tomorrow's company

Tomorrow's Company response to Industrial Strategy Green Paper

Tomorrow's Company welcomes the Government's green paper on industrial strategy. We support the vast majority of the proposals. We have offered short comments against each question, with a particular focus around pillar IV (Supporting Business to Start and Grow), as the this is the primary research focus of Tomorrow's Company.

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good in society. It believes that business can create more value for investors, other stakeholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. See more detail at tomorrowscompany.com.

General comments

The UK needs a clear vision for wealth creation and the part which business enterprises of all kinds play in contributing to a sustainably successful society. Economically, its people are still paying the price for the banking crisis. It is estimated that their living standards in 2025 will be little higher than 2007. Socially, the country is seeing increasing inequality between the highest and lowest paid, and notably between London and the South East and other parts of the country. Meanwhile vital public services such as education, and health and social care are under budget pressure. There is an acute shortage of housing, and infrastructure needs huge investment. Environmentally the country needs to make a transition to low carbon energy. Educationally it needs to make a major investment in the technical, creative and social skills that any enterprising economy needs.

Over the coming decade there is more turbulence to come, with the prospect of immense change. from the 4th industrial revolution, shifts in geopolitics and the inevitable disruption of Brexit. Disruptive change brings opportunity as well as threat. To succeed in this period of change will require bold action from finance, companies and government, and such action will be more effective if it is inspired by a clear sense of purpose. It will also be more effective it is achieved by thriving and purposeful regions in partnership with local enterprises, mobilising human and financial capital to meet the needs that they see around them, rather than more centralised and less agile policymaking.

Catalyse a cultural shift

Ultimately it is attitudes and values that determine behaviour, not specific corporate structures. As such, the aim of the industrial strategy should be to catalyse a shift in attitudes and values across the corporate landscape, rather than provide a prescriptive plan for UK industry. This should help create greater coordination while still providing the freedom for innovation. At the heart of this attitudinal shift the government needs to declare a clear vision of the kind of companies that it wants to help flourish – companies with a clear understanding of their human impacts, and a focus on purpose, values, relationships and the long-term. If this is clearly understood and applied, it can then inform different areas of policy, from corporate governance to public procurement.

A useful starting point would be setting out clear long-term goals, or the purpose of the strategy. This would help create consistency across a range of small reforms to nudge behaviours. We believe the purpose of the Industrial Strategy should be **to create the optimal conditions for sustainable and widely enjoyed UK prosperity in a fast-changing environment**

Clarity is also needed on the desired change in values and behaviours. We suggest three values that an industrial strategy should seek to promote – a focus on the long term, greater collaboration and an acceptance of risk. The aim of the industrial strategy should be to encourage individuals across business enterprises and government to think longer term, increase collaboration, and to be more accepting of the risk involved in long-term decisions and providing individuals and organisations with greater freedom. Being clear on the desired values and behaviours would help ensure that a range of small measures add up to more than the sum of their parts.

Consistency and continuity
An industrial strategy by its nature needs to be long-term, to provide business with the consistency and continuity in which to plan and invest. This has not always been the case. One participant in discussions pointed out that this is the ninth industrial strategy in his memory. Irrespective of the substance of the final strategy, the Government should consider how to create the maximum level of commitment and cross-party support.

We strongly support the aims of the ten pillars. However, apart from the need for a clear sense of purpose, our main concern is that the question of how to encourage and support the UK's large and medium sized companies to increase investment, as well as how to mobilise the nation's capital to support the economy, has been missed between the corporate governance and industrial strategy green papers. We also highlight the need for continuity, fairness, environmental sustainability, localised and regional solutions, and the role of the state in promoting innovation, and catalysing a positive cultural shift across the corporate landscape.

Investment by large listed companies
We draw attention towards our recent report, Promoting long-term wealth, which put forwards six policies to support long-term wealth creation in UK companies. These are under three themes – creating pools of patient capital to act as stewardship shareholders, increased stakeholder voice in governance structures, and clearing the clutter from the boardroom.

