EY ITEM Club

Special Report on Business Investment

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Foreword

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I am pleased to share our latest EY ITEM Club Special Report, which covers UK business investment. This report feels particularly timely as, despite a few bumps, it looks like – in Europe and the US at least – economies are beginning to recover from the COVID-19-induced shocks of the last 15 months. Forecasters are increasingly optimistic about the strength of recovery and, notably, April saw the EY ITEM Club upgrade its 2021 UK economy growth forecast to 6.8%, up from 5.5% in January. Further upgrades may come in July's EY ITEM Club Summer Forecast as consumer and business sentiment continues to improve. Attention is now turning to a post-pandemic world and how the economy will reshape and adapt in the medium to longer term. Business investment will have a key role to play in this recovery.

As this report shows, business investment has been relatively weak in the UK since the global financial crisis of 2007–8, both in the context of historical levels and when compared to international competitors. While some of this can be explained by the greater importance of the services sector to the UK economy, which tends to be less capital-intensive, lower levels of business investment are part of the explanation for the relatively poor productivity performance of the last decade.

Unsurprisingly, business investment fell by 10.2% during 2020 – slightly more than the decline in GDP of 9.8%. However, while this fall was substantial, it was much less than the 15.3% decline in investment experienced after the global financial crisis, and also masks some significant differential performance among various sectors. In 2020, investment actually increased in education, IT and communications, and transportation and storage, as a consequence of shifts in consumer behaviour and changing business models as much of the country shifted to working, learning, and shopping remotely.

There are now some optimistic signs that we will see a strong recovery in business investment. Consumer spending is expected to come back strongly, particularly in sectors such as hospitality and leisure which have been most affected by the pandemic, although international travel will lag as restrictions remain. Further, while some businesses have incurred significant debt to keep themselves afloat, many others are in far better health and have built up cash balances. If these are spent to meet the expected rebound in demand, then it will support a rapid recovery.

Government policy is also supportive – the 'super-deduction' announced in the March Budget will encourage businesses to bring capital spend forward. Further, with fiscal austerity now seemingly no longer the foundation of Government policy, and the imperative for Government to deliver on its levelling-up and net zero objectives, we can expect considerable public – and private – investment in physical and digital infrastructure, and in energy transition technologies. Taken together, we could see a sustained upwards shift in business investment in the UK in the next two to three years.

As ever, there are headwinds; we still live in uncertain times and business and consumers may remain cautious, while the planned corporation tax increases could offset some of the benefits of looser fiscal policy. Businesses will therefore need to closely calibrate their own investment plans based on expectations of a rapid recovery in their own markets against their own financial stability. Now, though, may be the right time to take a risk.

Highlights

- As the COVID-19 pandemic subsides and the economy reopens, questions surrounding how to ensure a sustainable recovery and resolve some long-standing economic problems, notably weak productivity growth, are emerging. The outlook for business investment is key to answering those questions. We expect a strong rebound in investment over the next few years. But the outlook further ahead will pit what could prove to be a 'higher-pressure' economy than the UK has experienced for some time against the psychological scars of the last decade-and-a-half of economic shocks and weak GDP growth.

- Since 2008, business investment has suffered a 'triple whammy' consisting of the global financial crisis, uncertainty from Brexit and the COVID-19 pandemic. Spending on fixed assets like machinery and IT equipment saw particularly sluggish growth in the half-decade preceding the pandemic. And UK firms have consistently invested less than their peers in other major economies.

- Business investment fell 10.2% last year. But this fell short of 2009's record 15.3% decline. The fact that the pandemic did not see the freezing of bank lending, which characterised the global financial crisis, averted a bigger fall. The economic pain being concentrated in less capital-intensive sectors also reduced the hit. And a COVID-19-related move online by retail spending and other activities contributed to investment in some sectors, including information and communications technology (ICT), education and storage, growing strongly during 2020.

- In the near future, consumer spending is likely to lead in bringing the economy back to its pre-pandemic position. But where consumption leads, investment should follow, as firms respond to stronger demand and rising confidence. Surveys of investment intentions have picked up significantly in the last few months. The strength of the recovery in business investment will be influenced by what resources firms can draw on to finance investment and the incentive to plough those resources into capital equipment. While large companies, overall, paid down bank debt during the pandemic, some firms, particularly in the SME sector, are coming out of the crisis with much higher levels of debt. This could impact investment.

- But in GDP terms, the burden of corporate debt ended 2020 still below the peak preceding the 2008–09 recession. Moreover, as outlays on wages and other expenses fell during the pandemic, while revenues were shielded by government aid, the corporate sector accumulated over £100b of 'excess' cash holdings. Firms' holdings of cash offer the hope of a healthy resurgence in investment.

- The investment consequences of COVID-19 will vary by sector. The fact that many companies intend to use increased homeworking as a permanent business model could promote spending on IT and communications equipment. The continuation of some social distancing measures may encourage investment in automation. And if the pandemic and Brexit reduce the number of foreign-born workers, employers might invest more in labour-saving technology. On the other hand, if homeworking becomes a fact of life for more people, investment in commercial real estate might be permanently affected.

- Meanwhile, the temporary 'super-deduction' tax incentive announced by the Chancellor in March's Budget should raise investment spending by making more projects profitable and provide companies with a strong incentive to bring forward spending from future periods. That said, the super-deduction's effect will be time-limited. Its coverage is restricted to a small subset of investment. And the incentive effect for small firms will be much less powerful than for large companies. What is more, the planned rise in the corporate tax rate in April 2023 presents a medium-term headwind to business investment.

- Overall, we are optimistic. Households are awash with savings, providing fuel for a possible consumer boom, and the political zeitgeist has turned against growth-sapping fiscal austerity. The Government is committed to a 'levelling-up' agenda to narrow regional disparities, while the Bank of England is likely to proceed slowly in raising interest rates. These factors support our forecast for business investment to grow by just over 7% in 2021 and by in excess of 10% in 2022.

- The pessimistic view is that after a long period of weak economic growth and the experience of two major global economic shocks in little more than a decade, companies will remain reluctant to invest, even if the economy enjoys a post-COVID-19 spurt. Key to a prolonged investment revival will be sustaining optimism long enough for firms to reset their expectations and factor in a hopefully more promising future, instead of being bound by the experience of a decade of disappointment.

1. Introduction

In assessing the economic impact of the COVID-19 crisis, coverage of the consequences for business investment has, so far, generally played second fiddle to the implications for other parts of the economy, notably consumer spending. This is unsurprising. The economic pain of lockdowns and social distancing measures fell most directly on consumption, with the slack taken up by government support. And with legal restrictions on social contact gradually being lifted, the burgeoning economic recovery is being driven, in large part, by a resurgence in consumers' freedom, and appetite, to spend.

