Flexibility in the UK economy

March 2004

HM TREASURY

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Introduction

I.1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. Flexibility in labour, product and capital markets is critical to ensuring that firms and individuals can adapt to these changes and thrive in a globally competitive environment.

I.2 A flexible economy is characterised by the ability of firms and individuals to adjust smoothly and rapidly to economic change. A high degree of flexibility minimises disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength.

I.3 The Government is committed to advancing flexibility and fairness together, by enabling individuals and firms to cope with and respond to change. By investing in education and training, it has helped equip people to adapt to new and changing employment opportunities. High-quality and responsive services such as Jobcentre Plus provide incentives and practical support to enable people who have become unemployed to re-enter the labour market rapidly, while reforms to the tax and benefit system help to cushion the impact of economic shocks on household incomes and the National Minimum Wage guarantees a fair minimum income from work. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

I.4 In his statement to the House of Commons on 9 June 2003 on UK membership of the European single currency,[1] the Chancellor gave a commitment to publish six-monthly reports on trends and progress in labour, product and capital markets. This document is the second of these reports. Flexibility would be especially important were the UK to join Economic and Monetary Union (EMU) where monetary policy at a national level is not an option. This document complements a range of other information which the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe.

I.5 This report is divided into two sections:

- Chapters 1, 2 and 3 explain the importance of a flexible economy and how the Government's policies combine flexibility with fairness; and
- Chapter 4 sets out the action the Government has taken to boost flexibility in labour, product and capital markets, including in Budget 2004.

[1] Available at www.hm-treasury.gov.uk

2 WHY FLEXIBILITY MATTERS

Why flexibility is needed

2.1 Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. Economic growth is driven by continual advances in technology that increase the efficiency with which existing goods and services can be produced and increase the range of goods and services that are provided. In addition, shifts in consumer demand for different products, the opening up of new markets, the emergence of new competitors and changes in the supply of key inputs all have important effects on the profitability of different firms and industries.

2.2 In recent years, advances in information and communications technology (ICT), the increased integration of emerging markets with the global economy and significant movements in input prices have been prominent developments affecting industry. However, individual firms and households may also be affected by more localised changes that affect particular industries or particular firms within an industry. In a global age, such changes are happening faster than in the past. As a result, the economy is continually undergoing a process of structural change, in which the amount of labour and capital required by some industries declines, freeing up resources that may be profitably used in the production of new goods and services, to the benefit of firms and individuals.

Characteristics of flexibility

2.3 Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may mean learning a new skill, a change in renumeration, moving into a different job in the same firm or changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets. This can be supplemented if necessary by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

2.4 There have been substantial structural changes in the industrial world throughout the last century. These have been driven by technological change, which alters the relative costs of producing different goods and services, and expands the range of goods and services available. Improvements in agricultural productivity allowed labour to be employed in other uses. Similarly, manufacturing productivity has advanced, freeing up resources that can be used elsewhere. Importantly, this has been associated with continuing growth in real income levels – the reallocation of resources has allowed consumers access to an expanded range of goods and services, with improved quality and value for money.

2.5 This process of 'structural transformation' is a well-established feature of economic development. Economies with higher levels of output tend to devote a relatively greater share of employment and resources to the more capital-intensive higher value added sectors, such as the financial services and technology sectors. In these industries the UK is better placed to exploit the highly skilled workforce and larger capital stock that are features of more developed economies.

FLEXIBILITY AND THE GLOBAL ECONOMY

Globalisation

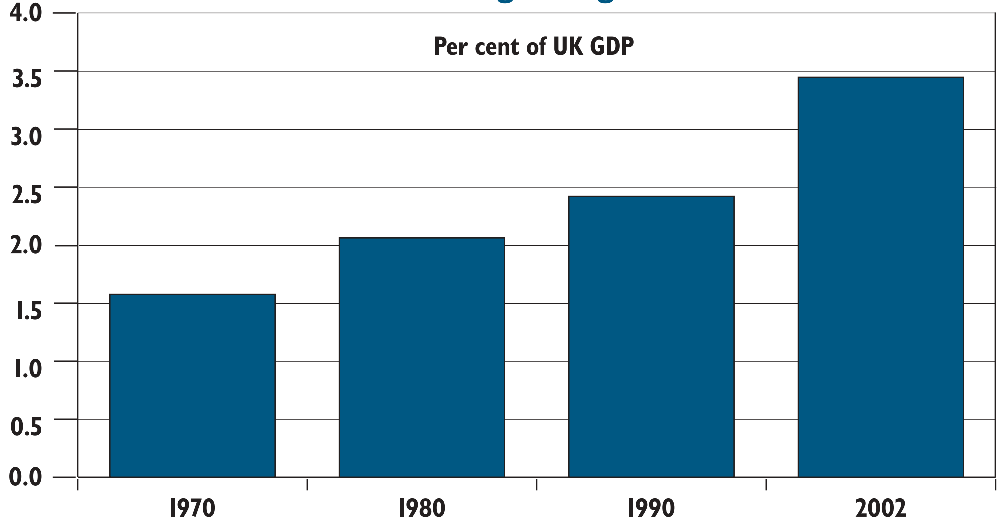
2.6 The process of structural transformation is brought into sharper focus by the increasingly rapid shift in the location of global production. In 1980, less than a tenth of manufacturing exports came from emerging countries – it is now 25 per cent and, as the process of globalisation accelerates, so the need for flexible markets becomes ever more important. For the UK to take advantage of the opportunities created by the increased speed of innovation and rapidly emerging hi-tech industries, necessitates the rapid reallocation of resources between sectors. This requires flexible labour, product and capital markets, which allow businesses and individuals to respond to changes in technology, consumer prices and competitive pressures by quickly adapting their production techniques, investment and employment. For example:

- as the pace of economic change has accelerated, competition and innovation have shortened the typical life cycle of products, leading to faster renewal. As a result, firms' abilities to adapt and to take advantage of new technologies and markets are increasingly crucial to their success. The same is also true in the labour market where employees need to refresh their skills more frequently and the concept of a job-for-life no longer holds; and
- faster information flows, and the increasing mobility of people, ideas and capital, are breaking down geographical barriers to economic activity. The growing integration of emerging markets with the global economy offers an important source of wealth and opportunity, but brings new challenges too. Rapid growth in a number of the world's emerging markets means that the geographical centre of gravity in the global economy is likely to change over the coming decades, with important implications for the world's major economies. For example, valued at current market exchange rates, China is already the sixth largest economy in the world, and valued at purchasing power parity it is second. Other countries are forging ahead too.

External openness and productivity

2.7 Globalisation and free trade offer important opportunities for the UK and Europe. As Chart 2.1 demonstrates, the UK has increased its share of trade with developing Asian economies over the decades. Greater external openness to trade and investment can be an important driver of growth, employment and productivity. Reduced trade barriers allow increased specialisation in areas where an economy has a comparative advantage, enabling firms to take advantage of new market opportunities, and leading to the re-allocation of resources to more efficient producers, increasing productivity of the economy as a whole.

Chart 2.1: UK trade with fast growing Asian[1] economies



[1] ASEAN, China, Korea and India.
Source: OECD Monthly International Trade Statistics.

