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MEETING THE PRODUCTIVITY CHALLENGE

The Government's long-term ambition is to close the productivity gap between the UK and its main competitors. The Government's strategy focuses on the five drivers of productivity growth: competition, enterprise and innovation, skills, investment and public sector productivity.

To achieve its aims, the Government is committed to a regional economic policy that exploits the indigenous strengths of each city and region, and which gives flexibility to locally and regionally based initiatives. This Budget gives Regional Development Agencies further flexibility to take responsibility for their own finances and to implement regional strategies for the delivery of economic development and regeneration.

In this Budget the Government is also:

Strengthening competition by:

- continuing to ensure that the UK competition regime does all it can to promote competition in the economy.

Encouraging enterprise and innovation by:

- introducing a package of measures to reduce the administrative burden of tax on small businesses;
- consulting on a new tax credit for community investment;
- expanding the scope of Enterprise Management Incentives;
- consulting on proposals for a new research and development tax credit for large firms; and
- launching an independent study aimed at enhancing the supply of highly qualified scientists and engineers in the UK.

Strengthening investment by:

- taking forward all the recommendations of the Myners review of institutional investment.

Working to raise the skills base by:

- examining the need for further action – including from Government – to address the low level of skills in the workforce.

THE PRODUCTIVITY CHALLENGE

3.1 The Government's objective is to deliver high and stable levels of growth and employment by raising the trend rate of growth. The nation's output depends on the number of people in work, and how productive those people are. Raising the rate of productivity growth is, consequently, a key route to raising living standards.

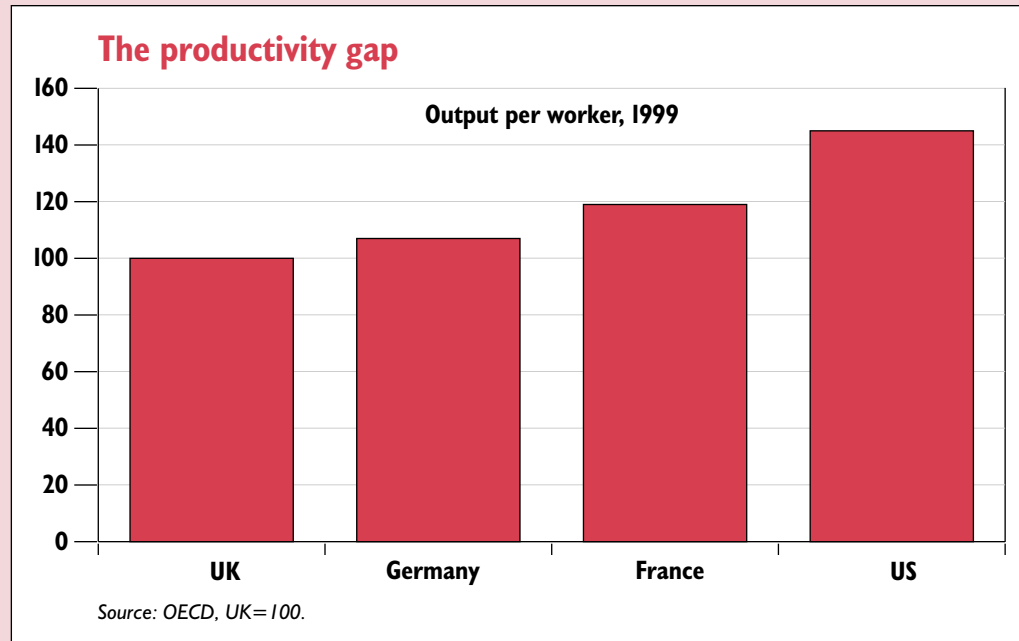
3.2 The UK has a poor track record on productivity. Historically, the UK economy has suffered from macroeconomic instability and microeconomic failures which have inhibited productivity growth and created a substantial productivity gap between the UK and many other advanced industrial economies.

3.3 To address these problems, the Government has developed a comprehensive strategy for increasing productivity growth and meeting the joint Public Service Agreement (PSA) target held by the DTI and the Treasury to narrow the productivity gap.

Box 3.1: Productivity ambition

In the 1999 Pre-Budget Report, the Government set the ambition that UK productivity would, over the next decade, rise faster than that of its major competitors.

The UK's output per worker performance has long lagged behind that of its competitors. By this measure, US productivity is 45 per cent higher, and productivity in France and Germany 19 and 7¹ per cent higher, respectively, than in the UK.



Increasing the employment rate may have a short-term dampening effect on recorded productivity – as new entrants are generally less productive than existing workers – and recent years have seen strong employment growth, with well over 1 million more people now in work. However, this need only be a short-term effect – as the US experience shows, high employment levels and strong productivity growth can be delivered side by side.

On the latest figures, year-on-year productivity growth is 2.6 per cent, with encouraging signs related to the drivers of productivity growth. For instance:

- business investment was above 14 per cent of GDP in 2000, compared with around 10 per cent in 1994;
- the number of small businesses in the economy increased by 170,000 between 1997 and 1999;
- civil R&D investment by business increased by 8 per cent in nominal terms between 1998 and 1999; and
- literacy levels at age 11 have increased by nearly a third over the last four years.

3.4 This is outlined in *Productivity in the UK: The Evidence and the Government's Approach*, which was published alongside the Pre-Budget Report. Alongside this Budget, the Government is publishing a further paper, which examines progress in improving UK productivity: *Productivity in the UK: Progress towards a Productive Economy*.

3.5 The Government's strategy tackles problems at regional, national and international levels. The Government's approach to European economic reform is set out in box 3.2.

¹ German employment figures have been revised upwards on account of a stricter application of ILO employment definitions and changes in the threshold for paying social security contributions, which have led to more workers being picked up by the administrative system. This has led to a downward revision in Germany's output per worker figures.

Box 3.2: European economic reform

At the Lisbon European Council last year, Europe's leaders committed themselves to an ambitious ten-year strategy for economic reform. The vision agreed at Lisbon is of a dynamic job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world.

Making this vision a reality is a substantial challenge: to raise the EU's employment and productivity performance beyond that of the US by 2010. Matching US performance on both measures would raise Europe's output by 40 per cent – equivalent to around £5,000 per person per year.

The Lisbon summit marked a major change in economic policy making in Europe. It was the result of three years' work to establish a new economic policy framework that will deliver the higher levels of growth, productivity and employment needed in the EU. Recognising the UK's interdependence with other EU economies, and in close cooperation with its European partners, the Government has been at the forefront of developing this new policy framework.

The next step is the Stockholm European Council on 23-24 March 2001. At Stockholm, Europe's leaders will need to continue along the path agreed at Lisbon. This will require:

- further reforms mainly at national level to deliver a full employment Europe and to close the R&D gap. Shared European social objectives need a modernised approach to social policy, focused on helping people find jobs, equal opportunities, lifelong learning and combating social exclusion;
- further reforms at EU level to strengthen the single market – fulfilling commitments in telecoms and financial services, setting new targets in areas such as energy and opening up cross border employment opportunities; and
- the EU to show global leadership by calling for a new trade round.