However, as the COVID-19 deluge subsides, questions regarding how to ensure a sustainable recovery and resolve some of the problems which afflicted the economy before the pandemic, notably low productivity growth, have emerged (or re-emerged). The outlook for business investment, which encompasses spending on assets which produce a stream of productive services, such as buildings, vehicles and IT equipment, is key to answering these questions. So it seems an opportune time to explore the issue. Business investment was a subject we last examined in a Special Report in late 2017. Then, uncertainties around Brexit and concerns about whether the UK, along with other advanced economies, had become stuck in a state of permanently weak aggregate demand ('secular stagnation') following the global financial crisis, were the focus of discussion.[1]

But uncertainty around Brexit has now been resolved, up to a point. The global financial crisis is an increasingly distant memory, fiscal austerity is over, for the time being, and policymakers are focused on repairing the damage from COVID-19, including via new tax incentives to encourage companies to spend. So the environment for business investment has changed in a potentially positive way. Indeed, some are arguing that a boom in consumer spending this year could be followed by a boom in investment spending in 2022.[2]

Is this hope realistic? To answer that question, this Special Report begins by examining the performance of business investment in the period immediately before COVID-19 struck. Section 3 then assesses the impact of the crisis on corporate spending. Section 4 considers the outlook for business investment – how might the future level, and nature, of investment be affected by the pandemic? And what role could the tax measures announced by the Chancellor earlier this year – including the 'super-deduction' tax allowance and planned rises in the corporation tax rate in 2023 – have in helping or hindering investment? Section 5 then concludes this report.

2. Business investment growth had been sluggish before the pandemic

In considering the issues which excited UK economists in those, seemingly far-off days before COVID-19, one popular and very long-running concern (arguably stretching all the way back to the late-Victorian era)[3] was the perceived failure of UK companies to invest enough. Low levels of investment can be bad news in three respects. First, if workers have older, outdated equipment to work with, they'll be less productive than they otherwise would be. Second, low investment might signal a lack of confidence in the future. If that pessimism is justified (indeed, an unwillingness to invest might make it self-fulfilling), the outcome will also be weaker GDP growth. And third, to the extent that national investment is low because firms think returns are better elsewhere, this might be indicative of structural economic problems at home.

Certainly, in the period running up to the pandemic, the performance of UK business investment had been sluggish. Real business investment grew only 1.1% in 2019, undershooting what was an underwhelming 1.4% rise in GDP. And business investment fell 2.5% in 2018, the first drop since 2009, when the economy was suffering the consequences of the global financial crisis.

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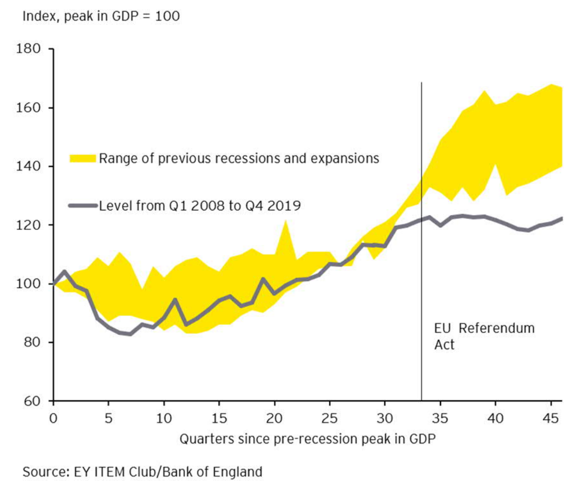
[1] Special Report on Business Investment, EY ITEM Club, October 2017. criticaleye.com/inspiring/insights-servfile.cfm?id=4977

[2] For example, see Ambrose Evans-Pritchard, 'The lords of global finance smile again on Britain's economy', The Telegraph, 14 May 2021. telegraph.co.uk/business/2021/05/14/lords-global-finance-smile-britains-economy/

[3] The case that underinvestment by UK firms is a failing which has persisted for over a century is argued in Michael Kitson and Jonathan Michie, 'The Deindustrial Revolution: The rise and fall of UK manufacturing 1870–2010'. Centre for Business Research, University of Cambridge Working Paper No. 459, 2014. cbr.cam.ac.uk/wp-content/uploads/2020/08/wp459.pdf

Economic theory tells us that heightened uncertainty about the future tends to have a negative effect on investment, since it increases the attraction of waiting to see how the uncertainty is resolved. And a commonly cited culprit for the weakness in investment growth during the late 2010s was uncertainty generated by the UK's vote to leave the EU in June 2016. The recovery of business investment after the 2008–09 recession had been broadly in line with previous episodes up to the passing of the EU Referendum Act in 2015. But the recovery then slowed sharply. The level of business investment in Q4 2019 was only 7.5% higher than at the start of 2015. In contrast, growth in investment over the previous five years (admittedly, a period which included the recovery from the global financial crisis) was almost 32%. The UK's performance in comparison with other advanced economies was also weak.

UK: Business investment

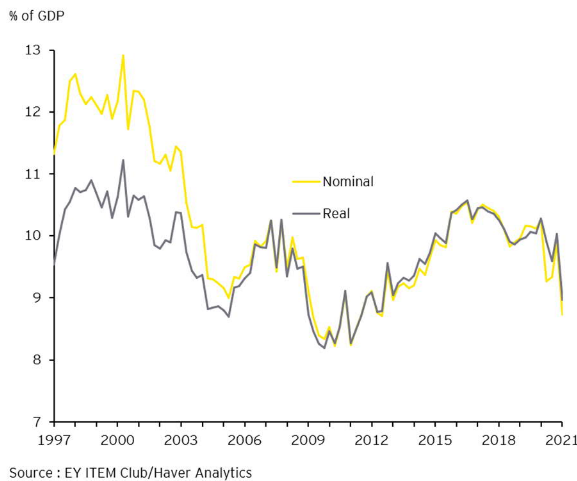


Source: EY ITEM Club/Bank of England

The picture is not quite as subdued if business investment is expressed as a share of the economy. In 2019, firms invested a sum equivalent to 10% of annual real GDP. This was slightly above the post-1998 (when official Office for National Statistics (ONS) data begins) average of 9.8%, and higher than in each year from 2008–2014. And, certainly, 2019's investment ratio was almost a percentage point of GDP short of the record 10.8% of GDP reached in 1998. But the excesses of the 'dot-com' boom, which neared its peak in the late 1990s, probably exaggerate the difference. In nominal terms, the decline in the investment/GDP ratio from the peak at the turn of the millennium to 2019 was more marked, reflecting a fall in the real-terms price of capital goods.

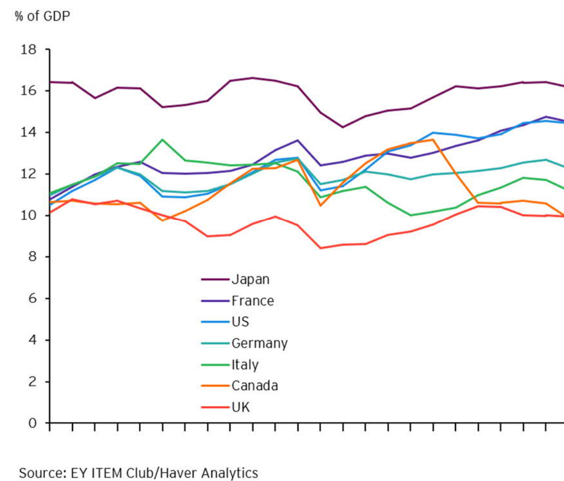
However, as a share of GDP, UK firms in aggregate have consistently invested less than companies in other advanced economies. For example, in 2019, UK business investment corresponded to a smaller share of real GDP than in any other G7 economy. The UK's investment ratio was around three-fifths of that of Japan, the G7 leader, where firms' spending on fixed assets was equivalent to 16.4% of GDP.

