3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity is a key determinant of economic performance and living standards. The Government's long-term economic goal is that Britain will achieve a higher rate of productivity growth than its main competitors, closing the productivity gap.

The Government's Enterprise Bill will enhance the UK's competition regime and modernise the laws on insolvency, bringing down barriers to enterprise and helping to create a more entrepreneurial culture. Budget 2002 sets out the further steps the Government is now taking to support the drivers of productivity growth, including:

- a reduction in the **corporation tax starting rate from 10 per cent to zero from April 2002**, meaning that 150,000 companies will no longer pay any corporation tax;
- a reduction in the **small companies' rate of corporation tax by one percentage point to 19 per cent from April 2002**, reducing the corporation tax bills of a further 335,000 companies;
- reforms to **reduce the burden of VAT and payroll administration** to simplify the tax system and reduce compliance costs for small businesses;
- announcing successful bidders to run **pilot projects to improve 'investment readiness'** among small firms;
- reforms to establish a modern and competitive business tax system, including an exemption for gains and losses on **substantial shareholdings**, relief for the costs of **intellectual property**, goodwill and other intangible assets, and reform of the rules governing **withholding tax** at source;
- **abolishing stamp duty** for non-residential property transfers in disadvantaged areas and introducing a new **Community Investment Tax Credit** to promote enterprise and wealth creation in under-invested communities;
- introducing a **volume-based research and development tax credit for large companies** to boost the UK's innovation performance;
- announcing details of **pilots to test new measures to improve access to training** and enable employees to attain basic and level 2 skills; and
- additional funding of **£30 million to help small organisations attain Investors in People status**.

THE PRODUCTIVITY CHALLENGE

3.1 Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy. Productivity growth, alongside high and stable levels of employment, is an important driver of long-term economic performance. Improving the UK's productivity performance is therefore essential to deliver higher living standards, tackle poverty and build world-class public services.

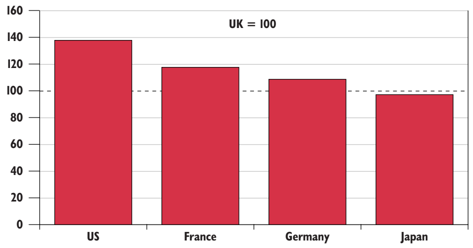
3.2 The UK has a poor track record on productivity. Historically, the UK economy has suffered from macroeconomic instability and microeconomic failures which have inhibited enterprise and innovation, stifled effective competition and discouraged firms and individuals from investing for the long term. This has led to a substantial productivity gap between the UK and many other advanced industrial economies. Further details of the productivity gap are set out in Box 3.1.

Box 3.1: The productivity gap

By international standards, the UK's productivity performance has historically been weak. Whether measured in terms of output per worker or output per hour, the productivity gap between the UK and its main competitors is substantial.

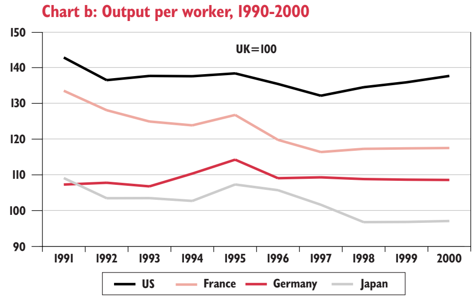
The Government's central measure of productivity is output per worker. This has the advantage of being relatively straightforward to quantify and is immediately related to the Government's economic growth objectives. As shown in chart (a), on this measure, productivity in the US – the world's most productive economy – is 38 per cent higher than in the UK. Productivity in France and Germany is 18 and nine per cent higher respectively. Measured in terms of output per hour, the gap against the US narrows slightly – to 25 per cent – while the gap against France and Germany widens to 27 per cent and 25 per cent.

Chart a: Output per worker, 2000



Source: ONS

Chart b: Output per worker, 1990-2000



Source: ONS

Closing the productivity gap is a long-term challenge. As chart (b) shows, the gap relative to France has narrowed over the last 10 years, while the gap against Japan has closed. The productivity gap against the US has remained relatively stable at around 40 per cent, although there has been some widening in recent years as a result of strong US productivity performance.

Following productivity growth of 2.0 per cent during 2000, with employment remaining at historically high levels, the UK registered a weaker productivity performance during 2001. Productivity grew by 1.3 per cent across the economy as a whole and by 1.9 per cent in manufacturing, with firms tending to retain labour despite weaker external demand. However, the continued strength of UK economic fundamentals should support a resumption of stronger productivity gains beyond the near term.

The Government's approach

3.3 The Government's strategy for closing the productivity gap has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future, and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently. These microeconomic reforms address historic weaknesses in the five key drivers of productivity performance:

- strengthening **competition** to encourage firms to innovate, minimise costs and provide better quality goods and services to the consumer;
- promoting **enterprise and innovation** to unlock the potential of new technologies and working practices, supporting entrepreneurship, risk-taking and management across the country;
- encouraging **investment** to improve the UK's stock of physical capital in every sector and industry;
- improving the **skills** base to maximise the contribution of human capital to growth; and
- improving the **productivity of public services**.

3.4 Government has a key role to play in supporting productivity growth – creating the best possible environment for private enterprise and investment and working directly to increase the productivity of public services. However, the productivity gap cannot be closed without a wider effort across the economy. The Government is therefore working alongside business, trade unions and other stakeholders at the regional, national and international levels to tackle the obstacles to greater productivity.

CBI-TUC productivity campaign

3.5 In this context, the Government welcomes progress made by the joint CBI-TUC productivity working groups in identifying key areas for action. Following recommendations by the investment and best practice working groups, in December 2001 the Government announced an additional £20 million package of support for best practice initiatives in the manufacturing sector and set out proposals for a major reform of the planning system.

3.6 In Budget 2002, the Government is taking further steps to implement the recommendations of the CBI-TUC working groups, including:

- setting out further details of pilots to improve access to workforce training. The Government agrees with the diagnosis in the CBI-TUC skills working group report that 'the major challenge is to help more individuals to achieve an initial level 2 qualification';
- introducing a new research and development tax credit for large companies, as recommended by the innovation working group; and
- announcing additional funding of £30 million to help small organisations attain Investors in People (IiP) status, reflecting the conclusions of the skills working group.

3.7 The Government welcomes proposals from the CBI and the TUC to continue joint working through the creation of a new CBI-TUC Productivity Group. The Group will report regularly to the Government before the Budget and the Pre-Budget Report.

Working across the regions

3.8 The Government is committed to ensuring that the benefits of improved productivity are felt in all regions across the UK. The Government's approach to tackling the productivity challenge at a regional level was set out alongside the 2001 Pre-Budget Report.[1] To drive

[1] *Productivity in the UK: 3 – The regional dimension*, HM Treasury and the Department for Trade and Industry, November 2001.

forward progress, the Government has set a Public Service Agreement (PSA) target to raise the rate of sustainable growth by increasing the trend growth rate of GDP per capita in all regions, with a long-term regional economic ambition to reduce the persistent gap in performance between the regions. Regional economic policy must be focused on raising the performance of the weakest regions, rather than the simple redistribution of existing economic activity.

