

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for the UK to achieve a faster rate of productivity growth than its major competitors. Budget 2005 sets out the next steps that the Government is taking to strengthen the drivers of productivity growth, including:

- **a package of radical reforms to tackle the burden of regulation on business**, while maintaining standards of protection for the public, consumers and employees, through:
 - building on the success of the Panel for Regulatory Accountability (PRA) by ensuring that regulation is only used where necessary, that it is not 'goldplated' if it originates from EU law, and that all Whitehall departments strengthen their focus on removing outdated and unnecessary regulations as recommended by the Better Regulation Task Force (BRTF) report;
 - adopting a risk-based approach to inspection and enforcement, streamlining regulatory structures and increasing accountability in order to reduce the costs to business of administering regulation, as recommended by the Hampton Review, and setting new targets to reduce the administrative burden over time;
 - applying the principles of better regulation in Europe through the six presidencies initiative;
- consistent with the Hampton principles, a strategy to meet stretching new targets **to reduce the administrative burden of the tax system for small businesses**, including in the short-term cutting the tax return for 500,000 of the smallest businesses and rolling out new options for paying and managing VAT online;
- **taking forward the ten-year Science and Innovation Investment Framework**, including a UK Stem Cell Initiative, chaired by Sir John Pattison, to formulate a ten-year vision for stem cell research, creating a platform for co-ordinated public and private research funding; a mandatory requirement that at least 2.5 per cent of public sector extra-mural R&D spending will be with Small and Medium Enterprises (SMEs) and engaging with business to ensure that the R&D tax credit better supports UK businesses with high potential to become major innovative firms of the future;
- **to support the Government's major new investment in education and skills**, plans to enhance workforce skills including continued support of £65 million for the Employer Training Pilots and funding to support a new Union Academy;
- **further support for enterprise**, through a new Local Enterprise Growth Initiative worth £150 million per year by 2008-9, to boost enterprise in the most deprived areas of England, following the end of the time-limited commercial stamp duty land tax disadvantaged areas relief in this Budget; and Regional Development Agencies' (RDAs) plans for the development of business coaching focused on businesses with high growth prospects;
- **a package of measures to increase the contribution of creativity to productivity growth**, including a review: led by George Cox, on how best to use the UK's world class creative industries and universities to support and develop the creativity of SMEs; and action by the RDAs to support the integration of design into corporate strategy, product and market development, including through the Design Council's Design Immersion Programme; and £12 million to the Arts Council England to promote better management and leadership within the cultural sector; and
- as a further step in reforming the investment chain, **taking forward the Morris Review recommendations** to promote greater competition in actuarial services and in advice to pension funds on investment issues, including asset allocation and fund manager selection, and to strengthen the regulation of the actuarial profession.

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth compared with other major economies. In recent years, however, the UK's performance has been improving. As set out in Box 3.1, the UK now has output per worker similar to Germany, and has narrowed the gap with France. However, despite some progress, there remains a significant gap with the US. The Government's long-term goal is for the UK to continue to close the productivity gap by achieving a faster rate of growth than its main competitors.

The Government's strategy

3.2 The Government's strategy for closing the productivity gap in this environment 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 and flexibly. Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and competition, and driving up standards. However, inefficient regulation can impose a significant burden on business. This Budget sets out a radical set of reforms to reduce the burden of regulation on business, and so promote enterprise and competition. As the global economy restructures, the success of developed countries will depend on building a flexible economy with a highly-skilled workforce, which can respond quickly to change and that focuses increasingly on high value-added sectors. Building on the new long-term plans to deliver twenty-first century facilities in primary schools and significant investment in Further Education colleges set out in Chapter 6, this chapter also sets out further plans to enhance workforce skills in the UK economy.

The five drivers of productivity

3.3 These reforms are described in the context of the five key drivers of productivity performance:

- improving *competition*, which is the lifeblood of strong and effective markets. Competition puts downward pressure on costs and prices, driving innovation and business efficiency, and delivering a better deal for consumers;
- promoting *enterprise*, by removing barriers to entrepreneurship, promoting an enterprise culture, and delivering a new and radical approach for improving the way that regulations are made and enforced across the public sector to deliver genuine reductions in the burdens on business;
- supporting *science and innovation*, to promote the development of new technologies and more efficient ways of working. Increasing rewards to innovation mean that the UK will increasingly depend on its ability to create new knowledge and translate it into innovative goods and services;
- raising *skills* levels, to create a more flexible and productive workforce, which can adopt innovative technologies and enable individuals to move into new areas of work; and
- encouraging *investment*, to increase the stock of physical capital, including through stronger, more efficient capital markets.

Productivity and the global economy

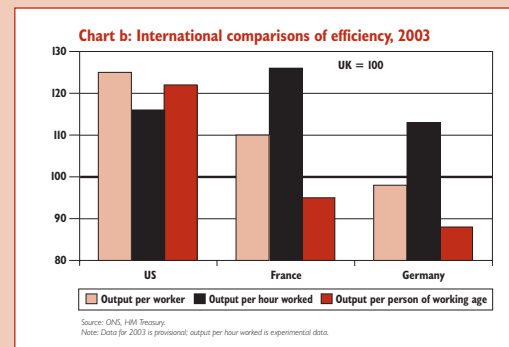
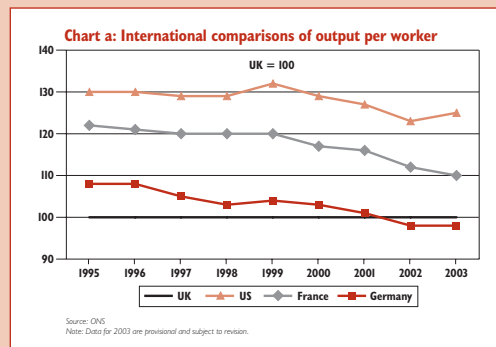
3.4 Continuing productivity growth will be key to long-term success in an increasingly integrated global economy. *Long term global economic challenges and opportunities for the UK*, published alongside the 2004 Pre-Budget Report, set out the challenges over the next ten years for the UK economy. The global economy is undergoing a profound transformation, with far-reaching and fundamental changes in technology, production and trading patterns. The rapid growth of large emerging markets, in particular China and India, is shifting the balance of global economic activity. Global markets can deliver significant benefits for

economic growth and productivity and enhance living standards by providing new opportunities for UK businesses to trade. The Government has prioritised making progress on multilateral trade liberalisation and is seeking to strengthen economic co-operation with major partners such as the US.

Box 3.1: UK productivity performance

Historically, UK productivity has been lower than in other major economies. However, recent data show clear signs that the UK is catching up on both of the key measures of labour productivity – output per worker and output per hour worked. The UK has narrowed the output per worker gap with France to 10 per cent from 22 per cent in 1995. Despite a slight widening in 2003, the gap with the US has narrowed to 25 per cent over the same period, and the productivity gap with Germany closed in 2001. On an output per hour basis the UK has further to catch-up, although steady progress is being made.

The UK performs relatively well in terms of output per person of working age, a measure which reflects both employment and productivity performance. This measure is closely related to prosperity and indicates how effectively an economy is using all of its potential labour resources. On this measure, UK performance is over 12 per cent higher than Germany and similar to France. However, the UK lags behind the US, which combines high labour productivity with high employment.



Between 1997 and 2001, the trend rate of underlying productivity growth (on an output per hour basis) is estimated to have grown by 2.7 per cent a year in the UK. This compares favourably with the previous economic cycle of just over 2.2 per cent a year. This improvement is encouraging, although it is too early to say definitively whether it will be sustained.^a

It is important to sustain recent progress on productivity growth to ensure that the UK is equipped to meet the long-term challenges of the global economy. The Government will continue to implement a programme of microeconomic reforms with the ambition of raising the productivity of British workers to a level comparable with the best in the world. A new set of productivity indicators^b launched in 2004 allows the Government to monitor progress towards its productivity target, highlights how the UK is performing against its major competitors on key dimensions of each of the five productivity drivers and provides early warning of where more policy action may be needed.

a: Chapter B sets out the trend productivity and trend growth projections.

b: HM Treasury and DTI Productivity Indicators, available at www.dti.gov.uk/economics.

Global challenges for Europe 3.5 *Long-term global economic challenges and opportunities for Europe*, published alongside this Budget, examines the implications for Europe's policymakers of changes in the global economy over the coming decade. As outlined in Chapter 2, through its Presidency of the EU in the second half of 2005, the UK will aim to develop a consensus on the need for a more global Europe, which by becoming more outward looking and embracing greater

flexibility in labour, product and capital markets, delivers higher growth and employment for its citizens. To improve the pace and focus of structural economic reform in Europe, the 2004 spring European Council launched a Mid-Term Review of the Lisbon strategy¹ and invited Wim Kok, former Prime Minister of the Netherlands, to report on this issue ahead of the 2005 spring European Council. The Government agrees with the central recommendation of Wim Kok's High-Level Group,² reiterated in the European Commission's February 2005 communication to the European Council,³ that the EU should focus its actions on raising growth and employment and will continue to work closely with other Member States and EU institutions to advance structural economic reform in Europe.

Productivity in the regions

3.6 The Government is committed to boosting productivity across all countries, regions and localities of the UK. Its goal is to make sustainable improvements in the economic performance of all UK regions and reduce the persistent gap in growth rates between the regions in the long-term. The Government believes that the best way to improve the productivity of the regions and to overcome regional disparities in economic performance is to allow each area the freedom and flexibility to exploit local sources of growth. The Regional Development Agencies (RDAs), as strategic leaders of economic development in the regions, working with local authorities and other partner organisations, have a good understanding of the opportunities and restrictions that they face in their efforts to enhance regional and local economic performance.

3.7 In recognition of this, the RDAs were asked to contribute to the development of Budget 2005 in a number of key policy areas: enterprise; skills; the development of science cities; aligning regional budgets; sustainable development; and the role of the voluntary and community sector in economic development. Budget 2005 announces measures developed with and building on the RDAs' input. These are detailed in this chapter and include a new framework for intensive business support developed by the East Midlands Development Agency which will be adopted by all RDAs; the designation of further science cities; a package of measures to ensure that small and medium enterprises (SMEs) maximise design and creativity in their businesses; a programme to allow SMEs to compete more successfully for public sector procurement contracts; a consultation document on developing a new devolved Local Enterprise Growth Initiative to promote enterprise in deprived areas; and an update on the development of Regional Skills Partnerships.

¹ *Brussels European Council: Presidency conclusions*, March 2000.

² *Facing the challenge: The Lisbon strategy for growth and employment*, High Level Group chaired by Wim Kok, November 2004.

³ *Working together for growth and jobs: A new start for the Lisbon Strategy*, Communication to the Spring European Council, COM (2005) 24, Brussels, February 2005.

Inter-regional growth strategies **3.8** The three northern RDAs, along with other regional partners, published the Northern Way Growth Strategy Report in September 2004.⁴ At the Sustainable Communities Summit in January 2005, the Northern Way published a progress report,⁵ which included updates on the strategy's plans for enterprise education, building up research capacity, raising the level of skills and promoting inward investment into the North. The report also included the Government's response to the strategy, welcoming the proposal for a Northern Transport Compact to help identify strategic priorities for transport investment in the north to support long-term economic growth, and agreeing that the Northern Way's additional £10 million investment to enhance the Pathways to Work pilots in the North should inform future decisions about the national scheme. Budget 2005 provides further support to the Northern Way through national initiatives including the National Employer Training Programme and the new Local Enterprise Growth Initiative, and welcomes the RDAs' establishment of a Northern Design Centre in Newcastle/Gateshead to strengthen creative industries. The Northern Way Action Plan will be published in April 2005. Both the Midlands and the South West also published strategies at the Sustainable Communities Summit as responses to the Sustainable Communities Plan.⁶

COMPETITION

3.9 Competition is essential to an efficient economy and is strongly correlated with productivity performance. A strong competition framework drives productivity by putting downward pressure on prices, increasing the diversity and quality of products available to consumers, and driving innovation. It will also prepare the UK to respond to the challenges of the global economy where international markets are becoming increasingly competitive as their geographical scope and accessibility expand.