UK: Business investment



Source : EY ITEM Club/Haver Analytics

G7: Business investment



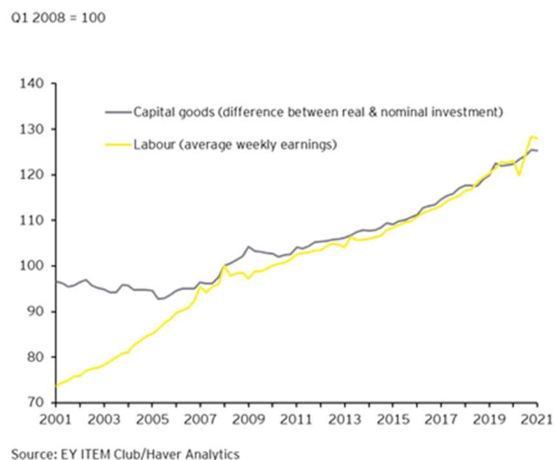
Source: EY ITEM Club/Haver Analytics

But whether this comparison shows that investment by UK firms was too low is not clear-cut. The share of GDP accounted for by services is larger in the UK than any other G7 economy. Since service activity is less capital-intensive than other sectors, it makes sense that the UK would have a structurally lower level of business investment. And in judging whether investment in a country is at the 'right' level, it is also important to consider the efficiency of investment in generating higher GDP. Over the last 20 years, Japan has headed the advanced economy pack in terms of the ratio of business investment to GDP. But between 2000 and 2019, Japan saw the second-smallest increase in GDP, of 14.8%, among G7 economies (with Italy taking the wooden spoon with growth of only 3.8%). The supposedly underinvesting UK enjoyed a much larger, 37.7%, rise in output, ranking third in the G7 after the US (where output grew 45.4%) and Canada (with a rise of 45.2%).

Structural factors may have weighed on investment

However, these mitigations go only so far. The US and French economies are only slightly less services-orientated than the UK, but investment is noticeably higher as a share of GDP. And an important chunk of UK GDP growth over the last two decades has come via strong growth in the workforce. Contributions from a larger capital stock and the efficiency with which capital and labour are combined (both of which are influenced by the level of business investment) have been weak by historical standards.

And there is a plausible case for suggesting that structural factors have depressed growth in UK investment. The effect of the UK's bonus culture in encouraging executives to pursue short-term share price gains at the expense of long-term growth has been cited as one.[4] The different paths taken by the price of labour and capital equipment offer another structural explanation. In the decade up to 2008, the cost of capital goods saw little rise, while average wages grew 4%–5% per year. All else being equal, this will have favoured the expansion of capital-intensive over labour-intensive firms and probably resulted in some capital-labour substitution within companies. However, between Q1 2008 and Q4 2019, the price of investment goods and average pay rose by a broadly similar amount. With the supply of workers proving very elastic, aided by high levels of inward migration, and the economic outlook, particularly post-EU referendum, an uncertain one, firms may have responded by hiring rather than investing.



Another potential structural headwind to investment is the rapid pace of technological change in recent years. Just as policy uncertainty can hold back investment, so too can the pace and direction of technical change. Firms might worry that new investment will be quickly rendered unprofitable by better future processes and products (the rise and fall of Nokia being a cautionary tale in this respect). Or the hope of exploiting spillovers from new technology may encourage a 'wait-and-see' approach. So short-termism in making investment decisions may have become an increasingly rational position. And companies may have wised up to the fact that, aside from exceptions like Apple, producers of innovations typically capture only a tiny fraction of the total gains.[5] If the profits from innovation are hard to realise, why bother?

Finally, data issues may mean the apparent problem of sluggish investment growth has not been as marked as it might appear. Over time, investment in intellectual property products (IPP), such as design, software and R&D, has accounted for a growing share of total business investment. But this is a category of investment which is probably the hardest to measure. And research has pointed to a correlation between the extent to which businesses have relied on intangible assets, and the degree to which there has been hard-to-explain weakness in investment over the past two decades.[6] That said, other research on intangible investment suggests mismeasurement effects are quite small. So this explanation does not appear to provide UK firms with a 'Get out of jail free' card.[7]

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[4] For example, see Andrew Smithers, 'Executive pay holds the key to the productivity puzzle', Financial Times, 28 May 2015. ft.com/content/64b73a8e-0485-11e5-95ad-00144feabdc0

[5] William D. Nordhaus, 'Schumpeterian Profits in the American Economy: Theory and Measurement', Cowles Foundation Discussion Papers 1457, Cowles Foundation for Research in Economics, Yale University, 2004. ideas.repec.org/p/cwl/cwldpp/1457.html

[6] 'Capitalism without capital: understanding our new "knowledge" economy'. Speech given by Professor Jonathan Haskel, External Member of the Monetary Policy Committee. Ken Dixon Economics Lecture at the University of York, 16 May 2019. bankofengland.co.uk/-/media/boe/files/speech/2019/capitalism-without-capital-understanding-our-new-knowledge-economy-speech-by-jonathan-haskel.pdf

[7] Jonathan Haskel and Stian Westlake (2017). 'Capitalism without Capital: The Rise of the Intangible Economy'. Princeton University Press

3. COVID-19 hit business investment, but not as hard as the global financial crisis

Given the whirlwind of uncertainty which struck the economy during the COVID-19 pandemic and the closure of some firms during lockdowns, the fact that business investment fell in 2020 will not come as any surprise. An annual fall of 10.2% was the largest drop since 2009 and left the level of investment at the lowest since 2014. The quarterly path of investment during 2020 and early 2021 corresponded closely to the timing of lockdowns and subsequent reopenings. The first lockdown over spring 2020 delivered the biggest blow to business investment. A 22.5% quarter-on-quarter (q/q) collapse in Q2 was comfortably the largest quarterly decline since records began.

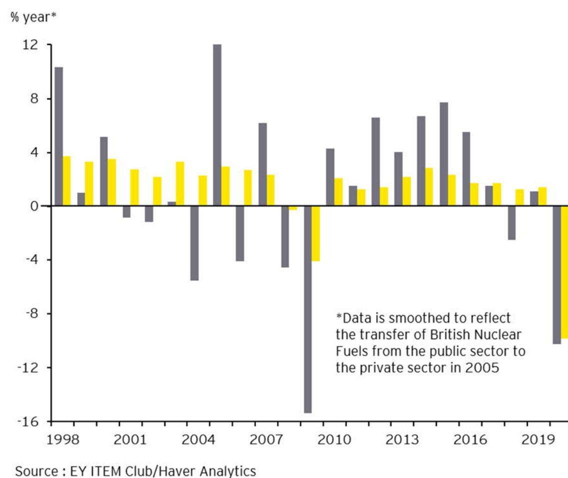
As the economy reopened over the summer of 2020, firms' appetite to invest staged some recovery. Q3 2020 recorded growth of 13.2% q/q. And the introduction of new restrictions in late 2020, including England's six-week lockdown from late October to early December, did not prevent business investment advancing a further 5.9% q/q in Q4 2020. But the most recent lockdown in early 2021 reversed some of these gains. Investment dropped 11.9% q/q in Q1 2021.