The Government will shortly publish a paper setting out its priorities for the Stockholm European Council. The Government will follow this up by publishing a White Paper on economic reform in Europe for the Spanish presidency.

3.6 The two pillars of the Government's approach are delivering macroeconomic stability, to allow firms and individuals to invest for the future, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. These reforms address historic weaknesses in five areas that can drive productivity growth:

- strengthening **competition**, encouraging firms to innovate and reduce slack, putting downward pressure on costs;
- promoting **enterprise and innovation** in an environment where people are enabled and encouraged to start up new companies, generate new ideas and introduce new technology and working practices;
- improving the **skills** base to maximise the contribution of human capital to growth;
- encouraging **investment** in physical capital by promoting well-functioning capital markets; and
- alongside these measures, working directly to improve **public sector productivity**.

The regional dimension **3.7** Raising productivity provides a sustainable basis for rising living standards. The Government aims to raise living standards across the whole of the UK. Regional imbalances – within or between regions – hold back national economic performance. Regionally balanced growth, led by the regions themselves, is not only desirable in its own right but also an essential element of the Government’s approach to raising productivity. The Government wants to maximise the potential of all areas – towns, cities and rural areas – and has set out its strategies for doing so in the Urban and Rural White Papers, published in November 2000. These strategies tie together the need to tackle economic, social and physical regeneration (also covered in Chapters 5 and 6).

3.8 The Government’s regional economic policy is based on two principles. First, exploiting indigenous strengths in each area and region is likely to be the most effective way of strengthening the essential building blocks of growth – innovation, skills and the development of enterprise. Second, the best mechanisms for achieving this are likely to be based in the regions themselves, and so national government must enable regional and local initiatives to work by providing the necessary flexibility and resources within a national framework.

3.9 Regional Development Agencies (RDAs) have a key role as the strategic leaders in regional and local economic development. They work with Government Offices, Learning and Skills Councils, the Small Business Service, Local Strategic Partnerships and locally-focused partnerships such as New Deal and Employment Zones. Taken together, these institutions form a powerful and influential set of levers, working with each other and central government to drive up productivity in all regions.

3.10 The RDAs have developed regional strategies whose primary purpose is to enhance each region’s competitiveness through sustainable economic development, regeneration and business growth. These have been agreed with regional partners and set out a shared understanding of the challenges their regions face and a strategic vision for meeting them. They provide an essential overall context for the work of other regional, sub-regional and local partners on economic development and regeneration.

3.11 This has two clear advantages. First, it provides a framework within which regional and local partnerships can develop in a coherent way, and so maximise their effectiveness. Second, it provides an inclusive focal point for strengthening regional accountability. The Deputy Prime Minister will shortly be setting out proposals for increasing the opportunities for the RDAs to demonstrate their achievements to their regions

Flexibility for the RDAs **3.12** The Government has strengthened the RDAs’ role with a substantial increase in resources and significantly increased flexibility over how they use those resources. The 2000 Spending Review increased RDA budgets from £1.2 billion in 2000-01 to £1.45 billion in 2001-02 and over £1.7 billion in 2003-04, with separate budgets from DETR, DfEE and DTI brought together in a cross-departmental Single Budget from April 2002.

3.13 In order to deliver a smooth transition to this Single Budget, the November Pre-Budget Report announced that from April 2001 flexibility would be enhanced within the existing framework and that a Strategy Fund would be created for innovative schemes.

3.14 **RDAs will now be given further additional flexibility to manage their finances within the Single Budget framework, boosting their effectiveness and efficiency.** RDAs will be given full financial flexibility within their capital and current budgets. They will also be allowed full “end-year flexibility” – freedom to carry their resources forward from one year into the next. This increased flexibility is to be matched with increased accountability. RDA Objectives and Targets for meeting strategic goals under the Single Budget have been agreed and will be announced by the Deputy Prime Minister shortly.

Box 3.3: The CBI/TUC productivity campaign

Recognising that closing the productivity gap cannot be achieved without a wider drive across the economy, in October 2000 the Chancellor invited the TUC and the CBI to work together on an agenda to raise productivity.

In a joint response, the TUC and CBI endorsed the Chancellor's request. As a result, working groups have now been set up in the four areas identified as being most urgently in need of attention:

- training, with a focus on developing intermediate skills in the workplace. The group will be chaired by John Monks (General Secretary, TUC) with John Roberts (Chief Executive, Post Office) his deputy;
- investment, to consider the barriers to investment in the UK economy. The work will be chaired by Digby Jones (Director General, CBI), with Bill Morris (General Secretary, TGWU) his deputy;
- technology and innovation. This group will be chaired by Sir Ken Jackson (General Secretary, AEEU) with John Robinson (Chairman, Wimpey) his deputy; and
- dissemination and application of best practice, building on existing Government initiatives. The work will be chaired by Paul Barron (President, Alstom UK) with John Edmonds (General Secretary, GMB) his deputy.

Each working group will include additional members from the two organisations, academics, and regional representatives. In advance of the 2001 Pre-Budget Report, the groups will come forward with proposals oriented towards action, concentrating on what employers, unions and the Government can do to raise productivity.

COMPETITION

3.15 Competition has long been recognised as essential to an efficient economy. Research² shows that competition is strongly correlated with productivity performance. Competition creates pressure to innovate, keep costs down and improve the quality and choice of products available, and it ensures that resources are allocated to the most efficient firms. Competition is also the most effective way of ensuring that consumers receive a fair deal. The Government has taken a number of measures during this Parliament to improve the competition regime in the UK. These include:

- introducing the Competition Act, which has strengthened the powers of the Office of Fair Trading (OFT) to take action against anti-competitive agreements and the abuse of market power; and announcing an intention to reform mergers control so that decisions are taken by the competition authorities against a competition-focused test;
- conferring a new role on the OFT (and other regulators) to assess when laws and regulations create barriers to entry and competition;
- increasing resources for the OFT;
- introducing the Utilities Act, to strengthen competition in the electricity sector through reforms to the wholesale electricity market and the separation of electricity supply from the monopoly activity of electricity distribution; and
- investigating competition in particular markets, including the Cruickshank review of retail banking. The Government will shortly announce its decision on how to increase competition in the water industry, following the Deputy Prime Minister's review.

² For example S J Nickell: "Competition and Corporate Performance", *Journal of Political Economy*, 104(4) 1996.