2.8 The economic benefits arising from increased external openness could be substantial. In order to take full advantage of these benefits, firms and individuals need to be flexible so they can adapt quickly to change and reallocate resources efficiently to the most productive economic sectors and firms.

2.9 Increased competition is one of the main channels through which trade may lead to higher productivity. It widens the market for the sale and sourcing of intermediate inputs as well as that for products for final consumers. Increased competition forces firms to become more efficient, driving down margins and the prices of goods and services for consumers. Greater external openness, is therefore a logical extension of the Single Market, with the potential to deliver greater benefits. The majority of general cross-country studies suggest that increased trade openness has a positive impact on country income – a 1 per cent increase in the trade-to-GDP ratio leading to increases in real GDP per capita of at least $^1/_3$ of one per cent in the longer term. Research[2] suggests that the total cost to consumers of existing EU protection, including non-tariff barriers such as quotas or product standards, could represent as much as 7 per cent of EU GDP, or around €600-700 billion.

2.10 International trade also facilitates the transfer of technologies between countries, providing a further boost to an economy's productive potential. Research and development (R&D) undertaken abroad may have a direct impact on domestic productivity, where new technologies, material, production processes or organisational methods can be replicated domestically. Foreign R&D may also have an indirect impact, where innovation and investment undertaken abroad leads to the import of goods and services that provide domestic producers with new, improved or cheaper products that they can use to improve their own production processes.

[2] Patrick A Messerlin, *The real cost of European protectionism*, Institut d'Etudes Politiques de Paris and Groups d'Economie Mondiale de Sciences Po (GEM), 2001.

2.11 External openness can also generate wider benefits. Foreign direct investment can lead to spillovers of technology or innovative business processes from the investor to the host economy, helping to increase productivity. Trade openness can encourage product market regulatory reforms, particularly those which liberalise entry, and so can be a spur to investment and economic growth. Finally, to the extent that reduced barriers to trade make it easier for firms to enter and exit the market, productivity can be enhanced by the entry of new and dynamic firms that are more innovative and enterprising, and the exit of unproductive ones.

International capital markets

2.12 Advances in ICT have facilitated the development of new financial products and enabled a greater integration of international capital markets. These developments have increased the opportunities for risk sharing and portfolio diversification. They have extended the range of financing options available to entrepreneurs, firms and households, thereby increasing both the flexibility and the resilience of the financial system. Increased financial market flexibility can also help economic adjustment by enabling firms to access the capital they need to adapt their production processes. And it can make it easier for areas with high unemployment to attract the investment needed to develop new businesses and create new jobs.

Flexibility in the US and Europe

2.13 Policies that impact on labour, product and capital markets are an important determinant of the overall balance between flexibility and fairness in different economies.

United States

2.14 The US has demonstrated a high degree of flexibility in all three markets. The minimum wage and Earned Income Tax Credit, combined with low benefit replacement rates, create a strong incentive for displaced labour to find new employment. In addition, relatively unrestrictive employment protection legislation has reduced the cost of providing employment and facilitated job creation. However, relatively low levels of out-of-work support mean that periods of unemployment can result in large reductions in family incomes.

2.15 Well-developed capital markets in the US, including a vibrant venture capital market, have provided finance for business creation and expansion, and support an already strong entrepreneurial culture. These features have helped the US to be at the forefront of developing and exploiting advances in ICT. However, the coverage of some key public services is less than universal. For example, the US does not have a national health insurance programme and 14 per cent of the population have no insurance coverage. The costs of health care are high and many Americans are at risk of being uninsured at some point in their lives. Most employers make substantial contributions to employees healthcare programmes; this constitutes a significant non-wage labour cost estimated at US$100 billion a year which may have an impact on flexibility. Surveys show that 30 per cent of US workers are reluctant to change jobs for fear of losing health cover – this leads to a less flexible and less mobile workforce with knock on effects for the economy as a whole.

Europe

2.16 In Europe, labour market policy has placed greater emphasis on mitigating the effects of change. In many European countries relatively generous levels of out of work support help insure households against labour market shocks but at the same time reduce incentives for claimants to return to and progress in work, leading to relatively high structural levels of unemployment. These effects are to some extent mitigated by active labour market policies, especially in the Nordic countries. In some countries overly restrictive legislation governing conditions of employment has placed significant constraints on employers. However, these are partially offset by the high functional flexibility of the workforce as a result of effective workforce training programmes.

FLEXIBILITY AND FAIRNESS – THE UK APPROACH

2.17 The Government's objective is to build a stronger, more enterprising economy and a fairer society, maintaining stability and ensuring rising living standards for all. This entails an approach to economic reform that advances flexibility and fairness together, combining the best features of the US and European systems.

2.18 Flexibility in labour, product and capital markets is critical to economic success in a globally competitive environment. A vibrant and productive economy can deliver the growth needed to generate the revenue to improve public services and to generate employment opportunities for all. Economies that lack flexibility will find it difficult to maintain employment and improve productivity and living standards in the longer term.

2.19 However, in the short term flexibility may be associated with considerable changes as labour and capital are redeployed from traditional activities into expanding industries. At any point in time these costs will fall disproportionately on particular individuals and particular industries. For the individuals concerned this may entail considerable short-term costs, in terms of income, and in the challenges that they face to acquire new skills and find new employment. It is therefore important that flexibility is accompanied by measures that enable individuals to make the transition from traditional activities that have ceased to be viable into activities where the demand for labour is high. Such measures ensure that flexibility is accompanied by fairness. For example, policies that support individuals through periods of unemployment and equip them to re-enter the labour force promote fairness by ensuring that these dislocation costs are minimised. They also contribute to flexibility by enabling individuals to make the transition between different forms of employment more rapidly.

2.20 The regulatory environment is an important determinant of both flexibility and fairness. Effective and well-focused regulation can play a vital role in correcting market failures, ensuring health and safety and good working practices, and in driving up standards. However, unnecessary or poorly designed regulation can be an obstacle to flexibility restricting employment growth and competitiveness, particularly for smaller firms. The Government is committed to ensuring that the negative impacts of the regulatory framework are minimised. This includes clear impact assessments for new legislation; removing unnecessary, ineffective or counterproductive regulation; and ensuring that where legislation is appropriate it is simple, clear and effective.

2.21 As described in the next section, a well functioning economy is characterised by efficient operation of labour, product and capital markets, where price signals and quantity adjustments allow the reallocation of resources in response to changes in supply and demand. Strong market adjustment is associated with the five key drivers of productivity performance:

- improving competition, which promotes flexible markets and increases business efficiency and consumer choice;
- promoting enterprise, through measures aimed at removing barriers to entrepreneurship and developing an enterprise culture;
- supporting science and innovation, to promote development of new technologies and more efficient ways of working;
- raising skill levels, to create a more flexible and productive workforce; and
- encouraging investment, to increase the stock of physical capital through stronger, more efficient capital markets.