Business investment data is typically volatile and prone to revision. Between 1998 and 2019, the standard deviation around the difference between when a calendar year's investment growth was first reported and when the revised figure was reported one year later, was about four percentage points. Indeed, estimates of the fall in investment during 2020 have been revised to be significantly smaller by the ONS in recent months. So caution should be exercised in interpreting the recent numbers. And among the clouds, there were some silver linings. For one, business investment in 2020 performed only marginally worse than the wider economy (GDP fell 9.8% last year). And it did not suffer the extreme drop seen during the global financial crisis. Business investment crashed 15.3% in 2009, more than three times greater than that year's 4.1% fall in GDP. The fact that the COVID-19 crisis did not cause the fractures in the banking sector and the freezing of bank lending which characterised the global financial crisis probably goes some way to explaining a less bad performance. And the fact that the economic pain was concentrated in less capital-intensive sectors such as hospitality also cushioned the blow.

On a sectoral level, 2020 was not all bad for business investment

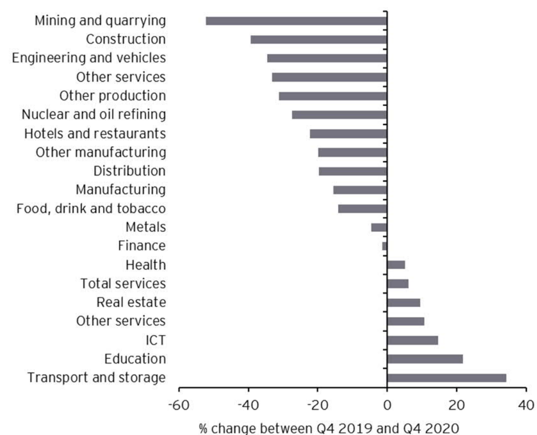
A third factor which helped to avert an even bigger drop in investment in 2020 was the degree of heterogeneity in firms' experiences during the pandemic. Damage caused by the crisis was far from equal across sectors or companies. For example, as of late May 2021, 64% of firms in the arts, entertainment and recreation sector and 63% of businesses in the hospitality sector reported a fall in turnover relative to normal times. But at the other extreme, less than a quarter of firms in the information and communication, real estate and construction sectors had suffered a decline.[8]

UK: Business investment



Source : EY ITEM Club/Haver Analytics

UK: Investment by sector



Source: EY ITEM Club/Haver Analytics

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[8] 'Business insights and impact on the UK economy: 20 May 2021', Office for National Statistics, 20 May 2021. ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/20may2021

The fact that some parts of the economy were relatively unaffected by the pandemic and the public health response, or even gained from a diversion of demand, helps to explain the very diverse performance revealed by a sectoral breakdown of business investment. Certainly, investment in the more ‘physical’ parts of the economy was hard hit. Investment in mining and quarrying (mainly oil and gas extraction) in Q4 2020 was a whopping 52.2% year-on-year (y/y) lower, while investment in construction and manufacturing was down 39.3% y/y and 15.4% y/y respectively. But investment in services in Q4 2020 was 6.1% higher than a year earlier. Within the services total, investment by the transportation and storage sector was up 34.2% y/y, investment by education firms rose 21.8% y/y and investment by the information and communication sector was 14.7% higher. The strength of investment in services versus weakness in manufacturing is also consistent with rates of return for services holding up reasonably well, while plunging for manufacturers.[9]

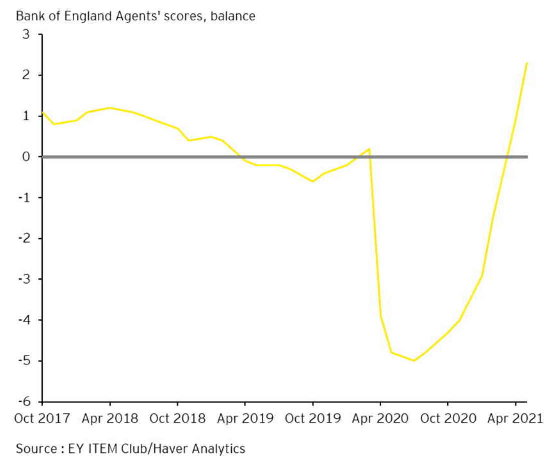
Many of the sectors which saw investment grow probably benefitted from the move online by retail spending and other activities, and the accompanying expansion in digital technologies to support new business models and practices. Online purchases accounted for almost a third of retail spending in the 12 months to March 2021 compared to an average of 19% in 2019. And last year saw a surge in homeworking (35.9% of workers did some work at home in 2020, an increase from 26% in the previous year)[10] and, with the closure of schools during lockdowns, home schooling.

This story is supported by timelier data on investment by asset type. Total business investment in Q1 2021 was 16.2% down on the level in Q4 2019, the last quarter before the pandemic struck. But investment in ICT and other machinery and equipment was 3.5% higher. The Bank of England (BoE) has taken note. In the view of Andrew Haldane, the BoE’s Chief Economist, spending on R&D and ICT “has actually picked up quite maturely and indeed quite unusually for a weak activity period”.[11]

4. Will investment take the baton from consumption in driving growth?

Business investment is emerging from the crisis battered, but in a less bad state than after the global financial crisis, and with some areas reassuringly healthy. In the near future, consumer spending is likely to lead in bringing the economy back to its pre-COVID-19 trajectory, as households take advantage of rediscovered liberties to spend and draw on considerable savings accumulated during the pandemic.

But where consumption leads, investment should follow, as firms respond to stronger demand and rising confidence by expanding capacity. This expectation is consistent with a recent pick-up in surveys of investment intentions. For example, the BoE’s regional agents reported in May 2021 that the balance of firms intending to increase investment was at the highest since the survey question began in October 2017[12]. And while the UK central bank’s latest Decision Maker Panel (DMP) Survey for May suggested that firms expected COVID-19 to weigh on investment in Q2 and Q3 2021, the adverse effect was much less than over the past year. Responses also suggested firms believed that COVID-19 will be a drag on investment over much of 2021 by less than they previously thought. And longer-term expectations for 2022 were positive, with firms expecting investment to be around 1% higher than it would have been had the COVID-19 pandemic not occurred.[13]



[9] ‘Profitability of UK companies time series’, Office for National Statistics, 27 April 2021. ons.gov.uk/economy/nationalaccounts/uksectoraccounts/datasets/profitabilityofukcompanies

[10] ‘Homeworking hours, rewards and opportunities in the UK: 2011 to 2020’, Office for National Statistics, 19 April 2021. ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/homeworkinghoursrewardsandopportunitiesintheuk2011to2020/2021-04-19