The corporate governance green paper focused on restoring public trust by tackling executive pay, increasing stakeholder voice and improving private company governance. Meanwhile, the focus for the industrial strategy paper and the Patient Capital Review (conducted by HM Treasury) primarily tackles the problem of capital provision to start-ups. There appears to be relatively little focus on how to tackle short-termism in large and listed companies.

This is ignoring a very important part of the equation. UK listed companies paid dividends of £80bn in 2015. In this same year, UK companies were domestic net savers of £71bn before distributed income. By contrast, in 2015 less than £10bn was raised on the UK equity market for IPOs. Furthermore, these numbers dwarf the investment levels by start-ups and scale-up companies. If the Government wishes to increase investment in the economy, then encouraging large companies to re-invest their earnings is the most important lever.

A practical step to address this issue would be to connect the work of the FCA in its Asset Management Market Study with the FRC's upcoming review of the Stewardship Code – as outlined in our response to the FCA's study. Greater alignment for stewardship through the investment chain should help improve UK investment, productivity, as well as returns to savers.

Strategic capital allocation
In order to increase investment, we point out that the UK does not have a shortage of capital. Total UK liquidity is over £1.5tn (M4), while pension funds have invested assets of £2.1tn and UK individuals more than £1tn. UK commercial banks are also able to provide funds at low rates of interest while capital may also be attracted from overseas. The question for the Government should not be how to create small pools of capital in government controlled funds, but instead how to harness existing pools of capital for the benefit of the economy and society.

The problem is that the investment decisions of these large pools of capital (banks, pensions funds and insurance companies) are primarily focused on delivering private financial returns and meeting regulatory obligations, rather than supporting the UK economy and companies. In essence, there is a lack of strategic capital allocation across the investment chain. Significant resources are devoted to company analysis, asset allocation and economic research, but little focus is given to where capital should be invested in the UK economy on a 20-year horizon.

Asset owners already have significant commercial incentives to support the UK economy.

- The systemic risk of UK pension fund deficits is ultimately reduced by a strong UK economy, and yet UK pension funds do not consider how they can support the UK economy while delivering financial returns.
- The long-term liability of UK pension funds is to meet the retirement income needs of UK citizens. The natural hedge against this liability is to hold UK investments. Hence, UK pension funds have a clear incentive to achieve financial returns by supporting the UK economy.

The Government could encourage this shift in focus through a range of measures. For example;

- Reduce pressure on pension funds to hold what are perceived by the 'low risk' assets. For example, the desire to de-risk pension funds has led to a significant shift from equities to debt.
- Provide a clarification that the fiduciary duty of pension fund trustees includes consideration for how investments are supporting the UK economy. (This would apply equally to the UK pension funds of companies with overseas ownership operating in the UK).
- Setup a new organisation to encourage greater collaboration between pension funds in supporting the UK economy. This could include a voluntary target for UK pension funds to invest in UK scale-up capital.
- Create a framework for new tax efficient investment vehicles with a mandate to support UK companies, as outlined in our report Promoting long-term wealth.
- Introduce measure to increase the scale of Master Trusts so they can be a meaningful investor in the UK economy.
- Introduce changes in the market for investment research to encourage research on the UK's industrial strategy and capital allocation.

Technological disruption and fairness

Technological change is currently accelerating across a range of areas from automation to computing power, biotech and data analytics – commonly called the 4th industrial revolution. Periods of technological change naturally create disruption in society as new industries take time to provide employment to displaced workers. Consequently, throughout history one of the main barriers to progress has been vested interests resisting the inevitable disruption of technology.

An effective industrial strategy should help to reduce the cost to society of technological disruption, while sharing the rewards. This is important, not only for the welfare of individuals, but also to encourage and enable the adoption of technology. If the costs and benefits of disruption are shared fairly across society, then technological progress and adoption will be faster than if the balance is viewed as unfair.

For example, increasing technological automation may lead to a shift in returns from labour to capital, as well as increasing inequality within the workforce. The impact of such a shift could be reduced through UK pension funds having some degree of ownership of the companies that are leading technological disruption.