2.22 Chapter 3 of Budget 2004 sets out the Government's strategy for boosting productivity by promoting flexible markets, based on the five drivers of productivity. The Government's reforms to the competition regime encourage firms to respond quickly to changes in market conditions and help to ensure that key product markets work better for consumers. The Government has also increased support for basic and applied research, encouraging innovation and helping businesses to harness the potential of new technologies. Investment in education and workforce skills helps individuals adapt to change. Investment in strong and flexible public services has helped to make them more efficient and responsive and extended opportunity and security for all.

2.23 The Government's approach to increasing employment opportunities for all is discussed in more detail in Chapter 4 of Budget 2004, and its strategy for building a fairer society is set out in Chapter 5.

Economic reform in Europe

2.24 The Government is also committed to promoting a more flexible European economy. It welcomed the commitment by Europe's leaders in March 2000 to the Lisbon goal aimed at making the EU *"the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion"*[3] by 2010. The Lisbon strategy focuses on structural reform of Europe's labour, product and capital markets aimed at increasing flexibility as the key to success in a global economy – success that is vital to ensure social justice and high standards of environmental protection. Box 2.1 provides an assessment of Europe's progress towards the Lisbon goals and sets out priorities in the year ahead, including the importance of new Member States continuing to implement structural reforms.

[3] Presidency conclusion Lisbon European Council, 23-24 March 2000.

Box 2.1: Progress with European Economic Reform

The Government's 2004 report *Advancing long-term prosperity: Economic reform in an enlarged Europe*[1] sets out its latest assessment of progress with economic reform in Europe. Many Member States have taken tough decisions and introduced important reforms. These reforms are welcome and should enhance flexibility. However, the pace of reform must be accelerated if Europe is to deliver the rising living standards and greater social cohesion its citizens expect. The Commission has noted that pursuit of Lisbon reforms could produce *"an increase in potential growth in the order of 0.5 to 0.75 of a percentage point of GDP within the next five to ten years."*[2]

Europe still has a long way to go to match the economic performance of its major competitors. Europe failed to recover as strongly as the US from the recent global slowdown, with several Member States experiencing recession. As the Commission concluded, *"the fact that the slowdown has persisted for three years suggests that supply side dynamics have been important and the growth weakness cannot solely be attributed to demand shocks"*[3]. Underlying trends in productivity and employment growth confirm this assessment. US productivity is at least 14 per cent higher than in the EU. Europe has succeeded in creating 6 million jobs since 1999, but an enlarged Europe must create another 21.5 million jobs to meet the Lisbon objective of raising the employment rate to 70 per cent, by 2010.

As the EU strives to raise both levels of productivity and employment, an immediate priority is for Member States to implement further labour market reforms, to deliver higher employment and skills. Wim Kok's European Employment Taskforce report sets out a clear way forward, emphasising the importance of improvements to the regulatory framework, active labour market policies, reforms to tax and benefit systems to improve incentives to work, and action to create a skilled and adaptable workforce.

Other priorities for reform in Europe include: strengthening competition in the single market and regulatory reform to minimise unintended burdens on business; advancing enterprise and innovation; and improving external openness, by adopting a leadership role in multilateral negotiations and taking steps to strengthen the transatlantic economic relationship.

The recent experience of the ten new Member States[4] has highlighted the importance of flexible markets. All ten have implemented significant reforms in preparation for EU membership, centred on the creation of new public institutions and agencies, the removal of obstacles to the free movement of goods and steps towards liberal capital markets. These reforms have helped to deliver significant improvements in economic performance with aggregate annual growth in the new Member States exceeding 3 per cent over the past five years. However, living standards remain significantly below those in the existing Union. In 2002, GDP per capita in the new Member States was on average 47.3 per cent of that in the EU15. This highlights the importance of the new Member States continuing to implement further structural reforms to ensure that their income levels converge rapidly on those in the existing EU, and that all Member States in the enlarged EU are able to adapt quickly and efficiently to changes in competition and comparative advantage.

[1] Available at www.hm-treasury.gov.uk.

[2] *Delivering Lisbon: reforms for the enlarged Union*, Report from the Commission to the spring European Council, January 2004.

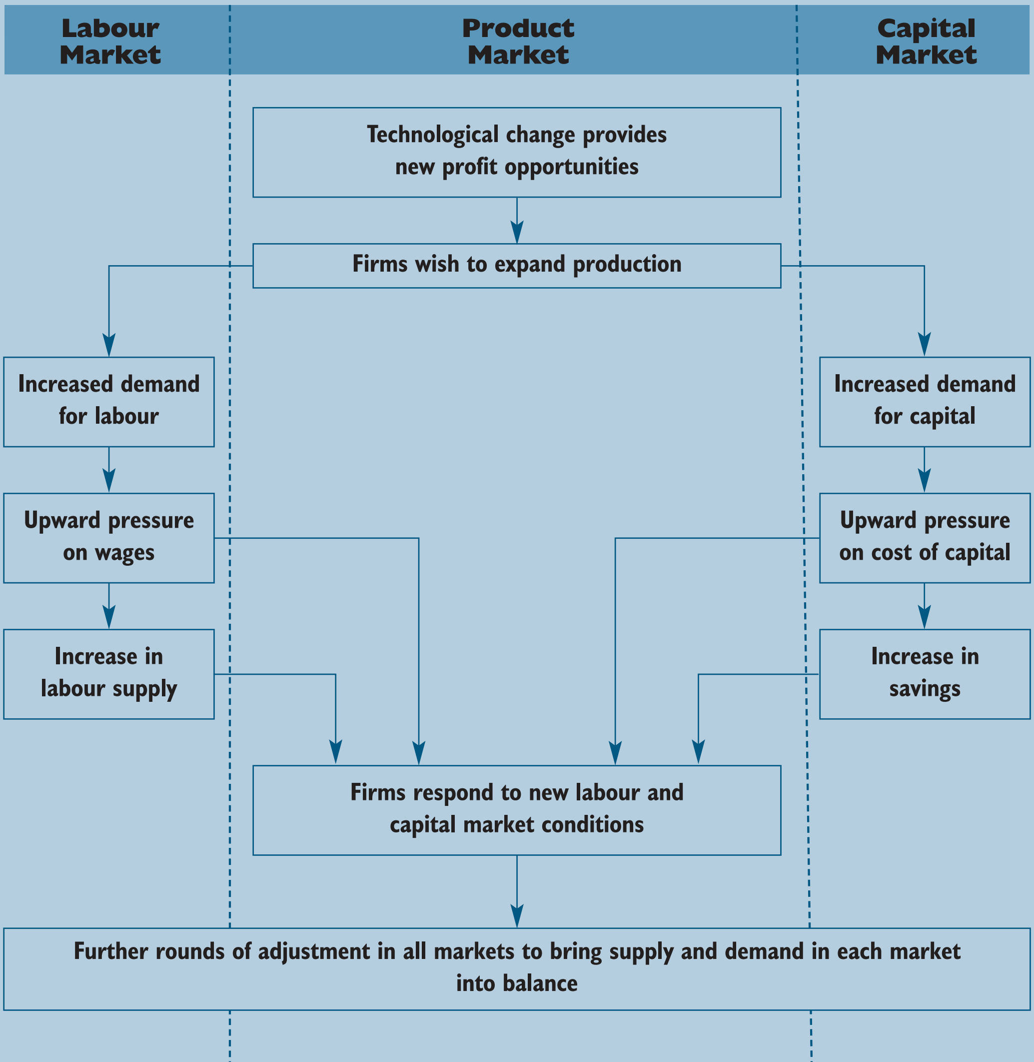
[3] *The EU Economy: 2003 Review*, European Commission.