[11] ‘Ben Broadbent and Andrew Haldane: Monetary Policy Report National Agency Briefing’, Bank of England, 7 May 2021. bankofengland.co.uk/events/2021/may/mpr-national-agency-briefing

[12] ‘Agents' summary of business conditions - 2021 Q2’. Bank of England, 24 June 2021. https://www.bankofengland.co.uk/agents-summary/2021/2021-q2

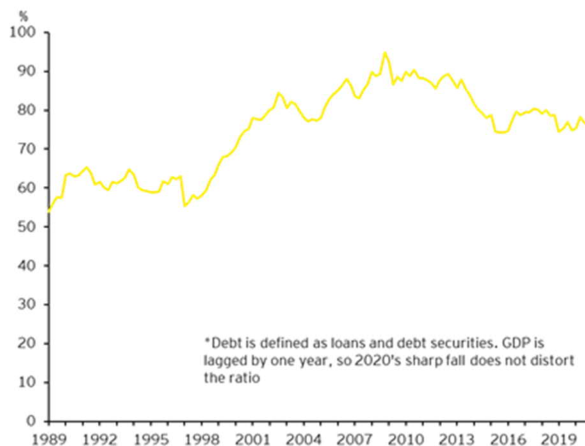
[13] ‘Monthly Decision Maker Panel data – May 2021’, Bank of England, 3 June 2021. bankofengland.co.uk/decision-maker-panel/2021/may-2021

According to the latest EY Attractiveness Survey Europe, international investors also seem more optimistic about the UK's post-pandemic prospects. Last autumn's survey showed the UK ranking third in Europe for post-COVID-19 attractiveness – behind Germany and France. And just 25% of those surveyed said they planned to invest in the UK in the following 12 months. But the latest survey implies a significant reversal in fortunes. The UK was perceived to be Europe's most attractive destination for investment, while 41% of survey respondents plan to invest in the UK in the next 12 months – the UK's highest-ever score on this question, up from 31% in spring 2020 and 23% in 2019.[14]

Firms are emerging from the pandemic with extra debt, but also more cash

Looking ahead, the recovery in business investment and the 'steady state' at which investment growth settles will depend, in part, upon what resources firms can draw on to finance investment and the incentives there are to plough those resources into capital equipment, rather than alternatives, such as higher salaries for staff or share buy-backs. On the question of resources, companies with healthy balance sheets should be well placed to invest as demand and confidence return. But firms coming out of the crisis with higher levels of debt will see debt servicing costs eat up a greater share of revenues and they may have less capacity to borrow in the future. Investment could suffer as a result. So the rise in corporate liabilities during the pandemic, as companies raised money to fill holes in revenue, does not, on the face of it bode well. In net terms, UK non-financial companies raised £77.7b of additional finance between March 2020 and April 2021. This was more than three times the £23.9b of net new finance raised in the 14 months to February 2020. The single largest component of pandemic-related finance was bank loans, which increased by a net £30.3b. Firms also issued equity and bonds worth a combined £49b in net terms.

UK: Private non-financial corporate debt relative to GDP*

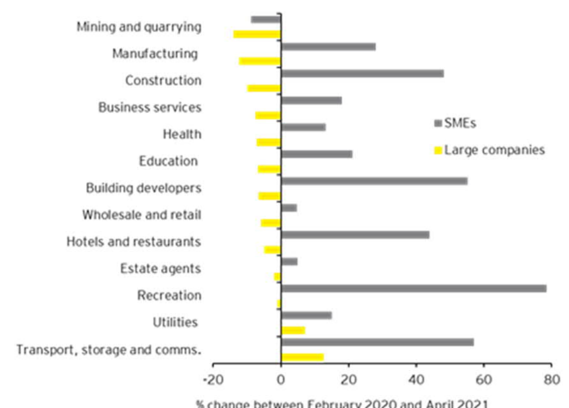


Source : EY ITEM Club/Haver Analytics

However, companies have already started to repay some of these new liabilities – additional net finance peaked at £87.6b in February 2021. And in GDP terms, the burden of corporate debt ended 2020 still well below the record set before the global financial crisis. It appears that some of the extra borrowing from banks was precautionary, with new debt paid down quite quickly. Indeed, while net borrowing by UK non-financial companies surged in the first month of the crisis, rising £33.2b in March 2020 alone, it was, on average, slightly negative in the 12 months to April 2021, as repayments exceeded gross lending. Of course, this aggregate picture disguises the fact that some individual firms in relatively hard-hit sectors may be emerging from the pandemic with painfully high levels of debt.

On that note, there's a clear division between large companies and small and medium-sized enterprises (SMEs). Larger firms owed a total of £306.5b in April 2021, 4.3% less than the £320b owed in February 2020, just before COVID-19 struck. But SMEs' bank debt rose to £215.2b from £167.2b over the same period, a 28.7% increase. The same pattern is also apparent on a sectoral basis. For example, SMEs operating in the recreational sector saw bank debt balloon by almost 80% in the 14 months to April 2021. But large companies in the same sector saw almost no change in indebtedness (the easier recourse which bigger firms have to alternative sources of finance, such as the issuance of bonds and equity, probably played a role here).

UK: Change in stock of bank loans by sector

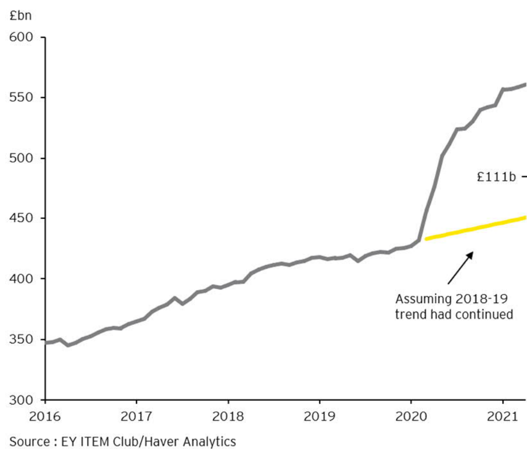


Source : EY ITEM Club/Bank of England

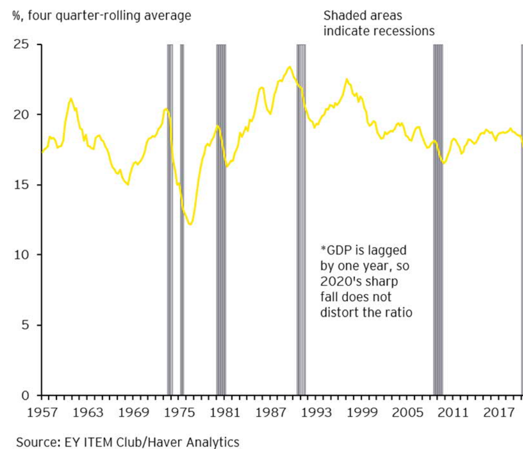
[14] EY Attractiveness Survey Europe: Foreign investors back Europe, but is Europe back?, EY, June 2021. assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/attractiveness/ey-europe-attractiveness-survey-2021-hr-v1.pdf