3.9 The Regional Development Agencies (RDAs) are central to the Government's response to the productivity challenge. The RDAs operate as strategic leaders for economic development in their region, working in partnership with key regional, sub-regional and local bodies. In addition to considerable budgets, rising to £1.7 billion in 2003-04, the RDAs have been given unprecedented flexibility and autonomy to find the most effective way of meeting stretching targets set by central government. From 1 April 2002, RDA funding is being provided under a single cross-departmental framework, the Single Pot, to give RDAs the greatest possible flexibility in deploying their resources. The 2002 Spending Review, described in Chapter 6, will consider how best to strengthen the RDAs' ability to deliver better outcomes.

3.10 The 2002 Spending Review will also assess the impact of departments' policies on different regions and seek to ensure that spending is targeted at those areas where it is needed most and will be most effective. In addition, the Deputy Prime Minister will shortly publish a White Paper setting out the Government's further detailed proposals for devolution in the English regions.

European economic reform

3.11 At the Lisbon European Council meeting in March 2000, the European Union (EU) set itself the goal of becoming the most competitive and dynamic knowledge-based economy in the world. Significant progress has been achieved since then, including five million new jobs, a further liberalised telecommunications market and a Charter for Small Firms. The Barcelona Council meeting of March 2002 took forward the EU's ambitious agenda, approving commitments to:

- fully open up the non-domestic energy market – 60 per cent of the total EU energy market – to free and fair competition;
- boost levels of research and development towards a target of 3 per cent of GDP by 2010;
- complete the single market in financial services, itself capable of boosting EU GDP by half a percentage point according to some estimates;
- bring forward proposals to reduce regulation on business by June 2002; and
- deliver broadband technology widely across the EU by 2005.

3.12 The Government will continue to push for further reform, building on the progress made at Barcelona. The Government's White Paper on economic reform in Europe[2], published in February 2002, sets out the next steps in this process, including labour market reform to help regain full employment, the full opening up of all energy markets in Europe, less but better targeted state aid, a review of the EU-US trade and investment relationship and a successful conclusion to the WTO's Doha development trade round. The Government is committed to realising these challenging goals for the benefit of consumers and industry within the EU and beyond.

Public services productivity

3.13 As well as creating the right environment for business to raise productivity, government must also strive for greater efficiency. Public services account for a substantial part of the economy, and productivity within the public sector therefore has an important and direct impact on the productivity performance of the economy as a whole. Increased public services productivity is also important because it gives people the public services they

[2] *Realising Europe's potential: Economic reform in Europe*, HM Treasury, 28 February 2002.

require, ensures that taxpayers receive better value for money, and helps to lay foundations for a high productivity economy through improved education, health and transport infrastructure.

3.14 The Government's approach to increasing the productivity of public services focuses on allocating resources to priority areas and programmes, and reforming delivery so that these resources are used as effectively as possible. This approach, and the steps the Government is taking as part of the 2002 Spending Review, are described in detail in Chapter 6.

COMPETITION

3.15 Competition is an important driver of productivity performance. Vigorous competition strengthens incentives to innovate and ensures that resources are allocated to the most efficient firms. By encouraging firms to reduce prices and improve the quality and choice of goods and services, it is also the most effective way of ensuring that consumers receive a fair deal.

The competition regime

3.16 The Government is committed to strengthening the UK's overall competition regime and has consulted widely on proposals for reform.[3] The Enterprise Bill, which was introduced on 26 March 2002, implements the Government's reform programme. Among other measures, the Bill will:

- give full independence to the UK competition authorities, so that they will take decisions free from political interference in the overwhelming majority of cases;
- give the Office of Fair Trading (OFT) a clear proactive role to keep markets under review and enable it to refer markets to the Competition Commission where they may not be working well;
- improve the mergers and monopolies investigations regimes, giving greater certainty through clearer timetables and a more transparent decision-making process; and
- introduce new criminal penalties for individuals who engage in cartels, covering the most serious forms of anti-competitive activity.

3.17 The Enterprise Bill also includes provisions to modernise the rules for insolvency (described later in this chapter). Together, this package of reform will help to bring down barriers to enterprise, provide greater opportunity for all and create a more entrepreneurial culture.

Promoting competition in specific markets

3.18 The OFT is already taking action to promote competition in specific markets as part of its new proactive role. In October 2001, the OFT launched three studies into competition in the markets for information technology (IT) goods and services, pharmacies, and extended warranties for electrical goods. The OFT has also responded to the first 'super-complaint' made by the Consumers' Association, launching a full investigation into the market for private dentistry.

[3] *Productivity and enterprise: A world class competition regime*, Department of Trade and Industry, July 2001.

The professions

3.19 The OFT's report into competition in the professions, published in March 2002, identified a number of issues in relation to professional rules that may hinder effective competition in the provision of professional services. In response to the report, the Government is acting to remove the special regime that provides for the exclusion of professional rules from competition law, by repealing Schedule 4 to the Competition Act as part of the Enterprise Bill. Following active dialogue between the OFT and the professions, professional bodies have carried out reviews of their own rules and have already agreed a number of improvements. Building on these, the OFT and the Lord Chancellor's Department (LCD) are now taking forward work to resolve any remaining competition concerns. The LCD has already stated that it plans to consult before the summer recess on matters that fall to it and will publish the results of this consultation as soon as possible. The OFT will also shortly be making a statement about its next steps.

Small business banking

3.20 The Competition Commission report into small business banking was published in March 2002. The report concluded that a complex monopoly exists in the supply of banking services to small and medium-sized enterprises (SMEs) and identified practices carried out by the eight main clearing banks in the UK which restrict or distort competition and operate against the public interest. The report also proposed a series of remedies, including measures to improve transparency and reduce the costs of switching accounts. As these remedies will take some time to have effect, the Commission recommended that the four largest banks should offer all SME customers in England and Wales interest on their current account at 2.5 per cent below the Bank of England base rate, free banking, or a choice between the two. The Chancellor and the Secretary of State for Trade and Industry have asked the Director General of Fair Trading to seek undertakings to implement these recommendations. He will report to Ministers in June 2002.

Payment systems

3.21 The Government is committed to introducing legislation to give the OFT new powers to promote competition in payment systems. Legislation will be introduced as soon as parliamentary time allows.

The water industry

3.22 As previously announced, the Government proposes to extend competition for non-household customers using large quantities of water. The Government will publish a consultation paper setting out detailed proposals later this year.

New cars

3.23 The Government welcomes the European Commission's proposals for major pro-consumer reforms of the new cars block exemption. The proposals should lead to greater price competition and a better deal for consumers. The new regulation is due to come into force on 1 October 2002, with a proposed transition period of one year.