The role of the state in funding long-term and uncertain investment

The majority of investment is more effectively carried out by the private sector. However, there are some investments that are too long term and too uncertain to be carried out by current private sector investment structures. Sometimes it is these innovations that are the most disruptive and beneficial for the economy and society in the long run. There is a role for the government to increase investment in long-term and uncertain projects to take technology to the point where it can be commercialised by the private sector.

The USA has done this effectively with its Defence Advanced Research Projects Agency (DARPA). The UK does not have the scale for such broad investment in innovation, but there may be a role for directed state investment in long-term innovation in the industries where the UK is a global leader.

I. Investing in science, research & innovation

5. What should be the priority areas for science, research and innovation investment?
6. Which challenge areas should the Industrial Challenge Strategy Fund focus on to drive maximum economic impact?
7. What else can the UK do to create an environment that supports the commercialisation of ideas?
8. How can we best support the next generation of research leaders and entrepreneurs?
9. How can we best support research and innovation strengths in local areas?

- We strongly agree that the UK needs to increase its investment in R&D. UK investment in R&D was 1.7% of GDP in 2014, versus the Euro Area of 2.0%, the USA 2.7% and Japan 3.5%.[1]
- One of the UK's strongest assets is its world leading universities. However, the UK is putting this at risk with a relatively low level of funding for research.[2]
- In addition, the use of targets in research funding can damage the quality of research, just as targets can damage outcomes in business. The Government could consider reducing the focus on short-term targets within research grants.
- We strongly support the creation of the Industrial Challenge Strategy Fund, and with this learning the lessons from DARPA in the USA.
- As the industrial strategy green paper makes clear, it is important for the focus of research to align with education, investment and other policy areas.
- The commercialisation of academic research requires a focus within universities on practical application, but it also relies on the demand from business. This can benefit from encouraging the creation of investment structures that can invest in the commercialisation of research. This could be in-house corporate venture capital, R&D units or listed investment funds such as IP Group.

II. Developing skills

10. What more can we do to improve basic skills? How can we make a success of the new transition year? Should we change the way that those resitting basic qualifications study, to focus more on basic skills excellence?
11. Do you agree with the different elements of the vision for the new technical education system set out here? Are there further lessons from other countries' systems?
12. How can we make the application process for further education colleges and apprenticeships clearer and simpler, drawing lessons from the higher education sector?
13. What skills shortages do we have or expect to have, in particular sectors or local areas, and how can we link the skills needs of industry to skills provision by educational institutions in local areas?
14. How can we enable and encourage people to retrain and upskill throughout their working lives, particularly in places where industries are changing or declining? Are there particular sectors where this could be appropriate?

- We support an increase in technical education. Importantly, this needs to increasingly provide for people to retrain more than once through their career, rather than only at the beginning.
- There is currently a disappointing completion and qualification rate and the government's efforts to improve this are vital. A successful industrial strategy will be one where employers and training providers can make plans with confidence without fearing shifts in policy. We hope that the foundations laid by Lord Sainsbury's review of technical education will be consistently built upon.
- A stronger regional focus would be helpful. The government's approach to devolution should make it easier for companies, regional and local government, and education and training providers to work closely together to identify and meet the particular skills needs in their region.
- UK education has often been too focused on academic success. An increased number of apprenticeships and increased support for technical education are both welcome in starting to correct this balance.

III. Upgrading infrastructure

As part of producing its National Infrastructure Assessment, the National Infrastructure Commission has issued a detailed call for evidence, seeking views from stakeholders on a range of questions about UK infrastructure policy. The National Infrastructure Commission's call for evidence is open until 10 February 2017. The questions below seek to complement this work.

15. Are there further actions we could take to support private investment in infrastructure?
16. How can local infrastructure needs be incorporated within national UK infrastructure policy most effectively?
17. What further actions can we take to improve the performance of infrastructure towards international benchmarks? How can government work with industry to ensure we have the skills and supply chain needed to deliver strategic infrastructure in the UK?