Moreover, extra debt taken on by some companies has been accompanied by other firms (or even the same companies) accumulating cash. Outlays on wages, investment and other expenses fell during the pandemic, while revenues were shielded by government aid, including the Job Retention Scheme. This resulted in corporate profits relative to GDP suffering only a modest fall in 2020 in comparison with the contraction in the economy. It also contributed to non-financial companies' holdings of bank deposits rising by £129.5b between March 2020 and April 2021. This was £111b (around 5% of GDP, or half a year's worth of business investment) higher than if the average monthly increase during 2018 and 2019 had continued. In contrast, companies' cash holdings fell in past recessions. There is a close analogy here with the 'excess' savings accumulated by households during the pandemic. Just as individuals drawing on their savings could fuel a strong revival in consumer spending, firms' holdings of cash offer at least the promise of a healthy resurgence in investment. This hope is supported by history. Evidence from the period following the global financial crisis found that firms with relatively large cash holdings invested more heavily during the recovery.[15]

UK: Non-financial corporate deposits



UK: Ratio of non-financial corporate profits to GDP*



Changes triggered by the pandemic could promote or hinder investment, depending on the sector

But will those companies sitting on large cash piles have the incentive to invest the money? On that question, the direct impact of the pandemic is likely to be mixed. Certainly, COVID-19 has given some companies an incentive to invest in changes they might have otherwise put off. According to an ONS survey, 24% of companies intend to use increased homeworking as a permanent business model going forward.[16] This could promote more spending on ICT. And evidence from the BoE's regional agents during the crisis has pointed to some acceleration of investment in automation as a result of social distancing measures.[17] To the extent that those measures, in some form, prove a semi-permanent feature of life, the incentive for further automation will persist. A similar development could flow from the effect of the pandemic on the supply of workers. Although the data as yet lacks clarity, there is some evidence that COVID-19 resulted in a significant number of non-UK born workers returning to their home countries.18 If they do not come back to the UK, this could spur employers to invest more in labour-saving technology. This effect could be magnified in some sectors if the experience of the pandemic encourages workers to find alternative jobs. For example, survey evidence suggests that, as of March 2021, more than one in ten workers who had previously been in the retail industry, and who had previously been furloughed, had moved jobs since the pandemic began.[19]

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[15] Andreas Joseph, Christiane Kneer, Neeltje van Horen and Jumana Saleheen, 'All you need is cash: corporate cash holdings and investment after the financial crisis', Bank of England Working Paper No. 843, January 2020. bankofengland.co.uk/working-paper/2019/all-you-need-is-cash

[16] 'Business insights and impact on the UK economy: 6 May 2021', Office for National Statistics, 6 May 2021. ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/6may2021#working-from-home

[17] See page 11 of 'Select Committee on Economic Affairs: Corrected oral evidence: Annual evidence session with the Governor of the Bank of England', House of Lords, 13 October 2020. committees.parliament.uk/oralevidence/1025/pdf/

[18] Michael O'Connor and Jonathan Portes, 'Estimating the UK population during the pandemic', Economic Statistics Centre of Excellence, 14 January 2021. escoe.ac.uk/estimating-the-uk-population-during-the-pandemic

[19] See page 29 of Nye Cominetti, Charlie McCurdy and Hannah Slaughter. 'Low Pay Britain 2021'. Resolution Foundation, June 2021. resolutionfoundation.org/app/uploads/2021/06/Low-Pay-Britain-2021.pdf

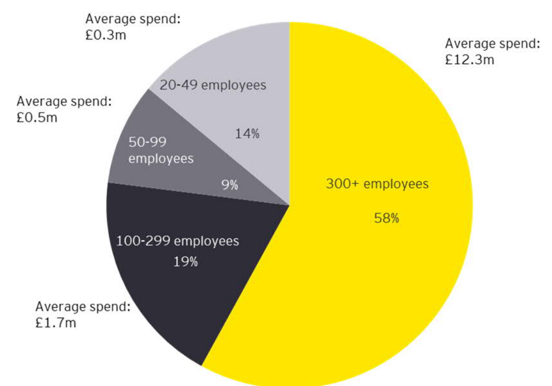
On the other hand, if homeworking becomes a fact of life for more people, even after COVID-19 has become a hopefully distant memory, demand for commercial real estate in city centres, as currently configured, might never recover to pre-pandemic levels. So investment in commercial real estate could prove to be permanently impaired relative to a 'no-COVID-19' counterfactual. A permanent shift from traditional office-based employment could also weigh on investment in other areas, such as company cars.

Tax could prove an important influence on investment over the next few years

It is easy to be sceptical about whether the tax system can be effective at promoting business investment. Notably, it is not obvious that the large reduction in the UK's corporation tax (CT) rate from 28% in 2011 to 19% in 2017 was matched by a rise in investment beyond that which a growing economy might have been expected to deliver. And recent research on the UK's Research & Development (R&D) tax credit by the Centre for Business Research at Cambridge Judge Business School concluded that the impact of the tax credit on investment in R&D has been "nugatory".[20]

However, given the scale of incentives for business investment announced in the Budget of March 2021, could it be different this time? One of the highlights of the Budget was the announcement of a 'super-deduction' allowing firms to write off 130% of their investment costs against taxable profits over two years, 2021/22 and 2022/23.[21] This compares to the present situation under which companies can claim 100% of costs up to a limit of £1m. The super-deduction should raise investment spending during the period of enhanced allowances by making more projects profitable. And it should also provide companies with a strong incentive to bring forward spending from future periods to take advantage of the more generous allowance.

UK: Investment by size of company in 2019



Source: ONS/Resolution Foundation

That said, being temporary, the super-deduction's effect on investment will be restricted. And the scheme has other limitations. One is that its coverage is restricted to plant and machinery. While this category encompasses spending on ICT, it accounts for only one-sixth of business investment. And the incentive effect for small firms, which, on an individual basis, typically invest much less than £1m per year, will be much less powerful than for large companies. The latter certainly account for a majority of business investment, but small- and medium-sized enterprises were still responsible for just over £4 out of every £10 of capital spending in 2019.

Nonetheless, analysis of similar schemes in the US suggest that investment is very responsive to temporary incentives.[22] And the Office for Budget Responsibility (OBR) expects a meaningful short-term effect. At its peak in the financial year 2022/23, the OBR estimates that the level of business investment will be around 10% (around £20b per year) higher as spending is brought forward.[23] So the super-deduction should boost the economy's post-COVID-19 recovery. What is more, given the supply-chain adjustments triggered by Brexit and the pandemic, and the investment required by the Government's net zero commitment on carbon emissions (for example, battery production plants for the car industry), the timing of the investment incentive could prove fortuitous and result in a bigger-than-expected boost to investment. Finally, factoring in the knowledge spillovers from businesses that invest and innovate to others, the policy's overall effect on the economy could prove more beneficial than predictions regarding the direct effect suggest.[24]

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[20] David Connell, 'Is the UK's flagship industrial policy a costly failure?', Cambridge Judge Business School, May 2021. jbs.cam.ac.uk/wp-content/uploads/2021/05/cbr-report-uk-flagship-industrial-policy-2021.pdf