[4] The 10 new Member States are Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

3 Flexibility in labour, product and capital markets

3.1 The overall flexibility of the economy depends on the interaction of flexibility in the labour, product and capital markets, as illustrated in Box 3.1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital markets and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.

Box 3.1: The interaction between labour, product and capital markets



Labour market flexibility

3.2 The performance of the labour market is central to economic and social well being. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people to adjust rapidly to change and provide support for those who are looking for employment, it implies an economy that is fairer, more competitive and more productive.

3.3 The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand. This must be balanced by measures that ensure fairness, for example the Government's tax credits;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms are able to create employment or to vary it when needed, backed up by employment legislation that ensures workers are not exploited;
- workers are able easily to commute or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- the institutional environment encourages labour force participation, equips people to adapt rapidly to change and provides support for those who are searching for work, enabling them to remain active participants in the labour market.

3.4 Chapter 4 of Budget 2004 sets out the Government's overall strategy for increasing labour market flexibility, and promoting employment opportunity for all. New measures since the 2003 Pre-Budget Report, including in Budget 2004, are summarised in Chapter 4 of this report.

Product market flexibility

3.5 Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive environment.

3.6 The main characteristics of a flexible product market are:

- a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and
- a regulatory environment in which the constraints on business yield clear benefits to the wider economy and are not disproportionately costly in terms of their effects on firms' incentives to hire, train, innovate and invest.

Capital market flexibility

3.7 Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that businesses, entrepreneurs and innovators have ready access to the funds that they require in order to develop their ideas and exploit market opportunities. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have unacceptably high level of risk.

3.8 Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should, for example, allow individuals to borrow when necessary in order to enhance their education and skills, with beneficial effects on productivity and on the employability of the individuals concerned. In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest as appropriate in new processes and products.

3.9 A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

3.10 The main characteristics of a flexible capital market are that:

- borrowers have a range of financing options available to them to access the capital they require at a competitive price and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- investors can allocate resources efficiently and responsively across the economy to support innovation and enterprise; and
- there is sufficient borrowing and lending capacity on credit markets to allow households and business to smooth fluctuations in income.

Flexibility and the productivity challenge

3.11 Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organisational changes that raise productivity and wages. Chapter 3 of Budget 2004 sets out the Government's overall strategy for promoting productivity in the UK economy through reforms which boost competition, enterprise, skills, science, innovation and investment. New measures since the 2003 Pre-Budget Report, including in Budget 2004, which promote product and capital market flexibility, are summarised in Chapter 4 of this report.

Box 3.2: Views on flexibility

There is wide consensus among academics and policymakers that flexibility enhances an economy's resilience to shocks. At the Treasury's *Advancing Enterprise: Britain in a Global Economy* conference in January 2004, Alan Greenspan stated that: *"The most significant lesson to be learned from recent economic history is arguably the importance of structural flexibility and the resilience to economic shocks that it imparts. The more flexible an economy, the greater its ability to self-correct in response to inevitable, often unanticipated, disturbances and thus to contain the size and consequences of cyclical imbalances".*[1]

The benefits of reducing rigidities in labour, product, and capital markets to achieve greater levels of productivity and employment are recognised by many, including:

- **Jean-Claude Trichet,[1] *"…what we need is both higher productivity growth and higher employment creation. What is needed for these objectives to be achieved are economic reforms that ensure that capital, labour and product market rigidities will be substantially lowered";***
- **John Snow,[1] *"…create an environment that encourages flexibility, capital formation and innovation, and in turn leads to job creation, productivity, and higher living standards";***
- **Michie and Sheehan,[2] *"Increased functional flexibility is significantly positively correlated with all categories of innovation and, in particular, with process innovation";* and**
- **Krueger and Pischke,[3] *"Much policy discussion has focused only on the supply side (e.g., wage rigidities) of the labour market. A neglected concern is that restrictions on entrepreneurs and product market regulations and institutions may distort labor demand, causing the labor market demand to shift in and become more inelastic."***

[1] See, Advancing Enterprise: Britain in a Global Economy -January 2004, available at www.hm-treasury.gov.uk.

[2] Michie, J. and Sheehan, M. (2003) '*Labour market deregulation, 'flexibility' and innovation*', Cambridge Journal of Economics.

[3] Krueger, A.B. and Pischke, J.S. (1997) *'Observations and conjectures of the US Employment Miracle'*, NBER Working Paper No. 6146.

4 MEASURES TO PROMOTE FLEXIBILITY

4.1 This section of the report summarises the action the Government has taken since the Pre-Budget Report 2003, including in Budget 2004, to promote flexibility and fairness in the UK economy.

MEASURES TO PROMOTE FLEXIBILITY AND FAIRNESS IN LABOUR MARKETS

4.2 The Government's long-term goal is to achieve employment opportunity for all – the modern definition of full employment. It aims to ensure a higher proportion of people in work than ever before by 2010. Achieving this goal requires a productive, enterprising economy with a flexible labour market that can adapt quickly to changes in global and domestic demand. Flexibility must, however, be matched with fairness. To this end, the Government has worked to advance flexibility and fairness together through a policy framework, built on macroeconomic stability, that:

- ensures that people are equipped to adapt to changing economic circumstances;
- provides adequate rewards from work while promoting stability in workers' incomes; and
- delivers the institutional and structural flexibility needed to achieve high and sustainable employment.

Developing skills

4.3 A highly educated workforce with a culture of lifelong learning is more likely to be able to adapt to an economic shock. Skilled workers adapt faster and more effectively to technological change, making the economy more flexible and more productive over the long term. The number of people in the UK with high skills compares well with international levels. However, the level of intermediate skills in the UK is low and a large proportion of people possess few skills. The Government is committed to reforms that will extend opportunity and equip young people with the skills to meet the demands of the twenty-first century. In Budget 2004, the Government announces:

- a New Deal for skills which sets out a vision for closing the skills gap with the UK's international competitors;
- reform of financial support for 16-19 year olds, to increase the proportion who reach the age of 19 equipped with the skills they need to succeed;
- that it will address any regional barriers identified by the Regional Skills Partnerships to create an effective and integrated approach to regional skills delivery; and
- the six new areas that will take part in Employer Training Pilots from September 2004, so they will now cover one-third of England.

Employment flexibility

4.4 If labour demand and supply are to be matched efficiently, a range of working patterns are needed, which give employers the flexibility to vary capacity levels and employees the choice to balance their work and other responsibilities, for example, through reduced hours or temporary work. The UK shows a significant degree of employment flexibility, with a wide distribution of hours worked and widespread adoption of flexible working practices, all of which are primarily a result of employee choice[4]. Chart 4.1 shows, for example, that although the overall average number of hours worked is at roughly the EU average, the range of part-time jobs available in the UK is much wider than elsewhere.

[4] *Balancing working and family life: enhancing choice and support for parents*, HM Treasury, January 2004.