The European trade mark regime

3.24 The Government is also committed to liberalising the existing European trade mark exhaustion regime and is seeking the support of Member States for this change. The current trademark regime allows brand owners to prevent the import of their products where they have already been marketed outside the European Economic Area, so giving power to brand owners to stop parallel importing into the Community. This prevents, for example, supermarkets from selling branded jeans at prices lower than in high street shops. Liberalising the trade mark regime would allow businesses to source from low-cost markets, applying strong downward pressure on prices and stimulating competition to the advantage of UK and other European Union consumers.

Box 3.2: Regulatory reform

Effective and well-focused regulation can play a vital role in correcting market failure, promoting fairness and ensuring public safety. Unnecessary or poorly implemented regulation, however, can restrict competition, stifle innovation and deter investment. The Government is committed to ensuring high standards of regulation across the UK and Europe. This requires changing the culture of regulation through institutional and procedural reform, lifting barriers to enterprise by reforming or removing specific regulations, and improving communication with business.

Institutional and procedural reform has an important role to play in minimising the burden of regulation on business. A major institutional reform, simplifying the regulatory environment and embodying principles of good regulation, was completed on 1 December 2001, when the Financial Services Authority assumed its powers and responsibilities under the Financial Services and Markets Act 2000. In an important reform to the policy-making process, the OFT now plays a new role in assessing the effects on competition of existing and proposed new regulations.

These changes have been accompanied by wide-ranging reform of specific regulations. In February 2002, the Government announced a package of 260 deregulatory measures, including simplifying fire safety regulation by moving from an inspection and certification regime to a risk-based approach. The Government has also published a Green Paper on reform of the land use planning system, setting out proposals to reduce dramatically the regulatory burden imposed by the current system.

The Goverment is also easing regulatory burdens by improving communication with business, especially SMEs. The Government will apply the lessons from the cross-cutting review of services to small business to deliver clearer presentation and more effective dissemination of regulatory information.

ENTERPRISE

3.25 An environment that encourages enterprise and supports people who take opportunities and risks is a crucial ingredient of productivity improvement. New and more dynamic businesses increase competitive pressure in markets and facilitate the introduction of new ideas, technologies and more efficient working practices. The Government is therefore taking further steps to:

- establish and maintain a modern and competitive business tax system;
- provide support for small and new business – encouraging business start-ups and promoting a culture of entrepreneurship;
- extend the enterprise culture throughout the country by tackling the obstacles to business growth and investment in Britain's most disadvantaged areas; and
- promote a better understanding of business, the economy and enterprise throughout the school and further education systems.

A modern and competitive business tax system

3.26 To provide stability for business in the longer term, and to ensure that the UK is an attractive place to start-up or locate a company, the Government has introduced a number of significant reforms to the business tax regime, including:

- a reduction in the main rate of corporation tax to 30 per cent;
- the introduction of a 10 per cent starting rate for small companies – the lowest in the European Union – to support enterprising individuals starting up their own companies;
- the introduction of a generous capital gains tax (CGT) taper for business assets to encourage investment and entrepreneurial activity. The 2001 Pre-Budget Report confirmed that, from 6 April 2002, the effective rate of tax for a higher rate taxpayer would be reduced to 20 per cent for assets held for one year and to 10 per cent after only two years, making the UK regime among the most favourable in the world. The Government is considering the case for further changes to the CGT regime for non-business assets; and
- the abolition of the requirement to withhold tax on interest and royalties between companies in the UK.

3.27 Budget 2002 takes further steps to build a corporate tax regime which recognises the realities of the modern business environment and competes with the best in the world. Following consultation, the Government is now introducing:

- **an exemption for gains and losses on most substantial shareholdings in trading companies from 1 April 2002** to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons;
- **a new regime for providing tax relief to companies for the costs of intellectual property, goodwill and other intangible assets from 1 April 2002** to encourage business to take advantage of new opportunities in the emerging knowledge-based economy;
- **an exemption from stamp duty for transfers of goodwill from 23 April 2002** to reduce the costs of buying businesses. This exemption puts goodwill on a consistent footing with intellectual property, exempted from stamp duty in 2000; and
- **a new regime for loan relationships, derivative contracts and foreign exchange gains and losses for accounting periods starting on or after 1 October 2002** to create a coherent regime governing the taxation of debt and derivative contracts.

3.28 The Government is also committed to reducing compliance burdens for business and investors. Budget 2002 therefore announces:

- **reform of the rules governing withholding tax at source** so that:
  - companies may choose to pay cross-border royalties without deducting tax at source, reducing administrative burdens for UK companies seeking access to international know-how;
  - financial dealers can make certain payments gross of tax, creating a level playing field with banks; and

- local authorities, pension funds, charities and other tax exempt bodies can receive more payments from companies without suffering deduction of tax at source.

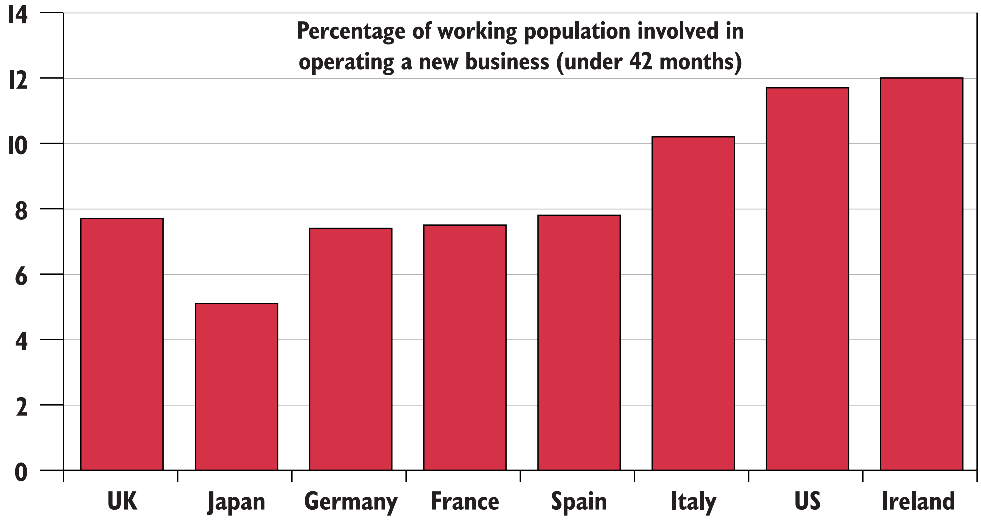
- **simplification of the CGT regime** to reduce compliance costs, in particular for those who invest in business and for employees.

3.29 The Government will **consider further steps that might be taken to reform and modernise the corporation tax regime and will publish a consultation document in summer 2002** to take forward its programme of reform.[4] To ensure that the UK remains the best possible location for business investment, the document will consider the case for bringing the remaining taxable gains made by companies into an income regime, examine the merits of rationalising the schedular system of taxation for companies, and review the scope for greater alignment between the treatment of investment and trading companies. Changes of this sort would have to take account of a range of issues, including the special position of businesses such as life assurance.

