same quarter a year earlier.

6. By sector, ICAEW's BCM found that difficulties with access to capital were most predominant in the property sector where 32% of firms reported problems in Q2 2023, a three-fold rise compared to Q2 2022 (10%). Concerns were second highest in Construction and 'property and business services' firms (both 20%), followed by energy, water & mining (19%). In contrast, transportation and storage and business services firms reported the fewest problems, with just 10% of respondents from these sectors reporting issues.

7. Regionally, ICAEW's BCM revealed that problems with access to capital in Q2 2023 were most prevalent in London where 22% of firms reported problems (partly reflecting the importance of the property sector in the capital), followed by the East of England (20%) and the North West (17%). In contrast, firms in Scotland and Wales reported the fewest problems with access to capital, with just 12% of respondents from the region reported issues.

8. ICAEW's BCM for Q2 2023 found that concerns with access to capital were most prevalent among small firms where 21% of respondents reported problems, almost double the

proportion who reported issues in Q2 2022 (11%). Difficulties over access to finance were second highest among medium size firms (19%), followed by large businesses (14%). While just 12% of micro firms reported difficulties in Q2 2023, this was still up sharply from 7% in Q2 2022.

9. Feedback from ICAEW members suggests that there is a lack of awareness of funding options. The external finance landscape, including banking, is complex and disparate, and it is difficult to maintain awareness of the range of options that are available. SMEs do not always have the network, internal resources or expertise to research suitable funding options. Smaller businesses find it hard to know who to speak to other than their bank. If they engage a broker, this will not necessarily open up the whole market. Where they have access to one, SMEs often rely on an accountant or adviser to identify the right option.

10. Portals and hubs are useful signposting resources. ICAEW, other professional bodies and business associations including UK Finance, as well as the clearing banks and others have online resources accessible to SMEs. The British Business Bank engages closely with intermediaries and through communication channels of business and finance provider organisations to make information available. ICAEW has a long record of providing substantial resources on sources of funding, including the Business Finance Guide.

11. Businesses tend to be more successful with funding applications via accountants, business advisers or qualified brokers, as these intermediaries have a good understanding of the wider funding marketplace. Some funding channels may also not be open to direct approaches. Knowledge of the business gained from an existing relationship with the business is a key factor for ensuring the appropriateness of the financial solution.

12. Financial innovation can play a key role in helping businesses fund investments. Open Banking has the potential to improve access to finance for SMEs. Providing the opportunity for an SME's financial and transactional data to be shared with third parties in real time, should improve the quality of credit applications, streamline the process and open up the market to non-bank lenders who do not have a current account offering. Greater work is needed to standardise open banking data for SMEs, and we would encourage further work on an industry standard. The Bank of England is supporting the development of an open platform for SME finance, which brings together a global identity standard, and a secure and permissioned method of sharing information. We believe this is a positive step but would like to see the initiatives' timescales accelerated.

13. Suggestions for government action to help firms access the funding they need emanating from ICAEW's member outreach and engagement include:

- Explore a new version of the Growth Voucher Scheme that closed to new applications in March 2015. That scheme was successful in helping small businesses access strategic advice around financing
- Enable larger Start-Up Loans via the British Business Bank (the threshold of £25k is unchanged since the start of the scheme in 2012) and simplification of the guarantee support
- Signpost sources of trusted business advice such as ICAEW’s Find a Chartered Accountant, and point SMEs to Growth Hubs and Chambers of Commerce in SMEs’ registered office locations
- Support Local Enterprise Partnerships (LEPs) to provide regularly maintained data on available finance. After receiving this suggestion from members, the government confirmed its decision to withdraw funding for LEPs from April 2024 and transfer their functions to local and combined authorities. It is vital that the government ensures continuity of the service of raising awareness of available business finance that has hitherto been carried out by LEPs.

- Keep under review the investment parameters and outcomes of the British Patient Capital Fund to ensure that the funding, and any potential extension the scheme meets the policy objective of supplying genuinely incremental funding and thereby enabling the development of new technologies and markets.

INCENTIVISING BUSINESS INVESTMENT

14. Feedback from ICAEW members is that different businesses have different processes for making investment decisions. Larger businesses in particular have a number of different departments involved in implementing their most significant projects. In many, decisions will be based on the needs of the business at the time, and it is often only subsequently that the financial impact of any relevant decisions is analysed. Even if the business' tax or finance function is involved in discussions at the project planning stage, the capital allowances impact will often only be considered at a high level, using indicative numbers to model the position. Hence, exact rates and timing of allowances generally do not have much of an impact on whether or not a project goes ahead, or the type of expenditure involved in it.

15. Above all else, businesses appreciate certainty in making investment decisions. Capital allowances rules and rates have changed frequently over the past 14 years. The annual investment allowance limit (AIA), for example, has changed six times over that period and is planned to change again next year when it returns to its permanent rate. A degree of stability in the system would allow businesses to take investment decisions with a greater degree of certainty. We recommend making as few changes to the capital allowances system as possible, and that any changes should be announced a few years in advance.

16. One of the major difficulties businesses face in implementing large scale infrastructure projects (especially those involving installation of environmentally friendly technologies, like offshore wind farms) is the uncertainty around what items of expenditure qualify for capital allowances. To incentivise these forms of expenditure, the government should look to examine the tax rules again and provide some form of capital allowances for expenditure on capital infrastructure projects that fails to attract a revenue deduction. This might constitute a whole new area of the capital allowances code (eg 'project management allowances') and a writing down allowances rate could be set at a rate that the government finds affordable. Examples of incentives the government may wish to consider are set out below:
    - Upfront grants and subsidies for particular types of expenditure the government is wishing to encourage. Given that grants are generally taxable, the government would get some of the cost back over time in increased tax receipts.
    - An ability for loss-making companies to surrender allowances for a repayable tax credit, similar to that provided under the SME R&D tax relief regime
    - In-year payable allowances for qualifying expenditure (assessed through a form of advance assurance procedure) which could then be adjusted for when the business' tax return is submitted

17. One of the limitations of the capital allowances system in encouraging investment is its lack of targeting. Some specific incentives remain (such as enhanced allowances for expenditure on electric vehicles) but many of the initiatives that had been in place over recent years have now been repealed. By providing specific allowances for specific types of expenditure, the government could nudge businesses into investment behaviour that helps to meet its strategic policy objectives, such as its net zero targets and the levelling up agenda. Targeted allowances would also be more cost-effective than a blanket increase in writing down allowances, for example, which would cost billions of pounds and may not actually incentivise investment. We believe it is useful to think about this in terms of:

- **Who** - Are there any particular industries that the government is looking to support in making capital investment? Is the government looking to incentivise large multinationals, small businesses or somewhere in between?
- **What** - Does the government wish to encourage expenditure on particular types of assets? For example, to what extent is the government interested in using the capital allowances regime to encourage progression to net zero by 2050?
- **Where** - the government may wish to support its levelling up agenda by providing more generous allowances to businesses operating in particular geographical areas, similar to the enterprise zone system of the 1980s. More power could also be given to local authorities and government bodies to issue grants on a regional basis.