VIEWPOINTSERIES

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# PLEDGES, PUZZLES AND POLICIES: WHAT'S IN STORE FOR INNOVATION AND ENTERPRISE?


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# FOREWORD

As the dust settles following the 2015 general election, it is time to consider the potential policy implications of the new government’s agenda. In the first in a series of Viewpoints, this one looks at the innovation and enterprise policy area. It draws on the Conservative Party’s Manifesto and early signs from the new government, including the programme set out in the Queen’s Speech. By shining a light on critical issues with reference to some of our recent and on-going work, we highlight some of the important challenges around enterprise support and industrial strategy. This demonstrates the fine balance that needs to be sought between reducing the deficit and the economic recovery, and as part of this solving the productivity puzzle.

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## THE VIEWPOINT SERIES

The Viewpoint series is a series of ‘thought piece’ publications produced by SQW and Oxford Innovation, the operating divisions of SQW Group.

The aim of the Viewpoint series is to share our thoughts on key topical issues in the arena of sustainable economic and social development, public policy, innovation and enterprise with our clients, partners and others with an interest in the particular subject area of each paper. In each Viewpoint, we will draw on our policy research and implementation experience to consider key topical issues, and provide suggestions for strategic and practical solutions.

# INTRODUCTION

After a fascinating run up to the general election and a result that took almost everyone by surprise, it's time to digest what this might mean for different areas of policy. It's clear that questions over Europe, devolution and fiscal consolidation will take centre stage in the coming months. Here we focus on the priorities and issues relating to innovation and enterprise, and shine a light on some of these issues by drawing on SQW's recent project work. This area of policy is, of course, closely linked to the aforementioned big questions. Business is already starting to speak out on the question of Europe, and will continue to do so. As we shall see, policies to support innovation and enterprise may be crucial to growth prospects and so ultimately to achieving deficit reduction targets.

# WHAT DOES THE CONSERVATIVE MANIFESTO SAY ABOUT INNOVATION AND ENTERPRISE?

The answer to this question is 'very little', or at least very little that we didn't know already. As may have been expected, the Manifesto largely presented a summary of announcements that had already been made (for example as part of the recently-published Science and Innovation Strategy) and existing policy direction. In summary, therefore, the new Conservative Government committed to:

- investing in scientific infrastructure through the Grand Challenges fund, building on previous announcements made in relation to the Turing Institute (on data/big data), a new polar research ship and the international Square Kilometre Array project (with Jodrell Bank in Cheshire recently selected to be the international headquarters)
- taking forward its industrial strategy, which includes individual strategies for the UK's key sectors, and intents to invest in the eight Great Technologies and the network of Catapult Centres that encourage collaboration between research and industry
- helping small business through addressing the issue of late payment, reducing red tape, and providing access to government contracts (with a target of one-third of government procurement heading the way of small businesses)
- tackling issues relating to access to finance, including providing finance for entrepreneurs wishing to start a business (through expanding the Start-Up Loans programme) and for those wishing to grow their business (through the Help to Grow scheme)
- making investments in science and innovation across different regions as part of the 'English' Manifesto, thereby contributing to spatial (as well as sectoral) rebalancing – for example investing in advanced materials and research into ageing in the North, automotive in the Midlands, cyber security in the South West, and agricultural technologies and energy in the East of England.

# INITIAL SIGNS RELATING TO ENTERPRISE

The devil, therefore, will certainly be in the detail, or at least the interpretation of the Manifesto pledges. Early signs, for example from Sajid Javid's first speech as Business Secretary and the single directly relevant bill in the Queen's Speech, highlight the pro-market and pro-business stance with a priority being given to helping small businesses through the Enterprise Bill.