3.16 But the Government remains anxious to ensure that all sectors of the economy are exposed to competition. The OFT has today published its report to the Government on competition in the market for professional services. The Government warmly welcomes the report and appreciates the effort that has gone into preparing it. While some of the issues raised are for the OFT to take forward using its Competition Act powers the report also contains a number of wide ranging recommendations for action by other Government departments. **The Secretary of State for Trade and Industry will outline the Government's response to these proposals.**

3.17 The Government wishes to ensure that the UK's competition regime does all it can to promote competition in the economy. Questions which the Government is keeping under review include whether:

- improvements should be made to the regime for complex and scale monopolies;
- consumer bodies should play a greater role in competition policy;
- third parties harmed by anti-competitive behaviour should have an easier means of seeking redress;
- more stringent penalties for those who breach competition law would lead to a more effective competition policy;
- improvements should be made to the UK regime in the light of international best practice, and the need for increased co-operation between competition authorities; and whether
- further steps should be taken to improve the independence and standing of UK competition authorities.

The Cruickshank review **3.18** In order to address the concerns raised by Don Cruickshank's report on competition in UK banking, published in March 2000, the Government has introduced a number of measures to improve competition in the banking industry and to deliver a better deal for consumers:

- Budget 2000 announced the Government's intention to legislate to open up access to payments systems and to oversee access charges. In December 2000, the Government published a consultation document, *Competition in Payment Systems*, which set out its proposals to give the OFT new powers to promote effective competition in payment systems for the benefit of consumers. The deadline for responses to this consultation is 20 March;
- the Government has also established an independent group to review whether self-regulatory codes, like the Banking Code, are delivering sufficiently strong benefits to consumers. This group, which is being chaired by DeAnne Julius and has members from a wide range of backgrounds, is due to report in April 2001. The Government is also seeking to benefit consumers by extending its scheme of voluntary CAT standard benchmarks to include basic bank accounts and credit cards, and published its proposals for consultation in January; and
- the Government also accepted Don Cruickshank's recommendation to refer the supply of banking services to small and medium-sized enterprises (SMEs) to the Competition Commission, which is due to produce a final report in June 2001.

ENTERPRISE AND INNOVATION

3.19 An environment which encourages people to take opportunities and risks, and rewards and supports those who do, is a crucial ingredient of productivity improvement. Not only do new entrants increase competitive pressure in markets, but also entrepreneurship drives innovation and change by encouraging the creation and introduction of new technologies and working practices.

3.20 To simplify and improve support for SMEs, and to provide the sector with a strong voice, the Government established the Small Business Service (SBS). Among its achievements in its first year, the SBS has helped to establish the £125 million UK High Technology Fund, and committed over £20 million of support from the Phoenix Fund for more than 60 innovative projects supporting enterprise in disadvantaged areas. In the White Paper on Enterprise, Skills and Innovation, the Government announced that the SBS will operate a new £75 million incubator fund to help ensure that all start-up companies likely to benefit from such facilities are able to do so.

3.21 The Government has reformed the tax framework for businesses to ensure that the right incentives are in place for enterprise. These reforms have included:

- lowering the main rate of corporation tax – at 30 per cent now the lowest among major industrialised countries – and introducing a 10p starting rate for small firms which is the lowest in the European Union;
- introducing a capital gains tax taper to encourage investment, with particular incentives for investment in business assets;
- developing the All-Employee Share Ownership Plan to promote employee shareholding;
- introducing Enterprise Management Incentives to help small higher risk companies recruit and retain employees through the use of tax-advantaged share options; and
- improving the Enterprise Investment Scheme and Venture Capital Trust scheme, and introducing the Corporate Venturing Scheme, to boost the supply of risk capital to small companies.

3.22 The Pre-Budget Report launched consultation on further improvements to ensure that the UK has a tax framework that competes with the best in the world. As a result, the Government will be:

- **abolishing from April 2001 the requirement to withhold tax on interest and royalties between companies in the UK.** This will simplify the tax framework and enhance the availability of funding from sources other than banks;
- **publishing the details of the proposed new regime for providing relief to companies for the costs of intellectual property, goodwill and other intangible assets.** A new Inland Revenue technical note, building on earlier discussions with business, sets out how the new system would operate and includes draft legislation. The Government wishes to consult with business to ensure that this new regime can be introduced as soon as is practicable;

- **allowing employers to settle unpredictable NICs liabilities on the growth in value of unapproved employee share options granted between 6 April 1999 and 19 May 2000** by making special employer contributions based on the value of the shares on 7 November 2000;
- consulting business on company taxation and the competitiveness of the UK tax system. A paper will be published in early summer that will set in a broader context the current proposals for a **relief on gains arising on the disposal of substantial shareholdings**. The objective is to achieve a more flexible and competitive company tax system for parent companies based in the UK which will provide stability for the long term.
- **extending the on-shore pooling rules with regard to double taxation relief** to allow relief for eligible unrelieved foreign tax, even if it arises at several levels in a chain of companies overseas; and
- **extending the benefit of the capital gains tax business assets taper to employees of non-trading companies, with effect from 6 April 2000.**

Encouraging SMEs **3.23** The Pre-Budget Report announced a major package of measures to allow businesses to manage their entry into the VAT system, reduce their VAT administration burden and improve their cash flow. This will include consultation in the summer on the introduction of a flat-rate scheme and changes to the annual accounting scheme for those smaller companies with a turnover of no more than £100,000. As announced in the Pre-Budget Report, legislation will also be amended to:

- **increase the VAT registration threshold, in line with inflation to £54,000**, keeping it the highest in Europe; and
- **create a new consolidated SME turnover level at £600,000** to allow more small businesses to qualify for the annual and cash accounting schemes.

3.24 In addition to these measures, the Government will be taking forward measures to enhance support for e-business.

Small business tax **3.25** The Government is committed to reducing, where possible, the regulatory burdens on small businesses. To this end it has established the Better Regulation Taskforce and the Panel for Regulatory Accountability. Continuing this commitment, **the Government will consult on a proposal to achieve a radical simplification of the way in which small businesses are required to calculate the tax due on their profits** by aligning their profits for tax purposes much more closely with those reported in their accounts. The aim of this proposal would be to reduce regulatory and compliance costs for small businesses and enhance the overall support available to small businesses from the Inland Revenue.

3.26 The Government wishes to discuss this proposal with small businesses and their advisers to ensure that policy and regulation take full account of their needs. The Government is particularly interested in suggestions for refinements and further ideas.

Enterprise Management Incentives **3.27** In Budget 2000 the Government introduced tax-favoured Enterprise Management Incentives (EMIs) to help small higher risk companies to recruit and retain the people they need to achieve their potential for growth. This has proved popular with business and nearly 500 companies have awarded EMI options. The close partnership with business in designing the scheme has helped to identify further improvements and this is reflected in Budget 2001.

3.28 In the Pre-Budget Report, the Government announced that it would consult on creating more flexibility for companies. This included a proposal to replace the limit on the number of employees who can be granted options by a limit on the total value of tax-favoured options, so that companies can allocate this in the ways best suited to their businesses. Budget 2001 confirms the removal of the limit on the number of employees and doubles the maximum value of options to £3 million per company, above the £2.5 million limit consulted on in the Pre-Budget Report.

