

C1 The Government's economic objective is to build a strong economy and a fair society, where there is opportunity and security for all. Reforms which promote flexibility and fairness are central to achieving this goal. Rapid technological progress and strong competition in global markets mean that the profitability and competitiveness of different industries and occupations are continually evolving. A flexible economy responds to such changes in economic conditions efficiently and quickly. A high degree of flexibility minimises disruptions to output and employment and helps an economy to sustain high rates of productivity growth and employment. Flexible and dynamic markets are therefore a precondition for economic strength. Flexibility is especially important when a country needs to adjust to a country-specific shock within a monetary union, where monetary policy at a national level is not an option.

C2 The Government is committed to advancing flexibility and fairness together by enabling individuals and firms to cope with and respond to change. By investing in education and training, it has helped to equip people to adapt to new and changing employment opportunities. The National Minimum Wage and reforms to the tax and benefit system help to cushion the impact of economic shocks on household incomes, while high-quality and responsive services such as Jobcentre Plus provide incentives and practical support to enable people to rapidly enter the labour market. Combining flexibility with fairness ensures that everyone in society has the support they need to achieve their full potential in a modern, dynamic economy.

C3 In his statement to the House of Commons on 9 June 2003 on UK membership of the single currency,¹ the Chancellor gave a commitment to publish six-monthly reports on trends and progress in labour, product and capital markets. This document is the first of these six-monthly flexibility reports. It complements a range of other information which the Government produces on economic developments and structural policy reforms in both the UK and internationally, particularly across Europe. This report records progress on the Government's reforms of labour, product and capital markets, which promote flexibility and fairness.

C4 This annex is divided into two sections:

- the first section explains the importance of a flexible economy and the Government's approach of combining flexibility with fairness; and
- the second section sets out the action the Government has taken to boost flexibility in labour, product and capital markets since Budget 2003 and in this Pre-Budget Report.

¹ Available at www.hm-treasury.gov.uk

WHY FLEXIBILITY MATTERS

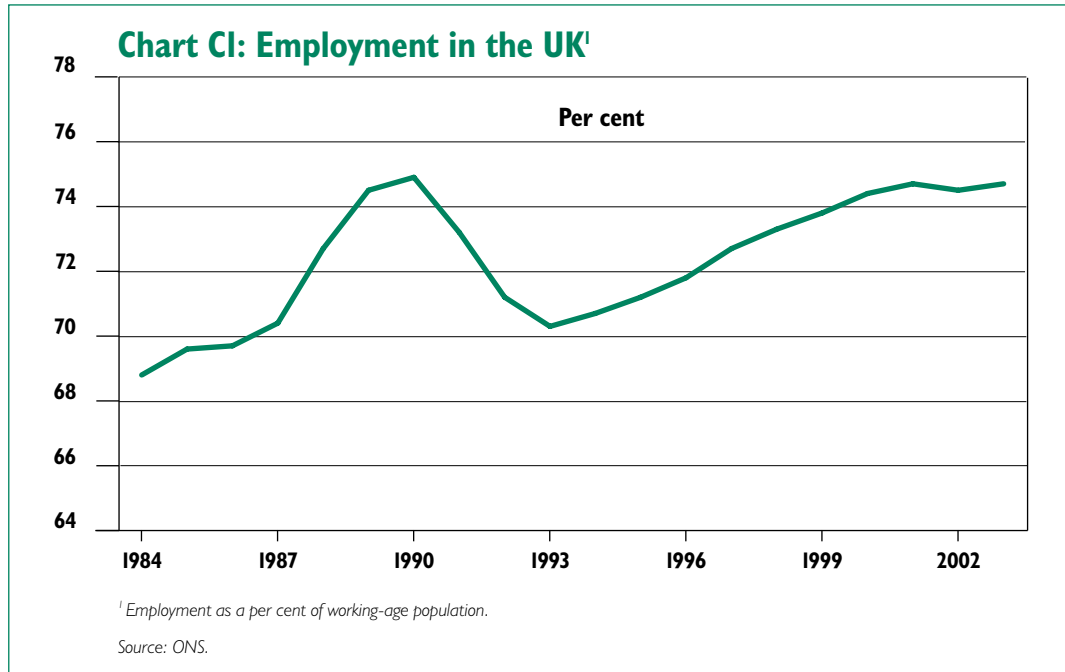
Why flexibility is needed **C5** Flexibility is the ability of firms and individuals to respond to economic change efficiently and quickly. Economic change can come in many different forms. Economic growth is driven by continual advances in technology that increase the efficiency with which existing goods and services can be produced and increase the range of goods and services that are provided. In addition, shifts in consumer demand for different products, the opening up of new markets, the emergence of new competitors and improvements or disruptions to the supply of natural resources all have important effects on the profitability of different firms and industries.

