Overcoming Short-termism within British Business

The key to sustained economic growth

An independent review
by Sir George Cox
commissioned by the
Labour Party

Contents

Labour Policy Review

Further copies of this report are available on Your Britain, the Labour Party policy review website: http://www.yourbritain.org.uk/agenda-2015/policy-review/cox-report

Foreword

This Review looks at ‘short-termism’ within British business: the pressure to focus on short-term results to the possible detriment of the long-term health of a company, or even a whole industry. Ultimately, the concern must be for the effect this has on the competitiveness and economic prosperity of the UK.

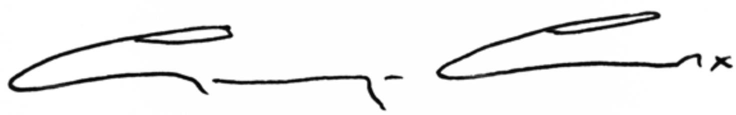
The Review was commissioned by the Labour Party in March 2012. It has, however, been an entirely independent investigation. The causes of short-termism are deep-rooted and long-standing. Any failure to recognise and address the relevant issues has been shared by governments of all persuasions over many years.

The Review sought the views of business leaders, investors, trade unionists, past heads of government departments and representative bodies. It received submissions and evidence from many organisations, and benefited from a survey specially carried out by the Institute of Directors (IoD), drawing largely on the experience of SMEs. It also examined the views of leading members of Intellect, the trade body representing the electronics and ITC industries. Unless otherwise stated, all results quoted or presented in charts in this report are based on this research.

Those who contributed are listed at the end of the document, and I am most grateful for their input, as I am to Dr David Slattery for his assistance with the research and analysis.

I am particularly indebted to the Steering Group for their guidance and to the EEF and IoD for their fulsome support. However, it should be pointed out that although these views proved invaluable in shaping the investigation, it should not be inferred that any individual or organisation supports the specific findings or recommendations contained in this report; those remain the sole responsibility of the author.

The investigation confirmed that short-termism constrains the ambition of UK business, holding back its development and inhibiting economic growth. The research established that the causes include, but go well beyond, the oft-blamed functioning of capital markets. It makes a number of recommendations but concludes that what is required overall is a strategic view of how to utilise the inherent strengths of British business to make it globally competitive in the 21st century. How effectively this issue is addressed will determine the future economic health of the nation.



Sir George Cox
26th February 2013

Executive Summary

The Review found that:

- Short-termism – the pressure to deliver quick results to the potential detriment of the longer-term development of a company – has become an entrenched feature of the UK business environment.
- Short-termism curtails ambition, inhibits long-term thinking and provides a disincentive to invest in research, new capabilities, products, training, recruitment and skills. It results in drastic cost-cutting and staff-shedding whenever revenue growth fails to keep up with expectation.
- Its most important consequence is that it militates against the development of the internationally competitive businesses and industries that are essential to the UK's future economic prosperity.

'Short-termism ...militates against the development of the internationally competitive businesses and industries that are essential to the UK's future economic prosperity.'

Its causes can be grouped under three headings:

- The way that equity markets now operate.
- The lack of a 'funding escalator' for smaller companies: the absence of a series of financing mechanisms to carry UK ventures through the successive stages of development from start-up to large-scale corporation.
- The short-term focus of (any) government.

Nearly three-fifths of the senior business leaders consulted judged short-termism to be a major or significant impediment to growth – notwithstanding the fact that this included individuals who have headed up some of the UK's most successful companies. The IoD survey of mainly smaller companies put the figure even higher at more than 90%.

The fundamental challenge for the UK is not how it emerges from recession, but how it earns its living in a world where other nations are building vigorous and innovative new industries. This applies to both manufacturing and services, and to every sector.

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The Review found an overwhelming consensus, not just on the importance and nature of short-termism, but also on the sort of things that need to be done to address it, particularly the role that government needs to play. This might seem surprising in view of the wide range of individuals and bodies consulted. It is often assumed that business simply wants government to get the macro-economy right and get out of the way. However, that is not the case. Indeed, there was recognition that the issue cannot be addressed without strong government action.

In the 21st century, existing industries are going to change and new industries are going to emerge. No nation is going to succeed in any of these fields by fortuitous outcome of economic circumstances and market forces.

What is needed is a strategic approach for the pursuit of long-term growth. This has nothing to do with ‘picking winners’ or getting involved with the way companies are run. It has everything to do with creating a structure from which winners emerge.

The Review makes recommendations in several areas: some specific, others requiring further investigation, concentrating on removing or reversing incentives to act or think short term. However, these are the start and not the end of the required change.

Overall, what is required is a clear ongoing strategy to enable the UK to exploit its innovative skills and to prosper in the growing but fiercely competitive markets of the 21st century. Exhortation, announcements and token initiatives will not do it. It requires clarity of vision and action on the right scale. Government – regardless of political persuasion – needs to focus much more on how wealth is to be created, not just on how it should be distributed.

Summary of Recommendations

Setting the framework:

1. Industrial strategy should form a cornerstone of government policy: providing a clear vision of how the UK is going to build competitive businesses in the 21st century.

There are many areas where steps could be taken to rectify the prevailing entrenched short-term culture. None is necessarily easy to implement, some carry a degree of risk, and virtually all will provoke a degree of opposition. Nonetheless, if such steps are not taken, nothing will change.

'Industrial strategy should form a cornerstone of government policy: providing a clear vision of how the UK is going to build competitive businesses in the 21st century.'

The proposals cover diverse areas reflecting the nature of the problem, and the author makes no pretence of their being exhaustive.

Improving the functioning of equity markets:

2.1. Taxation treatment should be changed to attract long-term investors back into the equities market and to incentivise longer-term shareholding. This should encompass both individual shareholders and funds.

For example, Capital Gains Tax on shares could be tapered, in a series of yearly steps, from a rate of 50% in year one to 10% after year ten.

Liability for tax on dividends could be reduced, in a series of yearly steps, from the prevailing rate of income tax in year one to 0% after year ten.

2.2. Further investigation should be undertaken into how taxation treatment could be changed to remove the bias towards debt rather than equity finance.

2.3. The law on takeovers should be changed, such that all shareholders who appear on the Register during the Offer Period (as defined by the Takeover Code) have no voting rights until the outcome of the bid has been concluded.

2.4. Quarterly reporting should be abandoned (as has been recommended by the Kay Review[1] and others).

2.5. Company reports should also include a clear description of long-term strategy, progress towards previously declared long-term goals, and actions taken and investment made in pursuit of these objectives.

2.6. The Governance Code should be extended to ensure sufficient long-term incentive is incorporated in both executive pay and non-executive directors' remuneration.

For example, The Code could call for at least 30% of executive directors' remuneration to be deferred and based on long-term (five-year) results.

As a further example, the Code could require 50% of non-executive director remuneration to be paid in the form of shares that do not vest until either five years have elapsed or the director has completed his or her term on the board.

2.7. The current Share Incentive Plan (SIP) system should be expanded to encourage wider employee share ownership.

For example, in addition to the current £3,000 of shares that companies can award each year, employees could be allowed to take up to 10% of basic salary or £5,000 (whichever is lower) in shares (subject to the same restrictions and tax benefits).

2.8. Further, urgent investigation should be carried out looking at the unintended effects of recent and forthcoming financial regulation in promoting short-termism.

1 The Kay Review of UK Equity Markets and Long-Term Decision Making: Final Report July 2012; Department for Business, Innovation & Skills.

Supporting the smaller company:

3.1. The various financial incentives and support schemes for smaller businesses should be reviewed to establish their effectiveness with regard to promoting long-term development. Those that have an impact – or with modification could have an impact – should be given greater backing and scaled up.

3.2. Measures should be taken to increase liquidity in the AIM market, making it more attractive for both listed companies and investors.

For example, Stamp Duty could be abolished on shares in AIM-listed companies.

It has already been proposed that liability for tax on dividends in general could be reduced, in a series of yearly steps, from the prevailing rate of income tax in year one to 0% after year ten. To increase the attractiveness of investing in smaller listed businesses, this taper could be accelerated to five years for AIM-listed companies

Infrastructure:

4. A mechanism has to be established to take infrastructure investment out of party politics. In selected major areas of infrastructure, an agency should be set up that is accountable to – but independent of – Parliament. Its role should be to determine strategy, to make decisions on the basis of independent studies, to commission suppliers and to oversee delivery.

Building research capability:

5.1. State spending on research should be progressively increased over the next five years to put it on a par (as a % of GDP) with of that of the leading industrialised nations.

5.2. Post-graduate education must be put on a par with our main economic competitors.

Making greater use of public procurement:

6. The public procurement process should be reviewed, looking specifically at wider exploration (and better implementation) of innovative solutions, more positive engagement with potential suppliers including smaller companies, and more concern for the long-term effect of decisions on the supply industry.

The Nature and Impact of Short-termism

When managing an organisation of any size, there is always a balance between the short and the long term: the extent to which one delivers results in the immediate period as opposed to investing in the future. The latter can take the form of research, product development, marketing, new plants, entering new markets, recruitment (or staff retention), training or new systems. Such things are the bedrock on which future success depends.

Nonetheless, there has to be a balance. It is all very well to consider the longer term, but it has to be funded, and the needs of investors, some of whom are reliant on dividend income, have to be met. Moreover, investor confidence needs to be maintained by demonstrating that the business can actually deliver results, not just promise them. However, the concern is that the balance for UK business has swung too far towards the short term: pressure to deliver results in the coming year, half-year or even quarter, overwhelming any consideration of the future.

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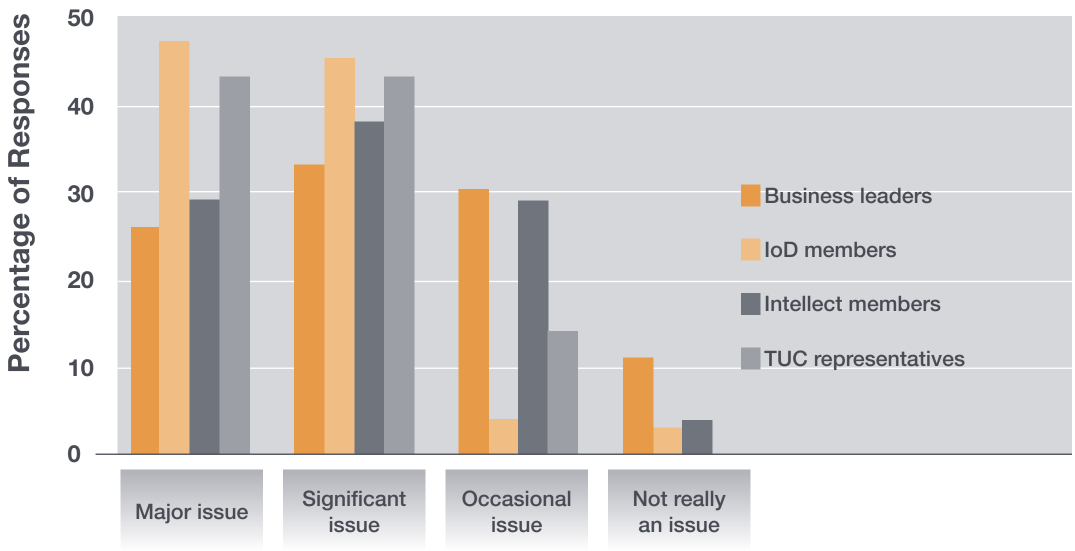
This does not just slow down company progress, it impedes the creation and development of the businesses and industries on which the future economic health of the UK depends. This is in sharp contrast to our competitors, particularly those in the fast-growing new economies.

The research undertaken for this report strongly supports this view.

Is short-termism really an issue?

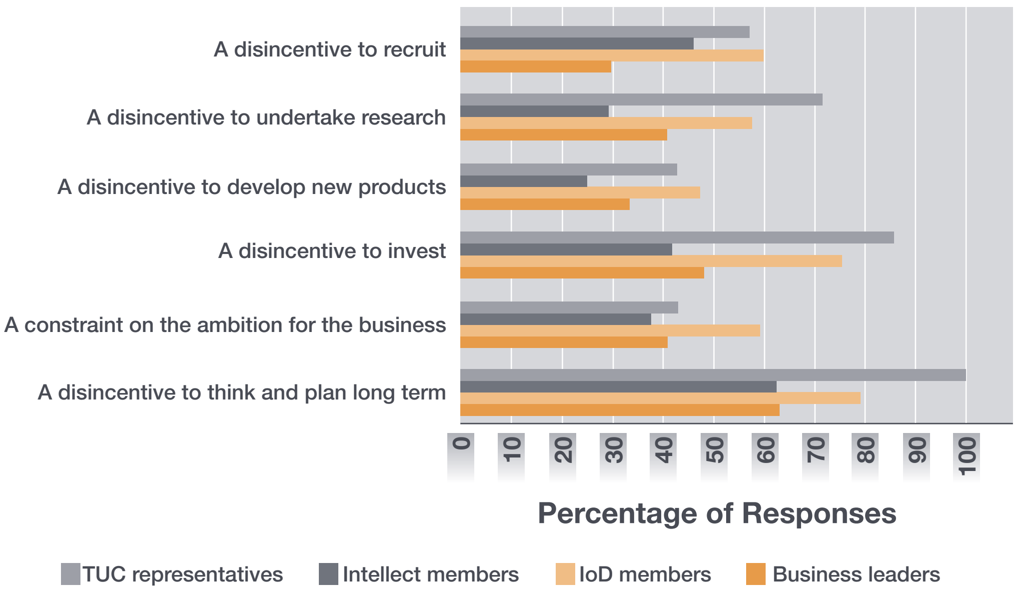


Concern about short-termism was widely reflected by those consulted. Almost 60% of the business leaders interviewed rated it as a major or significant impediment to the growth and development of British business; a survey of IoD members (made up largely of SMEs) put the figure even higher at 92%; the members of Intellect (the trade body for the ITC and electronics industries) rated it at 67% and a representative group of trade union leaders put it at 86%.