Encouraging employee share ownership

3.29 In Budget 2000 the Government introduced the All-Employee Share Ownership Plan (AESOP), to support employers' efforts to foster a more productive and enterprising relationship with their workers. Since then, 282 applications have been received, and over 100,000 employees are already covered by the plan. **To improve the plan even further, a stamp duty exemption will be introduced for employees buying shares through an AESOP trust.**

3.30 As well as creating targeted incentives for employees to take up share ownership, the Government also aims to reduce the fiscal barriers to companies using equity remuneration to provide incentives for their workforce, thereby enhancing the UK business environment. The Government will examine the corporation tax treatment given in respect of employee share awards and share options, including whether corporation tax deduction should be made available and how access to it could be streamlined.

Directors' pay

3.31 The DTI is announcing alongside this Budget the Government's proposals for strengthening transparency and disclosure on directors' remuneration. The Government will consider further whether there is a need to legislate to strengthen directors' accountability to shareholders, including the issue of a compulsory vote on the remuneration report, in the light of the Company Law Review's wider recommendations on company law reform.

Enterprise in disadvantaged communities

3.32 The Social Investment Task Force (SITF), led by Sir Ronald Cohen, reported to the Chancellor in October 2000. Its report, *Enterprising Communities: Wealth Beyond Welfare*, recommended a five-point programme of action aimed at stimulating enterprise, investment and wealth creation in disadvantaged communities. The report's five recommendations were:

- a new Community Investment Tax Credit, to encourage private investment in enterprises in disadvantaged communities;
- a new Community Development Venture Fund – a matched funding partnership between Government and the venture capital industry;
- more detailed disclosure by individual banks of their business lending activities in disadvantaged communities, combined with a rating system to reward excellent performance;
- greater flexibility for charities to invest in community development; and
- greater support for the community development finance sector.

3.33 The Government welcomed the SITF report in the Pre-Budget Report and has since begun to take forward all five recommendations by:

- launching a consultation document on the proposal for a Community Investment Tax Credit on 1 March. This aims to attract greater flows of private investment into enterprises in disadvantaged communities. Responses to the consultation are requested by 2 July 2001;
- working closely with Sir Ronald Cohen and others on setting up the first public-private Community Development Venture Fund, which will make

equity investments in enterprises with growth potential in disadvantaged areas. The Government hopes to see this first fund set up this year;

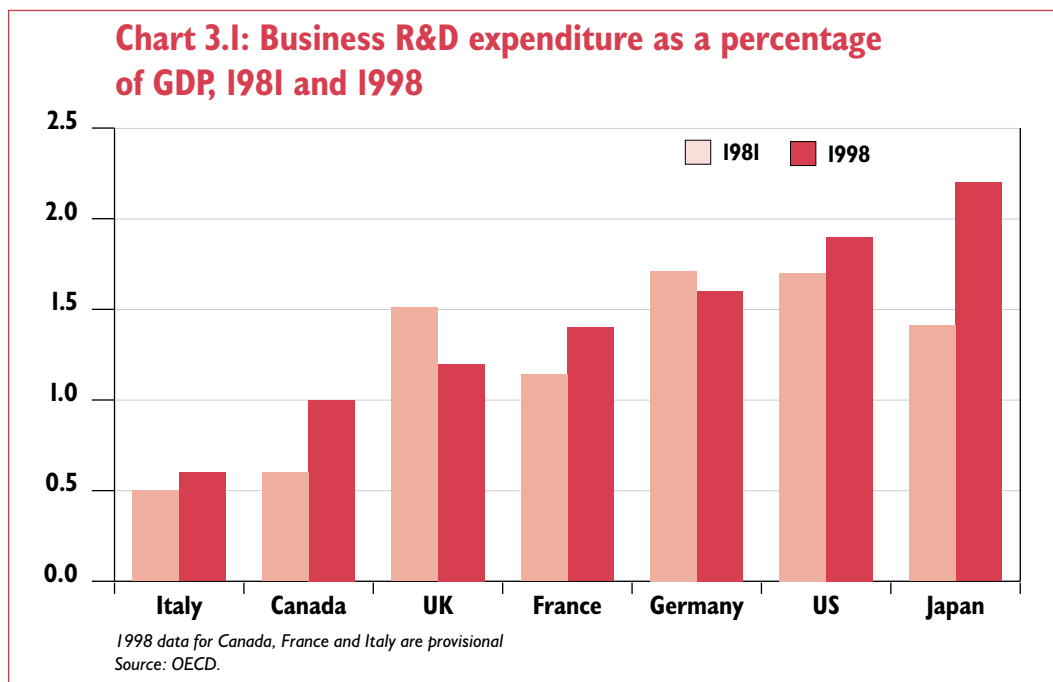
- encouraging the banks to disclose their individual business lending activities in disadvantaged communities on a voluntary basis. The Government believes that this would make a major contribution to improving the information flows in disadvantaged communities – which would in turn help to identify barriers to, and opportunities for, growth;
- welcoming the Charity Commission's planned programme of guidance, which will help unlock more charitable investment in enterprises in disadvantaged communities. This guidance means that the relief of unemployment, urban and rural regeneration and community capacity building all now count as charitable purposes. Also, many charities can now undertake “programme-related investments” – the provision of equity finance and loans, as well as grants, to further their charitable objectives; and
- encouraging the community development finance sector to form a single, high-quality and inclusive trade association.

3.34 The Chancellor recently launched the Inner City 100 which will celebrate the 100 fastest growing companies in the most disadvantaged inner cities. The Inner City 100 index will be published in autumn 2001.

3.35 Promoting enterprise is a key part of addressing social exclusion. Other elements of the Government's strategy for tackling social exclusion are set out in Chapter 5.

Encouraging innovation **3.36** Encouraging innovation and research and development (R&D) is a vital component of the Government's strategy for improving the UK's productivity performance. The Government believes that the most effective way to increase innovation is to work in partnership with business. The Government can help to ensure that the infrastructure and business environment are internationally competitive, giving businesses the platform from which to innovate. It can also help to overcome some of the barriers to longer-term investment created by the market, especially where there are wider benefits above and beyond those going to the firm making the investment. But it is business that must rise to the challenge of making the most of these opportunities.

3.37 Comparisons with other countries show that the UK business sector under-invests in R&D relative to its major competitors, and that whereas business expenditure on R&D fell as a percentage of GDP in the UK over the past two decades, it rose in most other major industrialised countries.



3.38 Relative under-investment in R&D by UK firms is translated into lower levels of innovation, with surveys³ indicating that UK firms – particularly, but not exclusively, larger firms – tend to be less orientated towards innovative products and services than their counterparts overseas. Innovation acts as a catalyst for growth and this analysis therefore supports the need for UK business as a whole to improve its innovation and R&D performance.