3.10 Radical reform of the institutional framework of the competition regime has been central to the Government's strategy for promoting competition. The reforms have made the competition authorities stronger, more pro-active, and responsible for making decisions on specific cases independently from Government. The Government has also introduced structural reforms to promote competition in specific markets. The latest international peer review of competition regimes ranked the UK regime third globally, and described the UK competition authorities as having all the necessary powers to develop a world-class competition regime.⁷

Competition in specific markets

3.11 Using its powers under the Enterprise Act 2002, the Office of Fair Trading (OFT) keeps markets under review to ensure that they are working well for consumers. Current and recently completed studies include the markets for ticket agents, care homes and property searches. The OFT has also completed an initial study on an economic framework against which to assess the types of and delivery methods for government subsidies, their impact on competition and how such impacts might be minimised. The OFT is currently working to develop more specific recommendations. The Government also believes that the pro-active enforcement of competition policy is key to increasing productivity in EU markets. In February 2005, the European Commission's Communication to the Spring European Council promised that "*sectoral screenings of the barriers to competition will be launched in sectors*

⁴ *Moving Forward: the Northern Way – First Growth Strategy Report*. Available at www.thenorthernway.co.uk.

⁵ *Moving Forward: the Northern Way – Progress Report*. Available at www.thenorthernway.co.uk.

⁶ *SMART Growth: The Midlands Way*. Available at www.emda.org.uk/midlandsway. *The Way Ahead: Delivering Sustainable Communities in the South West*. Available at www.southwestrda.org.uk

⁷ *Peer Review of Competition Policy*, KPMG and the Department for Trade and Industry, May 2004. Available at www.dti.gov.uk.

such as energy, telecoms and financial services". The Government strongly supports this action.

Payment systems 3.12 Payment systems play a crucial role in the economy. The Government continues to believe that improved competition and efficiency in these systems would deliver significant benefits to the UK. Innovation, price inefficiency, access and governance are key issues related to improving competition and efficiency in these systems. The Government welcomes the plans of the Payment Systems Task Force, chaired by the OFT, to examine these issues across all payment schemes in the UK. If successful in resolving the outstanding issues, the Government believes that the Task Force will improve competition in payment systems while being more flexible and less costly than legislation.

3.13 The Government looks forward to the conclusion of the Task Force's work on faster electronic payments in April 2005. The Government notes that progress has been made in some aspects of this work and looks forward to further progress on some outstanding issues. The Government also notes that the industry has agreed to form an implementation group that will decide by the end of 2005 how to implement the Task Force's recommendations. Unless the Task Force, and subsequent action by the industry, leads to significant improvements in competition and efficiency, the Government will legislate to tackle these issues. The Government will consider the forthcoming conclusions of the Task Force on faster electronic payments, and the work of the implementation group, in this context.

Home credit 3.14 Following its analysis of a super-complaint submitted by the National Consumer Council, the OFT has referred the supply of home credit to the Competition Commission for further investigation. The Competition Commission is also currently investigating the markets for liquefied petroleum gas (LPG) and store card credit services.

Competition in the supply of goods and services to Government

3.15 The Government is committed to achieving greater value for money through improved competition in the supply of goods and services to the public sector and helping business to maximise the opportunities offered by public sector procurement. The Office of Government Commerce (OGC) is implementing the recommendations of Sir Christopher Kelly's report⁸ on increasing competition and improving capacity in public sector procurement. Work on the first market selected by the Kelly Review – construction – is near completion and a briefing event will set out, in April, a strategic approach to construction procurement reflecting both demand and supply, which together with improved industry consultation should lead to greater predictability of the project pipeline. The programme will focus on a second market – waste management.

Improving access to public sector markets in Europe 3.16 Alan Wood's report on EU public procurement⁹ identified significant obstacles to competition in EU public procurement markets, and made fifteen recommendations to achieve improvements, including the promotion of best procurement practice and the use of competition tools to open markets in sectors relevant to public procurement. The Government is working with the European Commission and other Member States to implement the report's recommendations, particularly by implementing a new action plan to drive up use of new techniques such as e-procurement, developing new indicators to enable better measurement of performance, and actively promoting best practice in public

⁸ *Increasing competition and improving long-term capacity planning in the Government market place*, Office of Government Commerce, December 2003.

⁹ *Investigating UK business experiences of competing for public contracts in other EU countries*, Office of Government Commerce, November 2004.

procurement through networks of procurement agencies. The Commission has also made clear that stricter enforcement of procurement rules will be one of its top priorities in improving the functioning of the Single Market.

ENTERPRISE

3.17 Enterprise is a key driver of a modern, dynamic economy and is crucial in ensuring that the UK is well-placed to prosper in increasingly globalised markets. A vibrant small business sector creates wealth and employment, generates competitive pressure that drives innovative activity and improves the range, quality and prices of goods and services for consumers. There are 4 million SMEs in the UK, accounting for more than 50 per cent of business employment and 52 per cent of business turnover.¹⁰ Rates of entrepreneurial activity in the UK compare favourably with those of other European economies, but lag behind those in the US.

3.18 The Government is committed to improving the UK business environment and tackling barriers to business growth to allow the UK to fulfil its potential in the global economy. The Government's strategy has focused on five areas: regulatory reform; modernising and simplifying the business tax system; improving access to finance for small business; improving business support services and encouraging enterprise in disadvantaged areas; and promoting an enterprise culture.

Leading regulatory reform

3.19 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and increasing competition. Society expects the Government to provide protection for the general public, consumers and employees consistent with the best international standards, and these expectations grow over time. However, the Government believes that inefficient regulation can impose a significant burden on business, and has pursued a programme of reforms to deliver better regulation against five principles: proportionality, accountability, consistency, transparency and targeting.¹¹ The Government's approach focuses upon:

- ensuring that regulation is used only where necessary, that it is not 'goldplated' if it originates from the EU law, that it is only used to achieve policy outcomes for which there is a clear rationale and where alternatives to regulation are not feasible;
- minimising the administrative burdens upon business of understanding regulations and complying with them, including the costs of paperwork, undergoing inspection and complying with enforcement activity; and
- pursuing an agenda of regulatory reform in Europe, because around half of all significant new regulations affecting UK businesses originate in the EU.

3.20 This Budget outlines the next steps in the Government's agenda to deliver better regulatory outcomes while driving down the costs to businesses of complying with regulations, especially for smaller businesses. It builds upon the reforms already made, and sets out the steps needed to ensure that regulations, and the ways in which they are administered, are proportionate to the risks that they seek to address. It also outlines the Government's approach to working with other European nations and applying in Europe the principles of better regulation that it applies at home.

¹⁰ *Statistical Press Release*, Small Business Service and Office of National Statistics, August 2004.

¹¹ *Principles of Good Regulation*, Better Regulation Task Force, January 1998.

Regulating only where necessary

3.21 Since 1997, the Government has built a robust process for designing and scrutinising regulatory proposals, to ensure both that new regulations are introduced only if they are absolutely necessary and that they are proportionate to the problems that they are designed to tackle. The Government has now implemented more than 400 of the measures identified for reform in its Regulatory Reform Action Plan published in December 2003, and has laid 28 Regulatory Reform Orders before Parliament, 21 of which are now on the statute book.

Rigorous regulatory accountability

3.22 As announced in Budget 2004, the Prime Minister's Panel for Regulatory Accountability (PRA) has been established to hold departments to account for their regulatory performance. It scrutinises all new regulatory proposals that impose a significant cost upon business. In doing so it provides a rigorous mechanism through which the flow of new regulations is reduced, and through which the quality of the regulations that it approves is enhanced. The PRA continues to reject and delay a significant proportion of regulatory proposals, where departments have not properly justified extra burdens on business. It is delivering significant benefits for business, including commitments from the Department for the Environment, Food and Rural Affairs (DEFRA) to reduce the costs to business of complying with its regulations by 25 per cent, and from the Department of Trade and Industry (DTI) similarly to reduce the costs it imposes by £1 billion, both as part of their departmental five-year plans.

3.23 All government departments have to complete Regulatory Impact Assessments (RIAs) for new regulatory proposals. The 2004 Pre-Budget Report announced a strengthening of this system and said that regulations should also be reviewed after they are implemented to ensure that they are having the intended effect. Departments will have to set out how the regulations for which they are responsible are going to be monitored using post-implementation reviews before they are introduced.

Removing unnecessary regulations

3.24 The Government wants to increase the emphasis at the heart of the regulatory process upon the simplification and removal of regulations. The Prime Minister therefore asked the Better Regulation Task Force (BRTF) to produce a report, which is published alongside the Budget and summarised below in Box 3.3. The report recommends that the Government adopt an approach to new regulation that forces departments to prioritise between new regulations, and remove unnecessary regulations. In accordance with the Government's acceptance of the BRTF's recommendations, as set out below, the Budget announces that the Government is committing to:

- **always explore options for removing unnecessary and outdated regulations as part of the RIA process when new regulations are being proposed.** The PRA will expect to scrutinise proposals for simplifications alongside new regulations, and may reject proposed regulations unless the scope for off-setting simplifications has been addressed;
- **always respond, in detail and within 90 days, to suggestions made to government by businesses and business groups for regulatory simplifications;** and
- include from April 2005 **appropriate objectives on better regulation and reducing bureaucracy in the personal objectives of civil servants** and, as set out in the 2004 Pre-Budget Report, take part in a new award for civil servants who deliver innovative and deregulatory solutions to policy problems.

EU regulation: 3.25 The Government has to make decisions about how to apply, administer and enforce in the least burdensome way new regulations emerging from the EU. **The Government is publishing alongside the Budget new guidelines for the transposition of European legislation into UK law.**¹² These will ensure that the UK implements EU laws in the clearest and least burdensome way possible, so that they can be administered in accordance with the principles of good regulatory practice set out by the Hampton Review. The guidance establishes the principle that transposed UK laws should mirror as closely as possible the wording of the original EU directive and the need to work with other Member States to understand different approaches to transposition and share best practice, so that the relative burdens of the different approaches are understood. The guidelines also put in place new procedures for ensuring that Parliament and the public are better able to understand the implications of transposed legislation and identify any proposed over-implementation. The guidance also sets out new checks, through the PRA, to ensure that the negotiation and transposition of European legislation is properly scrutinised. Any proposed over-implementation of EU law will also need specific approval from the PRA.

Box 3.2 Deregulation in financial services markets

Following the Government's review last year of the **Financial Services and Markets Act 2000 (FSMA)**, the Government is taking forward the following initiatives to enhance further the regulatory environment for the financial services sector in the UK:

- considering the case for introducing a more effective and simplified financial promotions regime, in line with EU requirements;
- making the regulated activities regime easier to follow, and making requirements on the disclosure of shareholdings more market-focused;
- simplifying and lightening the FSMA controllers regime, under which individuals must notify the Financial Services Authority (FSA) when they hold any of a range of controlling relationships over regulated persons;
- reducing some of the burdens and restrictions placed by FSMA on the FSA, enhancing the FSA's efficiency and enabling it to reduce compliance burdens; and
- applying common commencement dates to statutory instruments made under FSMA, wherever possible and practical.

Reducing the administrative burden of regulation

3.26 As well as pursuing better and more proportionate regulation overall, the Government believes that the costs to businesses of administering regulations should be as low as they possibly can be without jeopardising regulatory outcomes. The time and expense incurred by businesses when trying to comprehend regulations, fill in paperwork and deal with inspections, is time that could otherwise be productively deployed in the running of the business. As such, the Government has worked to make regulations more transparent to understand, easier to comply with and created consolidated regulatory bodies such as Ofcom and the Financial Service Authority to rationalise regulatory structures in some sectors.