- We are supportive of actions to increase private investment in infrastructure, as outlined in Tomorrow's Capital Markets. However, the Government should be careful not to guarantee all risks and hence turn the investment into a form of 'off balance sheet' borrowing.
- As argued above and below under Pillar X, we believe there is great potential in taking further the regional approach which the current government has promoted, identifying the greatest infrastructure needs in dialogue with key capital providers and businesses, and consciously strengthening the local labour market and supply chain to meet some of the needs created by this investment. The approach taken by Lendlease and Bovis in the development of Bluewater in Kent is a good example of such a focus on a planned approach to generating local skills to meet the needs of a local investment.

IV. Supporting businesses to start and grow

18. What are the most important causes of lower rates of fixed capital investment in the UK compared to other countries, and how can they be addressed?

- It is true that the UK's rate of fixed capital formation (16.5% GDP in 2015) is low relative to its history and its international peers. But our focus should include investment in a broader sense. The drivers of long-term value are increasingly intangible and so fall outside this narrow accounting definition. For example, investing in employee well-being can be as important a driver of long-term value as investing in a new piece of machinery. The important question is whether UK companies are investing enough today to support long-term growth. Evidence suggests that UK companies are too focused on the short-term to take advantage from all such opportunities. The low level of fixed capital investment is just one symptom of this.
- At a macro level the issue is twofold. On one level, mid-sized and large listed companies are underinvesting and returning cash to shareholders. On another level, financial markets are relatively poor in reinvesting this money into growth companies.
- For example, over the last nine years the average money raised in UK IPOs each year has been £10bn per year, in comparison the average annual dividends from UK listed companies has been £68bn.[3]
- UK companies in 2015 were domestic net savers of £70bn before distributed income and foreign earnings. In short, large companies are paying high dividends and financial markets are not reinvesting the equivalent back into productive investments.[4]

19. What are the most important factors which constrain quoted companies and fund managers from making longer term investment decisions, and how can we best address these factors?

- Listed companies are critical to the UK economy. Companies with listed equity employ around 3.2m people (14% of employment by non-financial companies), and an estimate for 2007 was that they invested £45bn (a third of UK domestic investment).[5]
- Please see our recent report, Promoting long-term wealth, which focused on how to support and encourage listed companies to increase investment. It put forwards six policies under three themes of patient capital, stakeholder voice and clearing the clutter from boardrooms.

- As mentioned in this report, Tomorrow's Company convenes a 'Stewardship Alliance' of asset owners and managers, with the aim of improving the influence from the investment chain to listed companies so they can make better long-term decisions. We believe the solution involves a stronger and more granular Stewardship Code.
- In addition to the barriers mentioned in this report, the threat of takeovers can create a short-term focus. As has been widely recognised, the UK has one of the most open takeover regimes in the world. Especially since the 2002 Enterprise Act when the public interest test was weakened.
- We also agree that it would be beneficial to make it easier to have a dual-class share structure. It would then be up to investors if they invested in such companies. The experience from other countries is that this is not a problem. We find that too often the assumption is that having a controlling shareholder is negative, when the evidence finds it can be positive.
- We also highlight the danger of having this debate split between multiple initiatives across a number of organisations. For example, the question of short-termism in quoted companies covers the FRC's Stewardship Code, FCA's Asset Management Study, upcoming FCA's listed markets review, BEIS's Corporate Governance green paper, BEIS's Industrial Strategy green paper and the Treasury's Patient Capital Review. Ideally there needs to be a coordinated approach to how to encourage listed companies to invest long term.

20. Given public sector investment already accounts for a large share of equity deals in some regions, how can we best catalyse uptake of equity capital outside the South East?
21. How can we drive the adoption of new funding opportunities like crowdfunding across the country?
22. What are the barriers faced by those businesses that have the potential to scale-up and achieve greater growth, and how can we address these barriers? Where are the outstanding examples of business networks for fast growing firms which we could learn from or spread?