3.39 The Government has already introduced an R&D tax credit for SMEs, in order to address the particular difficulty that these firms face in accessing capital to invest in innovation and R&D. **In order to complement this measure and further to improve the UK's innovation performance, the Government is publishing a consultation document, *Increasing Innovation*, which sets out the Government's proposals for a new tax credit to encourage R&D and innovation among larger firms and consults on the design of such a measure.**

3.40 Given the policy aim of providing incentives for companies to undertake more R&D and increase their commitment to innovation, the Government is minded towards an incremental R&D tax credit, assuming that a number of design issues can be successfully resolved through consultation with business. An incremental scheme would reward companies in proportion to their additional current R&D expenditure above present levels. Similar measures are already in use in countries such as France, Japan and the US.

3.41 It is envisaged that pharmaceutical companies will be able to claim the proposed incentives which are discussed in Chapter 5 and are specifically targeted at encouraging work to eradicate killer diseases in developing countries, alongside both the existing and proposed generic R&D tax credits.

3.42 The Government is also keen to ensure that businesses are not constrained in increasing their R&D and innovation through inability to find suitably skilled scientists and engineers. The UK overall has been shown to have a strong science base and the Government has sought to complement this through launching a number of initiatives to improve the skills of the workforce. However, the Government is aware of the concerns expressed that this overall healthy picture could mask skills shortages at the top end of specific scientific and technological fields.

³ For example Eurostat: *Statistics on Innovation in Europe*, February 2001.

3.43 The Government has therefore asked Sir Gareth Roberts to undertake an independent study into the provision of skilled scientists and engineers in the UK, reporting back by February 2002. This study will examine whether there are adequate mechanisms in place for businesses to identify their needs for specific scientific and technical skills, for communicating these to the higher education sector and for the sector to respond effectively.

Making the most of the radio spectrum

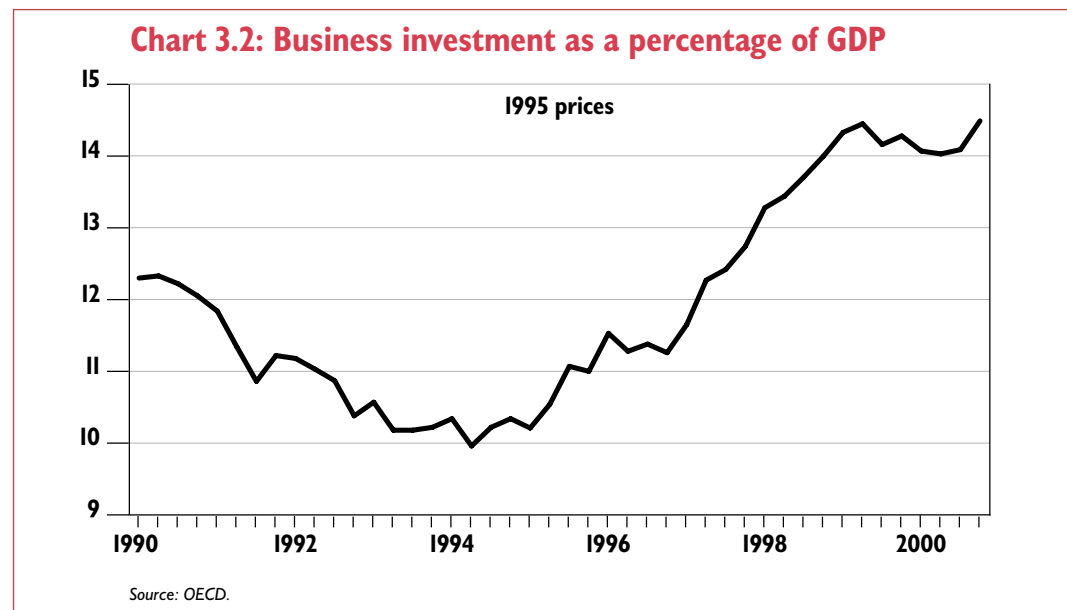
3.44 The Pre-Budget Report announced the Government's intention to commission a review of radio spectrum management, to advise on the principles that should underlie spectrum management and what more can be done to ensure that all users, including non-commercial users, are focused on using their spectrum as efficiently as possible. **The Chancellor and the Secretary of State for Trade and Industry have appointed Professor Martin Cave to conduct the review. As a first stage, the review will be consulting with interested parties on issues relevant to its remit, including:**

- means of ensuring that all of the spectrum, including that allocated to non-commercial purposes, is used with maximum efficiency; and
- investigating the scope for improving spectrum pricing and trading arrangements.

INVESTMENT

3.45 Empirical studies⁴ show a strong correlation between capital intensity and productivity. The UK has long suffered from under-investment and as a consequence has lower capital stock than most of its main competitors. Greater macroeconomic stability and targeted reforms have helped to create an environment in which business investment has grown (see chart 3.2) but this investment will need to be sustained if the effects of underinvestment are to be reversed.

3.46 A stable macroeconomic climate is essential to continuing investment. But it is also necessary to ensure that funding for investment is available to those who need it and can best use it. This means ensuring that capital markets are able to work efficiently in allocating investment across the economy. To this end, the Government commissioned Paul Myners to conduct a review of institutional investment. The findings of his review are summarised in box 3.4.



⁴ For example N Oulton: "Why do foreign-owned firms in the UK have higher labour productivity?" in N Pain: *Inward Investment, Technological Change and Growth*, Macmillan Press 2000.

Box 3.4: The Myners review of institutional investment

At the time of Budget 2000, the Government asked Paul Myners, chairman of Gartmore Investment Management, to look at whether there are factors distorting institutional investment decisions.

The final report of the review was published on 6 March 2000. The review concludes that there are a number of distortions affecting institutional investment decision-making:

- trustees are the ultimate decision-makers for pension funds, but they are typically unpaid; many have limited investment expertise and a low level of support from in-house staff;
- their investment decision-making, especially on asset allocation, is dependent on advice from a small number of advisory firms;
- sponsor companies have insufficient incentives to encourage efficient management of pension schemes;
- the objectives given to fund managers often do not align their interests effectively with those of their institutional clients, and there is a lack of clarity about the timescales over which they are measured;
- fund managers are excessively reluctant to engage actively with companies in which they are invested;
- the Minimum Funding Requirement (MFR) distorts investment behaviour without protecting pensioners;
- there are issues concerning capital and information flows around the personal investment products market; and
- private equity investment is affected by many of these factors, but also raises specific issues as an asset class for institutional investors.

In the light of these concerns, the review makes a number of recommendations, in particular:

- a code for institutional investment decision-making, the central principles of which include:
 - decisions to be taken only by those with the right skills and expertise;
 - clear objectives and timescales for managers;
 - performance measurement of all advisers; and
 - regular reporting of investment strategy and returns to members and the public;
- the replacement of the MFR with a scheme-specific regime based on transparency and disclosure;
- incorporation of the US ERISA principles on shareholder activism into UK law, making intervention in companies, where it is in shareholders' interests, a duty for fund managers;
- the Law Commission to look at clarification of the legal ownership of surplus pension fund assets;
- reduction of the rate of tax on withdrawal of the surplus;
- a legal change which would raise the duty of care for trustees, requiring them to be familiar with investment matters where they take investment decisions;
- a proposal for an independent review of capital and information flows relating to personal investment products; and
- a number of measures which take account of the special nature of private equity as an asset class for institutional investors – including changes to the maximum number of partners in a limited partnership and to the taxation of the proceeds from the investments of such partnerships.

