Response to BIS Consultation on Financing the Private Sector Recovery

John Van Reenen, Professor of Economics, LSE and Director of the ESRC Centre for Economic Performance

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Introduction and Summary

This is written is response to the BIS consultation on Financing the Private Sector Recovery (http://www.bis.gov.uk/businessfinance). I write in a personal capacity. CEP has no institutional views.

The main problem with the review is that it takes the extreme fiscal consolidation for granted (section A). I think the scale and speed of this consolidation is a mistake and would urge the construction of a "Plan B" which scales back the proposed cutbacks in spending in line with the budget of the last government.

The main priority is reform to the structure of our system of financial markets (section B). This means dealing with "too big to fail" and not trying to micro-manage who banks lend to. Further, the policy emphasis should be on types of investment subject to market failure – this is primarily in innovation (section C). This is an argument for retaining the R&D tax credit and strengthening top universities. The arguments for high subsidies and tax breaks for SMEs are the weakest (section D), so this is an area where there could be savings.

A. Macro Issues and general state of the evidence (Question 1)

To be clear: the increased deficit to GDP ratio over the last 3 years in Britain and elsewhere was fundamentally caused by a major financial crisis which led into the worst recession since the Great Depression. This was averted by timely government action in the UK and overseas to recapitalise banks and provide strong monetary and fiscal stimulus programmes. British levels of debt were not (and are not) excessively high by historical standards and, so far, the economy has done well to weather the global storm. We have had much more muted increases in unemployment than in previous recessions in the 1980s and 1990s with smaller GDP falls. We have also had lower increases in joblessness than other countries with high debt levels (due to liberalized financial systems) such as the US, Spain and Ireland. This success is, in part, due to the improvements in the operation of the labour market and public employment service over the last two decades[1].

The response in the Emergency Budget to embark on extreme fiscal consolidation is a mistake and poses serious risks to the recovery of the British economy. Far from securing an

[1] This is the subject of a separate submission in response to the DWP's "21st Welfare Reform" Document. See http://cep.lse.ac.uk/pubs/download/ea012.pdf on the labour market reforms and problems.

improved fiscal position it adds to the risk of a "double dip" recession which will worsen the public finances. My views on the macro situation are summarized in http://blogs.lse.ac.uk/politicsandpolicy/?p=3196.

While I concur with the general view that all programs should be evaluated rigorously, the scale of the cut-backs threatens good and bad indiscriminately.

B. Structural problems with Financial Markets (Q11)

The micro-economic problems behind the financial crisis are a system of perverse incentives that encourage banks to take excessive risks. This is essentially because too many financial institutions became "too big to fail", meaning that the government was effectively insuring them against downside risks through implicit promises of bail-outs. The structural solution to this problem is to restore credible bankruptcy risk to these financial institutions.

With Luis Garicano, we have outlined the kind of solutions necessary to deal with this problem which is a mix of regulation (higher capital requirements, "living wills" and transparency) and structural solutions that seek to (i) split the "casino" aspects of banking from the boring "utility" parts and (ii) reduce bank size. The proposals and analysis are available at:

http://cep.lse.ac.uk/pubs/download/ea011.pdf

For a more in-depth analysis see the CEP "Future of Finance" book

http://www2.lse.ac.uk/newsAndMedia/news/archives/2010/07/finance.aspx

C. Failures in financing innovation

There are many activities where financial markets may work poorly. High levels of information asymmetry for new ideas mean that R&D and start-ups face particular disadvantages in raising funds. In addition, innovative activities have local externalities implying that there will be a wedge between social and private returns. The obvious policy solution to this is to subsidise innovation in various ways.

The R&D tax credit is a major way of achieving this for business performed R&D. President Obama has just proposed to make this a permanent feature of the US tax code. This is rooted in strong economic evidence of (i) the wedge between social and private returns to R&D and (ii) the efficacy of tax credits in raising R&D.

Some papers to support this view would include:

"Technology Spillovers and Product Market rivalry" (with Nick Bloom and Mark Schankerman), CEP Discussion Paper No. 675, http://cep.lse.ac.uk/pubs/download/dp0675.pdf

"Mapping the Two Faces of R&D: Productivity Growth in a panel of OECD industries" (with Rachel Griffith and Stephen Redding) *Review of Economics and Statistics*, (2004) 86(4) 883-895. Lead article. http://cep.lse.ac.uk/textonly/people/vanreenen/papers/wp0002.pdf

"R&D and absorptive Capacity: from theory to empirical evidence" (with Stephen Redding and Rachel Griffith) *Scandinavian Journal of Economics* (2003) 105(1) 1-20 http://cep.lse.ac.uk/textonly/people/vanreenen/papers/wp0103.pdf