Supporting small business and promoting entrepreneurship

3.30 In seeking to make Britain one of the most competitive environments for business in the world, the Government is committed to rewarding entrepreneurial spirit and promoting growth, especially among new and small businesses. As Chart 3.1 shows, while small business creation in the UK is broadly comparable with many other European countries, the UK has failed to achieve the levels of entrepreneurship seen in the US.

Chart 3.1: The enterprise gap



Source: Global Entrepreneur Monitor, 2001

[4] The Government's strategy for reform was set out in *Large business taxation: the Government's strategy and corporate tax reforms*, HM Treasury, July 2001.

Corporation tax

3.31 In order to provide further support to new and growing companies, with effect from 1 April 2002:

- **the corporation tax starting rate – already the lowest in the European Union – is reduced from 10 per cent to zero**, meaning that 150,000 small companies will no longer pay any corporation tax; and
- **the small companies' rate is reduced from 20 to 19 per cent**, reducing the corporation tax bills of a further 335,000 companies.

3.32 These reforms mean that all companies with taxable profits of less than £10,000 will pay no corporation tax. Small taxpaying companies will save a maximum of £3,000 and an average of around £700 every year.

Simplifying VAT for small businesses

3.33 In recent Budgets, the Government has introduced a series of measures designed to allow small and newly-registered businesses to manage their entry into the VAT system, reduce their VAT administration burden and improve their cash flow. Building on the measures announced in the 2001 Pre-Budget Report, Budget 2002 introduces a range of further reforms:

- **the VAT registration threshold will be increased in line with inflation from £54,000 to £55,000**, keeping more than 4,000 businesses outside the VAT net, and maintaining the UK's threshold as the highest in the European Union;
- **the optional VAT flat-rate scheme will be extended in April 2003** to a further 200,000 businesses with turnover up to £150,000. The current scheme allows more than 500,000 businesses with turnover up to £100,000 to avoid accounting for VAT on every purchase and sale, cutting their compliance costs by up to £1,000 a year;
- **further reforms will be made to the VAT penalty regime**, to ensure that when businesses with turnover up to £150,000 are late with VAT payments, they are offered advice and support rather than facing automatic fines; and
- following consultation, **targeted reforms will be introduced in 2003 to allow approved importers to delay accounting for the VAT due on imported goods until they submit their regular VAT returns**, cutting compliance and cash flow burdens which are currently estimated to cost UK importers £175 million a year.

Easing the burden of payroll

3.34 The administrative burden imposed by payroll obligations can be a significant obstacle to small firm development. In June 2001, the Government asked Patrick Carter to undertake a review of payroll services in the UK. The review was published alongside the 2001 Pre-Budget Report.

3.35 The Pre-Budget Report invited comments on the specific proposals set out in the review, including the use of cash incentives to encourage smaller employers to file electronically, and the introduction of mandatory electronic filing by 2004 for larger employers and by 2007 for all employers. While the consultation revealed general support for making greater use of IT, many respondents regarded the adoption of universal e-filing by 2007 as too ambitious, particularly for smaller employers. Although the Government believes that all employers should in due course file returns electronically, it recognises that achieving this by 2007 will be difficult for the smallest employers. **The Government therefore proposes to implement a three stage move towards universal e-filing:**

- the largest employers, with 250 or more employees, will be required to file electronically for the year 2004-05 onwards;
- employers with 50 or more employees will be required to file electronically from the year 2005-06; and
- incentive payments to encourage smaller employers, with fewer than 50 employees, to file electronically will commence for 2004-05, at a level of £250, tapering to £75 by 2008-09. The Government proposes that electronic filing of employer returns should become a universal requirement from 2010, for the filing of 2009-10 returns.

3.36 To help business in dealing with payroll issues generally and, in particular, to encourage firms to realise the advantages and cost savings of greater use of IT, the Inland Revenue will also make improvements in the support services it offers to employers.

Promoting business start-ups

3.37 New entrepreneurs need clear information on what government can do for them, what government requires from them and where they can access help and advice. **The Department of Trade and Industry will shortly consult on a national strategy for start-ups,** building on the emerging conclusions of the cross-cutting review of goverment services for small business. The consultation paper will seek views on proposals for a new resource pack and on whether government should establish a helpline for start-ups. The resource pack would bring together in a single document information on government requirements and support, and would be made available through a wide range of outlets and over the internet. The helpline could complement the pack and provide a contact number for those thinking of starting a business to obtain information and advice on a comprehensive range of government services and requirements.

Improving access to risk capital

3.38 For many small businesses and entrepreneurs, access to risk capital is the key to realising growth potential. The Government is committed to increasing the supply of risk capital to UK enterprises and has encouraged private sector provision through a range of tax measures, including the introduction of the capital gains tax taper for business assets. Private equity investment in the UK has more than doubled since 1997 and now accounts for 38 per cent of the European total.

3.39 Despite the growth in private sector activity, many small firms still face problems in accessing risk capital, particularly for smaller amounts. To address this funding gap, the Government will shortly be announcing the first successful bidders to deliver a £50 million Early Growth Funding initiative, which is intended to help at least 1,000 businesses over the next three years. This will complement the Regional Venture Capital Funds, currently being set up in every English region, which will deliver £270 million of investment in small firms through a mixture of public and private finance.

3.40 A key financing option for small firms is provided by Venture Capital Trusts (VCTs), which deliver growth capital funding to companies that are generally too small to attract larger commercial venture capital finance. VCTs have already raised well over £1 billion from investors and the Government is now developing the scheme by **introducing provisions to allow VCTs to merge and be wound up while preserving the benefits to investors.**

Investment readiness

3.41 As well as stimulating supply, the Government is concerned to improve effective demand for equity finance by ensuring that entrepreneurs know how to access appropriate finance and understand its benefits. The Government is now **announcing successful bidders to run six pilot projects in different parts of the country to inform small firms about different financing options and offer a programme of support to help small firms become 'investment-ready'.**

Insolvency

3.42 Many potential entrepreneurs are dissuaded from starting new businesses by the perceived costs of failure. The Enterprise Bill, introduced on 26 March 2002, takes further steps toward reducing the stigma attached to business failure and creating effective incentives for the rescue of viable businesses. In particular:

- reforms to personal bankruptcy law will substantially reduce the cost and stigma of business failure in most cases, while providing stronger sanctions against the unscrupulous or dishonest;
- corporate insolvency will be conducted in a way that recognises the interests of all creditors, and provides the greatest incentive for the rescue of companies and their businesses;
- Crown preference, which allows many tax debts to be paid ahead of other unsecured creditors, will be abolished. The benefit of this reform will go mainly to unsecured creditors; and
- the financial regime for the Insolvency Service will be modernised, allowing creditors to receive the maximum possible investment return, and creating a simpler and more transparent fee structure.