Initial response to the Myners review **3.47** The Government is grateful to Paul Myners for his report and intends to take forward all his recommendations. In particular, the Government:

- believes that the principles for institutional decision-making set out in the report are correct. It agrees with the review's proposal that pension funds and in due course other institutions should set out to their members, and publicly, where they do not comply with any of these. **The Government will hold a short consultation on the precise detail of the principles before promulgating them;** the Government is willing – as recommended by the review – to legislate if necessary to ensure that disclosure against them occurs. As recommended, **the Government will undertake a public assessment in two years' time of the effectiveness of the principles in bringing about behavioural change;**
- **will legislate to require trustees to be familiar with the investment issues on which they are making decisions and to incorporate the principle of the US Department of Labor interpretative bulletin on shareholder activism into UK law;**
- agrees that it would be helpful for the Law Commission to examine whether legal change could clarify ownership of pension fund surpluses. **The Government will consult on abolishing the 20-partner limit for limited partnerships,** and also agrees that it would be helpful for the Law Commission's forthcoming review of the Limited Partnerships Act to look particularly at clarifying the scope for limited partners to play investment advisory roles. **It will also reduce regulatory obstacles to pension funds investing in private equity limited partnerships, by removing the requirement to invest through an FSA-authorized person;**
- **will, following recent reductions in the main corporation tax rate, restore the differential between this rate and the rate of taxation on the withdrawal of pension fund surpluses to its original level. The Government accepts the recommendation to change the taxation of insurance companies' limited partnership investments to taxation of the gains as distributed from the fund.** It will consult on the detail of this change and bring forward legislation in a future Finance Bill; and
- **will commission a further independent review of capital and information flows regarding personal investment products.**

Minimum Funding Requirement **3.48** The Government is also publishing a separate document alongside this Budget setting out its proposed way forward on the MFR, on which it received consultation responses from Mr Myners and others. The Government believes that the MFR should be abolished and replaced by a long-term scheme-specific approach based on transparency. The Government also wishes to draw on a number of points from consultation responses including, in particular, useful suggestions from the National Association of Pension Funds. **The Government will legislate to replace the MFR with a long term scheme-specific funding standard, with additional protective measures, including a statutory duty of care for the scheme actuary, stricter rules on voluntary wind-up and extension of compensation for fraud.**

Financing growing enterprises **3.49** To realise their growth potential, smaller enterprises are increasingly turning to external equity finance to provide the necessary capital. By linking provision of finance with business mentoring and networking benefits, venture capital and "business angel" investors can foster the growth of their investee companies. The Government has made significant progress since 1997 to improve the fiscal environment for this vital early-stage risk capital finance. It has also stimulated the creation of new public-private venture funds to address market weaknesses.

These policies have contributed to a rapid increase in the supply of risk capital to UK enterprises.

3.50 As well as stimulating the supply of risk capital to enterprises, the Government is concerned to improve the effective demand. Smaller enterprises are often ill-prepared to understand how external equity investment could enable their growth, or to obtain and use such finance effectively. The Pre-Budget Report highlighted the apparent gap in the provision of effective advisory services to SMEs to enable them to become “investment ready”, and committed the SBS to develop new services, in partnership with the RDAs and market practitioners, to help close the information gap. **The SBS will shortly set out the Government’s objectives of building on and spreading best practice in this area, with the aim of stimulating innovative proposals from market practitioners for new pilot programmes, to be launched with SBS support by summer 2001.**

3.51 Economies of scale in raising equity finance can operate against smaller companies raising relatively small amounts of risk capital. The Government will investigate whether there is a case for reducing fiscal barriers in this area.

3.52 The Government is continuing to develop a range of public-private venture fund partnerships across the UK, in order to address specific identified “equity gaps” between the demand for finance and the commercial supply. In Budget 2000, the Government set a target of £1 billion for investment over 2001 to 2004 and, towards this aim, committed an additional £100 million of public resources in order to lever in substantial extra private investment. By this summer, the Government hopes to be nearly half way towards achieving this target.

3.53 Finally, **the Government plans to streamline further the operation of the Enterprise Investment Scheme (EIS), Venture Capital Trust (VCT) scheme and Corporate Venturing Scheme**, which provide tax incentives for investment in smaller higher risk trading companies. The changes will make the schemes more responsive to the business needs of small enterprises. The Government also plans to commission research into the economic impact of the EIS and VCT schemes.

Investment in the film industry

3.54 In order to stimulate production of British films and to promote growth, employment, and investment opportunities in the UK, the July 1997 Budget introduced an immediate 100 per cent write-off against tax of the production and acquisition costs of British films with budgets of no more than £15 million. The measure was designed to improve the effectiveness of mainly small British film production companies competing in a market dominated by large, vertically integrated, US companies that control production, distribution and exhibition.

3.55 Over the past four years there has been increasing evidence of structural change in the British film industry with the emergence of sustainable investment packages and record inward investment – over £500 million in 2000. The tax relief was due to expire in 2002, but **Budget 2001 announces a further three-year extension of the relief to 2005 to give the industry time to build on these encouraging developments.**

SKILLS

3.56 The link between the quantity and quality of skilled labour and productivity has been demonstrated by numerous studies⁵. A more skilled workforce can generate greater levels of innovation, increase workplace flexibility, enable better adaptation to new technologies and facilitate best practice and spillover effects to co-workers. But the UK has had a weak skills base over a long period and skill levels in the UK are lower than in many of the UK's main competitor countries. Around 7 million adults in the UK still lack basic literacy and numeracy skills, and intermediate skill levels compare particularly poorly with the UK's European counterparts. Equally, only 27 per cent of the UK workforce has a degree or equivalent, compared with 38 per cent in the US.

Box 3.5: Higher education ambition

Skilled graduates and postgraduates are vital for a productive economy able to take advantage of the opportunities offered by rapidly developing technologies and scientific advances. Historically, the UK has been at least on a par with its European competitors in the number of people completing higher education, but has lagged behind the US. In the 1999 Pre-Budget Report, the Government set an ambition for higher education that, by the end of the decade, and for the first time, the majority of the UK's young people can expect to go on from school or college into higher education.

The Government is ensuring that higher education institutions have the resources and incentives to meet this aim. Two successive Spending Reviews are delivering a major funding boost for the sector, reversing more than a decade of decline in funding per student; increasing research output; and implementing a capital renewal programme. This includes spending almost £160 million more over the next three years to ensure more students from the poorest areas take up higher education places. Their current under-representation perpetuates social exclusion and is a loss to UK productivity. There will be a particular focus on improving the performance of those institutions which recruit the fewest entrants from the state education sector.