Chart 4.1: Hours per week usually worked in main job, 2002

Source: Eurostat.

4.5 In particular, this flexibility helps parents to better balance their work and family life, with benefits for families themselves, business and the economy. Enabling parents to combine fulfillment of their family responsibilities with work is central to improving the conditions in which children grow up, achieving greater equality between men and women, and increasing productivity in the workplace. It is therefore key to a number of the Government's policy objectives, including its commitment to halve child poverty by 2010 and eliminate it by 2020.

4.6 In line with this determination to advance both flexibility and fairness in the labour market, the Government is committed to giving parents more choice and support in balancing their work and family responsibilities. The Government's strategy involves, supporting parents' choices; tailoring financial support to families' circumstances; enhancing access to good quality childcare and parenting services; and working in partnership with business to promote the benefits of flexible working and support the take up of best practice approaches. The Government is acting to give greater choice to people who wish to extend their working lives, and has announced:

- a single regime for all pensions saving, which removes the existing barrier to changing job of moving to a less generous pensions taxation regime;
- flexible retirement – where people in occupational schemes will, where their schemes allow it, be able to draw benefits from their pension while continuing to work; and
- the option of taking a deferred state pension as a taxable lump sum instead of higher weekly pension payments, increasing flexibility for people to work past state pension age.

Improving labour market opportunities

4.7 The performance of the labour market has been strong over recent years by both historical and international standards. Employment has risen by nearly 1.7 million since spring 1997. The working age employment rate, at 74.5 per cent, is the highest in the G7 and this has been achieved with the economy close to trend rather than at a cyclical peak. The Government is determined to achieve its goal of employment opportunity for all by ensuring that everybody who is able and wants to work is given the appropriate assistance to help them to do so, while maintaining support for those people who are unable to work.

4.8 To this end, the Government has introduced a number of measures, described fully in Chapter 4 of Budget 2004, to provide support to each individual to help them overcome their barriers to work and develop the necessary skills to participate fully in the labour market, including:

- a range of measures to extend the support available for lone parents and people with health conditions and disabilities, who would like to return to work;
- the introduction of practical guidance to support the recruitment, retention and training of older workers; and
- a further increase in the adult and youth rates of the National Minimum Wage to £4.85 and £4.10, respectively, from October 2004; and the introduction of a National Minimum Wage for 16-17 year old workers at a rate of £3.00 an hour.

4.9 National policies are not always enough to address the specific problems that affect particular neighbourhoods and groups. Some problems are of a more local nature and need solutions designed to meet local needs. The Government has already increased the discretionary powers and funding available to local staff, with new flexibilities in the New Deal, discretionary funding for local managers, and a number of locally-led projects designed to meet specific local and individual needs, such as: the introduction from April 2004 of the Working Neighbourhoods pilots, which will provide a programme of intensive support in 12 neighbourhoods with very high concentrations of worklessness; Employment Zones, which provide personal advisers with complete discretion over funds to overcome individual barriers to work; and Action Teams for Jobs, which focus on the long-term unemployed and inactive and use innovative methods to address specific local barriers to work in 63 disadvantaged areas of the UK.

4.10 The Government will consider the case for extending further flexibility to respond to the needs of individual clients and local areas, subject to the maintenance of high national standards, and in the context of the overall framework of rights and responsibilities of the national benefit system.

Enhancing wage flexibility

4.11 Historically, the UK has had to cope with accelerating wage inflation during periods of low unemployment. However, the fact that unemployment has declined over recent years without generating significant wage pressures suggests a genuine improvement on the supply side.

Allsopp Review

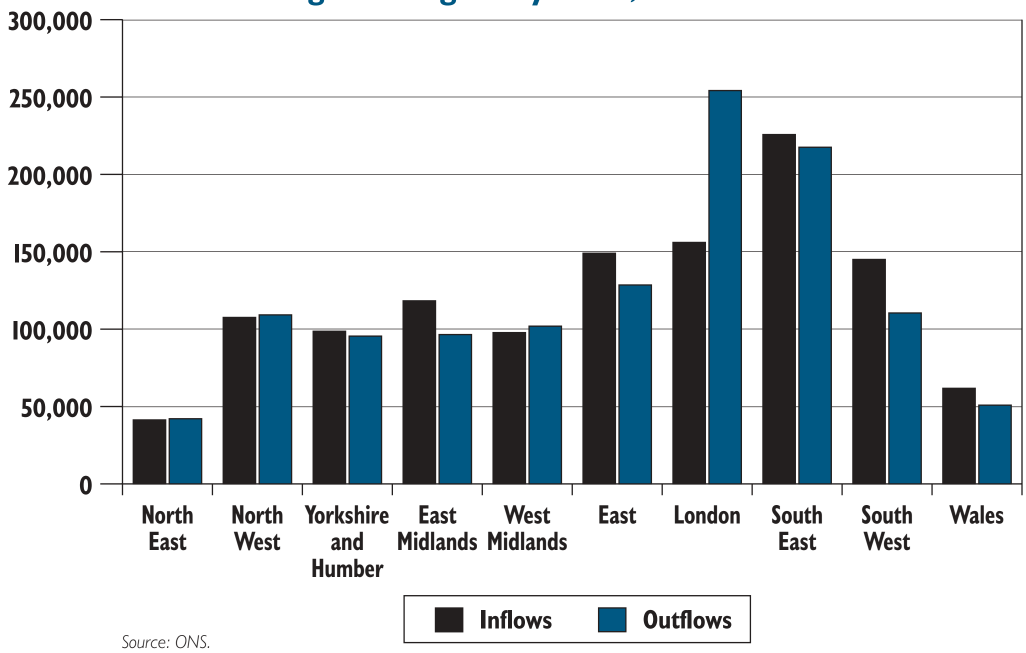
4.12 In an efficient labour market, wages should move to balance the supply of, and demand for, labour in regional and local labour markets. The UK has a system of wage determination that allows considerable scope for wage settlements to reflect conditions in individual industries and regions. The Government has amended the remits for the Pay Review Bodies to include a stronger local and regional dimension, and is now also working with the rest of the public sector to increase the focus on respecting local pay conditions, side by side with UK-wide guarantees of a National Minimum Wage and tax credit support for low paid workers, to make work pay.

4.13 In light of the growing regional productivity and flexibility agenda, Christopher Allsopp was asked by the Chancellor to undertake a wide ranging review of the informational and statistical requirements for monetary and wider economic policy making in February 2003. The first report, published at the time of the 2003 Pre-Budget Report, made a series of recommendations to improve the quality and availability of regional and sub-regional data. The Final Report will be published shortly after Budget 2004.

Promoting geographic mobility

4.14 In order to achieve high levels of labour market flexibility, workers must be able to take advantage of all available employment opportunities, if necessary by moving within and between regions. Greater mobility between regions improves the UK's ability to respond to an economic shock which disproportionately affects either a particular region or an industry largely concentrated in one region. Chart 4.2 shows the total inflows and outflows of people in all regions of the UK, and reveals that the net flow of individuals between regions tends to mask the somewhat larger gross flows.