There was also a remarkable degree of consensus in terms of its effects, which were:

- A disincentive to think and plan long term.
- A constraint on the ambition for the business.
- A disincentive to invest.
- A disincentive to develop new products.
- A disincentive to undertake research.
- A disincentive to recruit.

If it is an impediment, what form does it take?



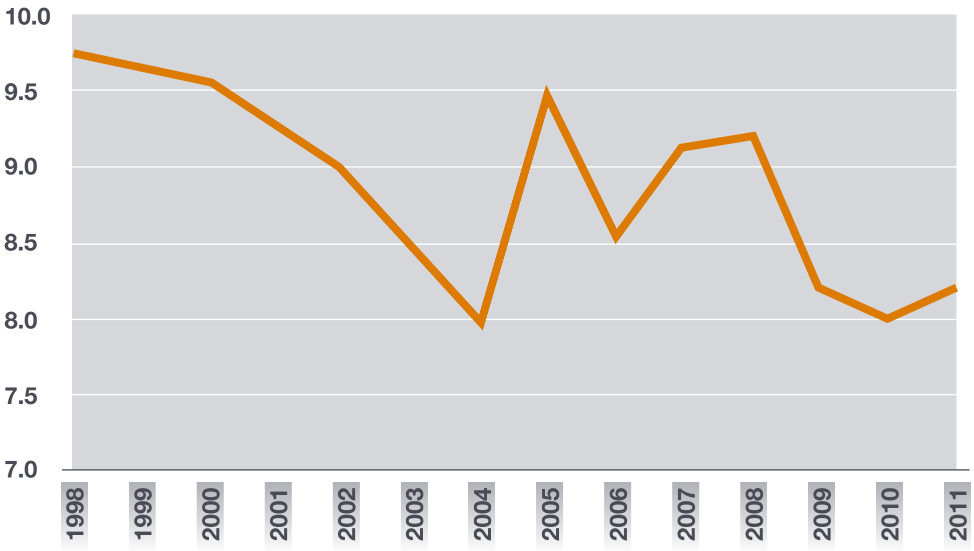
Business leaders, SMEs and union representatives all agreed that the major effect was the disincentive to think and plan long term. This is something that over time becomes engrained in the culture of a business. The focus – which starts at the top, but permeates down to all levels – is on the immediate; successful executives are those who can respond and deliver fast results; and incentive schemes are devised to ensure that this practice is embedded in the way the company behaves. It thus becomes part of the fabric of the organisation and a difficult thing to change.

This UK cultural malaise is apparent to anyone who has experience of dealing with the fast-expanding Asian economies. The growing competitive threat that these represent, resulting from their huge investment in higher education, skills, research and high-tech industries, is rightly a cause for concern. However, the oft-quoted statistics illustrating this build-up of industrial capability are only part of the picture. What should be of equal concern are their energy and their sheer belief and confidence in the future.

'…incentive schemes are devised to ensure that short-term focus is embedded in the way the company behaves. It thus becomes part of the fabric of the organisation…'

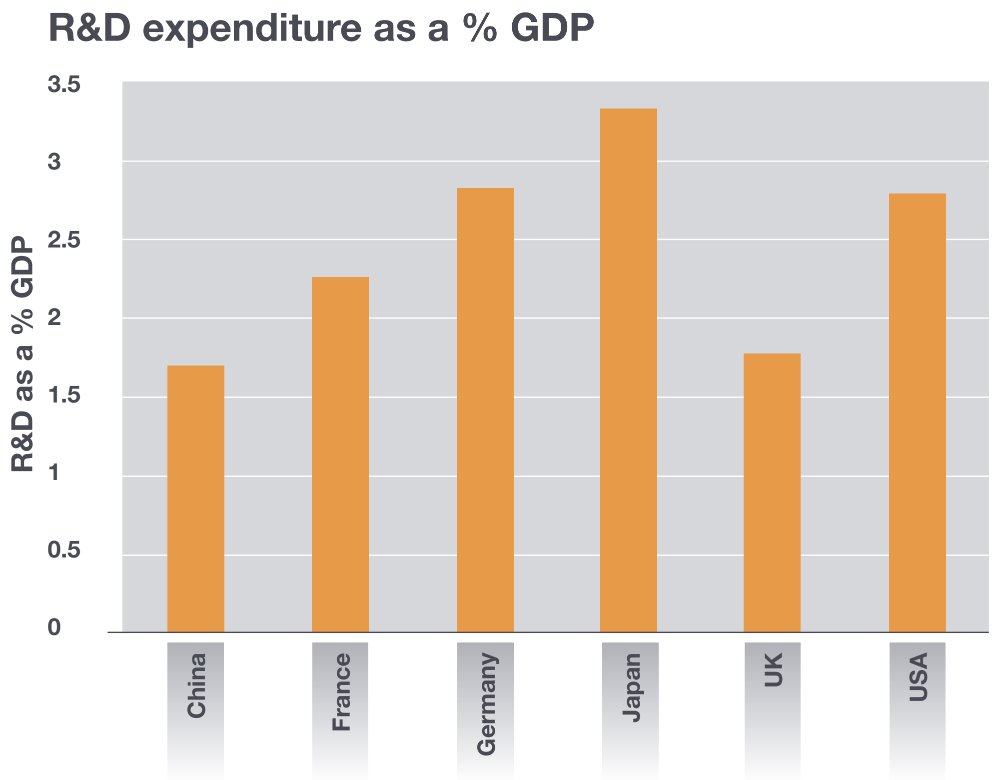
All groups consulted agreed that the second most significant effect of short-termism is a reluctance to invest. This is reflected in the overall figures for UK investment in recent years.

UK business investment as a % GDP



Source: Office for National Statistics (ONS).

One particular area that should be of concern is the under-investment in research compared with our major industrial competitors.



Source: Organisation for Economic Co-operation and Development (OECD).

'Scientific discovery and technological advance ….will give rise to new industries and new corporate giants.'

Scientific discovery and technological advance will form the basis of much of the economic advance of the next half century – just as it did for the last half century. It will give rise to new industries and new corporate giants such as today's Skypes, Googles and Microsofts. Nor will it simply be new technology companies themselves that will flourish. Of perhaps even more consequence, technology will create or enable the transformation of other companies that exploit rather than develop the advances. We have seen this with companies such as ebay, Amazon, Facebook and PayPal. The fact that the UK has not produced such companies has got to be a source of concern. The argument that this is because the UK's domestic market is too small is not the answer. These companies have exploited a world market. (Note that Nokia did not achieve its position because of the size of the Finnish market for mobile communications, but rather because it marketed its products internationally.)

In the area of information technology – where the UK was the first nation to introduce commercial computing – we have produced many fine niche companies and numerous influential individuals, but no global giants.

That should be of great concern. If the UK cannot create world-leading companies in a sector in which it had a head start, which is ideally suited to its creative skills, and for which the global language is English, where is it going to create such companies?

'..the application of technology to production processes has reduced the advantage of the world's low-wage cost economies, the assumption of which led to the mistaken belief that the UK had no future in manufacturing..'

Of perhaps even more significance is the effect that technological advance has on long-established businesses or industries: opening up new opportunities for those who adapt while threatening those businesses that fail to change quickly enough. One has only to look at the transformation – and globalisation – of the financial services sector. Financial exchanges, for example, have become extremely technology-dependent, handling volumes of transactions at speeds that would have been unimaginable a decade or so ago. Indeed, the whole concept of what constitutes 'an exchange' has been transformed due to technology.

Such changes to established industries are by no means confined to services. In the automotive industry, manufacturers now compete more than ever on technological innovation, resulting in cars that have doubled in fuel efficiency, that only need servicing at very lengthy intervals, that do not rust, that come with virtually a lifetime warrantee, and that can even recognise road signs and park themselves.

Of great significance too is the way that the application of technology to production processes has reduced the advantage of the world's low-wage cost economies, the assumption of which led to the mistaken belief that the UK had no future in manufacturing and should turn almost wholly to services.

Other pressures, such as environmental concerns, energy costs and the challenge of providing healthcare throughout longer lives, will all increase the demand for scientific and technological advance. Indeed, the challenges of those areas can only be met by new thinking, new products and new services.

This will create huge opportunity for business growth and new enterprises, even entirely new industries. One of the keys to exploiting such opportunity is clearly going to be keeping the nation in the forefront of pioneering advance. Given which, there is worrying evidence of a further manifestation of short-termism: under-investment – indeed further decline – in research.

The UK's record of research outcomes is remarkably impressive, whether measured by Nobel prizes, citations or the list of significant discoveries. This is despite an unimpressive record of investment compared with the world's most advanced nations. That level of relative investment is now dropping further.

R&D spend as a percentage of GDP compared with Germany, France and the US is declining. China, as one would expect, is climbing fast and will soon overtake the UK. However, if one looks at absolute spend, the situation is even more alarming.

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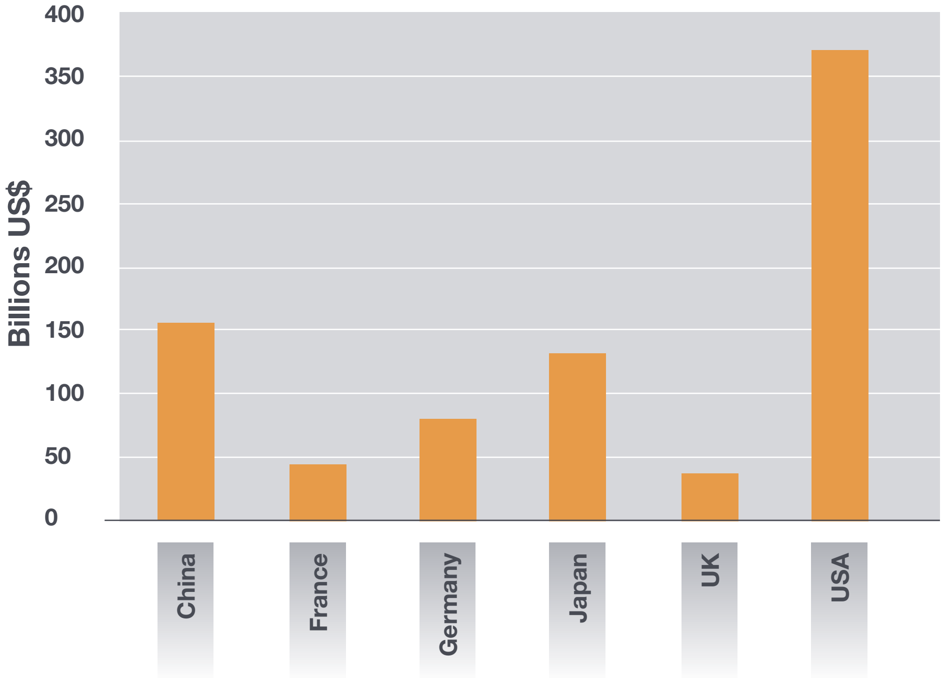
R&D expenditure in billions US$



Source: OECD.

In 2010, the government commissioned Elsevier to assess the performance of the UK research base. The report was positive in tone, describing the UK as a "leading research nation" and "a world leader in terms of article and citation output." However, it also noted that: "UK research has some potential areas of vulnerability" and that "its leadership position may be threatened by its declining share of researchers globally, and by its declining share of global spending."[2]

2 Elsevier, International Comparative Performance of the UK Research Base, Department for Business Innovation and Skills.

There are two research-dependent industries that have contributed substantially to the UK over recent decades: aerospace and pharmaceuticals. In both cases, the current decline in their research expenditure must give cause for concern with regard to their future global position. The aerospace industry estimates that for every £1 invested by the UK Government in aerospace research, France is currently investing approximately £8 and Germany £12.50.[3] Even allowing for any imprecision in the figures, the disparity is such that this must have a huge impact on the relative strength and scale of the future UK aerospace industry.

'Another manifestation of short-termism is the disincentive to recruit.'

A further recent example of the comparative reluctance or inability of UK companies to invest in exploiting new technology is the discovery of graphene. This extraordinary material, comprising a single sheet of carbon molecules, is one of the thinnest, lightest, strongest, hardest and most conductive materials ever created. It offers the potential for technological breakthroughs in a wide range of industries, some undoubtedly game-changing. First identified by two Russian academics at Manchester University in 2004 (for which they subsequently received the Nobel prize), the development of graphene has received Government research support to the tune of £60 million. Nonetheless, according to research by CambridgeIP, while UK businesses and businesses have to date filed 54 related patents, Chinese organisations have filed 2,204 and the US 1,754.[4] This threatens to be another area where pioneering UK research and innovation is not being fully and vigorously exploited by UK industry.