Promoting enterprise in disadvantaged areas

3.43 The Government is committed to encouraging enterprise, investment and wealth creation across all regions in Britain. To ensure that Britain's most disadvantaged communities are not left behind, it is introducing a range of measures to encourage investment and enterprise in these areas.

Community Investment Tax Credit

3.44 The Social Investment Taskforce, chaired by Sir Ronald Cohen, reported to the Chancellor in October 2000. The report recommended a new Community Investment Tax Credit (CITC) to encourage private investment in not-for-profit and profit-seeking enterprises in under-invested communities.

3.45 Following consultation, in July 2001 the Government announced its intention to proceed with a tax credit, available to both individual and corporate investors making either debt or equity investments. The 2001 Pre-Budget Report described a range of adjustments to the scheme to improve the allocation process and increase access to the CITC. The Government now intends to make a number of additional refinements to the operation of the tax credit:

- greater flexibility in the rules for the structure of loans qualifying for the credit and the use of funds by intermediaries;
- an emphasis on the role of social enterprises as well as for-profit businesses, including a generous regime for property development for social enterprise;
- an increase in the limit on the amount of funds that can be raised by wholesale intermediaries, from £10 million to £20 million; and
- treatment of bodies which become accredited between 17 April 2002 and 5 April 2003 as if they had been accredited from 17 April 2002.

3.46 The Government has published draft legislation for consultation, along with a draft prospectus for organisations wishing to accredit for the CITC. As announced in the Pre-Budget Report, the accreditation process will be run by the Small Business Service (SBS). **The Government intends to proceed with implementation of the CITC and will legislate in Finance Bill 2002.** The scheme will become operational once state aids approval has been obtained.

Community Development Venture Fund

3.47 The Social Investment Taskforce also recommended that the Government help set up a Community Development Venture Fund – a matched funding partnership between government and the venture capital industry to provide finance for firms operating in disadvantaged areas. The Government has now committed £20 million, and remains confident that private investors will provide a further £20 million, to create a £40 million fund. State aids approval has been obtained and the fund will be launched shortly.

Land and property in deprived areas

3.48 Since 30 November 2001, an exemption from stamp duty has been available for all property transfers up to £150,000 in the UK's most disadvantaged areas. One of a range of measures set out in the Urban White Paper, the exemption aims to encourage businesses and families to locate in these areas, boosting local enterprise and employment. To reduce further the cost to business of investing in deprived areas, **the Government will legislate in the Finance Bill to abolish stamp duty for all non-residential transfers in qualifying areas, subject to state aids approval.** Details of further measures in the Urban White Paper are set out in Chapter 7.

Enterprise and education

3.49 Strengthening the links between the education system and business is vital to promote an enterprise culture for the future.

Davies review of enterprise and education

3.50 In February 2002, Sir Howard Davies, Chairman of the Financial Services Authority (FSA), reported to the Chancellor and the Secretaries of State for Trade and Industry and Education and Skills on how to promote better understanding of business, the economy and enterprise throughout the school and further education systems. To equip young people with the enterprising skills and attributes needed to thrive in the modern workplace, the review recommended:

- a national agenda for building enterprise capability, business understanding and financial literacy in all young people;
- increasing the opportunities for young people to experience enterprise activity before leaving school, for example through mini-company schemes. These opportunities should be supported jointly by government and the business sector; and
- introducing a range of support and evaluation measures to ensure that teachers are assisted in promoting enterprise education, and that the value of government and business investment is maximised.

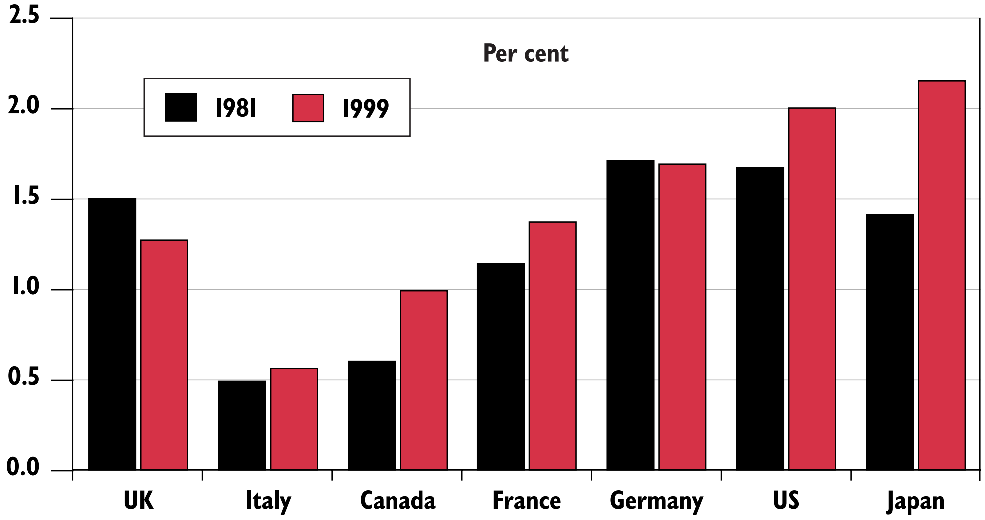
3.51 The Government welcomes the Davies report and agrees with its central conclusion that building a deeper and wider entrepreneurial culture must start in schools and colleges. **The Government will publish a formal response and implementation plan shortly.** Decisions on the major spending recommendations set out in the report will be taken in the context of the 2002 Spending Review.

INNOVATION

3.52 Innovation is a key catalyst for productivity growth. New ideas can act to open up new markets and opportunities for firms, through the creation of new and improved products and services. New technologies and the development of new processes also allow efficiency gains, enabling businesses to reduce their cost base and provide a better deal for consumers.

3.53 By international standards, levels of innovation in the UK have historically been low. As Chart 3.2 shows, levels of UK private sector investment in research and development (R&D), a key input to successful innovation, are significantly below those achieved in many other advanced industrial countries.

Chart 3.2: Business R&D expenditure as a proportion of GDP



Source: OECD

Research and development tax credit

3.54 To address this gap and to support the private sector in its efforts to raise R&D, Budget 2000 introduced an R&D tax credit for small and medium-sized companies. The Government has since consulted on extending this credit to all companies and is now **introducing an R&D tax credit for large companies. The tax credit will be available to all companies that do not already qualify for the SME credit, for R&D expenditure incurred on or after 1 April 2002.**

3.55 In designing the tax credit, the Government has sought to maximise the incentives for companies to undertake additional R&D. The consultation exercise identified the following important design elements:

- the credit must be stable, so that companies can rely on it;
- the credit must be transparent and predictable, so that companies can build the tax savings into their investment decisions; and
- the credit must be simple in design, to minimise the costs of administration.

