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NOTE

From:	The European Commission
To:	The High Level Working Group on Competitiveness and Growth
Subject:	Competitiveness check-up on investment in intangibles

Delegations will find in Annex a note from the European Commission on the Competitiveness check-up on investment in intangibles in view of the High Level Working Group on Competitiveness and Growth meeting on 26 January 2017.

INTANGIBLE ASSETS

This note elaborates on the trends of investment in intangible assets and their likely impacts as a potential source of innovation and productivity gains. It also focuses on regulatory barriers that may be hampering them and policy choices to tackle them.

The composition of investment is shifting from tangibles to intangibles. Investment can be divided into two subcomponents: (i) assets that have a physical form (tangible assets) e.g. ICT equipment, machinery, construction; and, (ii) assets that do not have a physical or financial embodiment (intangible assets). The latter include assets such as skills, organisational know-how, managerial expertise, software and databases, design, brands, various forms of intellectual property, and goodwill.[1]

While overall investment has significantly fallen in Europe as shown in the Competitiveness Scoreboard,[2] **tangible and intangible assets have displayed different behaviours.** The traditional physical investment has fallen significantly, while investment in intangibles has continued to grow steadily despite the crisis. In some Member States (FR, UK), intangible investment matches or already exceeds investment in traditional capital such as machinery, equipment and buildings. However, the stocks of tangible and intangible assets are very different. Investment in intangible assets is still lower than investment in tangibles. It is worth noting that the stock of intangibles is still relatively low. The EU as a whole is still lagging behind the US in this type of investments, without any sign of catching-up.

Intangible assets are critical elements of a knowledge-based economy. Intangible assets are key element to the success of many businesses, both small and large. Indeed, their value represents a greater proportion of the total value of most businesses than tangible assets, such as machinery and equipment. For instance, in 2010, it is estimated that almost 90% of the value of companies quoted in the S&P500 market (US) is attributed to intangible assets.[3]

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1 A frequently used system for categorising intangible assets distinguishes between computerised information (e.g. databases), innovative property (e.g. R&D), and economic competencies (e.g. skills).

2 Cf. Indicator on "Level of Investment in Manufacturing".

3 Source: Ocean Tomo.

Investment in intangibles are a driver of productivity and economic growth. They enable firms to innovate and increase their efficiency. For instance, they also increase the returns of investments in physical capital. Investments in ICT capital (e.g. computers, broadband access) can be more productive if accompanied by investment in intangible assets (e.g. ICT skills, new business processes). Certain studies show that intangible assets already contribute more to economic growth rates than tangible capital.[4] Member States investing more in intangible assets are those showing a higher labour productivity growth in the Competitiveness Scoreboard.[5] It is estimated that intangibles accounted for 20% of labour productivity growth in the EU between 1995 and 2007, and up to 37% in the case of the US.[6] In addition to traditional factors such as functioning of the product and services markets, a part of the productivity gap between the EU and the US seems to be explained by these differences in investing in intangibles.

However, the importance of intangible assets remains underestimated as not all of them are accounted for. Official statistics only include R&D, mineral exploration, computer software and databases, entertainment, and literary and artistic originals, as intangible assets and some critical assets are still excluded. These include brands, market research, training, management consulting and organizational investment. If we take them into account, we observe higher levels of investment and stock in intangibles than those reported by official statistics.[7] Broadening their statistical definition could therefore be helpful to better gauge their importance and impact on competitiveness.

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4 Cf. DG ECFIN, Investment in intangible assets, Note for Economic Policy Committee, October 2016.

5 Cf. Indicator on "Real labour productivity per hour", and indicator on "Real labour productivity per person".

6 It is estimated that between 1995 and 2007 at least 33.7% of labour productivity growth in the United States was due to investments in KBC. And over the same period, across fourteen EU countries, investment in KBC is calculated to have accounted on average for at least 19.9% of labour productivity growth (Corrado, Haskel, Jona-Lasinio and Iommi, 2012). http://www.oecd-ilibrary.org/docserver/download/9213021e.pdf?expires=1484760906&id=id&accname=oid031827&checksum=BEC2DF21B7DFF8D2365E25A5737EC7CA

7 Based on Intaninvest data (intangible GFCF) and Eurostat/BEA national accounts data (business sector GVA).

As important as these assets are, barriers remain to this type of investment. Policymakers can effectively address these barriers and foster this type of investment, for instance:

i. ***Intangible assets are not always adequately protected by intellectual property rights.*** A feature of intangible assets is that other businesses not owning them can benefit from them. Property rights usually cannot be as clearly defined and well enforced as for tangibles assets. As a result, owners of intangibles may fail to fully get the returns on their investments, which in turn can lead to underinvestment. To protect them various legal means can be used.[8] A common mean is the use of patents, which grant temporary monopolies to "inventors". However, they also involve significant transaction and litigation costs and can lead to monopolistic situations. Challenges also emerge in the case of copyrights. Measures aim at stemming piracy may indeed limit or prevent desirable and innovative uses of digital technology, including spill-overs and diffusion of knowledge.[9]

ii. ***Access to finance for firms investing in intangibles is more challenging***. Intangibles are distinguished by their high uncertainty and risk. This makes lenders more cautious in financing these investments. However, whilst caution may be reasonable, it can turn into reluctance due to the difficulties in valuing this type of assets (e.g. a company brand). Indeed, accounting can be challenging. As a result, lenders are not only reluctant to finance this type of investments, but also to use it as collateral to get credit. This especially affects companies not using international accounting standards (IFRS), which is the case of most SMEs, since their valuation of intangibles is not standardised and therefore may be considered as less reliable. As a result, SMEs heavily relying on intangible assets encounter more difficulties in accessing finance. This seems to be particularly the case for young innovative companies wanting to scale-up their business. This is particularly concerning worrying since intangibles can be even more important than tangible property for valuing a firm (see above).

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8 Legal means include patents (mainly new products and new processes), copyrights (mostly software, databases and artistic creation), trademarks (brand or logo) and design rights.

9 Farell and Shapiro, 2004

Well-designed framework policies can also promote investment in intangible assets as well as innovation in several areas, for instance:

Flexible and pro-competitive product and service market reforms: Commercialising a new product or process usually requires swiftly deploying resources. Tackling rigidities in capital and labour markets is therefore crucial for fostering investment in intangibles.

Availability of human capital: Most intangible assets are human-capital intensive. Ensuring the availability of labour with the necessary skills is critical. Education policies can contribute to the availability of these skills.

Investment in R&D: Businesses often capitalise research and development costs as intangible assets. Policies lowering the risks and cost of R&D activities, for instance facilitating its financing or providing a favourable tax treatment, could contribute to increase the level of intangible assets.

Possible questions to HLG members

- *Do you have specific policies to foster investments in intangible assets?*
- *Have you taken any specific action to remove barriers to investments in intangible assets?*
- *Do you systematically link your education and skills policies to the knowledge-based economy?*
- *What issues within investments in intangibles should be a priority for the upcoming competitiveness check-up in the COMPET Council?*