Another manifestation of short-termism is the disincentive to recruit. The Review found that smaller businesses and high-tech companies were particularly concerned about this issue. Around 60% of the respondents to the IoD survey and 46% of the Intellect responses cited it as a concern.

Given the vagaries of the economic cycle, it is unrealistic to expect companies to grow, uninterrupted, year-on-year. In any period of slowdown it is not unreasonable to expect costs to come under scrutiny and to be flexed to reflect any shortfall in revenue. There are times when this is not only necessary but perhaps overdue.

The problem with short-termism is that the pressure to maintain an ever-increasing bottom line or a progressive dividend policy can be such that the extent of the cost-cutting damages the longer-term prospects

3 A Strategic R&T Case for Aerospace. The Aerospace Growth Partnership. September 2012.

4 CambridgeIP Insight ReportTM 'Patenting flatland: Graphene'. 2013.

of the business. Cuts in expenditures such as research and product development are not only deemed acceptable, they are lauded. Any negative effects in the immediate term are not noticeable, whereas in the longer term the lost ground might be irrecoverable.

Of most consequence is the pressure to cut headcount. As long as this is a matter of pursuing greater efficiency and higher productivity, it can be a healthy exercise. However, it often does not stop there. The pressure quickly leads to reduction in productive capacity. Whether this might prevent taking full advantage of an economic upturn is not taken into account. As a consequence, the loss to the business is not just the number of staff that are released, but the skills and experience lost, especially when 'early retirement' is one of the strategies involved to reduce the cost and to make the process appear more palatable.

In essence, the high cost of redundancy programmes is deemed acceptable; it is treated as a one-off, an exceptional item, something separate from normal running costs. The potential cost of having to hire, train and re-build this capacity is not a priority consideration. That's considered a problem for tomorrow, a problem for somebody else.

'…downturns – thanks to short-termism – erode the nation's skills base.'

There is another detrimental effect of such action, going beyond the individual company. When you shed skilled staff, particularly in a sector like manufacturing, much of this capability is lost for ever. The skills are no longer there when the situation improves. The older, more experienced staff retire early or take part-time jobs elsewhere. The younger staff, faced with the prospect of the same thing happening again, perhaps repeatedly, move out of the sector altogether looking for a career elsewhere.

You cannot shelve numbers of unemployed skilled individuals, expecting them to be available for re-hiring when the market picks up.

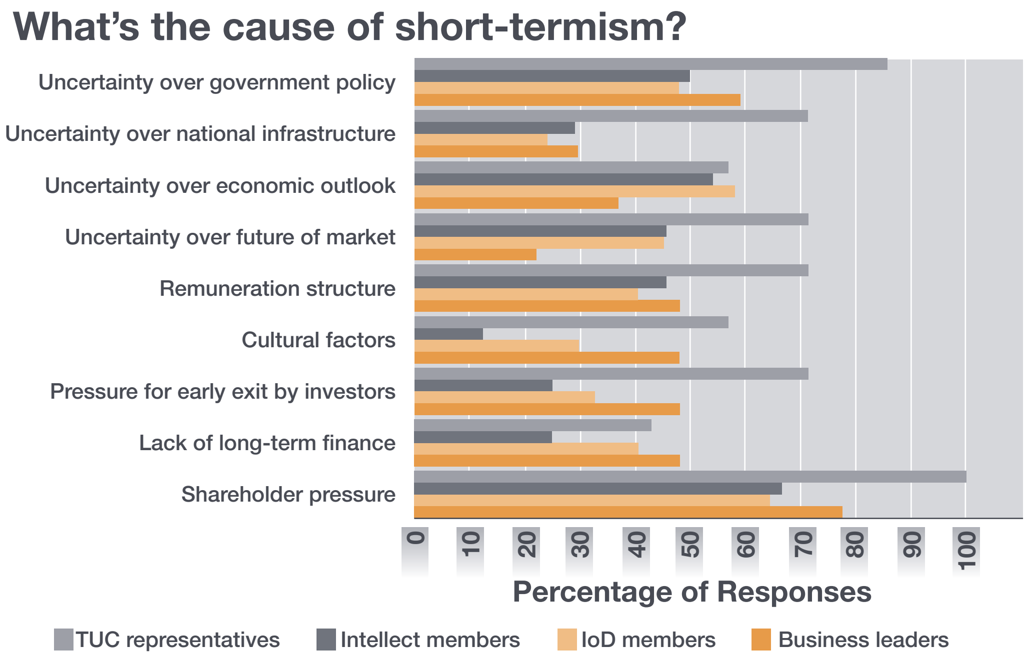
Thus, downturns – thanks to short-termism – erode the nation's skills base.

Enlightened long-term shareholders ought to be asking management not just what they are doing to drive down costs during a period of economic downturn, but what they are doing to preserve the capacity for long-term success. But that is not what happens.

Overall, short-termism stands in the way of the nation building the capacity to thrive in a world of both huge new opportunities and fierce competition.

The Causes of Short-termism

There are a number of aspects of short-termism and a number of causes, as the research identified.



'The ultimate shareholder, the individual saver or pension holder, is a long way removed from the company on whose growth his or her prosperity ultimately depends.'

However, there are three underlying drivers from which all else stems:

- The way the equity markets currently operate.
- The lack of a 'funding escalator' providing finance for the development of companies, all the way from start-up to large business.
- The behaviour of government.

Equity Markets

The nature of the equity markets and the way they operate in the UK has changed progressively over recent decades. This was thoroughly analysed and very clearly explained in the Kay Review. Professor Kay pointed out the diminution of the role of such markets as a source of funding for UK companies; the diminishing share held by major long-term investors in the form of the large UK insurance companies and pension funds; and the explosion of intermediation in equity investment. The ultimate shareholder, the individual saver or pension holder, is a long way removed from the company on whose growth his or her prosperity ultimately depends. The individual may well have a long-term interest, but that is not served by the cumulative behaviour of all the participants in the chain. For example, his or her pension will rest with a fund overseen by trustees. These trustees place the funds with one or more fund managers, the choice being made on the grounds of the recent performance of the fund in question. If that fund's investment performance compares unfavourably with others, the Trustees will feel it is their duty to switch. In turn, these funds will invest in other funds, again on the basis of recent performance. Thus share price performance over the immediate past period drives all the participants in the chain, ending with the individual company whose shareholders consist mainly of bodies or funds whose success is being judged on the immediate past results and the short-term outlook.

This gives rise to what has been described as 'ownerless capitalism'.

The consequence has been a change in the relationship between company management and shareholders, with 'engagement' progressively taking the form of the latter increasing or decreasing their holdings rather than engaging in dialogue with the company's management.

'..the UK's system of corporate governance.. is based on the concept of 'stewardship' (which) makes assumptions about shareholders' perception of - and willingness to fulfil - the role as stewards.'

This creates a vacuum at the heart of the UK's system of corporate governance, which is based on the concept of 'stewardship'. This concept makes assumptions about shareholders' perception of – and willingness to fulfil – their role as stewards.

The difference in perception has been succinctly put by BlackRock, the leading global asset manager:

"For our part, we define stewardship as protecting and enhancing the value of the assets entrusted to us by our clients. A subtle but important distinction exists between this and the stewardship responsibilities of the board of directors and company executives, namely to protect and enhance the value of the company over time. As shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that shareholders have a responsibility to engage with companies and 'make them better'. This confuses the two responsibilities. Sometimes fulfilling our stewardship to clients will involve engagement with companies; other times it will necessitate selling or reducing a shareholding if we cannot protect our clients' interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it."[5]

5 Stewardship and the Stakeholder Economy published by PIRC.

'The failure of shareholders to play an active and continuous 'stewardship' role and to exercise their rights as owners of the business is evidenced by the explosion in executive pay over recent years.'

There is nothing irrational or unprincipled in such a position – far from it. However, it is not that which the UK approach to governance assumes.

The failure of shareholders to play an active and continuous 'stewardship' role and to exercise their rights as owners of the business is evidenced by the explosion in executive pay over recent years. In theory, shareholders exercise strong influence over pay, participating in a vote on remuneration at the AGM, albeit non-binding. However, unless the company is doing extremely badly (in terms of share price), this usually goes through without dissent. Only occasionally has there been a significant vote against the board's proposals. When things are going well, remuneration is of little concern to shareholders.

Admittedly, directors' pay has become a much higher profile issue following the 'bankers bonus' scandals, but the issue is much wider than just the financial sector. Over the past decade the pay of executive directors in FTSE 100 companies has increased by 90% in contrast to overall pay increasing by just 10%.[6] The general spiralling increase is not so much an outcome of executive greed as the result of companies seeking to match or outstrip their competitors. Ironically, it is a consequence of greater openness in reporting. Virtually every company has a remuneration policy that seeks to pay 'in the top quartile for good performance'. No one seeks to pay below average and so pay is

6 Hutton Review of Fair Pay, March 2011 pages 17-18; H M Treasury.

ratcheted up each time it is reviewed. This practice will continue until shareholders play a stronger, more consistent role in overseeing and approving pay policy – or until some other mechanism of constraint is imposed. Only shareholders with a long-term interest can expect to be engaged in the issue.

Given the importance that the market is placing on short-term results, it is no surprise that business behaviour adapts accordingly.

As any board of a publicly quoted company will attest, the important concern in looking at results or outlook is not whether they conform to plan, but rather how they compare with 'consensus' or market expectation. However good the long-term story is, it is unlikely to compensate for any shortfall in what is expected for the period in hand. Indeed, the Ernst & Young quarterly analysis[7] of profit warnings between Q4 2011 and Q3 2012 showed that the 289 warnings issued resulted in an average share price drop on the day of 16.5%. These warnings are not necessarily an indication that a company is in trouble or making losses; they are simply an indication that the company does not believe it will meet the market's current expectations of profits for the immediate reporting period.

'Given the importance that the market is placing on short-term results, it is no surprise that business behaviour adapts accordingly.'

Management behaviour responds accordingly. Attention is focused on short-term delivery, reinforced with remuneration schemes with powerful incentives based on short-term results. Moreover, if there is any lack of prospect of short-term organic growth, attention quickly turns to consideration of financial engineering such as restructuring or share buy-back. If these actions do not produce the intended effect, companies either seek or become vulnerable to takeover. Faced with an immediate future, with little prospect of strong organic growth, a company is unlikely to keep its shareholders happy or its predators at bay. Under such circumstances, it is inevitable that management, rather than take a long-term view of how the business can be re-energised with new products or finding new markets, turns to other options. It is better to sell off assets or seek a buyer than to sit around with a declining share price whilst the predators circle.

7 http://www.ey.com/UK/en/Issues/Capital-and-transactions/Restructuring

Lack of Long-term Development Funding for Smaller Companies

For the smaller company there is a somewhat different problem. In the UK there is no 'financing escalator' enabling the company to obtain sufficiently long-term financing at the successive stages of development from start-up to large publicly quoted company. There has been much talk recently of the failure of banks to lend to small companies. That is certainly a problem. However, bank loans are a way of funding short-term needs, not powering long-term growth. The UK lacks either the US culture of investing in entrepreneurs or the German system where banks take a long-term holding in companies.

'(lack of long-term funding) has led to is an 'early-exit culture' in the UK: entrepreneurs and their backers both working on a clear, relatively short-term plan to get their money out.'

One thing this has led to is an 'early-exit culture' in the UK: entrepreneurs and their backers both working on a clear, relatively short-term plan to get their money out. How far this is a cultural issue as opposed to a feature of the funding structure is a moot point. It has been described as 'the old rectory syndrome': as soon as the founders of a business can afford the home and lifestyle to which they have always aspired, they are ready to sell out. Either way, the short-term aspiration and the lack of a series of steps by which companies can keep growing undoubtedly leads to the UK's failure to produce world leaders capitalising on its inventive skills. This Review is far from unique in recognising this situation.

The British Chamber of Commerce (BCC) noted:[8] "Across Britain, there is strong evidence of a serious market failure around access to finance, especially for fast-growing and newer businesses.' A BCC survey reported that 42% of businesses said that access to finance issues would have either "a strong influence" or "a significant influence" on their business during 2012.[9]

8 http://www.britishchambers.org.uk/assets/downloads/policy_reports_2012/12-09-03%20State%20Backed%20Business%20Bank%20Report.pdf

9 British Chambers of Commerce snap poll, June 2012.

The creation of the Business Growth Fund (BGF) was an excellent initiative, and the recent announcement of a new specialised business bank can only be welcomed. However, it is also equity capital that is needed in the system, not just loan capital. The National Endowment for Science, Technology and the Arts (Nesta) has done some first-rate work supporting smaller companies. Equally, the two Enterprise Investment Schemes (EIS) designed to encourage investment in smaller businesses have much to commend them.

However, all these initiatives only demonstrate the kind of support that is needed, rather than – as yet – solve a much wider problem.

Because smaller companies find it difficult to attract investment as they progress through the various stages of growth, fewer succeed in reaching their true potential. This, along with the limited number of exit points for investors, makes investment in smaller companies less attractive and so the cycle continues.