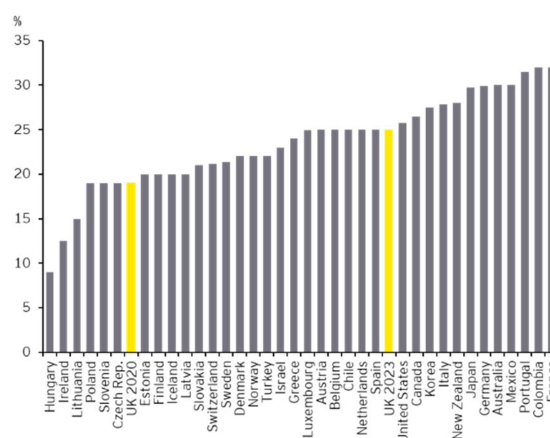
[21] 'Budget 2021: Protecting the jobs and livelihoods of the British people', HM Treasury, 3 March 2021. gov.uk/government/publications/budget-2021-documents

[22] Jean-François Wen, 'Temporary Investment Incentives', International Monetary Fund, 11 May 2020. imf.org/-/media/Files/Publications/covid19-special-notes/en-special-series-on-covid-19-temporary-investment-incentives.ashx

[23] See page 62 of 'Economic and Fiscal Outlook', Office for Budget Responsibility, March 2021. obr.uk/download/economic-and-fiscal-outlook-march-2021/

[24] Peter Spencer, Paulo Santos Monteiro and Peter Smith, 'The Chancellor's new Superdeduction: radical policy change or short-term expedient?', Economics at York blog, 5 March 2021. economicsatyork.blog/2021/03/05/the-chancellors-new-superdeduction-radical-policy-change-or-short-term-expedient/

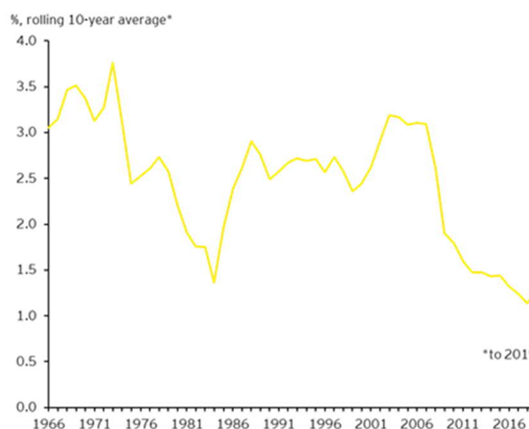
But whether the super-deduction will lift investment onto a permanently higher plane is debatable. And that task will be made harder by another tax measure included in March's Budget – a rise in the headline rate of CT from the current 19% to 25% from April 2023. (Note that in the absence of the super-deduction, this would have encouraged companies to delay investment until 2023 in order to set the cost against the higher tax rate.) This will constitute the first increase in the main rate of CT since 1973 and is forecast to raise an additional £17b per year from the corporate sector. A higher rate of CT will reduce the return from profitable investments. It will also take the UK from having the joint fourth-lowest corporate tax rate among OECD economies at present to being in the upper half of the international league table, absent any changes to other countries' rates.



However, if, as we think, the economic recovery proves stronger than the OBR expects, this will feed through to a more palatable fiscal position. So the Chancellor may find that he can rein back his plans for higher taxes on business while still meeting his fiscal goals. And to the extent that repeated cuts to the headline CT rate over the last decade or so seem to have done little to boost investment, a higher rate, if it is implemented, may not have too big an adverse effect. After all, there are other important influences on investment, such as a large domestic market and an internationally respected legal system, which the UK scores well on. As the latest EY Attractiveness Survey Europe shows, the UK managed to secure the second-largest number of inward investment projects in Europe in 2020, despite Brexit uncertainties and an economy relatively hard hit by COVID-19.[25] Moreover, the UK is not the only country to respond to the fiscal legacy of the pandemic with tax rises on business. Notably, the Biden administration in the US is planning to increase the corporate tax rate from the current 21% to 28%. On another international note, the competitive advantage of very low corporate tax jurisdictions like Ireland may be reduced by recent moves among the G7 economies towards a global minimum corporate tax rate.[26] These developments should reduce the extent to which a higher CT rate in the UK reduces the country's attractiveness to internationally-mobile capital.

Sustainably higher business investment needs sustainably high confidence

The panacea of investment-led growth, boosting GDP via spending on fixed assets while simultaneously increasing the supply capacity of the economy, and so creating room for further, non-inflationary, expansion, has long been sought by UK policymakers. But as the experience of recent decades demonstrates, microeconomic policy measures, such as tinkering with the tax system and adjusting financial regulation to discourage short-termism, have failed to lift business investment significantly, certainly as a share of GDP.



What does seem clear from recent history is the importance of demand in the economy in influencing investment. As a consequence of what Andrew Haldane, the BoE's Chief Economist, has described as the "psychological, financial and fiscal scarring" of the global financial crisis, the period since 2008–09 had been one of sluggish economic growth.[27] In the 10 years to 2019, the economy grew by an average of 1.3% per annum, close to the lowest since records began (2018 holds that spot with a 10-year average growth of only 1.1%). Weak growth manifested itself in very muted inflationary pressure, certainly once the effect of movements in sterling, oil prices and tax changes are stripped out, and average wages which, in real terms,

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[25] See footnote 14.

[26] 'G7: Rich nations back deal to tax multinationals', BBC News, 6 June 2021. bbc.co.uk/news/world-57368247

[27] Andrew Haldane, 'The beast of inflation is stalking the land again', New Statesman, 9 June 2021. newstatesman.com/2021/06/dangerous-moment

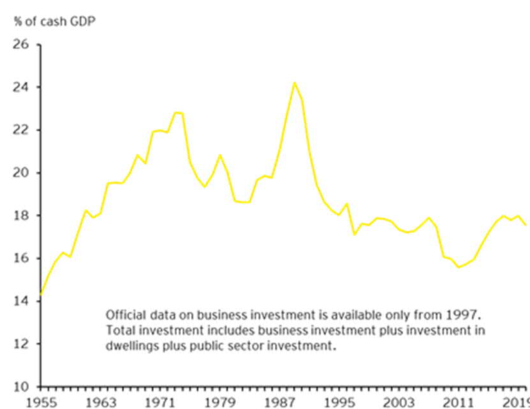
were still lower in 2019 than 12 years earlier. Firms could be forgiven for adapting to such an environment by investing less than otherwise.

The question is whether companies will be able to break out of their old mindsets and more aggressively add capacity than in the past. The super-deduction incentive will help. But perhaps of more importance will be ensuring that firms are confident that investment will be validated by future profits. And that means confidence that consumers will be able to buy the things that investment makes. Hence, it is crucial that policymakers continue to support the economy post-COVID-19. Specifically, this means not interpreting what is likely to be a transitory rise in inflation over 2020 and early 2021, as the economy emerges in fits and starts from the pandemic, as the start of a sustained period of higher price pressures and stepping on the policy brakes too early in response. In that world, hopes of an investment revival could prove stillborn. In practice, as the pandemic's restrictions are lifted, supply bottlenecks have already emerged, and more are likely to appear. But such bottlenecks will signal to companies where new investment is needed. And if the concern is around inadequate supply chains being stretched by strong demand, the most important thing is to sustain that demand, so businesses are willing to invest in increasing supply.