¹²Available at www.cabinetoffice.gov.uk

3.27 The Budget builds upon the measures outlined in the Pre-Budget Report by helping business to comprehend the regulations with which they need to comply by:

- extending the use of common commencement dates for new regulation, not only to new sectors as announced in the 2004 Pre-Budget Report, but also wherever possible **using common commencement dates for the commencement of the new simplification measures** that will be outlined in the plans that departments present to PRA; and
- **rolling out ‘Regulation Updates’ guidance for all new or significantly changed regulations.** Designed for SMEs, businesses can see at a glance what is being introduced, whether it applies to them, and what they have to do about it.

**Reducing
administrative
costs**

3.28 The BRTF was asked by the Prime Minister in 2004 to examine the merits of an approach taken in the Netherlands, where the Government has pursued targeted reductions for the costs to business of administering regulations. It was also asked to examine the merits of a ‘one-in, one-out’ approach to making regulations. Box 3.3 describes the findings of the BRTF report.

Box 3.3: BRTF Report: Less is more. Reducing burdens, improving outcomes

The BRTF’s report to the Prime Minister argues that the regulatory burden upon British business could be reduced if the Government adopted an approach similar to one applied since 2002 in the Netherlands. This involves first measuring the administrative costs to business of complying with regulations – i.e. those costs of familiarisation, form-filling and enforcement not directly attributable to the policy goal being pursued – and then setting a target to reduce them over time. The report also says that the Government should pursue a number of measures to force departments to prioritise between creating new regulations, and simplifying and removing existing regulations. It makes eight recommendations to the Government on ways in which it could introduce a greater focus upon regulatory simplification into the regulation-making process, through:

- adopting the Dutch method of measuring the administrative burden of regulation, and setting an independently monitored target for reducing the burden;
- establishing a system for businesses to suggest regulatory simplifications to government;
- developing, for each department, rolling simplification programmes to deliver regulatory simplifications on a consistent and systematic basis;
- being obliged always to explore regulatory simplification measures as part of the RIA process when new regulations are being proposed;
- reviewing the effectiveness of the Regulatory Reform Act and use of Regulatory Reform Orders where they can be used to simplify regulations;
- making parliamentary time for a Deregulation Bill where primary legislation is required to simplify regulations;
- extending the use of Common Commencement Dates, including to the commencement of regulatory simplification measures; and
- beginning to develop a methodology to measure the cumulative cost of regulatory proposals and reassess the merits of introducing ‘regulatory budgets’.

3.29 The Government welcomes the BRTF's report, and accepts its recommendations. It commits itself to a process of assessing the existing costs to business of administering regulations, including the time needed to comply with regulations and other costs including form-filling, inspections, data retention requirements, comprehension costs and, where relevant, the costs of license or permit applications. It will undertake this process using a common methodology on a departmental basis for all departments responsible for regulating business activity.

3.30 All departments responsible for aspects of business regulation will present to the PRA, by the 2006 Pre-Budget Report, their assessments of these costs and their plans for delivering reductions in the administrative burden of their regulations over time. Departments will achieve these reductions through their implementation of the recommendations of the Hampton Review, as outlined below. The PRA, based on this information, supported by the new Better Regulation Executive described below, will set a stretching but achievable target or targets and ensure their delivery.

Lowering the burden of compliance **3.31** In Budget 2004, the Chancellor asked Philip Hampton to lead a review into the burden on business of regulatory inspection and enforcement with a view to reducing the burden on business of complying with regulations to the minimum level necessary with maintaining the UK's excellent regulatory outcomes. The interim report of the Hampton Review was published alongside the 2004 Pre-Budget Report, and identified a range of possible reforms, centred around the application of risk-based regulatory enforcement, that could spread best practice across all regulatory bodies. The Review has consulted with businesses, regulators and other stakeholders upon these proposals and, as outlined in Box 3.4, Philip Hampton publishes his final report alongside the Budget.

Box 3.4: The Hampton Review. Reducing administrative burdens: effective inspection and enforcement

The final report of the Hampton Review finds that the administrative burden upon business from regulatory inspection and enforcement is significant. The 63 national regulators within the scope of the Review perform at least 600,000 inspections and send out 2½ million forms to businesses each year. In addition, local authorities conduct at least 2½ million inspections.

The final report outlines a balanced package of reforms that will reduce the costs to businesses of complying with regulations. It sets out a number of common principles that it recommends all regulators should follow and which, once implemented, will result in a step change in their culture and management:

- regulators should take a risk-based approach across all of their enforcement activities, so there should be no inspection of businesses without a reason, and regulators' resources and inspection activity should consequently be strengthened in the areas where the risks are greatest;
- information requirements should also be based on risk based assessment to reduce the number of forms and requests for information. The number of forms that businesses have to fill in should be reduced, through greater sharing of data between regulators;
- all new forms sent to businesses by regulatory bodies should have US-style 'time to complete' statements on them, and business reference groups should vet all forms for their business-friendliness before they are introduced;
- the penalty regime should be based on managing the risk of re-offending, and the impact of the offence, but there will be tougher penalties for 'rogue businesses' that persistently break the rules;
- there should be a greater focus upon giving advice and support to businesses on how to comply with regulations and regulators should provide advice on regulatory compliance to any business that asks for it;
- all regulators should set out standards for service delivery, and publish an annual report setting out their performance against them; and
- new policies should be made with a view to using, wherever possible, existing regulators' inspections, forms and enforcement mechanisms.

The Hampton Review identified a total of 674 different bodies at local and national level that administer regulations upon business. This current structure is fragmented and diffuse with little coordination between different bodies, causing overlap and duplication in many areas. The review believes that a confusing and complex regulatory structure imposes potentially avoidable administrative burdens on business, and that a more joined-up approach would improve regulatory outcomes overall. It therefore recommends a significant consolidation of existing regulatory bodies, with 31 existing national regulators being absorbed into seven thematic bodies over the next four years. The Review also recommends reforms to improve the coordination of local and national regulatory services to deliver greater consistency for businesses.

The Hampton Review's recommendations represent a far-reaching programme through which regulatory burdens upon businesses will be reduced. To manage the implementation of its advocated reforms, and to ensure a consistency of approach across the public sector, the review recommends that a stronger, and more accountable regulatory framework is needed at the heart of government.

3.32 The Government welcomes the final report of the Hampton Review and accepts its recommendations in full and will bring forward early legislation to implement them. The Government has asked Philip Hampton to work with it to ensure effective implementation of his recommendations. The Government believes that a risk-based approach should be applied by all regulatory bodies in all aspects of their work, including when making data requests from businesses, when shortening forms, when applying penalty regimes and when applying systems of inspection and enforcement. The benefits of a risk-based approach are that it focuses regulators' resources in those areas where the risks to society are greatest, ensuring inspections of riskier businesses that may not otherwise take place, delivering better regulatory outcomes overall and substantially reducing the costs incurred by the majority of low-risk businesses. Many regulators within the scope of the review operate in Wales, Scotland and Northern Ireland, and the recommendations on these bodies will need to be implemented following discussion between the Government and the Devolved Administrations.

Helping businesses comply **3.33** At the same time, regulators should focus greater resources upon providing comprehensive advice to businesses and do more to help them understand and comply with regulations easily and cheaply. As a result of the consolidation of national regulators, businesses should have to deal with many fewer regulatory bodies than before and be able to get clear helpful advice on how they can comply with regulations. The acceptance of the Hampton Review's recommendations will also mean that in the future forms will be shorter, simpler, written in plain English, and designed around business practices. The implementation of these recommendations will be the way in which departments deliver against the targets set by the PRA for the reduction in the administrative burden to business.

Strengthened regulatory scrutiny

3.34 The final report of the Hampton Review, and the report of the BRTF, recommend that stronger and more independent structures of regulatory accountability are needed at the centre of government to deliver effective implementation of their recommendations. Enhanced accountability will not interfere in individual regulatory decisions or regulators' independence, but should hold regulators to account for their delivery against their own performance indicators for reducing the burden to business of administering regulation and help to spread best practice between regulatory bodies.

3.35 The Government intends to deliver the ambitious regulatory reforms set out in the Budget by establishing a new Better Regulation Executive (BRE) in the Cabinet Office. The BRE will take on the work carried out by the existing Regulatory Impact Unit; drive delivery across Whitehall of the Hampton-led reductions in the administrative burden of regulation upon business against the targets recommended in the BRTF's report, and support the PRA in holding departments and regulators to account.

3.36 The BRE will be led by a person recruited from outside central Government, with a management board including several non-executive members recruited from the private sector. The BRE will bring greater weight to the delivery of regulatory policy across Government and will be responsible amongst other things for:

- driving departmental implementation of the recommendations of the Hampton Review;
- leading the work on reducing administrative burdens and the process towards setting targets for the reduction of the administrative burden of regulation;
- providing a secretariat function to the PRA, holding departments to account for the delivery of better regulation;

- holding regulators to account for their performance against the principles of good regulation set out by the Hampton Review;
- providing robust advice to Government on better regulatory policy, both in the UK and at the European level; and
- challenging departments on their RIAs and on their delivery plans for meeting their administrative burden targets.

3.37 The Government will set out plans to transform the BRTF into a new **Better Regulation Commission (BRC)** to sit alongside the BRE and provide independent advice to government from business and other stakeholders about new regulatory proposals, and about the Government's overall regulatory performance. It will continue the work of the BRTF and take on new responsibilities for monitoring the ambitious reforms set out in this Budget, including vetting departmental plans for administrative burden reduction. The Government also expects the BRC to work with business organisations and others to make proposals to government for regulatory simplification.

3.38 Finally, it is important that the performance of departments and regulators in implementing these changes is independently monitored. The BRC are well placed to do this on an ongoing basis, but there also need to be rigorous retrospective reviews of performance. The NAO should therefore be invited to take an enhanced role in overseeing the technical evaluation of departments and regulators in reducing the burden to business of administering regulation by reporting to Parliament on:

- departments' performance against their targets for the reduction of the administrative burden of regulations and, where relevant, their performance in establishing the new regulators recommended by Hampton; and
- regulators' performance against the Hampton Review's recommendations and principles.

3.39 These new arrangements represent a rigorous and transparent framework within which the Government's performance will be scrutinised. This strengthened institutional framework will support departments' efforts to progress regulatory reform, and hold government to account for the delivery of the radical changes that it is committing itself to make.

Regulatory reform in Europe

Regulating only where necessary in the EU

3.40 About half of all significant new regulations affecting UK businesses originate in EU law. The Government is therefore committed to promoting comprehensive reform of the EU regulatory framework and will found its approach to European regulation on the same risk-based principles recommended by the Hampton Review. Building on the progress of the Four Presidencies' initiative, in December 2004 the Finance and Economics Ministers of Ireland, the Netherlands, Luxembourg, the UK, Austria and Finland launched an updated and extended initiative, *Advancing Regulatory Reform in Europe*,¹³ establishing regulatory reform as a priority of the six EU Presidencies through to the end of 2006. The initiative presented a series of concrete proposals for ongoing reform of the regulatory regime in Europe, including to further develop the competitiveness testing of all new regulations, exercise stronger and more effective control over the administrative burdens associated with EU regulation, make faster progress in simplifying the existing stock of EU laws, and improve business input into the regulatory reform process.

¹³ *Advancing regulatory reform in Europe*. A joint statement of the Irish, Dutch, Luxembourg, UK, Austrian and Finnish Presidencies of the European Union, 7 December 2004.