Even when the successful company makes it as far as an IPO (initial public offering), the problem is not fully resolved. The London Stock Exchange's secondary market, AIM, launched in 1995, was designed to offer public listing facilities for the smaller, albeit well-established, business. The listing is offered at much reduced cost and with more relaxed requirements than the full market. Conceptually, it should be a highly attractive option for the fast-developing smaller business. However, the challenge remains to make AIM a far more liquid market, hence a more attractive market for both issuers and investors.

'Because smaller companies find it difficult to attract investment as they progress through the various stages of growth, fewer succeed in reaching their true potential.'

Government

Concern over the behaviour of equity markets and lack of investment in company growth are often cited as the inhibitors of long-term economic development, but there is another major driver of short-termism: Government.

Government is, by its nature, short term. Elected for a maximum of five years, it would be unnatural if an overriding concern did not soon focus on getting re-elected. That is not a cynical comment. There is little point in having convictions about changing the world if one is not going to be in office to bring it about.

'..decisions on major issues such as energy policy or transport infrastructure get shunted back from one administration to the next, until impending crisis forces action. '

Moreover, the electorate is short-term in its thinking – or at least that appears to be the assumption. The conventional wisdom is that there are no votes in the long term.

The situation is compounded by the fact that many ministerial roles are held for a very short period, with greater reward for – and certainly less risk in – making announcements rather than seeing anything through. Most long-term decisions involve up-front investment and, whatever the chosen path, provoke opposition, sometimes out of genuine concern, sometimes out of political opportunism. This is particularly true when it comes to aspects of national infrastructure. Why face the hostility and the cost when the benefits are to be felt not just by another individual but possibly by another party?

As a result, decisions on major issues such as energy policy or transport infrastructure get shunted back from one administration to the next, until impending crisis forces action.

There can surely be no more glaring example of this than the question of airport capacity in South East England. The full, hardly credible, history is summarised in Appendix 2. The prospect of running out of runway capacity, thereby losing out to other major European hubs, was first highlighted in 1955. The repeated dithering on what to do about it was the subject of a book, A Sadly Mismanaged Affair, written by David McKee and published in 1973! Little could the author have imagined that nearly 40 years later the saga would still be continuing – with no prospect of a clear decision for at least a further three years. When Sir Howard Davies' final report is published it will mark the Diamond Jubilee of the debate!

One consequence of such vacillation is the debilitation of the supplying industries. For example, decisions on energy supply policy have been repeatedly ducked, largely because any solution has its drawbacks and produces strong opposition. We thus wasted the years when we were able to rely on the North Sea reserves. Now with the prospect of a serious future shortfall if action is not taken, there is the intention to turn back to some degree of nuclear generation – which is an easier path to take when you can make a case for there being no alternative. To do so, the UK has had to turn overseas for the necessary expertise and delivery capability, first to Germany, then to various consortia involving France, the US and China. Having led the world in nuclear energy generation, we no longer have the expertise and supply capability. You cannot turn industrial capacity on and off like a tap.

'You cannot turn industrial capacity on and off like a tap. '

The consequence of a lack of consistent government long-term strategy is twofold. Firstly, there is a failure to construct a globally competitive infrastructure within which business can flourish. Secondly, there is no consistent pattern of government spend against which the relevant supplying industries can plan. Not only does this successively reduce industrial capability, it creates a balance of payments deficit, importing skills and goods one might otherwise be exporting. It also introduces uncertainty in terms of dependence on others to provide essential facilities.

The Significance of Short-termism

The fundamental question that has to be asked is, how does the UK earn its living in the 21st century? What do we offer the world in terms of either goods or services?

The most important consequence of short-term pressures is not the frustration of those trying to grow and manage businesses; it is the fact that it undermines the UK's ability to develop the companies and industries on which its future economic health depends.

'The most important consequence of short-term pressures is …that it undermines the UK's ability to develop the companies and industries on which its future economic health depends.'

This has become a more urgent issue in light of the advancing capability of countries such as India and China, with their huge investment in skills, research and high-tech industries. This is likely to be followed by a similar advance in areas such as design capability, brands and marketing: features and capabilities that have so far protected the market position of many established companies in the advanced economies.

The progress of these and other fast-developing economies is, of course, not just a threat. Their growth is expected – perhaps relied upon – to drive the expansion of the global economy, and they represent potentially huge new markets. The question is, what are we going to sell them? There is nothing that we are going to be able to produce cheaper than the rest of the world.

If we do not answer this question, we end up a theme park, trading on our history.

‘Economic growth needs to become an objective, with strategies to achieve it, not a forecast on which all other decisions are dependent.’

For too long UK governments have concentrated their economic policies on how to spend the nation’s income, not on how to generate it. The former has produced vigorous argument on how much government takes out (by way of taxation) and how it allocates it. Expenditure is a matter of planning, whereas income is seen largely as a matter of forecasting. In business terms – if one thinks in terms of UK plc – it is as if all the concern is for company expenditure rather than worrying about income. In business it is recognised that if you can generate the revenue, you can solve any other problem; if you can’t generate the revenue, no other problem matters.

Much more attention has to be given to how the nation is going to generate its wealth. Economic growth needs to become an objective, with strategies to achieve it, not a forecast on which all other decisions are dependent.

The Need for a Strategic Approach to Economic Growth

'The mantra 'government can't pick winners' has been regularly trotted out as justification for lack of industrial strategy.'

Government cannot deliver economic growth, but to a large extent it determines the conditions under which growth can or cannot take place. The pursuit of long-term growth can only be addressed by a joint understanding and shared goals between the (various departments of) government and the private sector.

The term 'industrial strategy' has unfortunate – and misleading – connotations. It is linked to concepts (hopefully long dead) of government involvement in individual companies and propping up badly managed or failing businesses. Nothing could be further from what is required or what is being advocated here.

The mantra 'government can't pick winners' has been regularly trotted out as justification for lack of industrial strategy. One might respond that no one else seems to be routinely capable of picking winners either, but that is not the point. It not a matter of 'picking winners' in terms of supporting individual companies or, even worse, getting involved in trying to run them. Rather, it is a question of creating the conditions in which targeted sectors will flourish: sectors in which individual winners will emerge and become world beaters. One sees examples of this around the globe. One can see the high-tech industries growing in India and China. Nearer home, one can only admire the French for creating its satellite-launching capability or, jointly with the Germans, creating

10 http://www.uksport.gov.uk/pages/about-uk-sport/

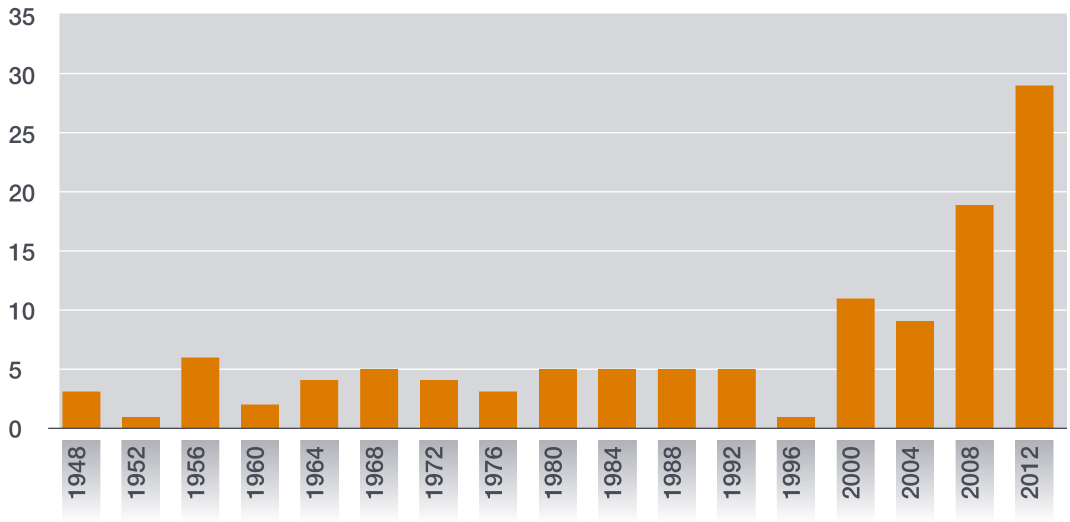
a world-leading civil aircraft manufacturer to rival Boeing. Such things don't happen by happy accident of private enterprise and market forces.

There is an interesting analogy to be drawn with the world of sport: an area where government certainly cannot pick winners. Back in 1996 Great Britain won just a single gold medal at the Olympic Games in Atlanta and finished 36th in the overall medal table. It was the nation's worst-ever result. The following year the Government committed substantial (largely National Lottery) funds to supporting Olympic sports. This allowed athletes to train full time and to benefit from world-class coaching and from back-up facilities such as physiotherapy, injury treatment and nutritional advice. However, the approach took the form of supporting success: money was directed to those sports and athletes that achieved results in major international competition, and withheld from those that did not. Indeed, the system has been quite brutal in its application. The funding was controlled by UK Sport which was set up by Royal Charter in 1997. To quote from UK Sport's own website it adopted "…a 'No Compromise' philosophy which targets investment at those most likely to deliver medals at Olympic or Paralympic level."[10]

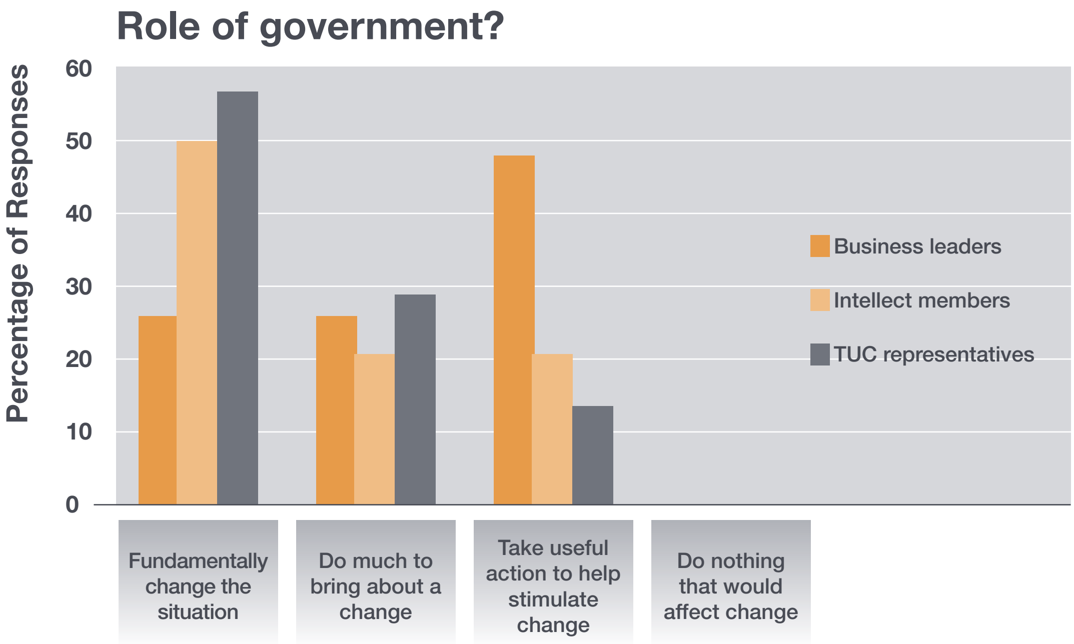
Over the following four Olympics, Great Britain's performance improved dramatically each time, to such an extent that in 2012 Great Britain won 29 gold medals and finished third in the overall rankings, beaten only by the giants of China and the US. It was a complete transformation in the nation's fortunes.

'There is an interesting analogy to be drawn with the world of sport: an area where government certainly cannot pick winners.'

GB - Number of Olympic Gold medals



Despite the oft-repeated phrase that 'all business wants is for government to get out of the way', that is not what those consulted by this Review believe. Quite the opposite. There was widespread recognition that the issues identified cannot be addressed without government action. Indeed, 100% of the business leaders consulted felt that government had a role to play, with over half believing that government could either fundamentally change the situation or do much to bring about change.



'Government has to provide strategic leadership in building an economy based on high skills, scientific and technological advances, creativity and continuous innovation.'

The research echoed what Lord Heseltine encountered in carrying out his recent review[11] for the Government: "What I have found is a hunger for ideas, a scepticism of the isolated initiative, and an appetite to consider radical proposals which will make a difference, long term."

Of greatest importance, Government has to provide strategic leadership in building an economy based on high skills, scientific and technological advances, creativity and continuous innovation.

This call for strategic leadership is echoed by many bodies. For example, the Aerospace Partnership Group, supported by the leading UK companies, recently concluded that:

"A key conclusion of the Aerospace Growth Partnership (AGP) Strategic Vision document launched in July 2012 is that a strategic long-term partnership with Government is crucial to the future economic growth of the UK aerospace industry."[12]

11 No Stone Unturned in Pursuit of Growth, Rt. Hon. The Lord Heseltine of Thenford CH published by Department for Business, Innovation & Skills, October 2012.