## ENTERPRISE BILL

The Bill will set out measures to remove £10bn worth of 'red tape', in essence a continuation of the current direction of travel through the 'Red Tape Challenge'. This should help small businesses, and potentially enable them to contribute to creating the two million jobs targeted by the Government. Under the Enterprise Bill the Government will also establish the Small Business Conciliation Service to help small firms settle disputes, principally over late payment. It has been variously estimated that small and medium sized enterprises (SMEs) are owed more than £30bn or £40bn in late payments, and to put this into context, bank lending to SMEs was £53bn in the whole of 2014[1]. As SQW's recent literature review for the British Business Bank showed, late payment together with tightening conditions for borrowing has put pressure on SMEs' working capital position[2]. This not only affects the individual SME, but can also affect wider supply chains given the "pay when paid" approach taken by businesses.

The creation of a Conciliation Service is laudable, and has been welcomed by some business representative organisations, but will it actually make a significant difference? Much will depend on whether it affects the balance of power and the inclination of SMEs to take action. According to our review of the evidence, there is limited take-up of legislative regimes by SMEs, with very few for example charging interest on late payment for fear of harming customer relationships[3]. If this holds true for the take up of the Conciliation Service, then large organisations may not perceive there to be a threat of action against them. As a result, policy-makers may need to work with the new Conciliation Service to consider how complementary measures can help tackle the problem further.

## OTHER SUPPORT FOR ENTERPRISE

In his first speech, Sajid Javid vowed to make the UK the best place to start a business. A major programme that started under the Coalition, and remained a feature of the Conservative Manifesto (with a commitment for expansion), is the Start Up Loans Programme. The programme provides loans to individuals wanting to start a business, or with a business that has been trading for only a limited amount of time. Initially established in England only for individuals aged 18-24, by the start of 2014 it had been expanded through additional commitments of funding and extended to all parts of the UK and for any individual aged 18 and above.

We are currently in the first year of a multi-year evaluation of the Start Up Loans programme, and so this evidence should be critical in underpinning how the programme is taken forward. It is important to note that the Start-Up Loans programme is agnostic of the type of business that an individual wishes to establish, whether growth-oriented, lifestyle-oriented or otherwise. In this context, the programme's objectives cut

*[1] Bank of England Trends in Lending*
*[2] SQW, Paul, S. and Boden. R. (2014) Trade Credit: A Literature Review, Research Report for the British Business Bank. Report available here*
*[3] SQW, Paul, S. and Boden, R. (2014)*

across economic outcomes (around the creation of sustainable businesses that may go on to grow) and social outcomes (such as supporting people to achieve their potential through self-employment, and develop new skills and knowledge that could be taken forward through employment). In relation to those businesses with growth aspirations, the Start Up Loans Company has been working with partners to offer follow-on loans to some of its loan recipients.

Elsewhere, we may expect to see on-going attempts to simplify the business support landscape. At national level, support for SMEs with growth potential has been streamlined into the Business Growth Service, and at local level, funding for Growth Hubs is premised on a process of joining-up and simplifying the landscape locally. The direction of travel is towards devolving more of business support to local level, and perhaps by the end of this Parliament we might see cities having control of a 'Business Growth Service' on their patch, rather than the existence of a blanket national service.

# WHAT NEXT FOR INDUSTRIAL STRATEGY?

Turning to industrial strategy, support for an active policy here was particularly championed by the then Liberal Democrat Business Secretary, Vince Cable. How far it survives in its current form and scale may be subject to question and scrutiny.

## BALANCING STABILITY, SPENDING AND GROWTH CHALLENGES

The Conservatives have signalled a commitment to industrial strategy in their Manifesto. Pre-election this was one area of policy where there seemed to be genuine cross-party support, and recognition that the role and remit of Innovate UK, the national innovation agency, was set to expand. As part of the Coalition, the Conservatives also sought to protect the science budget, recognising that investments in scientific and research infrastructure matter. Business is also calling for stability in industrial policy, in particular in the face of uncertainty in relation to Europe.

Nevertheless, some policy-makers may believe that there could be scope for simplification with the potentially confusing sets of 11 sector strategies, nine Catapult Centres and eight Great Technologies. Whilst they serve different purposes and technologies are not the same as sectors, this level of bureaucracy (perceived or real) may not suit Conservative ideals.