Box 3.5: European regulatory reform

In the past year significant progress has been achieved in reforming the regulatory framework in Europe. The Commission's communication to the spring European Council, noted that “[better regulation] will be the cornerstone for decision making at all levels of the Union”. Since the launch of the Four Presidencies' Statement in January 2004^a the initiative has been extended to six Presidencies, and:

- agreement has been reached on the principal elements of competitiveness testing, to ensure that all new regulatory proposals are properly scrutinised for their impact on jobs and competitiveness;
- as of 2005, the Commission is submitting all legislation set out in its legislative and work programme, as well as the most important cross-cutting non-legislative proposals, to an impact assessment;
- fifteen priority areas of regulation have been identified by the Council for simplification, marking an important step towards reducing burdens in the stock of existing EU legislation; and
- work is now underway to develop a methodology for measuring the size of administrative burdens imposed by new and existing regulations, so that such assessments may be included in all future impact assessments.

In addition, a number of concrete steps have been taken to reduce the regulatory burden of EU legislation:

- consultation with business, as part of an extended impact assessment of the European Commission's proposal for the registration, evaluation, and authorization of chemicals (REACH) directive, has resulted in at least £6 billion savings to business;
- in negotiating the end of life vehicles legislation, the cost to business was reduced from £100-£150 per car to around £25 per car through a focus on a light touch regulatory approach. This reduced overall costs from £200 million to £40 – 80 million a year while retaining the environmental objectives of the directive; and
- as a result of an extended impact assessment^b involving extensive consultation with business, the Commission chose not to impose a single standard for digital interactive television services, which would have had a negative impact on the UK digital television industry. Instead they have opted to allow the market to develop freely.

a: *Joint Initiative on Regulatory Reform*, An initiative of the Irish, Dutch, Luxembourg and UK Presidencies of the European Union, 26 January 2004.

b: Brussels, 30.7.2004, SEC (2004) 1028.

Simplifying tax administration for small business

3.41 The Government is committed to a modern, fair and efficient business tax system that can contribute to enterprise by encouraging investment and keeping pace with changes in business practice and the global economy. The Government has already introduced a number of reforms to business taxes since 1997, including cutting the main rate of corporation tax by 3 percentage points to 30 per cent and the small business rate by 4 percentage points to 19 per cent – the lowest levels ever – and reducing capital gains tax.

3.42 The tax authorities were not within the remit of the Hampton Review or the BRTF report, in recognition of the different nature of the enforcement of the tax system from the inspection and enforcement of other government regulations. However, many of the principles set out by the review apply equally to the activities of the tax authorities. In keeping

with the principles set out by both the Hampton Review and the BRTF report, the Government has already acted to simplify the business tax system, minimise administrative burdens on business and remove unnecessary barriers to innovation, for example by introducing measures to reduce the administrative burden of VAT.

3.43 Inland Revenue and HM Customs and Excise have today published *Working towards a new relationship: a consultation on priorities for reducing the administrative burden of the tax system on small business*. **This sets out how, consistent with the recommendations of the Hampton Review, the Government will realise the benefits to small business of the integration of the Inland Revenue and HM Customs and Excise.**¹⁴ It describes a number of near-term reforms, including cutting the tax return for 500,000 of the smallest businesses from sixteen pages to four, as well as rolling out new ways of paying and managing VAT online. The paper also seeks views from smaller businesses and their advisers on what the priorities for the new department should be in order to improve their relationship. In particular, it describes how in future small business customers can expect to:

- provide information only once, with information, where possible, flowing seamlessly from business systems to those of the new department without the need for forms or returns;
- benefit from a range of modern flexible payment options that suit their business needs;
- spend less time dealing with inspections, with no inspection without a reason and all enforcement activity informed by more sophisticated risk assessment;
- enjoy a single point of contact with the new department for all their tax affairs, either on-line or by phone. This will give them or their adviser access to the details of their tax account – the same details the department’s staff will see; and
- benefit from co-ordinated, clear and helpful support and education that will help them comply with their tax obligations at key stages in the development of their business.

Targets for reducing compliance costs

3.44 To benchmark and monitor progress in delivering real reductions in the administrative burden imposed on compliant small businesses by the tax system, both departments are already developing stretching targets that will be consistent with the new department’s objective to ensure that the tax system is fair for all business. They will be published and progress against them monitored.

Operational Impact Assessments

3.45 **The new department will publish impact assessments of all changes to a form, or changes to a business practice that could have a significant impact on businesses.** These Operational Impact Assessments will complement existing Regulatory Impact Assessments already carried out on new laws and regulations and will mean that for the first time any change that could have a significant impact on business will be assessed, with the results made public. The first such assessment – on the new short Self Assessment return – has been published today.¹⁵ This shows that the change will mean overall savings of £20 million for all taxpayers, including £5 million for business.

¹⁴The Commissioners for Revenue and Customs Bill which provides the legislative framework for integration has nearly completed its parliamentary passage and the Government expects the new department to be launched shortly.

¹⁵Available on the Inland Revenue website: <http://newinternet.inrev.gov.uk/menus/consult.htm>.

Tax credits: 3.46 Following consultation with representatives of employers and other interested parties, **the Government will phase out the payment of Working Tax Credit via employer payment via employers (PVE) between November 2005 and April 2006.** 1.2 million small businesses stand to benefit from this reform and the new tax department and employers will be issuing targeted publicity to make employees aware of the changes that will result from the phasing out.

VAT and small business 3.47 The Government has introduced simplified schemes to reduce the administrative burden of accounting for VAT. The Flat Rate Scheme, under which the requirement to account for every VAT transaction is replaced by one flat rate payment which can reduce a firm's costs by up to £600, has been extremely successful. Take-up has risen from under 17,000 to around 73,000 over the last 18 months. However, there are 600,000 eligible firms in total, and so **the new tax department will work together with the British Chambers of Commerce on a take-up campaign to ensure that more firms understand the benefits of the scheme.**

Further modernisation of the business tax system

VAT registration threshold 3.48 From 1 April 2005 the Government will increase the VAT registration threshold in line with inflation from £58,000 to £60,000, maintaining the highest threshold in Europe and helping to keep up to a further 5,000 of the smallest businesses out of the VAT system.

Corporation tax reform 3.49 A Corporation Tax Reform Technical Note¹⁶ was issued at the 2004 Pre-Budget Report. A number of constructive consultation meetings have been held on the issues raised in the Technical Note and on the wider international context in which the UK corporation tax system operates. The Government is grateful for businesses' contributions to this debate and for written comments received, which will help ensure that the Government can take forward reform with a clearer understanding of businesses' priorities.

Film tax reform 3.50 In the 2004 Pre-Budget Report the Government announced a review of the tax relief for large budget films, to ensure that it remains effective at delivering Government objectives for supporting a sustainable UK film industry. The Government has concluded that the current structure of the relief is no longer effective for this purpose and **intends to replace it next year with a structure that is similar to the new tax relief model that has been proposed for low budget films.** The Government will therefore conduct a formal consultation on draft legislation and retain the existing relief until an orderly transition to its replacement can be effected.

3.51 Details of the new tax relief for low budget films were launched in an Inland Revenue Technical Note in September 2004.¹⁷ The Government is committed to the principles and terms of the proposed new relief but understands that the industry has concerns, in the short term, about its practical operation. **The Government has therefore decided to extend the current relief for low budget films.** This will enable the formal consultation on draft legislation to consider issues across the entire film sector and will ensure that tax reliefs for low and large budget film production are provided on a coherent and consistent basis. The transition from the current to the new film tax reliefs will then be effected next year, subject to state aids clearance.

¹⁶ *Corporation Tax reform: Technical Note*, Inland Revenue, December 2004.

¹⁷ *Tax Relief for the Production of Low Budget British Films*, Inland Revenue, September 2004.

Promoting enterprise in the regions and in disadvantaged areas

3.52 The Government is committed to economic and business development across all the regions of the UK and believes that regions themselves should play a key role in determining their priorities. Raising levels of enterprise and economic activity is essential to sustainable regeneration in the UK's most disadvantaged communities. Since 1997, the Government has acted to improve the delivery of business support services to small businesses and enterprise through a programme of regionalisation, including devolving the control of Business Links to RDAs. It has also designated 1,997 Enterprise Areas in the most deprived wards in the UK, in which a number of specific policies to boost enterprise have been focused, including the Community Investment Tax Relief and the Phoenix Development Fund.

3.53 The Government wants to empower local areas with the freedom and flexibility to develop local approaches to enterprise and growth in disadvantaged areas, which respond to local needs. Therefore, the Government is introducing a new **Local Enterprise Growth Initiative (LEGI)**, worth £50 million in 2006-07 and rising to £150 million by 2008-09 (subject to confirmation in the next Spending Review), which will operate through local area agreements to support locally developed proposals to promote and remove barriers to enterprise in the most deprived areas of England. A consultation document is being issued today to determine the final details of the LEGI, described further in Box 3.6.

Box 3.6: A Local Enterprise Growth Initiative

The Local Enterprise Growth Initiative (LEGI) will provide significant and flexible investment in the most disadvantaged areas of England – determined by the Neighbourhood Renewal Fund areas – to support locally developed proposals that promote economic activity and growth through enterprise development – thereby boosting local incomes and employment opportunities. It will focus on helping local communities to achieve long-term changes in the business environment in deprived areas, building indigenous strength and making them more attractive places to do business. As a result of this investment, the Government wants to see more businesses starting-up; fewer businesses failing; stronger growth from locally-owned business; more businesses locating in these areas; and more jobs for local people.

The LEGI will support proposals for long-term enterprise growth in around 30 disadvantaged local areas. Local authorities that are designated as Neighbourhood Renewal Fund areas will be able to apply to the Government Offices for financial support from the LEGI to implement long-term local proposals for enterprise growth. £10 million will be provided in 2005-06 to pump-prime the development of local enterprise and growth proposals by local authorities, in partnership with their local business communities and Regional Development Agencies. The resources to support these proposals will be channelled through Local Area Agreements wherever possible, providing local authorities with the flexibility and freedom to determine what the local priorities should be, and how to pursue them effectively.

The details of the LEGI are being consulted on from now until summer 2005, with key questions outlined in *Enterprise and economic opportunity in deprived areas: A consultation on proposals for a Local Enterprise Growth Initiative*, published alongside this Budget.

3.54 In addition, Budget 2005 announces additional funding over 3 years to:

- **boost the capacity of the New Entrepreneur Scholarships beyond the existing funding levels over the next 3 years;** and
- **provide long term support for business incubation,** building on existing feasibility studies, which are currently funded through the Phoenix Fund and the Business Incubation Fund.

3.55 Business Improvement Districts (BIDs) also provide new opportunities for improvements in local services and activities. BIDs allow local authorities and businesses to work together on agreed projects to improve their local areas through a fund raised by an additional levy on local business rates. They can be used to fund a wide range of projects such as the appointment of ‘community rangers’ to deter anti-social behaviour. As BIDs are rolled out the Government will review progress to identify any barriers to their establishment, especially in deprived areas.

3.56 The LEGI will **follow the time-limited commercial stamp duty land tax disadvantaged areas relief, which will end on 16 March 2005,** and will better target support to drive forward local enterprise development and business regeneration.

Business premises renovation allowance **3.57** Following consultation launched in the 2004 Pre-Budget Report, **the Government will legislate in the Finance Bill for the introduction of the business premises renovation allowance.** This will provide 100 per cent capital allowances in Enterprise Areas for the costs of renovating business properties that have been vacant for at least a year. The scheme will be brought into effect subject to state aids approval.

Local Authority Business Growth Incentive scheme **3.58** To create a direct financial incentive for local authorities to promote local business growth the Government is **introducing the Local Authority Business Growth Incentive (LABGI) scheme, starting in April 2005,** originally announced in the 2002 Pre-Budget Report. Under the scheme, this financial year local authorities will receive a proportion of increases in local business rate revenues to spend on their own priorities. The Government estimates that local authorities in England and Wales could gain up to £1 billion over the three years to 2007-08.