12 A Strategic R&T Case for British Aerospace, the Aerospace Growth Partnership September 2012.

For the UK to enjoy economic success in the modern world it requires:

- A stable economic environment.
- A climate that encourages enterprise and entrepreneurship.
- A highly skilled and flexible workforce.
- Strong investment in research.
- Access to capital for both starting and continuously developing companies.
- An effective regulatory environment.
- A modern infrastructure for areas such as transport and (especially) communications.

Each of these is essential, but even together they are not sufficient. They need to be targeted towards sectors and industries where the UK can best succeed.

What is needed is not some one-off 'national plan' or series of initiatives, but the continuing pursuit of co-ordinated objectives shared between industry, business, commerce, trade unions and education. Addressing short-termism has to become part of a long-term process, not a matter of disjointed initiatives. It needs to engage all the different stakeholders. It needs to bring together different government departments. It needs to take account of the fact that world-leading companies do not exist in isolation; that they are dependent on supply chains; and that they form part of and emerge from geographic clusters within an industry. Industrial strategy therefore requires a regional dimension: a point strongly emphasised by Lord Heseltine's review. Only government can pull all these interests together.

'What is needed is not some one-off 'national plan' or series of initiatives, but the continuing pursuit of co-ordinated objectives shared between industry, business, commerce, trade unions and education.'

This report concludes with a number of recommendations addressing individual issues identified earlier. Some can be implemented relatively quickly. Indeed, they need to be. However, they should be the start of the process, not the end of it.

Strategy is a matter of tenacity as much as vision. Each decision, regardless of where it is taken, has to be tested as to whether it supports a strategy or impedes it. Focusing on the long term is not an act of faith; it is a matter of ensuring every short-term action builds towards a clear goal. There can be changes of pace and emphasis, but not reversals. Thus, an industrial strategy has to have broad understanding and support and to transcend party politics.

Immediate Steps

Having stressed the strategic, and hence long-term, nature of the changed approach that is required, there are a number of immediate actions that can be taken.

Government has four levers at its disposal: taxation, regulation (and quasi-regulation such as enforced codes of behaviour), investment in infrastructure, and national capability and public sector procurement, all of which could be beneficially employed to address some of the problems identified earlier. That said, every recommendation that could be put forward involves a degree of risk, is not necessarily easy to implement, and is likely to generate opposition from entrenched interests.

'…every recommendation that could be put forward involves a degree of risk, is not necessarily easy to implement, and is likely to generate opposition from entrenched interests.'

Providing Greater Incentives for Long-term Shareholding

Markets – that is, efficient, well-ordered markets – are essential to the successful running of a modern economy. London's markets are also a huge national asset, part of a global financial centre that is a key element of the UK's economic strength. Any change to the way in which these markets are regulated or influenced has to be carefully considered to ensure it does not put the UK at a competitive disadvantage by impeding the efficiency of the market, by reducing liquidity or by adding excessive cost. However, a number of steps can be taken that counter the short-term forces exerted by the market to the benefit of both the companies whose stocks are traded and the end investor.

Equity markets have changed. They trade large volumes at high speeds, but have become largely secondary markets, trading in shares without bringing further investment into the companies concerned. Long-term investors, such as pension funds and insurance companies, have progressively turned elsewhere. The average pension now invests 18% of its funds in UK equities compared with 52% in 1989,[13] and insurance companies just 12%:[14] substantially less incidentally than either currently invests in overseas equities. As a consequence, their combined stake in the UK-quoted equity market has fallen from 49.2% in 1989 to 13.7%[15] today. Meanwhile, short-term shareholders have become the most active in terms of engagement, pressing for their aims to be met.

None of the participants in the chain of intermediaries is acting irrationally or improperly. They are pursuing their own wholly justifiable objectives, but collectively they are not adding long-term value. What

13 Source: UBS, Pension Fund Indicators 2012, page 8.

14 Source: Association of British Insurers, Key Facts (2011) page 19.

15 Source: Office for National Statistics (data for 2010).

is in the short-term interest of the intermediary shareholders is not in aggregate in the long-term interest of the ultimate beneficiaries. To change things, the rules of the game need to be altered. There have to be incentives that draw more long-term investors back into the market, that make long-term shareholding more attractive, and that strengthen the voice of those with a long-term interest in the companies they own.

The rules or incentives need to differentiate between speculation and investment. There is nothing wrong with speculation – indeed it is an essential element in providing liquidity and price discovery – but it needs to be recognized as something different from investment.

There are various ideas that might be considered. Companies could issue separate classes of shares that, provided they were held for a long enough period, attracted preferential dividends or supplementary 'bonus' share issues. This would, however, be complex to implement, would rely on action by several different companies, and would be slow to have any effect. Moreover, the impact on the market is hard to predict. An alternative route could be taxation. Taxation – or exemption from taxation – is a powerful tool for incentivising behaviour. However, it has clear drawbacks. Firstly, it would be difficult to embrace all shareholders; secondly, it easy to invoke the law of unintended consequences, introducing changes that have unforeseen and undesirable effects; thirdly, any change adds complexity to a system that is already over-complicated; fourthly, it would add cost in terms of systems change; and fifthly, it would inevitably give rise to a further slew of tax avoidance schemes.

'There have to be incentives that draw more investors back into the market, that make long-term shareholding more attractive, and that strengthen the voice of those with a long-term interest in the companies they own.'

Nevertheless, if more long-term participants are to be attracted to the equities market and more institutional shareholders are to be encouraged to take a long-term view, there has to be an incentive to do so. Beneficial tax treatment would appear the best route, but it needs to be a powerful incentive if significant change is to be brought about.

It has been suggested that a Financial Transaction Tax, as currently being promoted within the European Union, would discourage the rapid turnover in shares and hence help counter short-termism. The overwhelming argument against such a move is that it would add to the cost of trading, putting London at a serious disadvantage compared with financial exchanges in the US and Asia. As there is no prospect of these exchanges adopting a similar tax, it would thus damage one of the few industries where the UK is still a global player. Moreover, there is no evidence that it would have any beneficial effect on the pattern of shareholding; the economic environment of the last couple of years has led to a substantial drop in the volumes traded daily on exchanges without any discernible increase in long-termism.

What is required is not an obstacle to share trading, impeding the market, reducing liquidity and making investment in companies less attractive, but the opposite, with greater incentive for taking a long-term stake in businesses. There are two tax measures that could be considered: reducing the tax on either dividend income or on the gain on the sale of shares, in each case dependent on the length of time the shares have been held.

'What is required is not an obstacle to share trading, impeding the market, reducing liquidity and making investment in companies less attractive, but the opposite, with incentive for taking a long-term stake in businesses.'

The shareholders on whom this would have the clearest impact are UK individuals, who pay income tax on dividend income and CGT on gains on disposals of shares. UK companies receive dividends tax-free and are not taxed on the disposal of substantial shareholdings provided they meet the conditions for exemption. UK pension funds are not taxed on their investment returns, and insurance companies are subject to a special regime. Bringing pension funds, companies that invest on their own account or foreign shareholders, within the scope of tax incentives to long-term shareholding, would require excessively radical changes to the tax system. Returns to collective investment funds such as unit trusts that meet standard conditions are taxable at the individual investor level, but only when unit holders receive their dividends or when they sell their units. So without a rule change, time-dependent tax benefits would be given if units were held for a long time, even if the fund only held shares for very short periods, which defeats the whole objective.

The answer would be to tax collective funds on their income and gains as if they were individuals, with the benefit of tax reductions for long-term shareholdings. This might mean applying artificial tax rates such as the old composite rate for building societies, either with a top-up tax for individuals on high rates of tax (but no top-up tax for basic rate taxpayers), or no tax on individual investors. The flatter the scale of income tax and CGT rates were to become, the more acceptable it would be just to tax the funds and not to tax individual investors.

Countering measures that constrain pension funds and insurance companies from investing more in equities are discussed below.

Recommendation

Taxation treatment should be changed to attract long-term investors back into the equities market and to incentivise longer-term shareholding generally. This should encompass both individual shareholders and managed funds.

For example:

Capital Gains Tax on shares could be tapered, in a series of yearly steps, from a rate of 50% in year one to 10% after year ten.

Liability for tax on dividends could be reduced, in a series of yearly steps, from the prevailing rate of income tax in year one to 0% after year ten.

The question, of course, is what such measures would cost in terms of loss of tax revenue and whether they would in fact have the desired commensurate impact on economic growth. This is examined in the note in Appendix 3.

Correcting the Bias that Favours Debt over Equity

'.. interest is tax-deductible whereas returns on equity are not. It thus encourages raising finance by way of debt rather than equity.'

There is also a feature of the current tax regime that positively reinforces short-term behaviour: namely, the tax incentive to fund the business by way of loans rather than equity. Under the present tax system, interest is tax-deductible whereas returns on equity are not. It thus encourages raising finance by way of debt rather than equity. This problem is not unique to the UK; the extent of the bias and the adverse consequences were assessed by the IMF in 2011. The bias is affected by how the recipient of either dividends or interest is taxed, especially if they are located in lower-tax jurisdictions.

This has been widely recognised in several countries, but no one has so far had the courage to address the issue, as any change is difficult. There are several options, none of them easy. They are set out in the note in Appendix 3.

Recommendation

Serious investigation should be undertaken into the options described in Appendix 3 as to how taxation treatment could be changed to remove the bias towards debt rather than equity finance.

Ensuring Takeovers Do Not Damage the National Interest

'.. there is something intrinsically wrong when the long-term future of a company can be decided by parties whose participation as shareholders is intended to be measured simply in weeks.'

The greater emphasis on seeking an increased proportion of long-term shareholders has to be balanced against protection of entrenched management. It is important that underperforming companies, failing to make the most of their assets or potential, should remain prey to intervention, change of management or takeover. This is an essential discipline.

However, there is something intrinsically wrong when the long-term future of a company can be decided by parties whose participation as shareholders is intended to be measured simply in weeks.

There are arguments for voting rights not being attached to shareholding until the shares have been held for, say, a minimum of a year. Several of those consulted supported such a move, though it must be pointed out, none from the investment community. It certainly addresses the issue of putting more influence in the hands of longer-term shareholders. The problem is that it cuts across a fundamental principle on which markets currently operate, the effects of which are not easy to foresee. For example, it could actively discourage shareholders who wanted to bring about change from buying into underperforming businesses. It is also possible to envisage a situation in which power was concentrated within a minority group of shareholders who were not actually good custodians, thereby encouraging more recent shareholders to sell or discouraging others from buying into the business. One answer could be to build up voting rights progressively over perhaps a two-year period, but this is adding considerable further complexity. Linking voting rights generally to length of holding is not therefore a recommendation of this Review, though it is an issue that will likely be raised again if other measures prove ineffective.

Nonetheless, a lesser measure of protection against unwarranted short-term influence on long-term direction is justified.

Recommendation

The law on takeovers should be changed, such that all shareholders who appear on the Register during the Offer Period (as defined by the Takeover Code) have no voting rights until the outcome of the bid has been concluded.

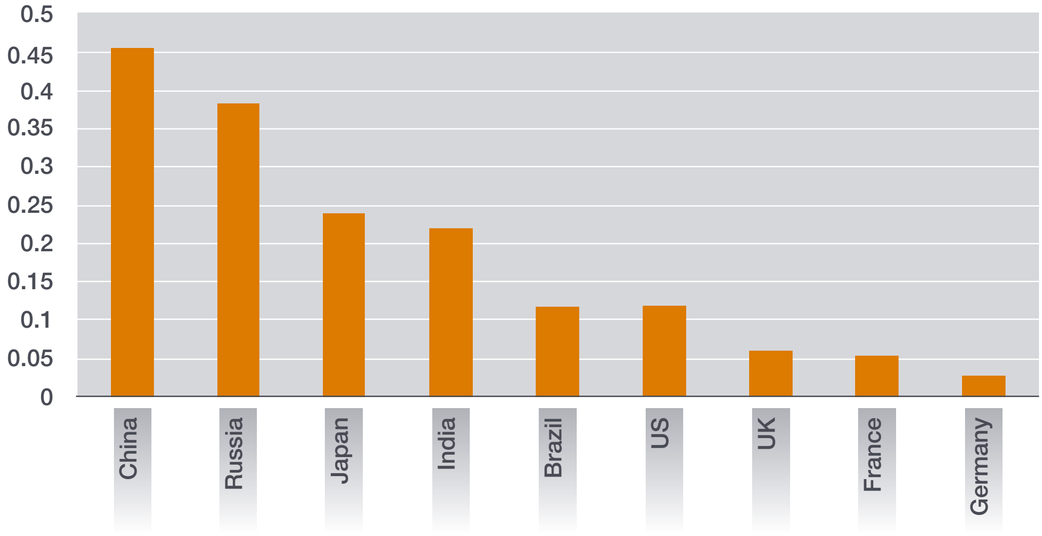
The research for this Review revealed a mixed response to overseas investment in UK companies. That is hardly surprising. On the one hand, there are several examples where overseas ownership has brought significant benefit to British industry. Despite all the fears when the domestic companies were taken over, the automobile industry has thrived under foreign ownership. Perhaps, with regard to short-termism, there is no more striking example than Jaguar Land Rover. When the company was acquired by Tata in 2008, the view was taken that what mattered was not the next six months, or even the next year or two, but an overhaul of the complete product range: restoring the brand image and producing a product range worthy of it. The outcome has been dramatic, not only in transformation of the bottom line but in the expansion of the business with increased working shifts and plans to open a new factory. A further example is Bombardier Aerospace which acquired the state-owned, investment-starved Shorts in Belfast in 1989 and subsequently invested to give the company new high-technology capabilities and made it the largest manufacturing employer in Northern Ireland.

