The UK needs a state investment bank to support its industrial strategy

Governments are increasingly recognising the important role that mission-oriented industrial strategy can play in tackling the key challenges of the 21st century. In the UK, the government's new industrial strategy set out four 'grand challenges' to position the UK at the forefront of the industries of the future.

At the same time, there is also a growing recognition that innovation is an important driver of growth, and that this requires not just any type of finance but patient, long-term, committed finance. Because the private sector does not often provide this type of finance, in many countries patient capital is provided by the public sector. In recognition of this, last year HM Treasury commissioned a Patient Capital Review to consider how to support innovative firms to access the finance that they need to scale up.

Despite these developments, thus far little attention has been paid to how these two agendas link together. The Institute of Innovation and Public Purpose (IIPP) brought together international experts and policymakers to discuss how patient capital can support mission-oriented industrial strategy at a workshop that took place in the UK House of Lords. The workshop saw the launch of a new IIPP policy brief, 'Patient Finance for Innovation-Driven Growth', which sets out the role that state investment banks can play in providing the long-term, patient capital that the private sector often does not provide. In the policy brief, we draw on lessons from our recent working papers to reflect on how state investment banks can be designed to address the challenges and opportunities of mission-oriented industrial strategy.

These lessons are more relevant than ever. Even before the vote to leave the European Union, the UK economy remained weak and unbalanced, with growth highly dependent on private debt-driven consumption. But with Brexit on the horizon, the UK faces new economic challenges—including the potential loss of access to the European Investment Bank (EIB). The EIB has long been a key source of patient capital for businesses and infrastructure projects in the UK, financing £7 billion of projects in 2016 alone.

The challenge for policymakers now is to move away from a consumption-driven growth model towards a modern investment-led strategy focused on addressing the key challenges of the 21st century. The government's industrial strategy is a step in the right direction—but unless there are sources of long-term, patient finance established to support it, it is unlikely to succeed.

At the workshop we heard how the National Infrastructure Commission is currently considering evidence on whether the UK should establish a new domestic institution to replace the EIB. Worryingly however, there are signs that HM Treasury is set to resist any such proposal.

In a recent blog post, Treasury Minister Kwasi Kwarteng MP described a new state investment bank as an "unrealistic prospect" because of the impact it would have on the government's balance sheet:

"it is highly likely that an infrastructure bank would be added to the government's balance sheet, as its lending would add to Public Sector Net Debt (PSND). This would potentially jeopardise the government's fiscal target of reducing PSND, as a percentage of GDP, in 2020–21. Since 2010, the government has worked diligently to restore public finances to health but despite nearly achieving its target of reducing debt as a percentage of GDP, debt still remains too high."

But as Stephanie Kelton recently explained at her sold-out talk at the British Library, part of the IIPP's public lecture series, such fear of the national debt is misplaced. The government's budget is not like a household's budget. And as I have explained elsewhere, HM Treasury's approach to measuring public finances is highly unusual, and creates a bias against public investment. The main measure of public debt in the UK is 'public sector net debt', which is defined as public sector financial liabilities less liquid assets. According to the Office for National Statistics definition, the public sector comprises central government, local government and public corporations.

While the UK government targets total debt across the whole public sector, this is not standard practice internationally. Most other countries, including across the EU, monitor and target 'general government gross debt', which includes both central and local government but excludes public corporations—including state investment banks. So while across Europe state investment banks such as the German KfW and the Italian Cassa Depositi e Prestiti can borrow and invest prudently without clouding the debate about the public debt and deficit, a British equivalent could not.

The UK's approach is entirely voluntary: the inclusion of public corporations in measures of debt and deficit is not imposed on us by anyone else. But in practice, this self-imposed constraint means that any borrowing undertaken by a state investment bank would be added to the public debt and deficit—meaning that politicians see it as unattractive and expensive.

But state investment banks are also investing in new assets, which will generate a future income steam. Finance theory states that if the return on the asset being invested in is greater than the cost of borrowing then the investment should be made because it is a net positive. However, under the current approach these new assets are not accounted for anywhere. As Sir Vince Cable has explained:

"borrowing to finance investment by a government body may create an asset (machinery, a building) but—bizarre as it may seem—this is not properly accounted for and so the activity is treated as adding to gross and net debt as well as government borrowing. The current enthusiasm for 'selling the family silver' has its roots in bizarre Treasury accounting conventions."

If the UK government is serious about its industrial strategy, then it must also be serious about creating new sources of long-term patient finance. It should not let bizarre accounting rules get in the way of transforming the economy to meet the challenges of the 21st century.

Notes:

- *This blog post appeared originally on UCL's IIPP blog on Medium. The IIPP workshop described here was hosted by Lord David Willets and supported by the EC Horizon 2020 Project ISIGrowth. Speakers included IIPP director Professor Mariana Mazzucato, Sir Vince Cable, Lord David Willets and Professor Stephanie Kelton.*
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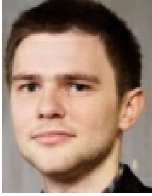

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