The pessimistic view is that after a long period of weak economic growth and two major global economic shocks in the space of 12 years, companies will remain reluctant to invest, even if the economy enjoys a post-COVID-19 spurt. And while policymakers may have become more Keynesian in their willingness to borrow and spend, we probably will not see the kind of public commitment to maintaining full employment and high levels of aggregate demand which guided macroeconomic policy in the 1950s and 1960s.

It was that commitment which gave firms the confidence to invest an increasing share of GDP despite the period also seeing strong growth in wages. And it was the faltering of confidence in the macroeconomy in the 1970s which contributed to firms cutting back on investment, a reversal which was only temporarily interrupted during the Thatcher boom of the late 1980s. If companies lack confidence that policy will sustain a high level of demand, investment risks showing little sensitivity to the economic recovery. And some of the structural headwinds to business investment, discussed in Section 2, may prove impervious to the COVID-19 shock.

UK: Total investment



Source: EY ITEM Club/Haver Analytics

But there is also an optimistic angle. The combination of positive forces generated by the end of the COVID-19 crisis could produce a surge in business optimism (what the economist John Maynard Keynes described as "animal spirits"), potentially shifting the economy from a low- to a high- (or at least, higher,) investment equilibrium. Households are awash with savings, fuelling a possible consumer boom and stimulating private investment via the so-called 'accelerator effect'.[28] The political zeitgeist has turned against growth-sapping fiscal austerity, a shift which was evident even before COVID-19 struck. Combined with the need to repair the pandemic's economic damage, the Government's levelling-up agenda to narrow regional disparities in the UK, and a BoE which is clearly in no rush to raise interest rates, the potential over the next few years is for a 'higher-pressure' economy than the UK has experienced for some time.

Academic work has shown that economies can fall into a 'stagnation trap'. If people expect economic growth to be weak, they will not invest or innovate as much. This results in even weaker growth and lower profits for other companies, which reduces the incentive to invest even further. So pessimism becomes self-fulfilling.[29] But this mechanism can work in the opposite direction. Optimism can encourage investment and innovation, which raises growth and profits across the economy, encouraging more investment and innovation. One of the conclusions of Joseph Schumpeter, the Austrian economist, was that innovations tend to come from over-optimism and excessive animal spirits.[30] We may be emerging into a period which offers as good a time

[28] Akhilesh Ganti, 'Accelerator Theory', Investopedia, 29 December 2020. investopedia.com/terms/a/acceleratortheory.asp

[29] Gianluca Benigno and Luca Fornaro, 'Stagnation Traps', Review of Economic Studies, Oxford University Press, vol. 85(3), pages 1425–1470, March 2017. econ-papers.upf.edu/papers/1487.pdf

[30] Joseph A. Schumpeter, 'The Creative Response in Economic History', The Journal of Economic History, Volume 7, Issue 2, November 1947, pp. 149–159. econpapers.repec.org/article/cupjechis/v_3a7_3ay_3a1947_3ai_3a02_3ap_3a149-159_5f05.htm

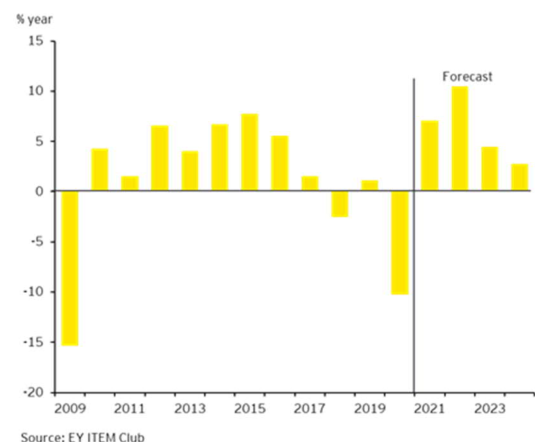
as any to test that hypothesis.

5. Conclusions

In our view, the balance of forces favours a strong recovery in business investment over the next few years. We expect it to grow by just over 7% in 2021 – matching the pre-COVID-19 level by the end of this year – and by in excess of 10% in 2022. Given the likely persistent structural changes driven by the crisis, sectors which saw investment grow during the pandemic, such as ICT and transport and storage, could see that outperformance continue post-COVID-19. And shifts in workers' preferences and the availability of staff could see traditionally less capital-intensive sectors such as retail and hospitality ramp up investment in response.

The prospect of at least a few years of strong investment growth would follow more than a decade when the climate for business investment has been a poor one. The global financial crisis gummed up the financing which business investment partly depends on and triggered a prolonged period of weak demand. 2016's vote to leave the EU, followed by three-and-a-half years of uncertainty over what form Brexit might take, or, indeed, whether the UK would actually exit the European bloc, was accompanied by a corrosive level of investment-sapping uncertainty. And 2020's COVID-19 shock delivered the biggest annual fall in GDP in over 300 years, while turning business conditions upside-down for many firms.

But subject to no nasty surprises from the virus, life should continue to return to normal. And thanks to the sheer scale of Government support, the UK corporate sector is emerging from the pandemic in a far less battered state than many had feared. Granted, business investment has a big hole to climb out of to return to pre-COVID-19 levels, let alone the trajectory before the pandemic struck. Some companies and sectors may never return to levels of demand considered 'normal' before 2020. And higher levels of corporate debt could weigh on the ability of indebted companies to expand, a particular risk among SMEs. But structural changes triggered by the pandemic and Brexit, including the move to online spending and less ready access to foreign-born workers, may open new avenues for investment in areas like ICT and labour-saving technology. The fact that investment in some sectors and assets saw healthy growth during the crisis perhaps offers a taste of what might come.



These new avenues will be appearing at a time when the overall macroeconomic environment should be more investment-friendly than at any point since before the global financial crisis. The economy is in the foothills of what will hopefully be a strong and sustainable rebound in consumer spending. And the super-deduction tax incentive should provide a strong incentive to invest, at least over the next two years. Moreover, what had been an overriding focus of governments on cutting the fiscal deficit, a policy which dragged on growth during the 2010s, has been put to one side. The planned rise in corporation tax presents a medium-term threat to investment. But the tax hike may prove unnecessary if the public finances recover more strongly than the OBR's pessimistic forecast expects.

The key uncertainty is the extent to which businesses will respond to the positives of the post-COVID-19 landscape beyond this year and next. Given recent economic history, psychological scarring could run deep, meaning a cautious approach to investment continues. This headwind should fade as time passes, as a new generation of entrepreneurs and business leaders, who have not been scarred by the recessions and crashes of the 2000s and 2010s, emerges, and opportunities in the world after the pandemic become clearer. We do expect a strong rebound in investment in the short term. But whether optimism can be sustained long enough for firms to reset their expectations and deliver a permanent upward shift in the level of investment, instead of being bound by the experience of a decade of disappointment, is the $64,000 question.

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