'It is .. important to recognise that in certain industries, global markets are increasingly going to be served by global suppliers.'

It is also important to recognise that in certain industries, global markets are increasingly going to be served by global suppliers. International mergers and takeovers are an inevitable feature of building such global capability. It is important that British companies are part of this and do not miss out on global consolidation. This is equally true for industries such as manufacturing. We may rue the recklessness and poor judgement with which British banks pursued global expansion, but we should not decry the ambition. The world requires global financial institutions whether we like it or not. The only question is whether any of these are British-owned.

The UK market is amongst the most open in the world for inward foreign investment.

OECD's FDI restrictiveness index



Source: OECD.

'One .. has to differentiate between 'investment' in terms of injecting capital or bringing new capabilities to the business and 'investment', meaning simply buying a company for the brand or the assets, or even to eliminate competition'.

However, whilst welcoming foreign investment in UK companies for the reasons just given, there is widespread concern that the openness of our markets both lays us open to predators and puts key industries in the hands of organisations for which the UK operation is not necessarily a priority consideration. Key decisions rest elsewhere. This does not just apply to production capacity but to essential areas such as research, design, engineering and product development. The fact that infrastructure companies such as airport operators, energy suppliers and utilities are under foreign ownership inevitably gives rise to concern. That is not to imply that their foreign owners have any intention of doing anything other than a responsible, highly professional job. However, it means that decisions on investment – which are dependent both on the financial health of the organisation and on competing international priorities – are made with no regard to the UK's particular requirements and international competitiveness.

One also has to differentiate between 'investment' in terms of injecting capital or bringing new capabilities to the business and 'investment', meaning simply buying a company for the brand or the assets, or even to eliminate competition.

Many would argue that the UK should ensure that the takeover of any strategically important company – one that forms an element of national infrastructure or cornerstone of an industry – is in the national interest and subject to scrutiny and to legally binding commitments. In the US, for example, regulation prohibits a majority foreign ownership of companies in several key industries. In China one can only get involved in joint ventures that guarantee a measure of skills transfer. However, for the UK to erect any such barrier to international investment would be a backward step in the opening up of global capital markets where the UK has been a leader. It would also run counter to a number of international trade agreements.

It is not, therefore, a recommendation of this study to impose foreign investment restrictions. Nonetheless, the issue is one that needs be kept under review. The concern could grow as the economic power of the BRICs (Brazil, Russia, India and China) increases, giving those countries not just the financial strength to buy more UK companies, but the ability to do so for strategic reasons unfettered by the constraints of the normal financial criteria that a UK (or for that matter, American or European) company would have to apply in either making or rejecting a bid.

Recommendation

None at the present time.

'..many companies could do far more to ensure a fuller understanding of the business by its principle shareholders.'

Many of those interviewed – particularly from the investment community – commented on the diminishing amount of meaningful dialogue between listed companies and their shareholders. Whilst the changed pattern of shareholding is largely the cause of this, many companies could do far more to ensure a fuller understanding of the business by its principle shareholders. This is essential if the latter are expected to take a longer-term view. As it is, too much of the communication is reduced to the formal reporting requirements and the accompanying earnings calls.

Recommendation

Quarterly reporting should be abandoned (as has been recommended by the Kay Review).

Company reports should also include clear descriptions of long-term strategy, progress towards previously declared long-term goals, and actions taken and investment made in pursuit of these objectives.

Encouraging a Longer-term Corporate Culture

If you change the way markets operate, you will automatically have an impact on corporate behaviour. Pressure for clearer long-term vision by shareholders will progressively have an impact on corporate management. However, a number of things need to be done to reinforce this change.

The Governance Code defines recommended best practice for corporate governance on a 'comply or explain' basis. It should be extended to ensure sufficient long-term incentive is incorporated in executive pay. There is a strong case for this deferred payment being paid in the form of shares, which has already become the practice in many companies.

'The Governance Code …should be extended to ensure sufficient long-term incentive is incorporated in executive pay.'

Similar consideration should also be given to the remuneration of the company's non-executive directors. At present in the UK it is the norm for such individuals to be paid in cash on the basis of a flat annual fee, presumably meant to ensure their independence in some way. A remuneration system that had a measure of long-term reward would align their interest with the other stakeholders and would also increase the ability of smaller companies with high-growth potential to recruit more experienced independent directors.

Recommendation

The Governance Code should be extended to ensure sufficient long-term incentive is incorporated in both executive pay and non-executive directors' remuneration.

For example:

The Code could call for at least 30% of executive directors' remuneration to be deferred and based on long-term (five-year) results.

As a further example, the Code could require 50% of non-executive director remuneration to be paid in the form of shares that do not vest until either five years have elapsed or the director has completed his or her term on the board.

There is also an important consideration of motivation of a company's workforce to support the pursuit of a long-term vision, accepting change en route. Trade unions argue that the best way to bring this about is by having worker representation on boards, as is the case in Germany. However, the many arguments for and against such a move are outside the scope of this study. Nonetheless, there is much to be said for an increased employee stake in the business. One can admire the success of the John Lewis Group, though it is far from clear how that formula might be replicated. The drawback of employee share schemes is that the individual's savings and source of income are bound up in the same entity. This is fine while the company is flourishing, but should the company hit hard times, both income and savings can be hit.

Nonetheless, long-termism would be encouraged by widening employee share ownership. It has been interesting to note how many employees have benefited, very substantially, from the success of some of the highly entrepreneurial US technology businesses cited earlier.

Share incentive plans (SIPs) already exist. The restrictions are that you cannot set up a SIP as an alternative to more cash pay; the limit is £3,000 of free shares per employee per year, although the employee can also buy up to £1,500 of shares, and receive extra shares from the employer, up to two for each one bought; and the holding period to ensure that there is no income tax on the grant of shares is five years. There is no income tax on dividends that are invested in more shares within the SIP, and no CGT on shares that are sold while they are in the SIP.

The limited, though still worthwhile, impact of the scheme can be judged from the fact that the current annual tax cost of SIPs is only £185 million.

'There is also an important consideration of motivation of a company's workforce to support the pursuit of a long-term vision,'

The question is whether the scheme could be expanded to encourage further, prudent, share ownership by employees.

Recommendation

The current SIP system should be expanded to encourage wider employee share ownership.

For example:

In addition to the current £3,000 of shares that companies can award each year, employees could be allowed to take up to 10% of basic salary or £5,000 (whichever is lower) in shares (subject to the same restrictions and tax benefits).

Unlike the current system, the above proposal would allow shares to be taken in lieu of cash or 'salary sacrifice'. The alternative limit of either a percentage or a cash figure is proposed both to protect the lower paid employee from excessive exposure and to prevent the scheme becoming a further source of tax avoidance for the higher paid.

Countering the Reinforcement of Short-termism by New Regulation

Several of those consulted expressed concern that much recent regulation had actually reinforced short-termism, not intentionally but whilst addressing other issues. Mark-to-market accounting distorting pension fund decisions is one example, as are the solvency requirements of BASEL III and Solvency II, which are intended to ensure that banks and insurance companies hold enough capital to withstand financial shocks.

'Recent developments in regulation… have .. intensified the focus on short-term movements in market prices.'

Accounting procedures and regulation within the financial sector have in recent years moved away from judgment-based matching of future returns on assets – including such things as dividend flows from equity investment – to the pattern of expected liabilities. The focus is now firmly on market values of liabilities and the risks arising from changes in such values and of the assets held to match them. This has accentuated trends towards greater holdings of fixed-interest investments designed to match the duration of projected liabilities.

Recent developments in regulation, and notably the development of the EU's Solvency II regime for insurers, have thus intensified the focus on short-term movements in market prices. The problems fall mainly in two areas: the level of capital required to be held by insurers and the rate used to discount the value of projected liabilities. This is explained in the note in Appendix 3.

In the case of banks, under the Basel system of regulation, the risk weighting of long-term lending activity has increased, and this has made them less prepared to commit to lend over terms that reflect the underlying need of businesses to fund the purchase of plant, equipment and other assets. All these regulatory changes may be highly understandable and well-intentioned for prudential reasons, but they have clearly contributed to a material reduction in lending capacity over the long term.

The issues here are complex and there can be no contesting the need to ensure greater stability in the financial services sector in the future. However, there are strong arguments that recent and forthcoming regulation is driving short-term behaviour in both banks and insurers through distorted assessment of long-term risk. It was not within the scope of this Review to evaluate this regulation in sufficient depth, but it clearly needs urgent examination.

Recommendation

Further, urgent investigation should be carried out looking at the unintended effects of recent and forthcoming financial regulation in promoting short-termism.

Stimulating and Supporting Smaller Company Development

Much is made of the importance of start-ups, both as a measure of the vibrancy of the business climate and their contribution to the economy. However, what creates jobs and benefits the economy is not start-ups *per se* but business growth. The management consultant, plumber, web designer or gardener who leaves an employer and registers him or herself as a company shows admirable initiative but brings no benefit to the economy. It is only when an entrepreneurial enterprise expands and takes on more staff that it has an economic impact – particularly if it offers new services or products rather than just capturing existing markets. In the UK there are plenty of impediments to such growth – particularly in the early stages. Much attention has been given recently to the need for banks to offer more support to SMEs. That need is certainly there, but the equally important need is not for loans but for equity investment. A business taking on a loan adds to its costs and pressures. On top of all its other issues, it now has to service the loan and ensure its repayment. Indeed, when it comes to the crunch, these can easily become the top priorities. The arguably more fundamental need is for long-term equity finance.

'.. what creates jobs and benefits the economy is not start-ups per se but business growth. … It is only when an entrepreneurial enterprise expands and takes on more staff that it has an economic impact.'

The Breedon Report[16] for BIS commented:

"It is worth noting that external equity funding is significantly under-used by smaller UK businesses: only 3% of small businesses[17] use equity finance, whereas 55% use credit cards.... These smaller businesses often need significant capital injections to achieve their potential and may often be deemed inappropriate for bank finance alone due to their innovative nature."

That said, it has to be accepted that while the potential gains are greater from investing in the fledging business, so too is the downside. It is not for government to underwrite the risk; what needs to be done is to give greater incentive for individuals to invest in such companies, either individually or collectively. In fairness, this is a problem that has been recognised and attempts have been made to address it by the creation of such investment programs as the Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCTs).

16 Boosting Finance Options for Business. Report of the industry-led working group on alternative debt markets for BIS chaired by Tim Breedon, March 2012.

17 Small Firms in the Credit Crisis: Evidence from the UK Survey of SME Finances. www2.warwick.ac.uk/fac/soc/wbs/research/csme/research/latest/small_firms_in_the_credit_crisis_v3-oct09.pdf

Both these schemes, which are described in the note in Appendix 3, are aimed at the right target. Nevertheless, their success to date is somewhat disappointing. A study into their effectiveness carried out in 2008[18] reported that:

"Overall, these results indicate that EIS and VCT investments have a positive effect on capacity building in recipient companies. However, in material terms, these effects remain at present very small. There is some additional limited evidence of a profit enhancing effect."

It would be interesting to see in the intervening period, with its difficult economic circumstances, how the schemes had affected survivability in smaller companies.

'..to develop, smaller companies need guidance and mentoring as well as finance. Simply making more funding available is an incomplete answer.'

It is possible to think of many ways that the various schemes might be enhanced. For example, one could stimulate further investment in SMEs by opening up the Enterprise Investment Scheme to owner-managers. At present, anyone either with a stake of over 30% in the business or who works for the company is excluded. The downside, as the HMRC would undoubtedly argue, would be the expanded opportunity for tax avoidance.

Overall, there is not enough evidence to be clear what effects any changes might have. Nevertheless, the fact remains the UK is not yet providing the right environment for the vigorous development of the smaller business, at least not on the scale needed to influence future economic success.

One can look elsewhere for lessons but they are not easily replicated. We may admire the entrepreneurial culture of the US but it cannot simply be imported. We may envy the German system of strong support of smaller companies by local banks but we do not have their banking infrastructure. We therefore need to look to other measures, not to a series of new initiatives, but rather to those already established or announced and then scale up those that are effective.

What is very apparent is that to develop, smaller companies need guidance and mentoring as well as finance. Simply making more funding available is an incomplete answer. The approaches taking by Nesta and by the recently formed Business Growth Fund (BFG) both address this issue. Such guidance will be a key feature of the success – or otherwise – of the newly announced 'business bank'.

18 Study of the impact of Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT) on company performance, HMRC Report 44 2008.

Moreover, it is not only financial guidance that is required. Other kinds of advice can prove useful. For example, the BIS Manufacturing Advisory Service has proved very effective over several years, and the Design Council's Designing Demand programme has introduced the use of professional design capabilities into around 2000 smaller companies. There have also been several positive moves to encourage smaller companies to engage with universities in areas such as research.

What is required is not a further set of initiatives, but extending and making the fullest use of those already in place.