C6 In recent years, advances in information and communications technology, the increased integration of emerging markets with the global economy and significant movements in the price of oil have been prominent developments affecting industry. However, individual firms and households may also be affected by more localised changes that affect particular industries or particular firms within an industry. In a global age, such changes are happening faster than in the past. As a result, the economy is continually undergoing a process of structural change, in which the amount of labour and capital required by some industries declines, freeing up resources that may be profitably used in the production of new goods and services.

Characteristics of flexibility **C7** Economic flexibility describes an economy's capacity to adjust to such changes. There are many different ways in which workers and firms can adjust to change. For firms, adjustment may involve altering prices or changing a product line. For a worker, adjustment may mean learning a new skill, accepting a lower wage increase, moving into a different job in the same firm or even changing employer. Adjustment is achieved by a combination of changes occurring in the labour, product and capital markets. This can be supplemented if necessary by complementary changes in the stance of monetary and fiscal policy. Flexibility is about minimising the costs of adjustment.

C8 A flexible economy has the ability to adjust smoothly and rapidly, with movements in relative prices and quantities that enable the economy to maintain high levels of output and employment. However, stability at the macro-economic level may disguise considerable changes at a more disaggregated level. Between 1995 and 2003, UK employment grew by 2.2 million, but with marked differences in the rate of growth even at a broad level of industry aggregation.

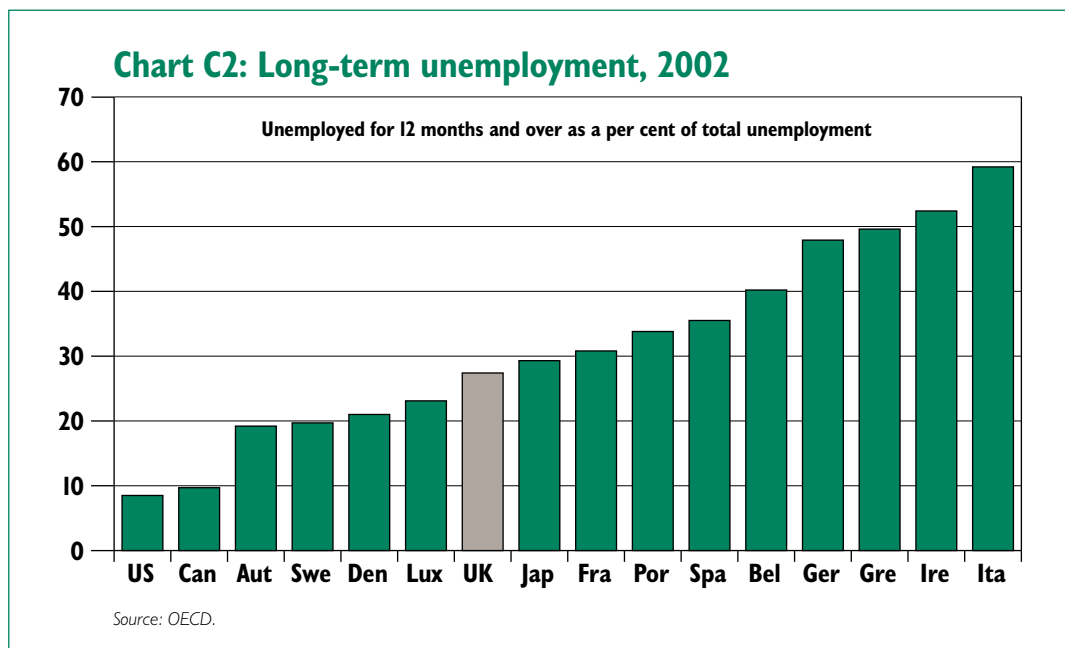
C9 In an inflexible economy, weak adjustment capacity increases the likelihood that adjustment will be slower and more disruptive. In the worst case, output and employment may be permanently affected. This is a particular risk when the economy experiences substantial disruptions. For example, the 1991-92 recession led to the employment rate in the UK falling from 75 per cent in 1990 to around 70 per cent in 1993 and it was not until 2001 that it returned to its 1989 level, as shown in Chart C1. The effect was particularly acute for older male workers, many of whom were forced into involuntary early retirement. As a result, both personal incomes and national income were lower than they would have otherwise been.