"Do R&D Tax Credits Work?" (with Nicholas Bloom and Rachel Griffith). *Journal of Public Economics* (2002) 85 1-31 http://cep.lse.ac.uk/textonly/people/vanreenen/papers/gvrb15_wp.pdf

The policy implications are:

1. Keep the R&D tax credit for the UK. In answer to Question 2, stability here (and in general) would aid economic performance.
2. Strong support for leading edge universities in UK – focus support where it will work, not spreading the research jam too thinly. Higher Education is one of the UK's few leading sectors and is based on worldwide academic excellence in research. This means concentrating research geographically and allowing finance and autonomy for universities to set their own fees.
3. Focus on the importance of new firms implies keeping entry barriers to low, supporting the development of VC and early stage investment.
4. Get rid of the "patent box" idea if it has not already been shelved. It is a complete waste of money - there is no market failure rationale.

D. Small and Medium Sized Enterprises (SMEs)

All over the world there are multiple tax breaks and benefits for SMEs. In my view the best way to support small firms is to ensure a level playing field by removing entry barriers to firms of all sizes, reducing barriers to growth, enforcing competition policy and strongly resisting the lobbying efforts of larger firms and their agents.

I am not hugely sympathetic to the current panoply of subsidies targeted at small firms in the UK and overseas, however, as the economic rationale and the evidence for market failures relating to size *per se* weak.

Here are 5 facts to bear in mind:

1. Small firms are less productive than large firms

There is now a huge literature showing that a major way in which economies grow rich is by improving the "creative destruction" mechanism that allows more productive firms to grow large and less productive firms to shrink and exit. A recent paper by Hsieh and Klenow (2009, QJE) suggests 40-60% of the TFP difference between India and the US is due to misallocation of output to too many small and low productivity SMEs in India.

Keeping SMEs on an artificial life support machine reduces aggregate productivity, which is the driver of long-run prosperity.

One reason for the lower productivity of SMEs is that they are also less well managed than larger firms. A factor in this is that many of them are family owned and family run (typically by the eldest son or grandson of the founder). This pattern of Primogeniture has been found, on average, to be associated with extremely poor management practices. The UK has many family firms and a poor record of management in comparison with other countries such as the US and Germany. This is related to the fact that we distort the tax system to give inheritance tax breaks to family firms (see http://cep.lse.ac.uk/pubs/download/pa004.pdf).

For evidence see:

"Why do Management Practices Differ across Firms and Countries? (with Nick Bloom). *Journal of Economic Perspectives* (2010) 24(1) 203-224 http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.24.1.203%20

"Measuring and Explaining Management practices across firms and nations" (with Nick Bloom) *Quarterly Journal of Economics* (2007) 122(4), 1351–1408. Lead article. http://cep.lse.ac.uk/pubs/download/dp0716.pdf

2. Small firms do not offer great benefits to workers

Related to the above fact on low productivity, small firms have lower average wages, less skilled workers, lower training less fringe benefits and are more likely to go bankrupt.

3. Small firms are not the "job creating backbone of the economy"

There is a common misperception that small firms create disproportionate numbers of jobs. This myth is due to two factors. First, many people look at gross job creation and ignores the fact that small firms also "destroy" huge numbers of jobs because they are much more likely to go out of business. Second, the myth confuses size with age. The most recent and comprehensive analysis of this phenomenon shows that young firms do create a disproportionate number of jobs, but small firms do not.

http://www.nber.org/papers/w16300

4. Financial constraints (especially for R&D) affect large firms as well as smaller firm.

For example:

"Investment, R&D and Financial Constraints in Britain and Germany" (with Steve Bond and Dietmar Harhoff) http://cep.lse.ac.uk/textonly/people/vanreenen/papers/annales_deconomie.pdf, *Annales d'Economie et de Statistique* (2005), 79/80, 435-462

"Uncertainty and Company Investment Dynamics: Empirical Evidence for UK firms" (with Nick Bloom and Steve Bond) *Review of Economic Studies* (2007)74, 391-415http://cep.lse.ac.uk/pubs/download/dp0739.pdf

"Micro-econometric models of investment and employment" (with Steve Bond) Chapter 65 in Heckman, J. And Leamer. E. (eds) *Handbook of Econometrics Volume 6A* (2007) 4417-4498 http://cep.lse.ac.uk/textonly/people/vanreenen/papers/bondvanr2003.pdf

5. Positive spillovers are created just as much (if not more) by large firms as by small firms

This is because they tend to operate more in technological "niches" see :

"Technology Spillovers and Product Market rivalry" (with Nick Bloom and Mark Schankerman), CEP Discussion Paper No. 675, http://cep.lse.ac.uk/pubs/download/dp0675.pdf, under consideration *Econometrica*

So why do we see so much policy support for SMEs?