To make sure that the increase in participation is matched with a sensitivity to skills needs, the Government is helping higher education get closer to the labour market. Course curricula, for example for the new two-year Foundation Degrees, will reflect a higher degree of employer input. How graduates from each university fare in the labour market will be tracked against new Higher Education Funding Council benchmarks. The new technology institutes – announced in the recent White Paper on Enterprise, Skills and Innovation – will bring universities together with colleges and local businesses to provide specialist ICT and other high technology skills, and to work closely with local companies helping them to apply advanced technology.

Improving schools **3.57** Improving the skills base needs to start in schools. The Government has sought to drive up school standards and reverse the long-term trend of under-investment and under-achievement. In summary, the Government has:

- established the Sure Start programme to ensure that children from disadvantaged areas start school ready to learn;
- developed strategies for improving pupil attainment in literacy and numeracy at primary school, and begun to extend that approach to improve performance in the early years of secondary education;

⁵ For example Benhabib and Spiegel: "The Role of Human Capital in Economic Development: Evidence from Aggregate Cross-Country Data", *Journal of Monetary Economics* 34(2), 1994.

- made a commitment to ensure that everyone can expect a minimum level of education wherever they live, including “floor” targets to improve outcomes for Key Stage 2 in English and maths and for GCSEs, backed by a substantial increase in resources announced in the 2000 Spending Review;
- set out plans to modernise and diversify the secondary system. As part of this, some schools will now be able to specialise in the teaching of enterprise and others in engineering and science;
- revised the National Curriculum to include a new focus on enterprise skills at both primary and secondary level;
- provided for a number of changes to post – 16 provision, including the introduction of new A/AS level qualifications, the introduction of vocational A-levels and a new key skills qualification to encourage all young people to develop communication, numerical and Information and Communications Technologies (ICT); and
- invested in connecting schools to the internet. The Government is well on course to ensure that all schools are connected to the internet by 2002, and by 2004, there will be one computer for every five pupils in secondary schools across England.

Higher education 3.58 To ensure that the UK has a world class supply of highly-skilled graduates and postgraduates, the Government has set a goal for increasing participation in higher education (see Box 3.5). It is also doing more to ensure that students from under-represented groups get better access to higher education. Achieving this goal will not only increase the opportunities for young people, but will also help the UK develop the human capital it needs for higher productivity growth.

Lifelong learning 3.59 Lifelong learning, improving the skills of people already of working age, is at the forefront of education and training policy. The Government has set about transforming the arrangements for lifelong learning by establishing the Learning and Skills Council. The Council will coordinate, promote and plan post-16 education and training outside higher education, focusing particularly on employers’ needs. It will seek to maximise the impact of the significant increases in funding which it will be allocated and will aim to make education and training accessible, including playing a fundamental part in the Government’s National Strategy for Basic Skills, which will help 750,000 adults improve their skills by 2004.

3.60 Meanwhile, increasing numbers of adults are taking advantage of three flagship initiatives:

- Individual Learning Accounts (ILAs) provide every adult over 19 with the opportunity to organise their own learning. The first 1 million account holders receive £150 towards training if they contribute £25. There are also substantial discounts, with reductions of up to 80 per cent on selected courses. More than 700,000 people have already opened an ILA. The Government expects 1 million account holders by March 2002;
- learndirect offers flexible, internet-based adult learning through its website (www.learndirect.co.uk) and through a network of over 900 learndirect centres. Over 70,000 people have now undertaken learning through learndirect since 1 May 2000; and
- the Government has allocated £252 million to establish 1,000 ICT learning centres across the country by 2002. More than 600 centres have already been announced.

Management 3.6I Recognising the importance of high quality management and leadership skills for raising the productivity of the economy, the Government established the Council for Excellence in Management and Leadership. The Council will be reporting back to Government before summer 2001.

Box 3.6: Workforce development

In a knowledge economy there are fewer opportunities for the unskilled. Though lack of skills may not be a barrier to employment, it will hinder both individuals' earning power and their ability to respond to changing circumstances.

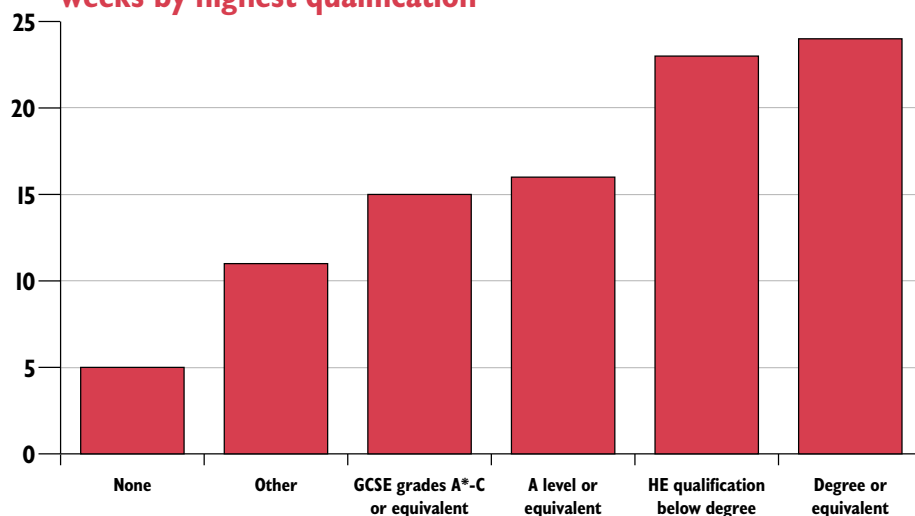
The lack of relevant or necessary skills in the workforce can also prevent business from exploiting new technologies and improving production and working practices that can lead to improved productivity.

The responsibility for investing in training lies with:

- individuals – if they wish to make the most of the opportunities provided (individuals with no qualifications earn on average 30 per cent less than average earnings);
- business – as good employers investing in their workforce (a study by the Institute for Fiscal Studies suggested that increasing the number of employees trained by 5 percentage points could increase productivity by 4 per cent); and
- Government – to ensure that the right opportunities and incentives are in place.

36 per cent of those in employment in the UK either have no qualifications or qualifications below level 2 (five GCSEs at A*-C). These employees receive the least training. An employee below level 2 is one quarter as likely to receive training as a colleague with a level 2 qualification: creating a vicious circle of low-skill-no-training. As the education system improves, this proportion is falling but not fast enough to address the legacy of social exclusion and the past failings of the education system.

Percentage of employees receiving training in the last four weeks by highest qualification



Source: Labour Force Survey, autumn 2000.

Many employers recognise that more training is beneficial. However, the economic and social benefits of training for those without a minimum skill level go wider than those reaped by employers.

The National Skills Task Force (NSTF) demonstrated that individuals with families and who are in full time work may struggle to find the time to participate in learning. This suggests the need to do more in the workplace.

The current voluntary approach has secured increased participation in workplace training since 1995. But this is not enough: the scale of the problem is significant and Government agrees with the NSTF that tackling this “chronic UK problem of low skilled adults” must be a priority and that a step change on the part of all – employers, individuals and Government – is required.