Better support and advice for small businesses

High Growth Business Coaching **3.59** The 2004 Pre-Budget Report announced that Bryan Jackson, the new Chairman of the East Midlands Development Agency, would lead the development of a framework for intensive business support for business and pre-start-ups with the potential for rapid growth. **The Government welcomes the publication today of the RDAs’ Framework for High Growth Business Coaching,**¹⁸ which sets out how they will develop and deliver in every region focused coaching for new and existing businesses with high growth prospects and for high-potential entrepreneurs in the pre-start-up phase. This new service will help entrepreneurs to meet the challenges of rapid growth, particularly in the areas of investment readiness and access to finance, developing markets, skills, innovation and technology transfer. In parallel with a range of measures to increase the contribution of creativity to productivity growth described later in this chapter, it will also assist entrepreneurs to harness creativity and design for the success of their businesses. Work over the next year will address the institutional arrangements to support coaching, and the Government welcomes plans for the RDAs and Learning and Skills Council (LSC) regions to develop the skills support component as part of their wider arrangements to identify joint priorities and plans to deliver more demand-led skills provision.

¹⁸ *High Growth Business Coaching - Executive Summary*, Regional Development Agencies, March 2005.

3.60 The Government continues to aim to improve the coherence and quality of its services through alignment of business support services. Good progress has been made on pilot projects in the North East and East Midlands to coordinate services, with the aim of making it easier for businesses to access the support they need. A pathfinder project will be launched in the East Midlands in April this year and the Small Business Service (SBS) is working with other RDAs to identify further possible pilots.

Women's Enterprise **3.61** Building on the Strategic Framework for Women's Enterprise published in May 2003¹⁹, the Government welcomes the action plan recommended by the national Women's Enterprise Panel to increase significantly the proportion of UK businesses owned and run by women. The Government will work with RDAs and other stakeholders to take these recommendations forward including that the RDAs consider proposals for Regional Women's Enterprise Units, and discussions with the banks on joint action to ensure the provision of better information for women on routes to financing their business. The Government published an analysis of the economic benefits of promoting women's enterprise earlier this month.

National Employment Panel Report **3.62** At the time of the 2004 Pre-Budget Report, the National Employment Panel was asked by the Chancellor to recommend measures to encourage employment, self-employment and the growth of small businesses for ethnic minorities and faith minority groups. Chapter 4 sets out the Panel's findings and recommendations for action.

Improving access to finance for small business

3.63 The Government is committed to addressing market failures in the supply of risk capital and improving access to finance for small business by enhancing incentives to invest in SMEs. Over £6 billion of private capital has been raised through the Enterprise Investment Scheme and Venture Capital Trusts. The Regional Venture Capital Funds, the UK High Technology Fund and the Early Growth Funding programme will collectively invest around £400 million in businesses otherwise affected by the equity gap. The Government has also introduced specific measures to improve access to finance in the UK's least prosperous communities, including the Phoenix Fund and Community Investment Tax Relief, and has supported the Bridges Community Development Venture Fund.

Enterprise Capital Funds **3.64** The Government is waiting for European state aids clearance before launching the pathfinder round of Enterprise Capital Funds (ECFs). Announced in the 2003 Pre-Budget Report, ECFs will be commercially-managed entities investing a mixture of public and private capital in potentially high-growth small businesses affected by the equity gap. The Government has published draft bidding guidance for fund managers interested in applying to establish an ECF, which will be finalised ahead of the formal launch of the programme. As announced in the 2004 Pre-Budget Report, the Government is establishing a panel to provide expert advice on the implementation of the pathfinder round of ECFs and taking forward the Graham Review recommendations for the Small Firms Loan Guarantee. If the pathfinder round of ECFs demonstrates the viability of a long-term ECF programme, the Government would seek to establish an arm's length delivery company that would take over the role of the advisory panel. Further, the Government believes that such a company should also manage the on-going delivery of all its risk-capital interventions for SMEs.

¹⁹A Strategic Framework for Women's Enterprise - Sharing the vision: a collaborative approach to increasing female entrepreneurship, Small Business Service, May 2003.

Improving access to public sector procurement for small business

3.65 The Government is also committed to improving access to public sector procurement for SMEs. SME involvement improves competition and drives innovation, and thus improves value for money in the delivery of public services. As described below, the Government is introducing a mandatory requirement that at least 2.5 per cent of public sector extra-mural R&D will be with SMEs. The SBS has today published further details of how this goal will be met,²⁰ including:

- with the involvement of RDAs, OGC and SBS will roll out measures nationwide to improve SMEs' ability to tender effectively for public sector contracts, building on the success of pilot projects in the West Midlands and Haringey which involved 1,600 businesses, increasing the number of SMEs competing for public sector projects and increasing the overall success rates of SMEs, including ethnic minority-owned businesses. In the West Midlands pilot, 14 per cent of SMEs had won government projects at the project start – by the end, SMEs had won 26 per cent of contracts awarded through the pilot portal, improving competition and innovation;
- the OGC and the SBS will launch a national portal for low-value contracts in the summer, making it easier for SMEs to compete for business;
- to improve the coverage and quality of information available on SMEs' participation in procurement opportunities, the SBS will publish an annual review of departments' spending, and explore how to extend this to local government. Furthermore, the SBS, OGC and others will review SME and other procurement information gathering across government to investigate opportunities for efficiencies and more robust data;
- the first phase of research commissioned by the SBS,²¹ providing evidence on the costs and benefits of SME involvement in public sector markets; and
- in response to particular concerns from SMEs on the public sector's use of third party assessment providers to pre-qualify suppliers, the OGC and SBS will research the effect this has on potential suppliers and identify options to reduce any barriers to SMEs' participation.

Enterprise culture

3.66 Creating a climate in which entrepreneurial achievement is valued underpins a strong business sector. The Government believes that anyone with the initiative, drive and talent to succeed in business should be able to do so, and continues to promote enterprise culture in the UK through number of initiatives, including:

- from September this year, £60 million will be available to schools to develop enterprise education at Key Stage 4. Over the last year, Enterprise Advisers have been working in the 1,000 most disadvantaged schools to embed enterprise education. The Government is announcing **an extension of funding for Enterprise Advisers** for an additional year until July 2006 to ensure that schools are able to continue this work during the national rollout of **Davies Review implementation**;

²⁰ Available at www.supplyinggovernment.gov.uk

²¹ Available at www.supplyinggovernment.gov.uk

- in February 2005, the Chancellor announced that Sherwood Energy Village was the winner of the first Enterprising Britain competition. The Government has been working with the European Commission to develop a proposal to launch a European Centres of Enterprise competition during the UK Presidency of the EU; and
- the Chancellor hosted *Advanced Enterprise: Enterprise in Global Markets*, attended by business leaders, entrepreneurs and Government representatives in February 2005. This conference addressed the challenges and opportunities posed by growth in rapidly growing emerging markets, including China and India, to large and small businesses in the UK.

SCIENCE AND INNOVATION

3.67 *Long-term global economic challenges and opportunities for the UK*, published alongside the 2004 Pre-Budget Report, emphasised the importance of science and innovation in ensuring the UK's long-term competitiveness in an increasingly knowledge-driven global economy. In all countries, economic activity is shifting towards innovation and knowledge-driven industries, with emerging economies moving up the value chain and challenging the predominance of the advanced economies. In this environment, the UK needs to build on its historical strength in scientific research to exploit new technology driven and high value-added areas and secure its long-term prosperity.

3.68 The UK science base is the most productive within the G7.²² However, the UK's national investment in R&D has been low compared with other major developed countries, with total public and private investment in R&D at 1.9 per cent of GDP in 2002, compared with 2.2 per cent in France, 2.5 per cent in Germany, and 2.7 per cent in the US.²³ In addition, the UK has not been fully effective at realising the commercial potential of research.

3.69 The Government's strategy for promoting science focuses on increasing public investment in the science base and boosting the teaching and learning of science, engineering and technology skills, while simultaneously tackling market failures that prevent firms from investing more in R&D and developing innovative products and services. Key steps under this strategy include increasing public investment in science and technology, introducing R&D tax credits for business and encouraging greater collaboration between business and academic institutions to further links between research and its commercial exploitation. To take this strategy forward, the Government published a *Ten-year Science and Innovation Investment Framework* in 2004, which set out the Government's ambition for the UK's public and private investment in R&D to reach 2.5 per cent of GDP by 2014 and the long-term policy framework to achieve this goal.

UK Stem Cell Initiative

3.70 Over £2.5 billion in the three years up to 2008 has been allocated for biotechnology, including stem cell research. To safeguard the UK's long-term excellence in the field of stem cell research and to shape the transformation of research into patient benefit and commercial opportunities, **the Government is launching a UK Stem Cell Initiative (UKSCI), in collaboration with the Wellcome Trust, the Medical Research Council, the Biotechnology and Biological Sciences Research Council, the DTI, the Department of Health and the proposed private-sector led UK Stem Cell Foundation.** This will take the form of a high-level review, led by Sir John Pattison, to formulate a ten-year vision for UK stem cell research,

²² Data from Evidence Ltd. PSA Target Metrics for the UK Research Base 2004. Available at www.ost.gov.uk

²³ Science and Innovation Investment Framework 2004-2014, p. 7. Available at www.hm-treasury.gov.uk

creating a platform for coordinated public and private funding of research. UKSCI will report back to the Government with its recommendations by the time of the 2005 Pre-Budget Report.

Business R&D

3.71 Business investment in R&D rose by 2 per cent in real terms in 2003, broadly in line with the economy as a whole, but it will need to rise faster than trend growth if the UK is to catch up with competitors. The Government's focus has been on working with business to encourage greater investment in R&D and innovation, and to promote closer collaboration between industry and the science base.

Analysis of UK business R&D 3.72 On 15 March 2005, the Treasury and the DTI published an in-depth analysis of UK business R&D and innovation performance, outlined in Box 3.7, fulfilling the commitment made in the 2004 Pre-Budget Report. The paper will inform the first meeting of the UK Science Forum, as well as the first annual progress report on the ten-year framework, due in Summer 2005.

R&D tax credits 3.73 Building on the continued success of R&D tax credits, the Inland Revenue has embarked on a programme to ensure greater consistency in the treatment of claims and a better understanding of the credit system amongst tax advisers. In conjunction with the SBS, it has developed **new guidance for small companies claiming the R&D tax credit, providing plain-English assistance to claimant companies and a template to help small companies determine their qualifying expenditure. The SBS will pilot the new guidance with small businesses soon after the Budget.**

3.74 The Government is continuing to evaluate the impact of the credits and to gather evidence on R&D activity in UK firms. In light of this, it is examining how the R&D tax credit can better support those growing firms with the potential to develop into highly-innovative companies in the future, and how it can help retain and grow current world-leading R&D intensive companies and make the UK an even more attractive location for R&D investment. **The Government will consult with business on this issue and will publish a discussion paper in summer 2005.**

Box 3.7: Analysis of UK business R&D performance

The DTI-HM Treasury paper on UK business R&D performance presents an in-depth analysis of UK business R&D performance, focusing in particular on differences between sectors and a comparison of global trends. The material presented is work in progress, and innovatively brings together several data sources for the first time. The key findings with implications for policy are:

- in sectors where UK firms do undertake R&D, there is some evidence to suggest they undertake less than their overseas competitors;
- however, outside a few sectors – notably pharmaceutical, aerospace, and healthcare – large UK firms tend to be concentrated in low R&D sectors. A survey of the top 600 European companies^a shows that, compared with the UK, French firms generate 14 per cent more of their value-added in the top ten R&D intensive sectors, while German firms generate 40 per cent more; and
- outside a few sectors, large foreign-owned firms are more likely to get their R&D from overseas.