3.56 Consistent with these principles, the tax credit will be based on a simple volume design, payable to the company that carries out the R&D. **The credit, which will take the form of a super-deduction against income chargeable to corporation tax, will be given at the rate of 125 per cent of all qualifying R&D expenditure.**

3.57 To ensure that the tax credit rewards all companies for the R&D they undertake in the UK, it will be available for all directly incurred expenditure regardless of how this is financed. This means that large companies will be able to claim credit for expenditure on work subcontracted to them by another large company. There will be no requirement for the company to own any intellectual property resulting from the R&D. To promote business links with academic research, companies that fund research undertaken collaboratively with universities, charities and certain not-for-profit research organisations will also qualify.

3.58 Alongside this tax credit, **UK companies will also be able to claim additional relief for the costs of R&D into drugs and vaccines to treat diseases threatening lives in the least developed countries.** Further details of this provision are set out in Chapter 5.

The Roberts review

3.59 Business, universities and the public sector need to be able to recruit and retain skilled scientists and engineers to underpin their R&D activities. In Budget 2001, the Chancellor and the Secretaries of State for Trade and Industry and for Education and Skills asked Sir Gareth Roberts to undertake a review of the supply of scientists and engineers in the UK.

3.60 Sir Gareth reported on 15 April 2002. The review sets out a number of recommendations to address issues throughout the supply chain for scientists and engineers – in schools, in universities and in relation to employment in R&D – including:

- addressing difficulties in the recruitment and retention of design and technology, maths, science and ICT teachers by considering issues relating to their training and remuneration;
- investing in the modernisation of school and undergraduate teaching laboratories and addressing other factors influencing practical work in schools and universities;
- encouraging participation, particularly by women, in science and engineering through appropriate course design and careers advice;
- improving the funding, training and career paths available to postgraduate students and postdoctoral researchers;
- addressing difficulties in the recruitment and retention of academic staff through enabling universities to respond better to market pressures in setting salaries; and
- improving the opportunities for scientists and engineers offered by R&D employers, and developing both the research collaboration and the coherence of skills communication between businesses and universities.

Supporting science and research

3.61 The supply of skilled scientists and engineers, comprehensively examined by the Roberts review, is a key element of the UK's scientific capability. However, skilled scientists and engineers can only undertake world-class research and innovation if they are properly motivated, funded and directed. This is a challenge for private sector firms carrying out R&D, as well as for government and others who fund and make use of the science base.

3.62 To complement the work of the Roberts review, and in preparation for the 2002 Spending Review, the Government is therefore taking forward a cross-cutting review of science and research in the UK. It is already apparent that sustaining and enhancing the science base in an increasingly competitive environment will pose major challenges for all key funders and users of UK science and research. The Government intends to play its full part in meeting those challenges, but a fully effective response will depend on complementary action by others.

3.63 In the past two Spending Reviews, the Government, in partnership with the Wellcome Trust, has allocated around £1.75 billion to investment in science infrastructure. Recent evidence suggests that while this money has helped, efforts should continue to address the issues that have arisen about the balance between different funding streams, as charities and industry, alongside government, fund increasing volumes of research. Dealing with these issues will require all parties to work in partnership, recognising that the long-term sustainability of the science base is a shared responsibility between research institutions and all funders and users. This will mean ensuring that the short-term quest for research output does not compromise the long-term sustainability of the science base.

3.64 The universities will have a key role to play. Universities have responded well to the challenge of improving research in recent years. As the 2001 Research Assessment Exercise shows, the quality of research in the UK has never been higher. This same drive now needs to be applied to the changes that will be necessary to ensure that the UK can properly sustain current research output as well as moving into new research fields. There will be particular challenges in improving financial and project management at universities so that they are better able to meet the needs of research customers, and in ensuring that university pay can respond to market pressures for the best and most promising research talent at all levels.

3.65 The Roberts review and the preparatory work of the cross-cutting review provide a comprehensive overview of the UK's science base. The Government will build on this work, in cooperation with other stakeholders, to develop a strategy for science in the context of the 2002 Spending Review.

Managing the radio spectrum

3.66 Radio spectrum is a key national asset of growing economic and social importance. It is vital that the spectrum management regime is sufficiently flexible to accommodate emerging changes in technology and the growth in demand for mobile communications. The Government has taken steps in recent years to improve the regime, making it more responsive to market developments and creating incentives for efficient spectrum use.

3.67 In March 2001, the Chancellor and the Secretary of State for Trade and Industry appointed Professor Martin Cave of Warwick Business School to conduct an independent review of spectrum management in the UK. Professor Cave's report was published on 6 March 2002. The review's over-arching conclusion is that all spectrum users should be exposed to the value of the spectrum they use. It advocates the introduction of market-based mechanisms for spectrum management, such as auctions and trading for both public and private sector users. Where a market-based approach is not practical or desirable, it recommends that the pricing and charging of spectrum can be used to ensure that all users are exposed to the value of the asset under their control. The Government will respond to the review's recommendations in the summer.

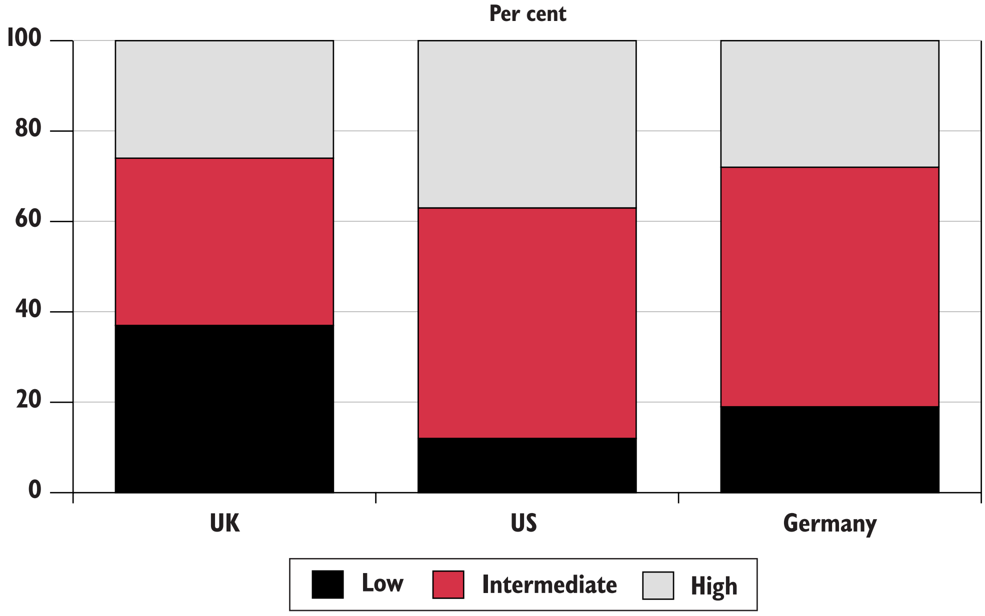
SKILLS

3.68 The quantity and quality of skilled labour available in an economy is an important determinant of economic performance and productivity growth. Skilled workers can often adapt faster and more effectively to change, and may be better at implementing new investments and pursuing innovation.[5] A highly skilled workforce enables firms to update working practices and products at the rate demanded by rapidly changing markets, making the economy more flexible and productive in the longer term.