The Learning and Skills Council is developing a workforce development strategy on which it will issue a consultation document in the summer. The CBI/TUC working group and the Cabinet Office Performance and Innovation Unit are also both looking at how the UK’s performance in workforce skills and training can be improved. Both are expected to report in the autumn.

Government, for its part, is willing to consider what else it can contribute to extending opportunity for all in work, particularly to obtain a qualification up to level 2. The Government is willing to consider a new tax credit for such training, possibly based on the model of payable R&D tax credits. Other possibilities will also need to be considered. But Government action alone cannot bring about the sort of changes that are necessary to make a real impact on the problem of low skills. It will be important that everyone – employers, individuals and Government – takes seriously their responsibility to deliver a high skill, high productivity economy.

PUBLIC SECTOR PRODUCTIVITY

3.62 As well as working to provide the right environment and incentives for business to close the productivity gap, the Government is changing the way it works. There are a number of challenges to improving productivity in the public sector, including:

- improving incentives – which are not always as strong as within the private sector;
- reducing and improving regulation;
- improving accountability and ownership; and
- improving information.

Setting clearer targets 3.63 Clear targets are important in business planning, management, and ensuring that the public sector is accountable to those that use its services. The Government has put in place a number of initiatives designed to ensure transparent measurable targets for the public sector.

3.64 The 2000 Spending Review set new Public Service Agreements (PSAs), containing 160 outcome-focused targets for central government. Technical notes setting out how these targets will be measured have also been published on departments’ websites. Service Delivery Agreements (SDAs) set out how departments will deliver their PSAs and how they will manage themselves more efficiently.

3.65 The Government is also piloting local PSAs with 20 local authorities, which stand to gain financial rewards and additional local freedoms in return for signing up to and delivering challenging outcome targets. This will reinforce the drive for continuous improvement through the Best Value performance framework which requires local authorities to draw up performance plans and undertake fundamental service reviews. Local authorities are also establishing Local Strategic Partnerships to aid strategy in coordination of local services.

Departmental Investment Strategies **3.66** Historically, the public sector's investment record has been poor. Not only does low public investment damage public sector productivity, but it can weaken private sector productivity if public services (such as the transport infrastructure) are not kept up to standard. The 2000 Spending Review set out plans that will more than double net public investment – to £19 billion by 2003-04. This programme of investment will be further boosted by the additional spending allocations announced in Budget 2001 (see Chapter 5 for more details).

3.67 The Government has put in place mechanisms to improve public sector investment. Coupled with the 2000 Spending Review increases in capital budgets the Government published Departmental Investment Strategies in November 2000, which set out departments' plans to deliver the scale and quality of the capital stock needed to underpin the Government's proposed improvements in public services. Each Strategy sets out the context that the department is working in, an analysis of the condition and use of its existing asset base, future investment plans and the systems which the department will be adopting to deliver value for money.

Public Services Productivity Panel **3.68** The Public Services Productivity Panel is a small group of senior business people, public sector managers and trade union leaders that has been established to identify ways to help improve the productivity of the public sector. Following the publication of *Meeting the Challenge*, which drew together main findings and lessons from the Panel's original work programme, the Chief Secretary to the Treasury announced a renewed and expanded Panel in September 2000. The Panel's new work programme is centred around the theme of securing ownership for performance. To support this, the Panel is undertaking a range of projects on defining and owning accountabilities, improving management flexibility to innovate and strengthening incentives for delivery. These include work on:

- *Delivering Public Service Agreements* – translating high level PSA targets into real improvements in front line service delivery;
- *The Role of External Review in Improving Performance* – identifying where and why inspection, audit and review have the biggest impact;
- *Effective Management of Partnerships* – identifying the appropriate selection and application of partnership models involving the public sector; and
- *Enhancing the Motivation of Public Sector Managers* – helping public service managers in practical ways to motivate staff and align that motivation with better performance and service delivery.

Improving incentives **3.69** As part of the work of the Panel, John Makinson, Group Finance Director of Pearson plc, produced a report, *Incentives for Change*. This report focused on how best to develop performance-based incentives in the Department of Social Security, the Employment Service, HM Customs and Excise and the Inland Revenue.

3.70 The report recommended that front-line staff should be rewarded through non-consolidated team-based bonuses, which would act as incentives for improved service delivery and overall performance. Teams' performance would be related directly to PSA targets cascaded down to them. Over the past year, all four departments have set up implementation teams and are working alongside the Treasury to develop robust mechanisms linked to PSA targets. These will need to be implemented alongside pay structures which will still motivate and reward good performance even if targets are not exceeded.

- Reducing regulation in the public sector** **3.71** Reducing red tape in the public sector is an important factor in creating a productive work environment. The Government has a team analysing, assessing and actively reducing red tape and bureaucracy on frontline public sector staff. Projects include work on reducing the burdens faced by General Practitioners, head-teachers, the police and local authorities.
- 3.72** The team has made significant progress in reducing the burdens faced by these service providers. It intends to develop further strategies to prevent the growth of bureaucracy and red tape in the public sector.
- Partnerships UK** **3.73** Partnerships UK was launched in June 2000 to build upon the success of the Treasury Taskforce and to provide a permanent and sustainable centre of expertise to continue the Treasury Taskforce's role in expanding the Government's Public-Private Partnership (PPP) programme. Partnerships UK has absorbed and expanded the activities and transaction staff of the Treasury Taskforce. The policy arm of the Treasury Taskforce has transferred to the Office of Government Commerce. Partnerships UK is expected to be at the forefront of the development and implementation of better, faster and more effective PPP transactions, helping to deliver value for money public services and efficient utilisation of public sector assets. Partnerships UK will work with central and local government and with other public bodies across the public sector.
- 3.74** The Treasury is currently seeking private investors to take a 51 per cent stake in Partnerships UK. By selling this stake, the Treasury plans to raise a minimum of £22.5 million of equity by private placement with qualifying institutions. Following completion of the Offer, it is expected that Partnerships UK will have a capital base of £45 million. Each potential qualifying investor will be invited to invest between £1million and £5 million.
- Office of Government Commerce** **3.75** The Office of Government Commerce (OGC) was set up in April 2000 to provide a greater sense of direction in procurement. It aims to deliver value for money gains totalling £1billion by the end of 2002 – 03 through the dissemination of best practice and the development of government purchasing power.
- 3.76** In its first year, OGC has concluded a strategic partnership with Vodafone which will save the Government over £38 million over two years. OGC (through The Buying Agency) has also negotiated the Watermark contract, an important step forward in government water consumption with the potential to deliver savings of 10 per cent a year on water services, amounting to £30 million a year for central government alone.
- 3.77** A priority for OGC in the coming months will be the Gateway Review Process, which aims to improve the management of projects through the use of independent peer reviews. The reviews will identify and implement actions needed for project success, understand and apply best practice and ensure lessons learnt are shared.