- The UK has struggled with providing sufficient capital to smaller high growth companies for many decades. We strongly support efforts to address this longstanding problem.
- Crowdfunding is an exciting platform for financing companies. Supporting its further growth can help. However, it is very small in the context of the total provision of capital for UK companies.
- A key issue is the reduction in lending by banks to companies. Bank lending to non-financial companies has fallen by £130bn since the financial crisis in 2008[6]. Meanwhile, lending for mortgages has increased by £28bn over the same period. The understandable desire to de-risk banks, may have had the unintended consequence of reducing capital for companies.
- The Patient Capital Review needs to look at how to enable banks to meaningfully increase lending to small and medium-sized companies, or to support an alternative channel that could be of a similar scale.
- The British Business Bank and Business Growth Fund are helpful in achieving this, but the capital they have is relatively small versus the reduction in commercial bank lending.
- An additional step would be to enable and encourage pension funds to increase the allocation to venture capital funds. UK pension funds hold £2.1tn in assets, with long-term investment horizons and the ability to spread risk, but typically allocate a very small proportion to venture capital. This would help address the issue of the UK venture capital industry being sub-scale.

V. Improving procurement

23. Are there further steps that the Government can take to support innovation through public procurement?
24. What further steps can be taken to use public procurement to drive the industrial strategy in areas where government is the main client, such as healthcare and defence? Do we have the right institutions and policies in place in these sectors to exploit government's purchasing power to drive economic growth?

- We agree that the Government's procurement rules can be an important mechanism to influence company behaviour. In our report, Tomorrow's Business Forms, we argued that procurement rules should allow consideration of a diversity in business forms. This idea was investigated further in collaboration with the BSI by looking at the idea of a trust test for procurement.

- In our discussions with companies with distinctive cultures and a strong focus on purpose beyond profit, we have heard from them that at present government procurement does not factor in the longer-term economic benefits that come from such cultures, and instead favours those who cut corners and focus on the short term in order to bid at the lowest price. The Social Value Act was introduced as a means of allowing public procurement to take a wider view of value, and government should re-examine its provisions and explore how to make it more effective in supporting innovation of corporate form as well as environmental, social and governance value.
- Accordingly, we propose the development of a consensus-led standard for public procurement that provides a form of cultural due diligence, which we call a trust test. Following a discussion of this at a Ministerial Round Table we have written to the Minister with further details of this initiative.

VI. Encouraging trade and inward investment

25. What can the Government do to improve our support for firms wanting to start exporting? What can the Government do to improve support for firms in increasing their exports?
26. What can we learn from other countries to improve our support for inward investment and how we measure its success? Should we put more emphasis on measuring the impact of Foreign Direct Investment (FDI) on growth?

- A critical distinction needs to be made between FDI which generates economic growth and boosts productive potential, as against FDI which simply involves acquiring a pre-existing financial asset. As highlighted in the report by the Centre for Progressive Capitalism, Rebalancing the UK economy – A post-Brexit industrial strategy, the UK has principally attracted the latter, which arguably has little or no effect on productivity, and serves instead to push up asset prices and the exchange rate.
- In 2015, the UK recorded inward FDI of £22bn. But of this figure £15bn consisted of purchases of equities or inter-company accounting movements with the parent company. The remaining £7bn related to unremitted profits of foreign MNC's operations in the UK. Even if *all* of these earnings were invested in GFCF this would represent less than 30% of the total recorded FDI, and less than 4% of total Corporate GFCF in 2015 (£181bn).
- Over the last few decades, the UK's widening current account deficit has been financed by the sale of existing UK assets to foreigners (either FDI, Portfolio Investment, Reserve Assets, or Other). In 2014, the UK's net investment position was -£330bn contributing to a net income outflow on the primary balance of its Current Account. Attracting foreign capital to purchase UK financial assets will simply make this situation worse over time.
- The UK needs to welcome the capital and expertise of foreign MNC's but this should manifest through productive investment. This is the one measure that is not explicitly included in the way we currently record inward FDI. As part of the Bank of England's work on measuring productive investment they could develop a measure of inward foreign productive investment.

VII. Delivering affordable energy and clean growth

27. What are the most important steps the Government should take to limit energy costs over the long term?
28. How can we move towards a position in which energy is supplied by competitive markets without the requirement for ongoing subsidy?
29. How can the Government, business and researchers work together to develop the competitive opportunities from innovation in energy and our existing industrial strengths?
30. How can the Government support businesses in realising cost savings through greater resource and energy efficiency?