The paper's analysis therefore supports a number of the policy priorities for business investment highlighted in the ten-year framework, in particular: maintaining or growing R&D in sectors where the UK is strong; attracting R&D investment into the UK from multi-nationals; increasing the R&D intensity of firms or sectors that are lagging behind their peers; and, developing new R&D intensive sectors through the creation and growth of R&D-intensive SMEs. These will be the central themes of future analytical and policy work in pursuit of the objectives set out in the ten-year framework.

a: DTI estimates based on DTI Value Added scoreboard 2004 and DTI R&D scoreboard 2004.

UK Science Forum **3.75** As announced in the 2004 Pre-Budget Report, the new UK Science Forum will meet in the summer to discuss progress in implementing the ten-year framework, trends in UK business R&D as outlined in the DTI-HM Treasury Paper, and science and technology education. The Forum will be chaired by Sir Tom McKillop of AstraZeneca and will bring together business leaders, scientists and representatives of government to discuss science investment and to inform future decisions on public and private funding of UK R&D.

Guaranteeing SMEs' involvement in public sector R&D **3.76** SMEs undertake some of the UK's most innovative R&D, and can make an important contribution to meeting the public sector's R&D needs. Some SMEs have faced obstacles in offering their services to public sector R&D purchasers. The Small Business Research Initiative (SBRI) has, since 2000, addressed these issues through departments and agencies adopting voluntary targets for minimum levels of R&D contracts with SMEs. **Recognising the potential for a greater positive impact on SME innovation and growth, the Government now intends to adopt a mandatory requirement, through the SBRI, that at least 2.5 per cent of the value of departments' and agencies' extra-mural R&D contracts will be placed with SMEs.** This requirement will further encourage SMEs to enter bids for public sector work, while maintaining value for money and quality of procurement.

3.77 The economic spillover benefits of R&D spending add an extra dimension to procurement judgements, and this is reflected in the exclusion of certain R&D services from EU procurement directives. Departments and agencies will use this limited facility to ensure that their efforts to meet SBRI obligations are successful while remaining within the overall policy and legal framework for public procurement and the EC Treaty generally. SBS will work with OGC and HM Treasury to deliver the new SBRI regime.

Investment in science and innovation

UK Research Councils 3.78 On 7 March 2005, the Director-General of the Research Councils announced the detailed allocation of the science budget up to 2008. This provides a major boost to UK science and fulfils the commitments made in the 2004 Spending Review. Substantial funding increases have been awarded to a number of strategic priorities, including:

- investment of over £1 billion over the period to ensure the sustainability of university research and infrastructure, including £440 million to enable Research Councils and Learned Societies to pay a greater proportion of the full economic cost of research;
- over £300 million to support knowledge transfer and business-university collaboration;
- £60 million to underpin the health of key disciplines such as engineering, and to attract the best researchers from around the world; and
- additional funding of £25 million for clinical research, as part of the Medical Research Council's £1.5 billion budget allocation over the period. This will take the combined budget for medical R&D to over £1.2 billion per annum by 2007-08, meeting the commitment made at Budget 2004.

Energy R&D 3.79 The Government is committed to supporting research and development into sustainable energy technologies, as part of its response to climate change. Funding for energy R&D from the Science Budget will rise from a current level of £40 million per year to £70 million per year by 2007-08, with additional support for business via the DTI Technology Programme and The Carbon Trust. **To underpin this investment, the Government will establish a UK Energy Research Partnership, bringing together public and private funders of energy research to enhance opportunities for collaboration and identify shared priorities for research.**

Science cities 3.80 At the time of the 2004 Pre-Budget Report, the Government welcomed the commitment by the three Northern RDAs to designate three 'science cities', and asked the RDAs to come forward with further proposals on how to develop science cities by Budget 2005. The RDAs have recognised science cities as a valuable model for targeting investment in science and technology in cities which have particular potential to benefit from higher growth in this area. **In partnership with the RDAs, the Government welcomes the announcement today by the RDAs that three further science cities will be developed in Bristol, Birmingham and Nottingham.**

Box 3.8: Science cities

'Science cities' are those with strong science-based assets – such as a major university or centre of research excellence – which have particular potential to use these assets as the basis for generating business success. Developing science cities requires a range of complementary policies to address the specific needs of research and development, to support university-business collaboration, and to influence a wider spectrum of factors that contribute to the growth of knowledge-intensive industries, such as skills, transport, finance and infrastructure. By bringing these factors together in a concentrated space, science cities can attract a critical mass of innovative businesses and become drivers of regional growth.

While cities will need to tailor their strategies to their individual circumstances, successful science cities will typically emerge where world-class research capacity combines with successful knowledge-based industries in an environment with the physical infrastructure and supply of higher level skills to support significant further investment. Strong local and regional leadership, in partnership with business, is also an essential factor for the growth of science cities.

The 2004 Pre-Budget Report announced an initial set of science cities in Manchester, Newcastle and York, as part of the Northern Way initiative. These cities are currently developing their strategies and will provide details in their city-regional development plans in May 2005.

Regional science and innovation 3.81 The Government is working to ensure that national funding streams for science and innovation better reflect regional priorities. It is currently developing an allocations procedure for the third round of the Higher Education Innovation Fund, supporting universities' collaboration with business, and will consult with stakeholders on how funding for knowledge transfer can best be aligned with regional priorities. The next round of the Science Research Infrastructure Fund, which provides capital funding of £500 million per annum to renew university infrastructure, will require universities to develop their implementation strategies in light of regional priorities, and make research facilities more accessible to businesses as well as academic users.

Scientific research organisations 3.82 Budget 2004 announced proposals to refine the tax treatment of scientific research organisations (SROs) bringing the definition of R&D into line with that used in the rest of the tax system and modernising the monitoring process. These changes will be included in the Finance Bill. The Government will consult with SROs and their representatives on the statutory framework necessary to underpin the new monitoring regime.

University spin-offs 3.83 As announced at the 2004 Pre-Budget Report, the Government will bring forward legislation to remove the tax uncertainty surrounding the formation of spin-off companies from universities and public sector research establishments (PSREs). This will take into account responses to the Technical Note published alongside the 2004 Pre-Budget Report.²⁴ **A full Regulatory Impact Assessment on the new legislation and summary of consultation responses is published today.**

Creativity in industry 3.84 UK creative industries represent around 8 per cent of UK GDP, and lead the world in many areas including music, design, fashion, digital media and the arts. However, there is evidence that, beyond the success of the creative industries, businesses in other sectors of the economy do not recognise the potential to raise performance and productivity by investing in creativity and incorporating innovative design ideas into their products, as described in Box 3.9.

²⁴New Tax measures to help researchers acquiring shares in spinout companies created with universities and research establishments, Inland Revenue, December 2004.

Box 3.9: Creativity and business performance

Creativity is a key ingredient in the success of businesses right across the UK economy. By applying a range of creative skills, businesses transform goods and services from commodities to differentiated products which can be marketed on the strength of their unique characteristics. This can reflect a range of creative contributions, from the impact of product innovation and design, to innovation in delivery through digital media, and influences from the arts and diverse cultures. By increasing the distinctiveness of products and services, creativity allows large and small firms to compete in global markets on the basis of the added value of their unique appeal to consumers. Research for the Design Council and the DTI's Innovation Review^a bears this out, showing that:

- design-intensive companies outperformed the FTSE 100 by more than 200 per cent over a ten-year period;
- rapidly growing businesses attach much greater weight to the importance of creativity than the average firm – ranking design as the second most important factor, after marketing, in their success, compared with seventh for the average UK firm;
- growing businesses are more than twice as likely to use creativity to improve quality than static businesses; and
- 70 per cent of businesses where design is integral to strategy say that design has increased the quality of their products and services.

The UK has a world-leading creative sector, directly contributing 8 per cent to UK GDP and employing more than 1.3 million people. It has a major creative cluster around London, but is also spread across the nations and regions, with 60 per cent of creative sector employment outside London. The UK's artistic and cultural diversity, and its trading and cultural connections across the world, contribute to the economy's creative strength.

The challenge is to ensure that businesses – especially SMEs and modern manufacturers – are aware of the potential for improving their profitability and productivity by applying creativity; and know how to go about it. The success of the creative industries notwithstanding, there is evidence that UK business is not realising the full potential of applying creativity more widely:

- on average, UK businesses expected a return on investment of 50 per cent on their most successful design project last year, but actually secured a return of more than 75 per cent;
- many companies suffer the consequences of under investing in creativity: for example, 45 per cent of businesses which do not use design are driven to compete mainly on price, whereas this is true of only 21 per cent of design-intensive firms;
- significant innovative breakthroughs remain scarce for UK businesses. Only one in ten firms have come up with new products, services or processes based on major innovation in the last 3 years;

The measures announced in this Budget seek to match the UK's world-class creative talents with untapped potential for enhancing business performance.

a: The Impact of Design on Stock Market Performance (Design Index), Design Council, 2004; *National Survey of Firms*, Public and Corporate Economic Consultants, 2004; *Competing in the global economy, the innovation challenge*, DTI, 2003.

3.85 For many businesses, effective use of creative inputs to their goods, services and business processes can improve their value-added, and provide a means of competing globally – not just on cost but on the quality, value and distinctiveness of their products and services. This is particularly important for SMEs and in modern manufacturing, where cost competition is intensifying in a globalised economy, making it critical that producers are able to differentiate their products by adding value.

3.86 This Budget announces measures to increase the contribution of creativity to productivity growth. In particular, it takes steps to improve access for firms to the substantial capability in the creative sector's institutions and businesses:

- **the Chancellor has asked George Cox, Chair of the Design Council, to review how best to ensure that SMEs are able to apply creativity and innovation to improve their performance and productivity.** The review will consider how to raise awareness of the potential benefits for SMEs, including in modern manufacturing, and the steps needed to ensure that SMEs are able to draw on the UK's world-leading creative skills in areas such as digital media, product and industrial design, the arts and culture, graphics, branding and advertising, publishing, packaging, interior and retail design. It will also examine how links can be improved between universities and colleges, SMEs and creative skills in businesses and other institutions;
- **the Government welcomes the initiative of the Design Council in devising and piloting the Design Immersion Programme** with the RDAs in the West Midlands and London to provide mentoring for business chief executives to support them in integrating design into corporate strategy, product and market development. Building on this initiative, and similar plans in Yorkshire and the Humber, and the North East, the Government is encouraging the RDAs to consider how best to build design, including the Design Immersion Programme, into their plans;
- as part of the Northern Way, **the RDAs for the North East, North West, Yorkshire and the Humber will launch a modern Design Centre in Newcastle/Gateshead** to ensure that businesses across northern England are able to access creative talent and design skills;
- to help to improve the business impact of cultural creativity, **the Government will provide £12 million over 2 years from 2006-07 to the Arts Council England and others to promote excellence in management and leadership within the cultural sector.** This will ensure that a larger number of talented high-flyers in cultural organisations will be able to develop commercial and business leadership skills, encourage the leadership talents of leading ethnic minority figures in the arts, and create new opportunities for business-arts collaboration; and
- **the DTI will launch a study of the value and productivity impact of creativity and design in businesses,** helping firms to identify how creativity can improve their performance.

SKILLS

Skills in the global economy **3.87** *Skills in the global economy*, published alongside the 2004 Pre-Budget Report, highlighted the increasing importance of skills to the UK economy. As described in Chapter 4, UK employment is now at a record high. However, while the proportion of people in the UK with high skills compares well internationally, the share of the workforce with intermediate skills is relatively low and, despite improvements over the last few years, there is still a large stock of workers with no or low skills. There is strong evidence that investment in training is lower than optimal because of market failures, especially for those with lower level qualifications or no qualifications at all.

3.88 Chapter 6 sets out in detail the Government's major new investment in education, including plans for investment to deliver twenty-first century facilities in primary schools, further support for ICT in schools, and significant investment in Further Education colleges.