Chart 4.2: Regional migratory flows, 2002



Source: ONS.
Note: Net lo is the di erence in hei ht et een the t o colu ns.

4.15 The net flow between most regions is generally very small over the year, with the exception of London. However, the ability of individuals to move between regions is greater than would be inferred by simply looking at the net movements. In 2002, 1.2 million individuals, equivalent to 2 per cent of the UK population, changed region. The additional movement of individuals between regions is consistent with the patterns associated with a more flexible labour market. Economic adjustment is facilitated by the ability to reallocate labour between regions in response to variations in demand and skill requirements. Regional differences in unemployment have narrowed significantly since 1997,[5] reflecting both the effects of inter-regional migration and the ability of previously high unemployment regions to attract jobs.

4.16 That said, evidence suggests that UK geographic labour mobility is low compared to the US, as is the case elsewhere in Europe. To tackle this, the Government has introduced a number of policies to increase geographic mobility by making it easier and more worthwhile for workers to commute or move location in order to find employment.

4.17 The current housing benefit system is complex and can reduce work incentives and create barriers to geographic mobility. The Government has announced a number of Housing Benefit reforms to address these problems, including the piloting of a new Local Housing Allowance (LHA) for tenants in the private rented sector in nine pathfinder areas. The Government is building on these measures in Budget 2004 by announcing new measures to ensure that Housing Benefit does not constrain the ability of the unemployed to find work, including:

- the introduction of a second set of LHA Pathfinders in the private rental sector from April 2005; and
- a package of measures to simplify the rules surrounding entitlement and take-up of Housing Benefit and how the rules align to those for other support, such as tax credits and Pension Credit.

4.18 The Government has introduced housing and planning reforms to increase housing supply and in turn make it easier for households to access employment opportunities wherever they occur. Analysis of the importance of housing market flexibility is provided in Box 4.1. The Government is committed to a comprehensive programme to improve the functioning and flexibility of the UK housing market and to ensure a better match between supply and demand. In Budget 2003 the Government commissioned Kate Barker to conduct a review of issues affecting housing supply. This included the role of the competition, capacity, technology and finance of the house building industry; and the interaction of these factors with the planning system.

4.19 The final report, published alongside Budget 2004, sets out challenging reform proposals to central, regional and local government to deliver increased supply. The Government accepts the need for these reforms and intends to implement a programme of change as recommended in the review. Details of the recommendations and the Government's response are set out in Chapter 3 of Budget 2004.

4.20 The Government has taken a number of other steps to promote investment and stability in the UK housing market:

- the removal of tax barriers to the development of a market in property based derivatives;
- a consultation seeking views on how a new bespoke vehicle for investing in property might be structured; and
- a consultation on possible measures to promote flexibility in the commercial property lease market.

[5] *Full employment in every region,* HM Treasury and Department of Work and Pensions, December 2003

Box 4.1: Housing and flexibility

A stable and flexible housing market is essential to a healthy economy as housing market imbalances are a potential brake on economic development. The cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets. Conditions in local labour markets affect firms' location decisions and hence an inefficient housing market may also constrain investment and production decisions, influencing the longer-term development of local economies. In addition, volatility in housing markets affects the wider economy through private consumption, since changes in housing wealth affect the level of household spending. As movements in housing wealth are strongly pro-cyclical, this link tends to amplify the economic cycle. Consequently reduced volatility in housing markets could further promote macroeconomic stability.

The Government is committed to a comprehensive programme of action to improve the functioning of the UK housing market and to ensure a better match of supply and demand of housing. The Government's approach balances the economic case for development against its environmental and social implications. The Government's reform programme is discussed in detail in Budget 2004.

MEASURES TO PROMOTE FLEXIBILITY AND FAIRNESS IN PRODUCT MARKETS

Competition

4.21 Competition enhances flexibility by providing incentives for firms to respond quickly to changes in market conditions. Competitive pressures on firms in UK product markets results in firms striving to adopt more efficient working methods and to develop new products and services, which meet the changing demands of consumers. Greater competition enhances the incentives for firms to innovate, and to invest in order to raise their productivity and keep ahead of their rivals.

4.22 Establishing strong competition in UK markets is central to the Government's productivity and flexibility agenda. By enforcing competition law and providing an effective deterrent against anti-competitive behaviour, the strength of a country's competition regime can strongly affect firms' incentives to compete. The Government has taken important steps to strengthen the UK competition regime. The reforms of the Enterprise Act 2002 built on the Competition Act 1998 to create a world-class competition regime in the UK. The reforms have given full independence to UK competition authorities and given the Office of Fair Trading (OFT) more proactive powers to investigate markets where competition may be restricted or distorted. The Global Competition Review (2003) ranked the UK competition regime joint second, behind only the US.

4.23 As discussed in earlier sections of this report, international trade and investment also add to the competitive intensity of the economy. Open markets, with low barriers to trade and investment, permit access to new opportunities in new countries and markets. This facilitates specialisation in those goods and services that economies produce more efficiently.

4.24 The Government continues to take steps to enhance competition, empower consumers, and promote flexibility, discussed in more detail in Chapter 3 of Budget 2004:

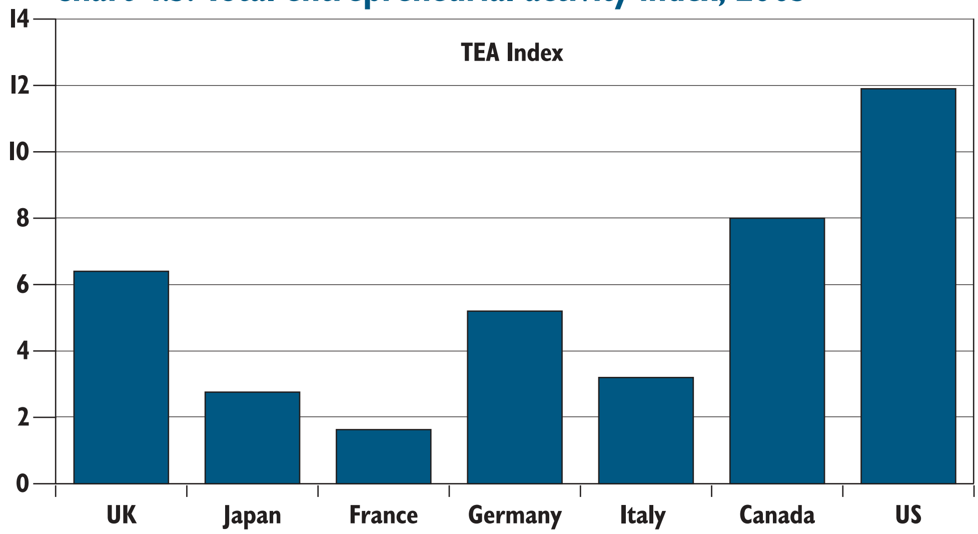
- progress on promoting competition in a number of specific markets, including legal services, financial services and energy markets;

- an OFT review into how public sector procurement affects competition;
- encouragement for the OFT to review Government regulations and consider their impact on competition; and
- the roll-out from summer 2004 of a consumer help-line, Consumer Direct across four 'pathfinder' regions.