3.69 International evidence suggests that the UK suffers from significant skills shortages, especially at the lower-intermediate level. In particular, a higher proportion of the UK population have low skills compared with Germany, other European countries and the US.

[5] See, for example, R. Cassen and G. Mavrotas: *Education and training for manufacturing development* in M. Godfrey (ed): *Skill Development for International Competitiveness*, University of Sussex, 1997.

Chart 3.3: Employees by skill level



Source: OECD, 2001

Note: International comparisons of workforce skills are complicated by the difficulty in establishing equivalencies between countries with widely different education systems. The data used here is drawn from OECD (2001) which, unlike previous studies, compares both work-related and academic based qualifications across countries. The study shows the UK with a greater human capital deficit compared to the US than the data cited in 'Productivity in the UK: Enterprise and the Productivity Challenge', HM Treasury, June 2001. More detailed discussion of this issue may be found in the accompanying document, 'Developing Workforce Skills: Piloting a New Approach'. Low skills are defined as International Standard Classification of Education (ISCED) levels 0-2, intermediate skills as ISCED level 3 and high skills as ISCED levels 4-6.

3.70 To improve UK skill levels and increase productivity, government action needs to address both the skill levels of young people entering the workforce from education and the opportunities for those already in the workforce to continue to acquire new skills.

Developing the skills of young people

Primary and secondary education

3.71 The Government is committed to raising standards across the education system. Between 1997 and 2001, the proportion of 11 year olds reaching expected reading levels increased by 12 per cent, while those achieving expected levels in maths rose by nine per cent. The proportion of 16 year olds achieving five A*-C grades at GCSE also increased from 45 per cent in 1997 to 50 per cent in 2001.

3.72 Despite these improvements, the UK education system still faces significant challenges. In 1999, the UK had one of the lowest post-16 participation rates of any developed country – the rate among 17 year olds was 74 per cent in the UK, compared with 83 per cent in the US, 91 per cent in France and 92 per cent in Germany. Increasing participation rates requires an education system that is flexible enough to meet the varied needs and interests of all young people. As a step towards this, in February 2002 the Government announced major new proposals to transform secondary education, including new options for young people who wish to follow vocational pathways from the age of 14 and more choice for all young people. Breaking down the barriers between academic and vocational education is crucial if more young people are to remain in education after the age of 16 and acquire the skills they need to progress.

Modern Apprenticeships

3.73 To widen the vocational choices available to young people and enhance skill levels among those entering the workforce, the Government also intends to reform, strengthen and expand the Modern Apprenticeships scheme. In November 2001, the Government announced:

- a target for 2004 that 28 per cent of young people should enter an apprenticeship before they are 22;
- an entitlement, from 2004, to an apprenticeship place for all 16 and 17 year-olds with five or more GCSEs at A*-G, including maths and English;
- a national framework for apprenticeships to ensure world-class standards, with high quality Apprenticeship Agents to help more employers deliver apprenticeships; and
- a major three-year £16 million marketing campaign aimed at promoting apprenticeships and increasing take-up among both young people and employers.

Higher education

3.74 Higher education is also central to the development of a highly skilled workforce. The Government's aim is that, by 2010, 50 per cent of young people will have the chance to participate in higher education. The Government is pursuing two key objectives: widening access to higher education, and improving the current funding system to ensure that universities are better able to respond to demand and to sustain teaching and research excellence. Further decisions will be taken in the context of the 2002 Spending Review.

Developing workforce skills

3.75 While improvements in the skills of young people help to lay the foundations for long-term improvements in the UK skills base, their effect will only be gradual. Two-thirds of today's workforce will still be in the labour market in 2020, and more than one-third have qualifications below level 2. A faster improvement in the skills base can only be achieved by updating the skills of those already in the workforce.

3.76 Workforce training in the UK is limited by a range of market failures. Individuals and businesses may be unable to gain the full returns to investment in training and commonly face credit constraints. Survey evidence also suggests that people are often poorly informed about the value of training and that time and money are important barriers to take-up. These market failures affect low-skilled workers in particular – people with lower qualifications are much less likely to receive training. There is also strong evidence to suggest that those who work for small firms are less likely to receive training than those who work for larger firms.

3.77 The 2001 Pre-Budget Report set out a vision for UK training and skills based on shared responsibilities between employers, individuals and government. The vision centres on increasing the demand for training by reducing the barriers which prevent people – particularly low-skilled people – from training. It recognises that the voluntary training policies of the past have often failed to reach those with the lowest levels of skills who need most government support to train.

3.78 As outlined in the Pre-Budget Report, one policy approach now being considered by the Government, and being tested through new pilot schemes, would build on existing basic skills policy, lifelong learning and the commitment shown to improving education since 1997. The approach to be tested consists of four complementary, linked elements:

- free learning provision and accreditation for employees without basic skills or level 2 qualifications to work towards recognised qualifications up to the level 2 standard (including basic skills), with approved providers. This would build on the current provision of free courses for basic skills under the Government's *Skills for Life* initiative;

- some form of arrangement for individuals to take up training – such as a minimum entitlement for all employees who have not attained basic skills or level 2 qualifications to paid time off each year to train towards the standard;

- financial support for employers whose staff take time off to train to acquire basic literacy, numeracy and ICT skills and to progress to level 2, with additional financial incentives for small firms. This financial incentive could be delivered through a tax credit or some other mechanism. The Government will consult on these options, which will be developed jointly with the Department for Education and Skills and alongside the wider work of the Performance and Innovation Unit (PIU); and

- extended information, advice and guidance for employers and individuals taking part in, or considering taking part in, any new system. Among other possibilities, these could include arrangements along the lines of Union Learning Representatives.

3.79 To take forward this strategy, **new Employer Training Pilots will be operated by local Learning and Skill Councils in Birmingham and Solihull, Derbyshire, Essex, Greater Manchester, Tyne and Wear, and Wiltshire and Swindon from September 2002.** The pilots will test different periods of time off for employees to train towards the level 2 standard and different levels of compensation for employers. Further details of the national pilot model and of individual pilots are set out in the accompanying paper, *Developing Workforce Skills: Piloting a New Approach*.

3.80 The Employer Training Pilots are only one aspect of the Government's commitment to improving UK skills and supporting those in the workforce who most need training to progress in employment. The PIU is taking forward the workforce development strategy set out in its November 2001 paper in close cooperation with the Learning and Skills Council (LSC) and other government departments.