3.89 Alongside this, the Government is introducing a major package of reforms to ensure that, for the first time, every young person will be able to benefit from education and training between the ages of 16 and 18. Chapters 5 and 6 set out reforms to improve financial support for 16-19 year olds and raise levels of participation in education and training post-16. This includes a pilot scheme offering 16 and 17 year olds who are not in education, training or employment financial support in return for a commitment to progress towards formal learning, and a further pilot scheme targeted at 16 and 17 year-olds in work with no training, offering financial support in return for a commitment to further study.

Leitch Review **3.90** The 2004 Pre-Budget Report announced that the Government had established an independent review to examine the future skills needs and priorities for the UK economy, led by Lord Leitch, Chairman of the National Employment Panel.²⁵ The Review will report in spring 2006 on what skills profile the UK should aim to achieve in 2020 to support productivity and growth over the longer term. In addition to the economic case, the Review will also consider the benefits to society of improving workforce skills. The Review will work with a wide range of stakeholders to build an evidence base upon which the Government can set its skills ambitions for 2020 and will consider the implications for skills policy.

Developing the skills of young people

3.91 The Government has introduced a number of measures to encourage all young people to take part in some form of education or training up to the age of 19. These include reform to the financial support system for 16-19 year olds through the introduction of Education Maintenance Allowances, which have been rolled out nationally from September 2004, and the extension of Child Benefit and Child Tax Credit to unwaged trainees, described in Chapter 5. In addition, the continued development of Apprenticeships allows young people to combine vocational training with valuable work experience.

14-19 education **3.92** Building on progress to date and reforms set out in the five-year skills strategy, the Government recently published a White Paper setting out the detail of the reform programme for 14-19 education, building on the work of Sir Mike Tomlinson's Working Group on 14-19 education reform. The White Paper describes the Government's long-term vision for an education system that provides every young person with a route to success in life through work and dedication. This includes an increased focus on securing basic skills, reform of vocational qualifications, greater stretch and differentiation between students, and measures

²⁵ www.hm-treasury.gov.uk/leitch

to tackle disengagement. The reforms will deliver a system which is more tailored to the talents and aspirations of individual young people, with greater flexibility about what and where to study and when to take qualifications.

3.93 The Government has set an ambitious participation target for higher education to ensure that more young people than ever before will have the opportunity to progress to higher skill levels. The expansion of Foundation Degrees aims to facilitate young people and adults moving on to higher education by strengthening the choice and routes for progression. These vocational qualifications are designed and developed with employers and provide students with the skills and knowledge employers are looking for, typically taking two years to complete but with the opportunity, after further study, to gain a full honours degree.

Workforce development

3.94 The Government is committed to enabling all adults to continue training and developing skills during their working lives. The Government's skills strategy in 2003, and the New Deal for Skills in 2004, introduced a number of measures including: an entitlement to free training to NVQ level 2 and in basic literacy, numeracy and ICT skills; a more flexible qualification and curriculum structure; improved adult information and guidance services; improved services from training providers; and a new network of Sector Skills Councils to provide a forum for employers and employees to tackle skills needs in each major sector of the economy.

Skills White Paper **3.95** The Government will shortly publish a Skills White Paper setting out the next phase of reform to make this country a world leader in skills. It aims to do this by putting employers' needs centre stage in the design and delivery of training, supporting individuals to gain the skills and qualifications they need to achieve at all levels, from basic skills in literacy and language, through to Foundation Degrees, and delivering this in partnership with the Skills Alliance. Together with the White Paper on 14-19 education this represents a clear and determined strategy to tackle the long-standing weaknesses in the UK's education and training system for young people and adults.

Employer Training Pilots **3.96** The Government has taken action to address market failures that restrict business and individuals from investing in skills training. Employer Training Pilots (ETPs), introduced in September 2002, now have over 17,000 employers and 120,000 learners participating. Most employees involved left school at or before age 16 and half have no qualifications at all. 70 per cent of participating firms employ less than 50 people. The first evaluation of the scheme shows that it has been successful. After involvement with ETPs, 63 per cent of learners were more positive about the likelihood of progressing to further training. 93 per cent of ETP employers felt the training would result in improved quality of service and production.²⁶ Building on this success the Government will ensure that the pilots are funded to continue to meet employer demand, by providing an additional £65 million in 2005-06.

National Employer Training Programme **3.97** As announced in the 2004 Pre-Budget Report, the Government will rollout a National Employer Training Programme from 2006-07 to cover the whole country by 2007-08. This will build on the success of the ETPs and guarantee that, where employers are prepared to offer their low-skilled employees paid time to train up to level 2 qualifications, the costs of this training will be fully subsidised. It will also include support from brokers to assess, design and source training needs for employers and employees. There is mixed evidence on the impact of wage compensation, offered in all but one pilot to help employers meet the costs of giving staff paid time off to train. However, some early evidence suggests that it may be important in initially engaging those employers who would not usually provide training. The Government will continue to consider this issue and look to further evaluation before making a final decision on the inclusion of wage compensation within the national programme.

²⁶ ETP second year evaluation, DfES, forthcoming - to be published alongside Skills White Paper on 22 March 2005. [Check reference to forthcoming document with DFES]

Regional Skills Partnerships 3.98 Evidence shows variations in the skill levels of different regions are a key factor in explaining differences in economic performance. Regional Skills Partnerships (RSPs) were announced in July 2003 to bring together the work of a number of bodies, including the RDAs, on skills, training and business support. In the 2004 Pre-Budget Report, the RSPs, the RDAs and the LSC were asked for an update of progress in each region on aligning regional priorities for adult skills provision.

3.99 Overall progress is encouraging, although some regions and RSPs are further advanced than others. Detailed work is underway in some regions on 'dual key' arrangements for planning and funding adult skills, which will enable RDAs and Regional LSC Directors better to align regional skills budgets with regional economic strategies. The Government expects all RSPs to agree skills priorities, and reflect these in adult skills provision over the 2004 Spending Review period. The Government also remains committed to removing obstacles, where regional partners identify them, to further integration.

Union Academy 3.100 In the skills strategy the Government made a commitment to a new social partnership for skills – bringing together key economic and delivery partners to drive forward reform. As part of this partnership, the TUC and trade unions have made a significant contribution in helping union members with low or no qualifications to take advantage of learning opportunities offered by government initiatives such as Skills for Life, ETPs and online learning. Drawing together the strands of existing union learning activity, the TUC plan to launch a Union Academy to increase the capacity of unions to help members recognise the value of learning and training opportunities and drive a step change in the level of learning and development delivered through unions. The unions are committing significant resources of their own to the development of the academy and the Government will provide additional funding to implement the proposal.

3.101 The Government opened a discussion in 2003 on the role tax incentives can play in encouraging workforce development. Since then, it has been discussing ideas with interested parties, alongside the development of the skills strategy. The Government recognises the case for reform and will continue to work with key groups to develop its plans for the future.

Migration 3.102 As the global economy integrates, labour markets are becoming increasingly international. To remain competitive it is important that the UK continues to attract and retain talent. The Government's Five-Year Strategy for Asylum and Immigration, published in February 2005, will deliver a flexible points-based system to ensure that the UK attracts the migrants needed by economy and businesses. **The Government will also provide the opportunity for young Chinese graduates to develop a greater understanding of the UK by establishing a China Youth Exchange Scheme, to allow a year-long working stay in the UK.**

INVESTMENT

3.103 Capital investment is a key driver of productivity. Evidence suggests that the UK has a significantly lower level of capital per worker than the USA, France and Germany, and that this capital gap contributes to the labour productivity gap with those economies.²⁷ The UK economy has historically experienced among the lowest overall levels of investment relative to GDP in the OECD, in particular owing to low levels of investment by government and households.

²⁷ Britain's Relative Productivity Performance: Updates to 1999, National Institute of Economic and Social Research, O'Mahony and de Boer, 2002.

3.104 The Government is committed to enhancing the economic environment within which businesses make their investment decisions. Central to this is providing a platform of macroeconomic stability to enable firms and households to plan for the long term. The Government is also implementing microeconomic reforms to remove the barriers that prevent capital markets from functioning efficiently and flexibly, so removing barriers to innovation and investment. A report on progress to promote product and capital market flexibility is provided in Box 3.11. The Government recognises that foreign direct investment brings a range of economic benefits. It is refocusing the resources of UK Trade and Investment towards strengthening inward investment services and promoting FDI, building on the UK's excellent record in attracting FDI. As described in Chapter 6, the Government has also taken action to address historic under-investment in the public sector, which plays a key role in driving productivity.

Investment in transport **3.105** There is a clear consensus on the importance of appropriate investment in transport for productivity and economic growth. The Government's White Paper *The Future of Transport: a Network for 2030*, published in 2004, set out a strategy for long-term increased investment by both public and private sectors, combined with smarter choices on travel. This also set out, as a result of the 2004 Spending Review, increased transport funding over the ten-year period through to 2015 with the introduction of a new Transport Innovation Fund to support the development of innovative transport measures that can benefit national productivity. Total public sector investment over this period will be over £79 billion in today's prices. Recognising the need to take a sustainable longer term view, and building on the 30-year strategy, it is necessary to bring together the right investment plans and the right framework for prioritising and delivering new infrastructure. **The Secretary of State for Transport and the Chancellor have asked Rod Eddington, outgoing Chief Executive of British Airways PLC, to work with the Department for Transport and HM Treasury to advise on the long-term impact of transport decisions on the UK's productivity, stability and growth.**

The investment chain

3.106 UK institutional investors manage almost half of UK equities, investing a large part of the wealth of UK savers and exerting indirect control and influence over much of UK industry. This ownership is intermediated through an 'investment chain' of relationships connecting ultimate owners with their investment in companies. Ensuring this chain works efficiently is of vital economic importance for productivity and long term growth, because the chain is a critical mechanism for ensuring that investment is efficiently allocated. The Government has taken action to improve the functioning of the investment chain, identifying under-performing links in this chain and implementing solutions, including:

- addressing the problem of distorted investment decision-making by institutions through the original Myners Review.²⁸ The Government endorsed Paul Myners' recommendation that trustees of occupational pension funds voluntarily adopt, on a 'comply or explain' basis, a set of principles codifying best practice for investment decision-making. Building on this, Sir Derek Morris' Review, described below, makes recommendations for increasing competition in the market for actuarial services and strengthening the regulatory framework for the actuarial profession;

²⁸ *Institutional investment in the UK: a review*, Paul Myners, March 2001.

²⁹ *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2002.

- rectifying, following the Sandler Review²⁹, the failure of the retail savings industry to serve medium to long term savers optimally, by working with the FSA to develop simplified and more transparent savings products and to enhance disclosure of the cost of advice;
- improving the UK corporate governance regime following Sir Derek Higgs' Review³⁰ into the role of non-executive directors. The Financial Reporting Council has issued a revised Combined Code on Corporate Governance. As a result of the Smith Review³¹ and the work of the Co-ordinating Group on Audit and Accounting, measures have been implemented to improve the independence and transparency of audit and the quality of financial reporting; and
- to promote more active engagement by shareholders with companies, welcoming in October 2002 the Institutional Shareholder Committee (ISC) principles and the commitment to reflect these in fund management mandates. The ISC will shortly conclude its review of the impact of the principles on engagement and the government will take account of the ISC's conclusions when finalising its own review.

Myners principles: review of progress **3.107** Addressing the problem of distorted investment decision-making by institutions is central to improving the functioning of the investment chain. In December 2004, the Government published a review of progress against the Myners principles. This shows that, while behaviour is beginning to change, progress is lagging in key areas. The Government has therefore proposed changes to the principles designed to: strengthen trustee expertise; ensure more effective use is made of advisers; improve the quality of asset allocation activity and the resources devoted to it; and provide greater clarity on funds' investment time horizons. In addition, the Government will work with key stakeholders to improve the quality of the commentary trustees make on how they are implementing the principles. The Government is consulting on its proposals.