Enterprise

4.25 The Government is committed to creating an enterprise culture where people from all backgrounds can consider and act on opportunities for enterprise. A strong entrepreneurial culture means that the economy is better equipped to identify and develop the opportunities offered by new technologies, new products and new markets. Latest data from the Global Entrepreneurship Monitor find that levels of UK entrepreneurial activity, measured by the proportion of the working age population starting or growing new firms, has risen to 6.4 per cent from its 2002 level of 5.4 per cent. Chart 4.3 gives an indication of the UK's position relative to other major global economies.

Chart 4.3: Total entrepreneurial activity index, 2003



Source: lo al Enter rise Monitor .

4.26 Although ahead of other major European economies and despite the recent improvements, entrepreneuraial activity in the UK still falls behind the US, where 11.3 per cent of the working age population started or grew a new firm in 2003. The 2003 Pre-Budget Report announced the Government's decision to increase the statutory audit threshold to £5.6 million, which will give 69,000 more companies the flexibility to opt out of an independent audit. This brings the UK up to the EU maximum, and allows companies to choose whether to pay for an audit or invest the capital in another part of the business.

4.27 In Budget 2004, the Government has taken the following new steps to promote enterprise in the UK economy, discussed in more detail in Chapter 3 of Budget 2004:

- to promote enterprise in local areas, details of a Local Authority Business Growth Incentives scheme to allow local authorities to retain a proportion of increases in local business rate revenues;

- intention to devolve regional and local Business Link services to the Regional Development Authorities;
- subject to state aid approval, the introduction of a Business Premises Renovation Allowance scheme in 2005; and
- a number of measures to promote an enterprise culture in the UK, particularly among young people.

4.28 Unnecessary or poorly implemented regulation can be an obstacle to flexibility, stifling enterprise and growth, particularly amongst smaller firms. Where appropriate the Government is reducing the regulatory burden and considering well-targeted exemptions. In December 2003, a further 147 deregulatory measures were announced, giving a total of over 650 specific deregulatory measures identified since February 2002.

4.29 In Budget 2004 the Government has taken the following new steps to help promote enterprise in the UK economy, discussed in more detail in Chapter 3 of Budget 2004:

- consulting on the implementation of phasing out payment via employer of tax credits;
- in future, any regulatory proposal likely to impose a significant new burden on business will require clearance from the Panel for Regulatory Accountability chaired by the Prime Minister;
- considering the scope for more efficient approaches to delivering excellent regulatory outcomes; and
- a formal consultation with businesses on the feasibility of extending common commencement dates to other areas of regulation and tax.

Corporation tax

4.30 The Government has introduced a wide-ranging and effective package of measures to modernise the business tax system and promote enterprise. These reforms have encouraged growth and promoted flexibility in the UK economy; and have reduced distortions and addressed market failures which are barriers to economic growth. Overall, the UK's capital gains tax regime is now more favourable to enterprise than that of the US. Measures introduced by the Government include cutting capital gains tax to 10 pence for most transactions in business assets; providing an exemption for gains and losses on most substantial shareholdings in trading companies to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax reasons; and a new regime for providing tax relief to companies for the costs of intellectual property, goodwill and other intangible assets to encourage business to take advantage of new opportunities in the emerging knowledge-based economy.

4.31 The Government remains committed to reform in other areas of the corporation tax system and intends to publish detailed legislative proposals on some issues later this year, focusing on those areas where the system may create unjustified barriers to modern commercial activity.

4.32 Significant reforms have been introduced to reduce tax administrative burdens and ease cashflow of small businesses. Budget 2004 introduces further measures to enhance flexibility including:

- increasing the VAT registration threshold, keeping the smallest businesses out of the VAT net, and extending measures to help smaller businesses reduce their VAT compliance costs.

Science and innovation

4.33 Through innovation businesses generate new and improved products and find less costly ways to provide goods to consumers, thereby increasing competitiveness. The UK has an excellent science base, but has been less effective than some of its major international competitors at realising the commercial potential of its research. The Government is taking steps to promote innovation in the UK economy, discussed in more detail in Chapter 3 of Budget 2004, including:

- a commitment to publish a ten-year investment framework for science and innovation alongside the 2004 Spending Review;
- the implementation of the proposals in the recent DTI Innovation Report;
- development of the main strands of policy reform put forward by Lambert Review of Business-University Collaboration;
- further clarifications to the R&D tax credit, to provide an even greater incentive for companies to invest in R&D; and
- proposals to clarify the tax status of Science Research Organisations, in order to foster the wider economic benefits which such organisations can provide to UK businesses.

MEASURES TO PROMOTE FLEXIBILITY AND FAIRNESS IN CAPITAL MARKETS

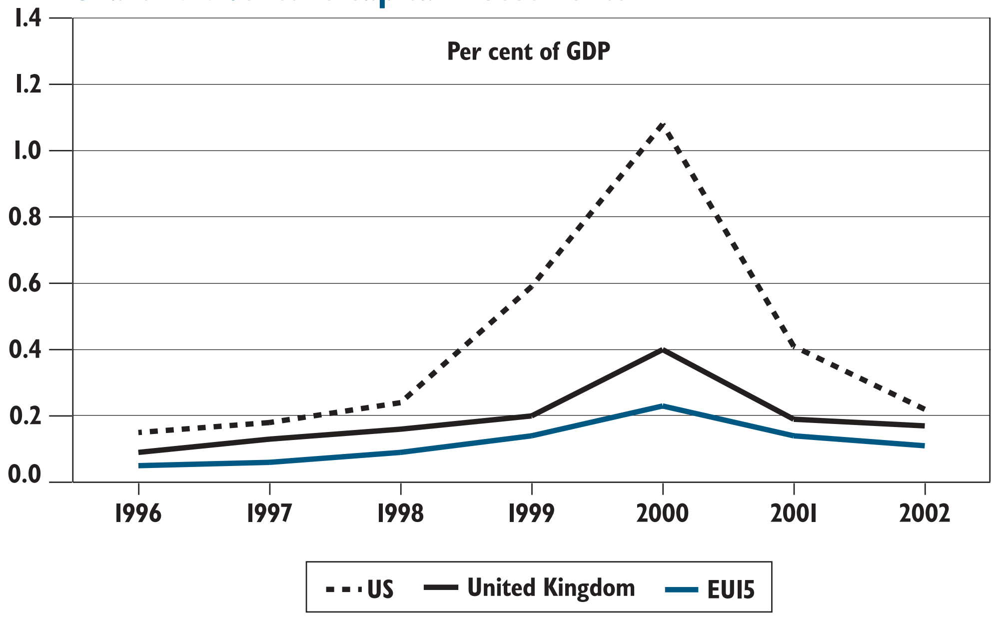
4.34 A flexible capital market ensures that funds flow to firms and entrepreneurs to finance their activities. This helps to ensure that innovation is supported and the structure of industry responds to shifting patterns of demand. Investing in new technology and physical capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. This means ensuring that capital markets are able to work efficiently and responsively in allocating investment across the economy. Capital markets can also offer a wide range of saving vehicles and allow individuals to borrow prudently against future income. This ensures that individuals can smooth out fluctuations in their incomes through saving and borrowing as appropriate, enabling them to respond to shocks in the labour market and their personal circumstances.