- While outside the scope of our research, we would encourage the Government to focus on supporting the UK's renewable energy industry, in addition to increasing demand for renewable energy.

VIII. Cultivating world-leading sectors

31. How can the Government and industry help sectors come together to identify the opportunities for a 'sector deal' to address – especially where industries are fragmented or not well defined?
32. How can the Government ensure that 'sector deals' promote competition and incorporate the interests of new entrants?
33. How can the Government and industry collaborate to enable growth in new sectors of the future that emerge around new technologies and new business models?

- We strongly support moves to help build more industry collaboration through sector councils and sector deals. This could be supported by increasing the pools of patient capital that invest in the UK, as advocated in our report, Promoting long-term wealth.
- We agree with an open approach where any sector can come forwards with a sector plan, though the final version of an industrial strategy should identify the industries where the UK aims to be a global leader, and how the range of measures coordinate to support this industry. The UK's relative scale in the global economy is decreasing, so it is important to specialise and focus resources on the industries where the UK can be a global leader.
- A UK focused investment fund, such as a pension fund, can look across an industry and advocate changes that benefit the whole industry value chain within the UK, rather than only one individual company. Similarly, an investment fund that invested in disruptive start-ups would help ensure that industry collaboration did not lead to collusion and measures to prevent disruption.

IX. Driving growth across the whole country

34. Do you agree the principles set out above are the right ones? If not what is missing?
35. What are the most important new approaches to raising skill levels in areas where they are lower? Where could investments in connectivity or innovation do most to help encourage growth across the country?

- We support the proposed principles. In addition, we suggest increasing the provision of capital through regional investment funds. New regional investment funds could be created with a mandate to deliver investment returns and support the local economy.
- When a company invests, it receives a private financial return on its investment, there is also a social return to society and the local economy in which the investment takes place. A company or investment fund with no other presence in the region will not capture these benefits. However, because of its greater focus on the needs of the region as a whole, a regional investment fund would partly capture these externalities and therefore would have a greater incentive to invest. The easiest way to create this alignment would be if the regional investment fund held a portion of its assets in property in the region.

X. Creating the right institutions to bring together sectors and places

36. Recognising the need for local initiative and leadership, how should we best work with local areas to create and strengthen key local institutions?
37. What are the most important institutions which we need to upgrade or support to back growth in particular areas?
38. Are there institutions missing in certain areas which we could help create or strengthen to support local growth?

- We support the government's commitment to a policy of devolution. This offers an opportunity for leaders in government, civil society, and business, together with investors and asset owners and providers of education to work closely together to achieve the particular investment and development that is appropriate to local needs while fully mobilising local pride and budget synergies. The Inclusive Growth Commission which has been funded by Rowntree and run by the RSA is an important blueprint for this. It recommends place-based industrial strategies, and a reset of the relationship between Whitehall and town hall. Manchester provides an example of what can be achieved. Thanks to strong and consistent leadership for 20 years it has laid the foundation for the current emphasis on health and social care and joined-up solutions. In Manchester, this context helps improve outcomes for individuals that then create collective value. Whereas there is a clear methodology for making a business case to the Treasury for infrastructure investment, there is no such simple process for those justifying investments in the social infrastructure and an industrial strategy should facilitate this.

- Regional investment funds, as described under pillar IX, could clearly assist in such a strategy, especially when they incentivise the kind of local collaboration mentioned above in line with Local Enterprise Partnerships and other local and regional agencies.

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[1] ONS Data
[2] The Guardian, *UK research funding slumps below 0.5% GDP – putting us last in G8*, 13 March 2015.
[3] London Stock Exchange for data on IPOs and Capita UK Dividend Monitor for data on listed company dividends.
[4] ONS
[5] Pattani, A. and Vera, G. (2011) *Going Public: UK Companies' Use of Capital Markets*, Bank of England Quarterly Bulletin 4: 322.
[6] Bank of England