Morris Review **3.108** The Government asked Sir Derek Morris to conduct a wide-ranging independent review of the actuarial profession following Lord Penrose' Inquiry into the Equitable Life³² and as part of the Government's wider programme of reform to improve the efficiency of the investment chain. The provision of high-quality actuarial advice is a key element of the investment chain – actuaries advise pension funds on strategic investment issues, including asset allocation and fund manager selection. Sir Derek Morris has today published his final report and has made a number of recommendations, described further in Box 3.10, to increase competition in the market for actuarial services; to strengthen the regulatory framework for the actuarial profession and on the future role and institutional status of the Government Actuary and his Department.

²⁹ *Review of the role and effectiveness of non-executive directors*, Derek Higgs, January 2003.

³¹ *Audit committees: Combined Code guidance*, Financial Reporting Council appointed group chaired by Sir Robert Smith.

³² *Report of the Equitable Life inquiry*, The Right Honourable Lord Penrose, March 2004.

Box 3.10: Morris Review Recommendations

The central recommendation of the Morris Review is that regulation of the actuarial profession should be subject to independent oversight by the Financial Reporting Council (FRC.) The FRC should:

- create an Actuarial Standards Board as a new operating body of the FRC to set actuarial professional standards and oversee the regulatory and other activities of the actuarial professional bodies – including their role in: setting ethical standards; administering education and CPD; monitoring of compliance with professional standards; and in administering disciplinary procedures.

In order to promote an open and competitive market for actuarial services the review recommends that it is best practice for pension scheme trustees to:

- invite tenders separately for actuarial advice, strategic investment advice and fund manager selection advice, as proposed by the Government in its recent revision to the Myners' principles.
- (i) informally evaluate their actuarial advisers on an annual basis, (ii) undertake a more formal evaluation every three years and (iii) undertake a formal market test of their actuarial advisers no less frequently than every six years.

In relation to the Government Actuary's Department the review recommends that:

- the Government should increase choice and competition for users of actuarial advice to public service pension schemes and should transfer a limited number of functions to other government departments in order to achieve more effective integration of the services provided; the Government Actuary should continue to report to Ministers and Parliament on the National Insurance Fund; and the Government should consider converting the Government Actuary's Department into a trading fund.

3.109 The Government welcomes the report of the Morris review and, in principle, accepts its recommendations, and looks forward to working with the actuarial profession and other stakeholders on implementation. The Government believes that the report's recommendations provide a blueprint for practical and effective reform of the actuarial profession and clarify the ongoing role of the Government Actuary and the Government Actuary's Department. **The Government urges all stakeholders – the actuarial profession and its users, the Pensions Regulator, the Financial Reporting Council, and the Financial Services Authority – to support the report's recommendations and work with the Government to see how they can be implemented in practice.**

Investment in housing and property

3.110 A stable and flexible housing market is essential to a productive economy. Housing market imbalances between supply and demand are a potential brake on economic development, as the cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets.

Implementing the Barker Review

3.111 Kate Barker's independent review of housing supply,³³ published alongside Budget 2004, set out the long-term lack of supply and responsiveness of housing in the UK. It identified problems of affordability for new households, wealth redistribution from those outside the housing market to those inside the market, and significant regional price differentials and expectations, reducing labour mobility and constraining productivity. It recommended a step change in housing supply and a programme of wide-ranging reform to

³³ *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004

deliver better balanced housing markets, including a proposal for a Planning-gain Supplement to help fund additional investment in infrastructure and social housing and to give local authorities stronger incentives to deliver housing growth.

3.II2 The Government is making significant progress in implementing the Barker Review's recommendations on investment planning reform and affordability. The 2004 Spending Review announced a 50 per cent increase in new social house building by 2007-08 compared with 2004-05 – an additional 10,000 homes a year. It also established a new Community Infrastructure Fund (CIF) of £150 million by 2007-08 to support the transport infrastructure costs required to enable faster housing development in the four growth areas. An announcement on the projects that have been provisionally approved for funding through the CIF will be made imminently.

3.II3 Following recent consultation, the Government is considering how best to merge Regional Housing Boards (RHBs) and Regional Planning Bodies (RPBs) to create integrated bodies responsible for managing regional housing markets. It will also establish an independent advice unit to strengthen the evidence and analysis on improving housing market affordability available to regional bodies throughout the regional planning process.

3.II4 Ahead of a full response on Barker Review implementation later this year, the Government will consult in the summer on other aspects of the Barker Review package, including introducing a long term national goal for affordability in the housing market and on increasing the planning system's responsiveness to housing market signals by reforming Planning Policy Guidance on Housing (PPG3). The Government will also consider by the summer progress made by the house building industry to improve service quality and customer satisfaction ratings and to increase investment in skills and innovation.

Planning reform 3.II5 A transparent and flexible planning system is central to delivery of the Government's economic, social and environmental objectives, and plays a vital role in driving up productivity. In addition to the implementation of the Barker Review recommendations, the Government has taken steps to make the planning system work more quickly and predictably. The 2004 Planning and Compulsory Purchase Act introduced a simplified planning structure with strengthened Regional Spatial Strategies and flexible local development frameworks. **The Government will shortly publish its revised policy statement on town centres (PPS6) in England. This will set out the Government's objectives for promoting the growth and development of town centres to strengthen their vitality and viability, enhance consumer choice and tackle social exclusion.**

Implementing the Miles Review 3.II6 Professor David Miles published the final report of his review of supply and demand side factors limiting the development of the UK longer-term fixed-rate mortgage market alongside Budget 2004.³⁴ Good progress has been made in taking the recommendations forward:

- information and advice to borrowers – the new FSA regulatory regime for mortgages covered a number of elements of the review's recommendations on disclosure and advice, including the introduction of an improved mortgage information leaflet and consumer fact-sheet on switching mortgages. The FSA will launch a review of the effectiveness of the current regime by end of 2005 and will consider further recommended changes on advice and disclosure as part of that review. The Financial Capability Steering Group's borrowing group will also include work on understanding the risks of mortgage borrowing as part of its broader work on risk messages;

³⁴ *The UK mortgage market: taking a longer-term view*, David Miles, March 2004.

- the structure of pricing of mortgages – the FSA will consider the review's recommendations on cross-subsidy within the mortgage market, possibly in the context of their ongoing work on Treating Customers Fairly;
- the funding of fixed-rate mortgages – the Treasury introduced legislation in December 2004 to remove a constraint on building societies' ability to securitise assets as a source of funding. As recommended by Miles, the Government has considered whether the funding limit for building societies should be changed. In light of the greater flexibility provided by the legislation, and following consultation, no further action will be taken at this time, but the position will be kept under review. The lack of symmetric mark-to-market charges and stand-alone interest rate cap products at present means that it is not possible to assess their potential tax treatments. However, the Treasury and the Inland Revenue will engage with lenders considering developing such products in future; and
- the Debt and Reserves Management Report 2005-06, published today, responds to the recommendation that it consider the potential costs and benefits of issuing interest rate derivatives. A substantial degree of uncertainty remains over the balance of advantage to the Government and the case for issuing these instruments from the perspective of debt management policy has not yet been made. Accordingly the Government does not propose to issue any such instruments at this time.

Real Estate Investment Trusts **3.117** Alongside Budget 2004, the Government launched a consultation to consider the introduction of Real Estate Investment Trusts (REITs)³⁵ with the aim of promoting greater efficiency in the UK property investment market, supporting the Government's wider objective of raising UK productivity. **The Government is today publishing *UK Real Estate Investment Trusts: a discussion paper, along with a summary of responses to the Budget 2004 consultation.***

3.118 The Government is committed in principle to reforming the taxation of property investment. The consultation has enabled the Government to better define the key features of a potential UK-REIT model that allows for market flexibility. These features are set out in the discussion paper. The paper also raises some challenging issues in designing the tax treatment for a model that meets both the needs of the UK property investment market and the Government's objectives for a UK-REIT. The Government will therefore engage in further dialogue with industry representatives. **Subject to finding a workable solution that meets the stated objectives, including reform at no overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.**

Flexibility of commercial property leases **3.119** The Government has been considering the outcome of a consultation by the Office of the Deputy Prime Minister (ODPM) on legislative remedies for the prevalence in commercial property leases of upward-only rent review clauses.³⁶ A recent report into flexibility in the property market, published in February 2004,³⁷ showed that while there is encouraging evidence that parts of the market are becoming more flexible, there is also evidence of much less progress in a number of important respects. Since 2001, the Government has been working with the commercial property industry to promote a voluntary code of practice to improve the flexibility of commercial lease terms for businesses. While the Government welcomes the recent trend towards greater market flexibility, it believes much more can be done to strengthen the impact of the code of practice on the market. It will continue to work with the industry on strengthening the code, but remains willing to pursue legislation if further movements towards greater market flexibility are not forthcoming.

³⁵ *Promoting more flexible investment in property: a consultation*, HM Treasury and Inland Revenue, March 2004.

³⁶ *Commercial property leases: Options for deterring or banning the use of upward only rent review clauses*, ODPM, 2004.

³⁷ *Monitoring the 2002 Code of Practice for Commercial Leases*, ODPM and Reading University, 2005.

Box 3.11: Product and capital market flexibility – report on progress

Flexible product and capital markets stimulate enterprise and innovation, and create jobs and growth. Product market flexibility that promotes competition and encourages innovation and research enables firms to respond quickly to changing market conditions, allowing them to exploit new opportunities and deal with potential challenges. Capital market flexibility ensures that capital is allocated efficiently, so that business and entrepreneurs have ready access to the funds they need to develop their ideas. It also enables financial risks to be shared across firms and individuals, so reducing the economy's vulnerability to economic shocks.

The assessment of the five economic tests for UK membership of Economic and Monetary Union (EMU) in June 2003 examined the flexibility of UK product and capital markets. It noted that a decision to join EMU would highlight the need for rapid price and factor movements, and for firms to sharpen their ability to respond effectively to shocks and competitive opportunities. It concluded that the UK has a reasonable degree of price flexibility and generally exhibits a competitive business environment, but that the degree of competition and market flexibility falls short of what might be achievable. The assessment also concluded that capital markets can play an important role in stabilising the impact of shocks, but that risk-sharing is not significant in the EU at present and greater integration could bolster its role as an adjustment mechanism. This box and chapter report on trends and progress in product and capital markets. Key new measures introduced since Budget 2004 to promote capital and product market flexibility include:

Modernising the business tax system: the Government is establishing a new integrated tax department, and taking immediate steps to deliver benefits for business. Further proposals for the reform of corporation tax have been published for consultation.

Regulatory reforms to ease the burden on business: including the Government's acceptance of the recommendations of the Hampton Review of regulatory inspection and enforcement and the recommendations from the Better Regulation Task Force, and a continuing commitment to regulatory reform in Europe as a priority of the six EU Presidencies until the end of 2006.

Promoting competition: through reviews into, and action on, competition in a variety of markets including legal services, payment systems, subsidies, ticket agents, home credit, liquefied petroleum gas and store card credit services; an Office of Fair Trading (OFT) review of how public sector procurement affects competition; an audit of public sector radio spectrum use; and an OFT review of the impact on competition of the Financial Services and Markets Act 2000.

Planning reform: including the Planning and Compulsory Purchase Act 2004 which introduces a simplified planning structure with strengthened regional spatial strategies; updating national planning guidance on housing, town centres and retail, and economic development; and increased resources for the planning system. Significant progress has been made in implementing the planning reform recommendations of the Barker Review, published alongside Budget 2004.

Improving access to finance for SMEs and individuals: including the final report of the Graham Review of the Small Firms Loan Guarantee Scheme and action to implement its recommendations by end 2005, and deregulatory changes to the financial promotions regime.

Capital market integration: together with the FSA and Bank of England, the Government has set out a strategic approach to developing the Single Market in financial services following the EU Financial Services Action Plan. The Government has taken action to improve the functioning of the investment chain, identifying under-performing links in this chain and implementing solutions.