SME finance

4.35 The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to finance enables entrepreneurs and innovators to develop their ideas, ensuring that resources get directed to where they can be most profitably employed. The Government aims to ensure that the process of capital allocation works well for all businesses, and that funds are allocated to all those companies who can profitably use them regardless of their size. It is concerned about market failures in relation to the access to finance enjoyed by some small but potentially high-growth businesses. Chart 4.4 shows that the UK has a large venture capital market compared to European countries but a smaller market than the US. The 2003 Pre-Budget Report, building on previous initiatives, announced a series of steps to further improve the access to finance for small businesses. Budget 2004 highlights the following developments:

- enhanced tax relief for investments in Venture Capital Trusts (VCTs) and incentives to invent under the Enterprise Investment Scheme;
- the independent Graham review into the effectiveness of the Small Firms Loan Guarantee scheme has issued a call for submissions from interested parties;
- the publication of a consultation on reducing the barriers posed by financial regulation facing business angles and other high-net worth investors;[6]
- a new self-accreditation programme for accountants and other business advisers who are competent and experienced in providing advice to small businesses seeking finance; and
- the examination by the Small Business Investment Taskforce (SBIT) of the quality and extent of financial intermediation between small firms and investors.

Chart 4.4: Venture capital investments[1]



Source: Eurostat Structural Indicators.
[1] *Early sta e, e ansion and re lace ent rate.*

[6] *Informal capital raising and high net worth and sophisticated investors: A consultation on proposed changes to the Financial Promotion Order*, HM Treasury, January 2004.

Investment and Corporate Governance

4.36 The management and ownership of collective investments and of companies are separated functions, with a chain of intermediairies connecting owners and managers. To ensure that the management's resulting decisions adequately reflect the interests of the owners there has to be a good framework of governance. Such a framework ensures that investment managers consider all reasonable investment opportunities and corporate decisions reflect the interests of shareholders. This should enhance flexibility by facilitating an effective allocation of capital and promoting better company performance. The Government has taken steps to improve the framework for governance of the chain connecting investors with the companies they own, particularly by promoting greater accountability and transparency in the links between investors and companies. These steps include the Myners review of institutional investment, published in March 2001, and the Higgs review of the role and effectiveness of non-executive directors, published in January 2003. Following on from Myners, in October 2002 the Institutional Shareholders Committee (ISC) issued best practice principles for Shareholder engagement with companies, and its members committed to incorporating the principles into fund management mandates. Looking forward, the Government:

- is engaging with industry on key issues outstanding from the Myners Report;
- has included a legal requirement for trustees to have appropriate knowledge of investment matters in the Pension bill; and
- will examine later this year the extent to which the ISC's principles have delivered change.

Sandler Review

4.37 Individuals need an effective range of savings and investment products to enable them to save for their short, medium and long term needs. Following on from a report into medium and long term savings in the UK by Ron Sandler in July 2002, the Government with the FSA has continued to develop a suite of simple, low-cost, risk controlled Stakeholder savings products. In taking this forward, the Government has said it will be announcing the charge cap, as well as publishing the regulations for the product suite, later this year.

Financial inclusion

4.38 The Government will also work to ensure that individuals have fair access to banking and affordable credit. Lack of access to mainstream financial services can result in vulnerable consumers being exposed to higher costs for accessing their money, making payments and for credit. The Consumer Credit White Paper published by the Department of Trade and Industry (DTI) in December 2003 contains proposals to improve transparency and fairness of credit markets and a strategy to tackle over-indebtedness. The problem of financial exclusion exacerbates the debt problems of the most vulnerable. Government will work in partnership with the financial services sector and voluntary and community bodies to achieve: a dramatic reduction in the 3 million households without a current account; a significant increase in the availability of affordable credit for those on the lowest incomes; and a step change in the availability of debt advice for those who need it.

Capital markets integration

4.39 The flexibility of capital markets is enhanced by integration of domestic markets with international markets. Greater integration provides access to deeper and more liquid capital markets with probable benefits in terms of a lower cost of capital and greater diversification of risk. The Government continues to work with other Member States towards the creation of an integrated EU capital market and to press for greater integration of EU-US capital markets. Box 4.2 provides further details of progress in the EU Financial Services Action Plan (FSAP). Recent important steps in this direction include: initial preparations for implementation in the UK of the suite of wholesale financial services directives most recently passed under the FSAP.

Box 4.2: UK Capital markets and financial integration

Despite London's status as a leading international financial centre, capital markets in Europe are still significantly less integrated than those in the US. Studies suggest that there are significant benefits to be had from greater integration of European financial markets. London Economics estimates that pooling the present regional bond and equity markets would eventually raise GDP in the EU by 1.1 per cent and employment by 0.5 per cent.

The Lisbon European Council in March 2000 endorsed the European Commission's Financial Services Action Plan (FSAP) which consists of a set of measures to fill gaps and remove remaining barriers so as to provide a legal and regulatory environment that supports the integration of financial markets. Of the 42 original measures in the FSAP, 37 have now been finalised, 3 are under negotiation, and 2 proposals have still to be made. The final date for adoption at EU level is mid-2004, allowing 18 months for transportation by the deadline of end of 2005.

Nevertheless, there are a number of issues and policy questions arising out of the FSAP that need to be addressed going forward. The UK believes efforts to promote financial services integration following completion of the FSAP can best be achieved by focusing on:

- **better implementation and enforcement:** more emphasis should be given to ensuring that FSAP measures are implemented consistently and promptly at national level and properly enforced;
- **better regulation:** a greater use of rigorous cost-benefit analysis needs to be made in assessing need for legislation;
- **exploring alternatives to regulation more extensively:** the UK believes regulation should not necessarily be the first best policy option; for example: where a given barrier is specific to one member state and not EU wide. So greater consideration needs to be given to using alternative non-legislative policy options (e.g. ombudsman networks, codes of conduct) going forward, as well as enhancing the role of competition policy;
- **making Lamfalussy arrangements work well:** this should be a priority and can be effectively done by reinforcing the co-operation that already exists between the network of national regulators with greater exchange of information and mutual recognition of core principles; and
- **greater recognition of global nature of Financial Services:** far greater consideration needs to be given to the consequences of EU regulation on the competitive position of EU-based firms operating in a global market. Equally there will be a need to increasingly look for regulatory solutions at the global level.

CONCLUSIONS

4.40 Globalisation and the rapid pace of technological change highlight the importance of flexible and dynamic economies. The emergence of new competitors has seen a reorganisation of production processes and a change in the nature and location of jobs across the global economy. Flexible labour product and capital markets which allow businesses and individuals to respond to changes in technology, consumers prices and competitive pressures by quickly adapting their production techniques, investment and employment, provides the key to economic success in a globally competitive environment.

4.41 As was highlighted in the Treasury's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

4.42 The Government is committed to the approach of advancing flexibility and fairness together, by enabling individuals and firms to cope with and respond to change. This report sets out the range of specific measures the government is implementing in pursuit of these objectives, to ensure that the UK economy is well equipped to respond to current, and future, opportunities and challenges.

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