With education, health and aid budgets protected, analysis by the Institute for Fiscal Studies indicates that unprotected departments collectively will need to find cuts of 15% (or £30billion) in annual spending by 2018/19[4]. George Osborne has already announced some initial savings, with £450m to be found by the Department for Business, Innovation and Skills (BIS), in particular from higher education and further education budgets (and referred to as "efficiency savings")[5]. In the future, BIS may have to look at industrial strategy as a source of savings. In weighing up the decisions, there are two challenges that analysts in BIS and HM Treasury will need to grapple with.

The first challenge reflects the timeliness of the availability of evidence on the current crop of industrial strategy interventions. Unfortunately the evidence base may be thin, not because there is no commitment to evaluating

*[4] Crawford, R., Emmerson, C., Keynes, S. and Tetlow, G. (2015) "Post-election Austerity: Parties' Plans Compared", IFS Briefing Note BN170*

*[5] See: https://www.gov.uk/government/news/chancellor-announces-4-billion-of-measures-to-bring-down-debt*

them (BIS has invested significant resources already into scoping and planning evaluations, some of which we have supported such as on agri-tech and aerospace), but simply given the lead times to realising outcomes and so in being able to make a judgement on value for money. Throughout much of this Parliament, there will be limited *ex post* evidence on the impact of industrial strategy interventions, and so spending decisions are likely to require some reliance on *ex ante* assessments of potential impact and interim evaluation findings.

The second challenge reflects the trade-offs in any spending decisions, and in particular the short-term/long-term balancing act. Meeting the deficit reduction targets is reliant on hitting the Office of Budget Responsibility's economic growth forecasts of around or just below 2.5% per annum for the next few years. Cut spending too quickly and the recovery may be choked off. In the longer-term, BIS and HM Treasury will want to ensure that they are not hindering progress against another related economic challenge, which received limited airing in the run up to the election, namely productivity.

## THE PRODUCTIVITY PUZZLE

Poor productivity performance has been hindering the economic recovery. Previously when the UK has come out of recession unemployment has been high, and businesses have used this spare capacity alongside new investment, which has stimulated growth in output and productivity. However, during and following the recent recession, unemployment did not increase as much as expected, and real wages have stayed low. Some commentators believe that this has, in part, contributed to low productivity: businesses have kept on workers on relatively low wages and not invested in capital, and so output per worker has stagnated.

There are other explanations. Risk aversion and a requirement to consolidate balance sheets have meant that enterprises with potentially good ideas have not been able to attract investment. We have found evidence of this in our own work, including in recent studies on SME finance in, for example, London, the North West of England, Northern Ireland and Scotland. At the same time, firms surviving (or indeed starting) may have been of lower productivity, with for example corporate insolvencies staying low in the recent recession (indicating the survival of so-called zombie firms). The result has been inefficiency in the allocation of resources in the economy, and an absence of creative destruction processes that can help drive up productivity.

There is also an important sectoral dimension, with high levels of productivity growth in recent years in transport equipment and administration/support sectors, but falls in productivity in the finance sector, and the chemicals and pharmaceuticals sector.

The key issue is in what to do. This is where industrial strategy may be important given its focus on investing in and stimulating R&D and innovation, which is an important part of the solution to the productivity puzzle. Business investment in R&D remains low in the UK relative to comparator nations. There is a range of non-targeted interventions to incentivise investment in R&D and innovation, some of which SQW has evaluated such as Smart and Innovation Vouchers (both with UK programmes as well as programmes in the devolved administrations). Evaluations of R&D grants of this nature have been found to increase levels of R&D and product and process innovation, which wider literature suggests helps to improve productivity. Recent econometric analysis also found evidence that public R&D grants *crowded in* further private sector investment in R&D; and also that collaboration can deliver greater innovation benefits[6].