I think there are several political reasons

1. There is confusion between the "height" of firms and the "length" of firms. There are reasons to believe that there are market failures for potential new entrants and new entrants tend to start small. Help is given for the small as a proxy for the new, even if many SMEs are not at all new.
2. There is confusion between helping the "small guy" and helping the small firm. Redistribution is an important activity to help protect those who the market would leave with socially unacceptable standards of living. But this is redistribution between people NOT between firms. Many small firms are not owned by poor people (e.g. Hedge Funds) and vice versa.
3. £1 given to 1 million firms generates more favourable press column inches than £1m to a single large firm. Thus it is attractive to politicians.
4. Large firms are seen as successful at lobbying for state "lollypops" so this needs to be counterbalanced by allowing SMEs to also get their snouts in the economic trough. Needless to say, the response as noted above should be a resistance to handing out lollypops in the first place.

Conclusion

The scale of public spending cuts is unnecessarily severe and should be scaled back. The next priority is to improve the system is through reforms to regulation to deal with the "too big to fail problem".

Since money has to be found, it could come in part from removing the tax and subsidy breaks for SMEs. The one caveat to this is that larger firms may be much better than smaller firms at "gaming" the system of subsidies[2]. But this is an argument for moving resources from policies that support firms to policies that support people.

Innovation support programs are the R&D tax credit and strengthening UK universities through lifting the fees cap and concentration research spending.

Questions

General Evidence Base

1. Do you agree with the evidence base as set out in this paper? Are there any additional issues
that should be considered?

Certainty Over Frameworks

2. Do you think greater certainty over future tax and regulation would have a significant impact
on current demand for or supply of business finance?

Equity Markets

3. Are there any regulatory obligations that may disproportionately deter SMEs from listing on
exchange-regulated markets such as AIM and Plus Quoted? What can be done to address this?
4. Are there any additional barriers to corporates (of any size) accessing equity markets and how could these be addressed?
5. How can Government ensure that the best small businesses in all parts of the UK are visible
to publicly backed venture capital funds? Should Government intervention to address the equity gap focus on the best firms regardless of geography, or seek explicitly to address regional economic disparities? The Government would be particularly interested in views on regional stock exchanges.
6. How can publicly-backed equity schemes and the Growth Capital Fund make more use of private capital in future? How could the scale and reach of publicly backed funds be improved? Are there any gaps within the portfolio? Does the potential model for the Growth Capital Fund meet the objective of filling a gap in the availability of funding for growth companies? Are there ways in which the potential model could be developed to improve its appeal to investors or its ability to make a material contribution to the funding of growth companies?
7. How could more high-net-worth individuals be encouraged to become Business Angels and
participate in larger deals through syndicates? Are there specific issues impeding business angel activity that the Government should address, such as investor readiness or the structure of publicly-backed venture capital funds?
8. How can eligible businesses help themselves to become 'investment ready' for equity finance? Where should this be done by private sector, market-led solutions? What role is there for Government in supporting this, and should intensive Government support be focussed on businesses high growth potential?
9. How effective are current tax incentives for equity investment in small businesses, such as the
Enterprise Investment Scheme or Venture Capital Trusts?

Debt Capital Markets

[2] For example, see http://cep.lse.ac.uk/textonly/_new/staff/vanreenen/RSA_final.pdf

10. Are there any steps that industry, financial institutions or government could take to promote
access to debt capital markets for a greater number of UK businesses?

Competition

11. What more could be done to promote greater competition in the provision of business finance?

12. What other actions could be taken to help businesses (of all sizes) access a wider range of
different finance options?

Addressing Future Risks

13. Looking ahead, what are your views on future risks to the provision of business finance, in
particular bank lending? If you have concerns, do these reflect transitional factors in the wake of the financial crisis, or structural factors? Are there steps that the banking sector, regulators or policy makers should be taking to mitigate these risks?

Banking Sector Environment

14. What steps can banks, industry or Government take to strengthen bank's relationships with
their customers and ensure businesses are not discouraged from seeking finance? What steps can the banking sector and others take to improve the financial readiness of business?
15. What options might Government consider to support increased lending to business (including possible expansion of the EFG or of payments to part of the supply chain)? How effective is the EFG in increasing access to debt finance for small businesses? What could be
done to improve it and can more cost be borne by users?
16. What steps would be beneficial in making securitisation more attractive to investors and a
stable form of funding for lenders? Are there particular sectors or products that this should be focused on?

International Trade

17. Are there significant constraints on access to trade finance for UK exporters? What measures
could banks, industry or the government take to increase the availability of trade finance?

Responding to the Consultation

5.6 This consultation began with the publication of this document and will last for a period of 8
weeks, closing on 20th September

business.finance@bis.gsi.gov.uk