Recommendation

The various financial incentives and support schemes for smaller businesses should be reviewed to establish their effectiveness with regard to promoting long-term development. Those that have an impact – or with modification could have an impact – should be given greater backing and scaled up.

At the same time, there is an issue that these schemes do not address, which is the question of encouraging further development once an SME has reached the point of achieving an IPO. Indeed, addressing this issue could well stimulate the ambition of smaller companies and those who invest in them.

'..an IPO would be more attractive if there were greater liquidity in quoted smaller company shares.'

For all investors, even long-term, there needs to be an exit, either through a trade sale or an IPO. In many cases, the former is likely to prove the easier, whereas the continued growth of the business might be better suited by an IPO. This latter path would be more attractive if there were greater liquidity in quoted smaller company shares.

The London Stock Exchange set up its AIM market in 1995 specifically to meet the needs of smaller publicly quoted companies. It has less demanding and less-costly listing requirements than the full market. However, it does not have the liquidity of the latter.

Recommendation

Measures should be taken to increase liquidity in the AIM market, making it more attractive for both listed companies and investors.

For example:

Stamp Duty could be abolished on shares in AIM-listed companies.

It has already been proposed that liability for tax on dividends in general could be reduced, in a series of yearly steps, from the prevailing rate of income tax in year one to 0% after year ten. To increase the attractiveness of investing in smaller listed businesses, this taper could be accelerated to five years for AIM-listed companies

'..you cannot have a first-division competitive nation in the world of the 21st century with a third-division infrastructure.'

Such measures could transform the vitality of this market. Research carried out by Deloitte for the London Stock Exchange claimed that scrapping Stamp Duty and giving preferential tax treatment to AIM company dividends could together: lower the cost of capital for high-growth companies by up to 25%; increase their valuation by 32% (£24 billion); enable these companies to facilitate the creation of up to 38,000 new jobs (a 20% increase in current employment by UK AIM companies); and be tax-neutral over the medium term.

This Review is not unique in recommending tax incentives to stimulate the AIM market. In November 2012 the CBI called for the scrapping of Stamp Duty for this market.

Investing in Infrastructure

Investment in infrastructure has been widely touted recently as a means of stimulating economic recovery. That is not the issue here.

The concern here is that you cannot have a first-division competitive nation in the world of the 21st century with a third-division infrastructure. This applies particularly to transport, energy supply and telecommunications. Having a first-division infrastructure requires not just investment but a clear strategy and the commitment to pursue it. That may be obvious, but the trouble is short-term considerations render this difficult if not impossible, at least as far as the UK appears to be concerned.

Any major decision concerning infrastructure inevitably encounters hostility from vested interests or from special-interest groups. It can also be seized upon by political opposition. As a consequence, there is great pressure to defer any such decision: to use its very importance as a reason for yet another review. Even if a decision is reached there is no guarantee that it will be implemented before further questioning, or before change of minister or government overtakes it.

There can surely be no better illustration of this than the ongoing debate on airport capacity in South East England as described earlier. You cannot possibly run a modern competitive nation in such a manner.

Whilst airport capacity might be the most obvious example, it is far from unique. Not only does such vacillation and indecision deprive the nation of the kind of infrastructure that is essential for prosperity, it makes it impossible for the supporting industries to maintain expertise and capacity.

You cannot turn industries on and off. When a domestic industry is run down, you do not just face the economic consequences of having to turn overseas, you become vulnerable to another nation being willing to supply what is required. For some industries this may not matter a great deal and no nation is going to satisfy all its needs domestically. However, where it is of strategic significance, as in matters of national infrastructure or defence, it is another matter.

'You cannot turn industries on and off.'

Whilst priorities and the amount of finance devoted to various aspects of infrastructure will inevitably remain subjects of political argument (quite properly so), the long-term strategy to be followed in each area needs to command greater cross-party support.

Recommendation

A mechanism has to be established to take the direction and delivery of infrastructure out of party politics. In each major area of infrastructure, an agency should be set up that is accountable to, but independent of, Parliament. Its role should be to determine strategy, to make decisions on the basis of independent studies, to commission suppliers and to oversee delivery.

Levels of investment (where this comes from the taxpayer) would, of course, remain a matter for parliamentary approval. The Olympic delivery body provides both an interesting example and a useful template. Not only was the physical infrastructure of the Games delivered on time, but a largely run-down and much neglected area of East London was completely transformed. It is difficult to think of any other event that could have brought the latter about, certainly in such a short timescale.

The forthcoming report on infrastructure investment from Sir John Armitt, who headed up the Olympic Delivery Authority, on infrastructure investment should make interesting reading.

Investing in the Nation's Research Base

'research.. has to be targeted. It has to support those sectors, or even sub-sectors, in which the UK can realistically achieve world leadership.'

Clearly, the UK cannot match the overall level of research undertaken by countries such as the US and China. However, it must be put on a par with our major European competitors. It also has to be targeted. It has to support those sectors, or even sub-sectors, in which the UK can realistically achieve world leadership.

This funding cannot all come from government. Industry – hopefully, taking a longer-term view that this report is hoping to bring about – has to play its part, but state investment in research must be restored to an internationally competitive level.

According to the latest figures available from the Office for National Statistics (ONS), Gross Expenditure on R&D (GERD) was 1.85% GDP, while Business Expenditure (BERD) was 1.12%, which would imply a public sector expenditure of 0.73% of GPD. At current prices, that would equate to around £10.2 billion. Assuming business steps up *pro rata* to the challenge of meeting the levels of our major industrialised competitors (around 2.6% GDP), then government expenditure would need to increase by around 40%, or just over £4 billion per annum. It would not be possible to do this in a single step. Apart from affordability, the facilities cannot be instantly brought into play. It would need to build up over, say, five years.

However, increasing the nation's research capability is not only a matter of funding. There is another important dimension. Whilst education is beyond the scope of this Review, post-graduate education clearly has a fundamental bearing on research capability. Writing in 2006,[19] Lord Leitch described postgraduate skills as "one of the most powerful levers for improving productivity" and "critical to a high skills, high performance economy."

19 The Leitch Review: Prosperity for all in the global economy – world class skills, HM Treasury.

Therefore, it was worrying to learn that the Higher Education Commission[20] recently concluded that with regard to post-graduate education, "Government departments and senior figures in a number of sectors have expressed concern about immediate industrial skills shortages. Meanwhile, the Research Councils and the British Academy have concerns about recruitment and retention of the next generation of researchers in a number of disciplines." The same report also referred to the Bologna process report which revealed that substantially fewer UK students move on to masters or doctoral level education than in other European countries. Indeed, the UK is one of only three countries with a progression rate of less than 10%, alongside Andorra and Kazakhstan. The situation could well get worse; recent research by the Higher Education Careers Service and Warwick University[21] found that half of the graduates who would like to have pursued further study had chosen not to do so because they were reluctant to take on more debt.

Recommendation

State spending on research should be progressively increased over the next five years to put it on a par (as a % of GDP) with of that of the leading industrialised nations.

Post-graduate education must be put on a par with that of our main economic competitors.

'...the process of procurement in the public sector... fails to stimulate the development of the kind of products and solutions that suppliers can then offer to the rest of the world.'

Using Public Procurement to Greater Effect

The public sector spends around 43% of GDP. What the appropriate level should be is the subject of endless political debate, but that is not the concern here. It is how it is spent that is relevant to short-termism.

With the occasional exception, the process of procurement in the public sector works against innovation and imaginative solutions to the demands of society. The consequence is that this fails to stimulate the development of the kind of products and solutions that suppliers can then offer to the rest of the world. This is particularly frustrating when the problems facing society – in areas such as healthcare, education, transportation, security, waste management and energy – cry out for creative solutions.

20 http://www.policyconnect.org.uk/hec/research/postgraduate-education

21 Higher Education Careers Service and the University of Warwick: Futuretrack Study 8 November 2012.

'..the (quite proper) emphasis on 'value for money' is all-too-often interpreted too narrowly as 'cheapest solution'.'

The problem is twofold. Firstly, it is difficult within the culture and structure of public sector purchasing to seek out and to pursue innovative solutions, particularly if these involve smaller suppliers; secondly, the (quite proper) emphasis on 'value for money' is all-too-often interpreted too narrowly as 'cheapest solution'.

The responsible body, the Cabinet Office GPS, states its purpose primarily in terms of savings, or sustainable cost reductions, with attention largely focused on centralisation and integration of government procurement activity. Long-term strategic competitive issues for the UK economy are not part of its brief. A number of reviews have been carried out looking at improving government procurement, but none of these was primarily concerned with improving the UK's supply capability.

A recent review on ICT procurement looked mainly at process issues. Innovation is mentioned but only after best value. A review by Lord Currie focused on cost reductions, though it did mention making UK industry more competitive in world markets. A review by Anne Glover covered access to the public sector by SMEs, which is an important element of stimulating more innovation. The earlier Wood Review covered the perceived problems UK companies face in winning contracts in the EU.

However, there has been no widespread examination of the role that public procurement can make in stimulating the capacity to develop and to supply world-leading products and services. This is despite the role that procurement has played in the past in the development of two of our internationally competitive industries: defence (particularly aerospace) and pharmaceuticals.

The Cox Review (of Creativity in Business)[22] in 2005 recommended the following:

- Allow and require more discussion pre-specification.
- Identify project needs more holistically.
- Improve purchaser capability through better training (with regard to evaluating innovative solutions and controlling risk).
- Help smaller, more innovative companies to bid.
- Require the National Audit Office (NAO) and the Audit Commission to monitor innovation.

Talking to business representatives and industry bodies in the course of this Review would indicate that little has changed. Indeed, the current economic climate has probably made the situation worse. Public procurement remains process-driven and adversarial, driven by rules that are detrimental to innovative solutions and suppliers.

'..there has been no widespread examination of the role that public procurement can make in stimulating the capacity to develop and to supply world-leading products and services.'

Recommendation

The public procurement process should be reviewed, looking specifically at wider exploration (and better implementation) of innovative solutions, more positive engagement with potential suppliers including smaller companies, and more concern for the long-term effect of decisions on the supply industry.

22 The Cox Review of Creativity in Business: building on the UK's strengths, pub. HM Treasury 2005.

Conclusion

This has been a brief review of a very big topic. However, had it been undertaken with greater resources and over a longer timescale, I believe it would have produced more evidence but still arrived at the same conclusions.

What it has made clear is that short-termism is significantly impairing the development of internationally competitive UK businesses. Unless this is addressed, the UK will inevitably fall behind not just the rapidly developing economies, but also its traditional competitors.

The fundamental issue the nation faces is not how to recover from a recession, but how to create wealth and generate sustainable economic prosperity long term.

'What is really needed is an over-arching strategy for the UK's industrial development that is continually evolving as technologies and new markets emerge.'

This Review has made recommendations for areas where there is a clear need to address a specific issue that is either reinforcing short-termism or represents an opportunity to strengthen the UK's long-term outlook. Although the recommendations are not necessarily easy to implement, addressing these issues would have an enormously beneficial impact. However, that is not the end of the matter. What is really needed is an over-arching strategy for the UK's industrial development that is continually evolving as technologies and new markets emerge.

As the world's sixth-largest economy, the UK still has enormous industrial strength; it is in the forefront of many areas of scientific research; it has one of the major financial centres of the world; it has outstanding universities; and its creative industries are world-class. Companies as diverse as Jaguar Land Rover, Rolls Royce and Dyson – all of which are research-intensive and take a long-term view – have demonstrated how success can be achieved, even in the toughest of economic climates.

A strategy is needed that stimulates the emergence of many more such companies. Government does not have the capability of forming such a strategy, but it does have the capability to bring together those who do.

Appendix 1

Acknowledgements

Individuals interviewed:

Sir John Armitt	Chair, Olympic Delivery Authority; past Chief Executive, Network Rail
Brendan Barber	Past General Secretary, TUC
Dr John Mellor	Foundation for Governance Research and Education
Sir Brian Bender	Chair, London Metals Exchange; past Permanent Secretary DTI
Peter Cadbury	Investor
Ian Cheshire	Chief Executive, Kingfisher
John Cridland	Director General, CBI
Julian David	Director General, Intellect
Chris Dodson	Mortimer Technology and Torftech
Ian Dormer	Managing Director, Rosh Engineering; Chairman, Institute of Directors
Rod Dowler	Chairman, Industry Forum
Ian Entwistle	Chief Executive, Norland Managed Services
Peter Hare	Finance Director, MHH Engineering
Lord Heseltine	
Will Hutton	Past Director General, Work Foundation
Professor John Kay	Visiting Professor, London School of Economics; Author 'The Kay Review'
Ian King	CEO, BAE Systems
Sir Richard Lambert	Past Director General, CBI
Paul Lester*	Chairman, John Laing Infrastructure
Frances O'Grady*	Director General, Trades Union Congress
Juergen Maier	Managing Director, Siemens UK Industry Sector

David Marshall	John Laing, Infrastructure Fund Manager
Charlie Mayfield	Chairman, John Lewis Partnership
Professor Joe Nellis*	Professor of International Management Economics, Cranfield University
David Paterson	Head of Corporate Governance, NAPF
David Pitt-Watson*	Senior Advisor, Hermes Pensions Management; and Deloitte Consulting
Peter Rogers	Chief Executive, Babcock International
Christopher Rodrigues	Chairman, VisitBritain
Xavier Rolet	Chief Executive, London Stock Exchange
Simon Rowlands	Senior Advisor, Cinven
Michael Ryan	Vice President & General Manager, Shorts
Terry Scouler*	Chief Executive, EEF
Dianne Thompson	Chief Executive, Camelot
Mike Turner*	Chairman, Babcock International
Lord Sainsbury	
Richard Saunders	Chief Executive, Investment Management Association
Penny Shepherd	Chief Executive, UKSIF
Ralf Speth	Chief Executive, Jaguar Land Rover
Martin Stanley	Past Chief Executive, the Competition Commission
Sir Richard Sykes	Past Chairman, GlaxoSmithKline and past Rector, Imperial College
Stephen Welton	Chief Executive, Business Growth Fund
Simon Walker*	Director General, Institute of Directors
Simon Withey	Chief Executive, Survitec
Sir Robin Young	Past Permanent Secretary DTI

*Member of Steering Group for the Review.