This is where industrial strategy can play a role. Well-targeted interventions to stimulate more R&D spend in technologies and sectors where the UK has key strengths means investing in the tools and techniques that can help with the longer-term prospects for growth. In addition to providing subsidies for R&D, industrial strategy can help to bring together partners in particular sectors and technologies, which can stimulate the new collaborations between businesses and between businesses and the research base that may result in innovation benefits. Bringing together partners and experts can also help to ensure that R&D spending is targeted towards those areas with the most potential. This is not about 'picking winners', rather 'picking racers'.

Innovation also requires private financing. Short-termist financial markets and risk aversion continue to contribute to inefficiencies in the allocation of capital to innovative and growth businesses. There is a role for the state, for example through the British Business Bank and local funds (such as the Life Sciences fund for Cheshire and Greater Manchester for which we assisted with the business case and that is part-financed by the Local Growth Fund), to help address this.

## APPRENTICESHIPS AND SMALL BUSINESSES

Related to the innovation and enterprise agenda is the issue of skills. The Full Employment and Welfare Benefits Bill, announced in last month's Queen's Speech, includes a commitment for 3 million more apprenticeships over the next five years. CEBR research for the Skills Funding Agency[7] provided compelling evidence on the contribution that apprenticeships can make to productivity, though the extent of the benefit varies between sectors. The recent increases in take-up of apprenticeships have been, to some extent, amongst those aged 25 and over where apprenticeships may be used as certification for existing skills – and so the productivity gain here is lower. To get the productivity benefits, therefore, apprenticeships will need to be for new skills and/or for younger people. On the latter, apprenticeships need to be seen as attractive to young people and those that influence them (e.g. parents, teachers and careers advisors).

In order to achieve the targets, more businesses will also need to be encouraged to take on apprentices. The CEBR report highlighted other business benefits of apprenticeships. These included improving staff retention and morale, and the potential for commercial benefits, with consumers indicating that they would be willing to pay a premium for goods and services of firms that offer apprenticeships.

On a positive note, there has been an increase in interest and take-up of apprenticeships amongst SMEs, which has been partly helped by the incentives available, and also by other initiatives. These initiatives have been designed to tackle the barriers that prevent SMEs from investing in apprenticeships, such as Apprenticeship Training Agencies (that help to pool demand, including from SMEs, and help cover all aspects of an apprenticeship framework) and awareness-raising and information on the benefits of investing. SQW has reviewed some of the evidence on these

[6] King, M. and Woolley, E. (2014) *Estimating the Effect of UK Direct Public Support for Innovation*, BIS Analysis Paper No. 4

[7] CEBR (2015) *The Benefits of Apprenticeships to Businesses*, A report for the Skills Funding Agency

initiatives in our work for UKCES[8], and these have been found to stimulate apprenticeship starts across a range of sectors, including those not traditionally associated with apprenticeships. Though there is a smaller benefit to productivity from some of these non-traditional sectors.

Therefore, meeting the commitment on apprenticeships could be achieved in different ways. The more straightforward ways, such as increasing apprenticeships amongst those aged 25 and above, may be cheaper, but may not help to improve productivity as much. Moreover, extending the reach into other sectors could be an attractive option, but again the benefits to productivity are likely to be smaller. There are also funding questions to resolve, which may mean asking employers to contribute more. However, this will need to be done carefully as it may hinder the need to obtain wider take-up, in particular amongst SMEs.

# CONCLUSIONS

Whilst questions on Europe and devolution may take the front pages in the next couple of years, we have seen that there is still much to consider in relation to innovation and enterprise policy. These issues are critical for Government given the challenges around productivity, the often-forgotten debate of the election.

However, there will be some difficult choices and balances to strike. The productivity problem cannot be solved through pro-market or regulatory reform policies alone; rather it is likely to require some investment from government at a time when departments will be tasked with finding savings.

[8] Mackay, S., Cook, J., Agur, M., Daff, K., Hallam, R., Macleod, K. and Cox, A. (2015) *Review of the Employer Investment Fund and Growth and Innovation Fund: project level learning and performance*, A Report to UKCES. Available here

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