Investors in People

3.81 The CBI-TUC joint report on skills identified increasing the take-up of Investors in People (IiP) by small organisations as a key priority for raising skill levels across the economy. The Government believes that working to obtain the IiP standard can help firms to identify skill needs and act strategically to raise general skill levels. **Budget 2002 therefore announces additional funding of £30 million for the Department for Education and Skills to encourage small organisations to reach the IiP standard.** The LSC will work with the CBI-TUC Productivity Group and others, building on the joint LSC and IiP UK action plan, to ensure that small organisations are supported in a way that meets the needs of both employees and employers as effectively as possible. Further details will be announced shortly.

Migration

3.82 Recruiting staff from overseas can be a valuable tool for employers facing skill shortages in the UK, and the Government has therefore taken action to reform the work permit and immigration systems. Work permits now last for up to five years, rather than four, and processing times have fallen significantly, with more than 95 per cent of complete applications processed within 24 hours of receipt. Procedures have also been revised to make it easier for overseas students to obtain permission to work in the UK on graduation.

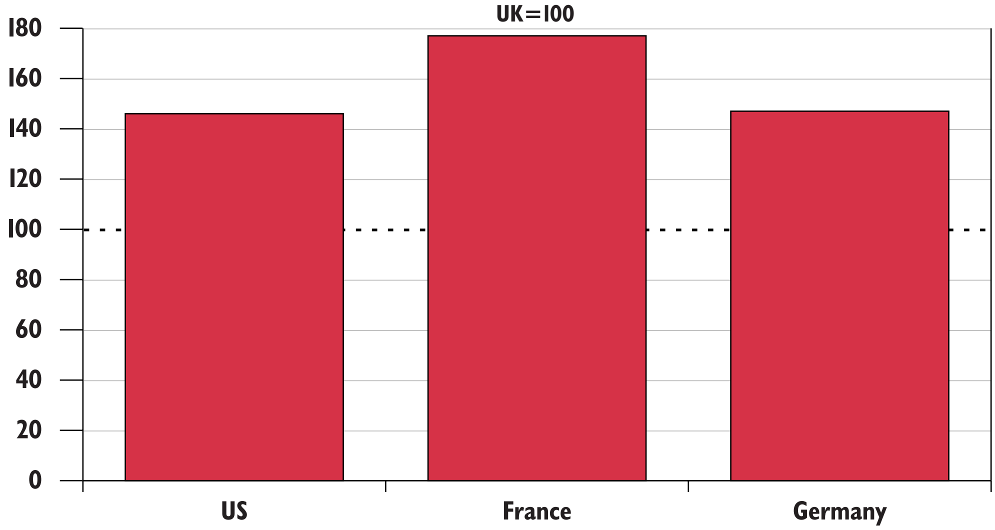
3.83 To support employers further in their efforts to recruit highly skilled staff, a new Highly Skilled Migrant Scheme was launched on 28 January 2002. The scheme enables highly skilled individuals to come to the UK without a specific job offer. Applicants can demonstrate their eligibility for the scheme through educational qualifications, work experience, achievements in their field or past income. The Government will keep the scheme under review to ensure that it continues to operate as effectively as possible.

Management **3.84** The CBI-TUC investment working group highlighted the importance of management and leadership skills in helping companies to grow and raise productivity. The Council for Excellence in Management and Leadership (CEML) is due to publish its final report to the Government in May, with recommendations to 'ensure that the UK is able to develop the managers and leaders of the future to match the best in the world'. The Government will respond to these recommendations in due course.

INVESTMENT

3.85 Economic theory and empirical evidence both suggest that physical capital is closely linked to productivity growth and performance. As a result of long-term under-investment, the UK today is significantly less capital intensive than its major competitors, contributing to the productivity gap.

Chart 3.4: Relative capital per worker, 1999



Source: O'Mahony and de Boer, 2000

3.86 A stable macroeconomic environment is essential to help business plan and undertake long-term investment projects. But to establish the conditions for future sustained increases in investment, action is also needed to address market failures at the microeconomic level. The Government is therefore introducing targeted reforms designed to remedy these failures and help to reverse Britain's legacy of under-investment.

Planning **3.87** An effective planning system is vital for successful investment decisions in a modern economy. In December 2001, the Government published a Green Paper on planning reform, setting out proposals to improve the speed, flexibility and responsiveness of the current system. The Government will set out its final proposals in the summer and take forward legislation as soon as parliamentary time allows.

The Myners review of institutional investment **3.88** The Myners review of institutional investment in the UK was published in March 2001. In October 2001, the Government confirmed that it would take forward all of the recommendations of the review, including revised Codes of Investment Principles to encourage diversity in investment approaches. In March 2003, the Government will conduct an assessment of the effectiveness of these principles in delivering change.

3.89 Following the Myners review, the Government published three consultation documents on 4 February 2002, covering proposed legislation on:

- pension scheme trustees: pension funds' investment decisions are of vital importance to the future security of their members and to the health of the wider economy. Trustees therefore need to increase the skills and resources they bring to the job;
- shareholder activism: the review found a culture of non-intervention among UK institutional investors. The Government proposes to introduce a duty for trustees and fund managers to intervene in companies, where it is in the beneficiaries' interests; and
- independent custodians: the review proposed increasing pension fund members' security by requiring funds to have an independent custodian.

The Minimum Funding Requirement

3.90 In March 2001, the Government also published proposals to replace the Minimum Funding Requirement (MFR) with a long-term, scheme-specific, funding standard based on transparency and disclosure, and introduce additional measures to strengthen security. Implementing these proposals will require primary legislation, and the Government has set up a consultation panel with representatives from the pensions industry and other interested parties to assist with this process. In February 2002, the Government announced an interim package of changes that will improve the operation of the MFR in the period leading up to its replacement and increase protection for pension scheme members where an employer decides to wind up a scheme voluntarily.

The Sandler review of retail savings

3.91 In June 2001, the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the long-term savings industry. The review is examining the markets for medium and long-term savings products purchased by retail customers, identifying the competitive forces and incentives that drive the industries concerned and analysing potential policy responses. The review will report to the Government in summer 2002. The Government's wider strategy for promoting saving and asset ownership is described in Chapter 5.

Corporate governance and non-executive directors

3.92 The Company Law Review, published in July 2001, drew attention to a growing body of evidence from the US suggesting that companies with a strong contingent of non-executives produce superior performance. Building on the work of the Myners and Company Law Reviews, including the Government's recent proposals to strengthen the duties of institutional investors, the Chancellor and the Secretary of State for Trade and Industry have therefore appointed Derek Higgs to lead an independent review of the role and effectiveness of non-executive directors in the UK. A consultation document will be published in due course. The review will assess:

- the population of non-executive directors in the UK – who they are, how they are appointed, and how they can be drawn from a wider pool of talent;
- the independence and effectiveness of non-executives, including the role of the Combined Code;
- the actual and potential relationship between non-executives and institutional investors; and
- what more could be done – by individual boards, institutional investors or government – to strengthen the quality, independence and effectiveness of UK non-executive directors.