It is recognised that many of the above hold, or have held, multiple roles. The associations mentioned are those considered most relevant to the subject of the Review.

Discussions were held with representatives or groups from the following organisations: the Association of British Insurers (ABI), the EEF, Intellect, the Investment Management Association (IMA), the National Association of Pension Funds (NAPF), PIRC and the Trades Union Congress (TUC).

Submissions were also received from the ABI, Co-Operative Asset Management, the Confederation of British Industry (CBI), the Corporate Responsibility Coalition, F&C Asset Management, FairPensions, Generation Investment Management, the London Stock Exchange, the Ownership Commission, the Quoted Companies Alliance, Unison, Unite, the Smith Institute, Standard Life Investments, the TUC and the UK Sustainable Investment and Finance Association (UKSIF).

Appendix 2

The Saga of Airport Planning in the South East

1955: A committee is set up under Sir Eric Millbourne .

1957: Report forecasts that Heathrow would be at full capacity by 1970. Gatwick would require further development and a third airport might be needed.

1961: An Interdepartmental Committee (IDC) is set up within Whitehall.

1963: Committee recommends that Stansted should be designated as London's third airport.

1964: Government accepts the Stansted recommendation.

1965: Government sets up a public inquiry into Stansted.

1966: Blake Enquiry reports: "It would be a calamity for the neighbourhood if a major airport were to be based at Stansted…" However, the report is not published immediately. Instead, government sets up another IDC working in secret in Whitehall. This leads to a White Paper confirming the decision for Stansted and over-ruling the Blake inquiry.

1967: White Paper published confirming Stansted. Later the potential size of the airport is increased from two to four runways.

1968: Government sets up an independent commission under Sir Eustace Roskill: "To inquire into the timing of the need for a four-runway airport to cater for the growth of traffic at existing airports serving the London area, to consider various alternative sites, and to recommend which site should be selected."

"To inquire into the timing of the need for a four-runway airport to cater for the growth of traffic at existing airports serving the London area, to consider various alternative sites, and to recommend which site should be selected."

1970: The Roskill Commission recommends Cublington, rejecting the Thames Estuary option of Foulness on the grounds that airlines and passengers would not use it.

1971: Government overrules Roskill and announces that its choice is Foulness (Maplin).

1974: Following extensive opposition Maplin project abandoned.

1978: Government White Paper 'Airport Policy' proposes major expansion of Stansted.

1980: BAA submits planning application.

1985: Following public enquiry, Government gives permission for development to about 15 million passengers a year, but subsequently caps the number of take-offs and landings.

1991: New terminal, aprons and taxiways open at Stanstead, increasing capacity from two million to eight million passengers a year.

2000: Work on Phase 2 begins to increase capacity to 15 million with a public consultation initiated on expansion to 25 million.

2002: Planning permission granted to expand Stansted to 25 million passengers a year.

2003: Government publishes White Paper 'The Future of Air Transport', stressing urgent need for additional airport capacity in the South East and stating that there is no strong case for case a second international hub airport alongside Heathrow. Proposes two new runways, one at Stansted (by 2011-12), the other at Heathrow (by 2015-20).

2006: Planning permission for Stansted expansion rescinded.

2007: BAA commences consultation on road and rail strategy for a two-runway Stansted followed by public enquiry on plans to raise the limit on the existing runway operation from 25 to 35 million passengers per year.

2008: Planning application submitted for a two-runway, two-terminal Stansted.

2008: Permission granted allowing airport to operate to 35 million passengers a year.

2010: Planning application for Stansted withdrawn following formation of new government.

2011: Government rules out plans for third runway at Heathrow, and makes it clear it will refuse permission for new runways at Gatwick and Stansted.

2012: Government announces Sir Howard Davies to lead a review of airport capacity in the South East, to report by summer 2015.

Appendix 3

Notes to the Recommendations

The Cost of Tapering CGT and Preferential Dividend Tax Treatment

With regards to the proposed tapering of CGT, a scheme was, of course, in operation pre-2008, albeit to a less radical extent to that proposed. Under the pre-2008 taper regime, total CGT revenue in 2006-07 was about £5.4 billion and in 2007-08 it was about £7.7 billion. A figure of £8 billion might therefore be a reasonable current equivalent allowing for inflation. About 60% of gains each year are made on equities; therefore, the total tax income would be about £4.8 billion. However, unlike the earlier regime, this would be increased by the fact that there would be a ten-year taper for all shares, and no faster taper for business assets. The figure does include gains on non-UK shares, but the data is not readily available to adjust for that. It would also probably be necessary to treat foreign shares in the same way as UK shares, certainly EU shares and possibly shares worldwide, as free movement of capital is a worldwide EU Treaty freedom.

The £4.8 billion figure needs to be compared with the tax that would be collected on the shares under the current 18% and 28% regime. That figure is hard to estimate, as receipts have been low in the first couple of years of the current regime due to poor stock market performance. Revenues in 2011-12 from all assets, not just shares, are expected to be £4.3 billion, but this does not mean that there would, in the long term, be an increase in revenue from re-introducing a taper system.

Some idea of potential tax impact can be gained from the distribution of periods for which shares have been held up to the time of disposal. Both the mean and the median periods are around two years, which would suggest that the change to the proposed taper regime would lead to higher tax rates on average, and therefore higher revenues, as after only two years of ownership, tapered rates would still be 80% of full rates. Assuming no change in behaviour, the proposed change would, therefore, be revenue-neutral, or even revenue-raising. If long-term investment were encouraged as intended, tax revenues could fall, perhaps by £1 billion. However, this would not be an immediate cost but a figure that was reached over time and that would not require a huge increase in economic impact to justify.

The cost of the preferential tax treatment of dividends on longer held shares would undoubtedly be greater and is slightly more difficult to assess. Annual dividend income taxable at 25% (net) is currently of the order of £25 billion, and taxable at 30.56% (from April 2013) of the order of £20 billion. This indicates a total tax take from dividends of about £12.5 billion. This would fall immediately if the scheme were to come in with immediate effect, taking account of holding periods since purchase, or would decline slowly if only holding periods dating from the introduction of the scheme counted. Either way, the cost would build over time if the proposal were to have its desired effect; indeed, it is difficult to envisage it not having a very significant effect. All one can conclude is that there is a substantial revenue risk here, perhaps of at least £6 billion a year. Again, one is looking for this to be more than offset over time by the greater emphasis on company growth that the measures are intended to stimulate.

Correcting the Bias that Favours Debt over Equity

This problem of tax treatment favouring debt over equity is not unique to the UK; the extent of the bias and the adverse consequences were assessed by the IMF in 2011. The bias is affected by how the recipient of either dividends or interest is taxed, especially if they are located in lower-tax jurisdictions. In the UK, the tax bias has diminished somewhat with the reduction in the rate of the corporation tax rate. A deduction of 22% of interest payment (as is due to be introduced in 2014) is worth less than a deduction of 28% but it is still significant. There are three options. Two came out of an IMF examination of the issue in 2011; the third was put forward by the 2020 Tax Commission.

The first option would be simply to stop or restrict the deductibility of debt interest. The problem that this would create, of course, is that it would cut across vast numbers of existing financing arrangements on which companies have based their financial planning. Not surprisingly, the UK Government has explicitly backed away from this option.

The second would be to offer some sort of tax deductibility on dividend payments or to provide allowance for the cost of corporate equity. The problem here is that such a scheme could get very expensive. To compensate, it might be possible to increase the tax charge on individuals receiving dividends, though this runs counter to recommendations proposed in this report. Moreover, the latter would not recover anything from non-UK shareholders unless one imposed a withholding tax on dividends being paid abroad. That would in turn conflict with both EU law and several of the UK's tax treaties.

The third option would be radical reform. The idea would be to levy no tax at all on corporate profits at the time they were made, but to tax returns on capital - regardless of whether equity or loan - at a uniform rate, as and when paid out to investors. There would be a flat charge regardless of whether the shareholder or lender, corporate or individual, was UK or foreign-based.

The problem here is that the short-term fiscal impact could be very large. There would also be conflicts with EU law that would need to be addressed. However, this option would have many benefits beyond that of removing the bias in favour of debt.

Constraints of Pensions Regulation

The intention of the EU's Solvency II is to achieve 99.5% confidence that, over a 12-month period, the value of assets will exceed the value of liabilities. Where liabilities will crystallise only after many years, it is clearly sensible to invest in assets of similar duration. However, in the interim, say over a one-year period, there may well be volatility in asset prices, even though in the long term it could reasonably be expected that these changes will reverse. This creates artificial volatility for regulatory solvency purposes with a consequent increase in required capital. This results in a bias against long-term investment and an increase in the cost of provision of the long-term savings products.

Efforts are currently underway to reduce this adverse impact on long-dated insurance business through application of a 'matching adjustment' where credit will be given for having fixed interest-type assets with cash flows that replicate the projected liability cash flows. However, it is by no means yet certain that these efforts will be successful, and, of course, this does not affect equity investments.

Further adjustments are also needed to the regulatory discount rate to reflect the ability of insurers to invest in assets that provide effective matches over the full life of liabilities. These need to be designed to include the risk that liabilities are not discounted at an unduly low rate but more accurately reflect the rates of the return that may be expected to be earned on long-term assets. However, the design of these has also not yet been finally determined.

The expectation that, over the long term, equity returns will exceed debt returns is a fundamental tenet of a capitalist system even if equities undergo periods of underperformance along the way. Indeed, business growth is what actually creates wealth. A focus on returns and volatility on a 12-month view is clearly unhelpful to any true assessment of equity investment.

The establishment of The Pensions Regulator (TPR), with substantial powers to require pension schemes to make good funding deficits, and of the Pension Protection Fund have had a major impact on the pension schemes' investment strategies and have led, in many cases, to a requirement to make high contributions to reduce deficits, calculated on snapshots within the economic cycle. This added to existing pressures resulting from accounting changes (first under the UK ASB's FRS17 and then under the equivalent standards under IFRS).

EIS and VCT Schemes

The EIS scheme has been around under its present name since about 1994, but the Business Start-Up Scheme and the Business Expansion Scheme that preceded it go back to the early 1980s.

The EIS currently allows an individual to invest up to £1 million per annum in smaller company shares, which may be spread across several businesses. Each company must be unquoted, must have fewer than 250 employees, and must have gross assets that do not exceed £15 million before the issue or £16 million after. It also needs to carry on a qualifying trade. Most trades qualify, but trades that involve holding a lot of land or investments tend not to qualify.

Shares must be fully paid ordinary shares, and only issued to new subscribers. Tax relief is allowed at 30% of what is invested, regardless of the individual's tax rate, provided the latter has a tax liability against which to set the allowance. This is conditional on the shares being held for three years, starting from the later of when the investment was made or when the company started to trade. If that condition is met, there is also no CGT on their sale.

HMRC has estimated the cost for 2011-12 to be £260 million.[23] This cost may rise in future years, as the limits have been made more generous.

23 HMRC table 1.5, updated December 2011.

There is also the new seed EIS. This is for companies that have carried on their trade for less than two years, and that have gross assets of up to £200,000 and fewer than 25 employees. Shares must be fully paid ordinary shares, and only the issue to new subscribers counts, not second-hand purchases. The company can raise up to £150,000 under the scheme. The investor gets 50% income tax relief, regardless of his or her tax rate, provided they have a tax liability against which to set it.

The estimated long-term cost according to the 2012 Budget is £20 million.

VCTs were introduced in 1995, with the aim of increasing the supply of finance to small unquoted companies. They are managed funds and, unlike the EIS schemes, they are intended to appeal to private investors who are not seeking an involvement with any particular company. Spread across several smaller businesses, they limit the risk and are more liquid.

The VCTs must themselves be listed on the Stock Exchange and can invest up to £1 million per annum in each qualifying company in their portfolios. A qualifying holding consists of newly issued shares or securities (including loans of at least five years) in companies similar to those that would qualify for the EIS.

Subscribers of new ordinary shares in VCTs are entitled to claim income tax relief on their subscriptions provided their shares are held for at least three years. The maximum annual investment for which income tax relief is available is £200,000. No income tax is payable on dividends received from ordinary shares in VCTs, or on their disposal.

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