Flexibility and recent economic performance

C10 In recent years there have been striking differences in the performance of the leading industrial nations which appear to be associated with the overall flexibility of their economies. Between 1995 and 2002 labour productivity in the US grew by 2 per cent per annum on average, compared with 1.6 per cent in the UK and 1 per cent in the EU. While this partly reflects differences in the macroeconomic policy stance between countries, much of the difference appears to be more deep-seated, reflecting structural differences. The OECD estimates that the structural rate of unemployment in the euro area in 2003 is 8.1 per cent, compared with 5.2 per cent in the UK and 5.1 per cent in the US.

C11 Chart C2 illustrates that the UK has lower rates of long-term unemployment compared to a number of other major European countries. This is partly as a result of the New Deal regime, which has been effective at reducing long-term unemployment. However, the chart shows that the rate of long-term unemployment in the UK still remains above the low levels achieved in the US and Canada.



CI2 Policies that impact on labour, product and capital markets are an important determinant of the overall balance between flexibility and fairness in different economies. In the US, the minimum wage and Earned Income Tax Credit combined with low benefit replacement rates create a strong incentive for displaced labour to find new employment. In addition, relatively unrestrictive employment protection legislation has reduced the cost of providing employment and encouraged job creation. However, relatively ungenerous levels of out-of-work support mean that periods of unemployment can result in large reductions in family incomes. Well-developed capital markets in the US, including a vibrant venture capital market, have provided finance for business creation and expansion, and support an already strong entrepreneurial culture. These features have enabled the US to be at the forefront of developing and exploiting advances in information and communications technology (ICT). However, the US provides lower levels of publicly funded support to its citizens. For example, it does not have a national health insurance programme and 14 per cent of the population has no insurance coverage. The costs of health care are high and many Americans are at risk of being uninsured at some point in their lives.

CI3 In Europe, labour market policy has placed greater emphasis on mitigating the effects of change. In many European countries relatively generous benefit systems help insure households against labour market shocks but at the same time reduce incentives for claimants to return to and progress in work, leading to relatively high structural levels of unemployment. These effects are to some extent mitigated by active labour market policies, especially in the Nordic countries. Furthermore, in some countries overly restrictive legislation governing conditions of employment has placed significant constraints on employers. The effect of these restrictions on overall flexibility is partially offset by high functional flexibility of the workforce as a result of effective workforce training programmes.

CI4 Product market competition is more restricted in Europe than in the US, with some markets strongly segmented along national lines, particularly in utility and service industries. Similarly, capital market integration has been impeded by regulations that have restricted cross-border capital flows. EU Member States have committed themselves to a programme of economic reform to further promote the integration of European labour, product and capital markets. While there has been welcome progress in some areas – including modernisation of the EU's competition regime, steps towards liberalisation in markets such as energy and telecommunications, reform of the state aid regime, and increased employment – more work is required to deliver improved outcomes for the EU economy. As in previous years, the Government will publish a progress report on European economic reform ahead of the Spring European Council in March 2004.

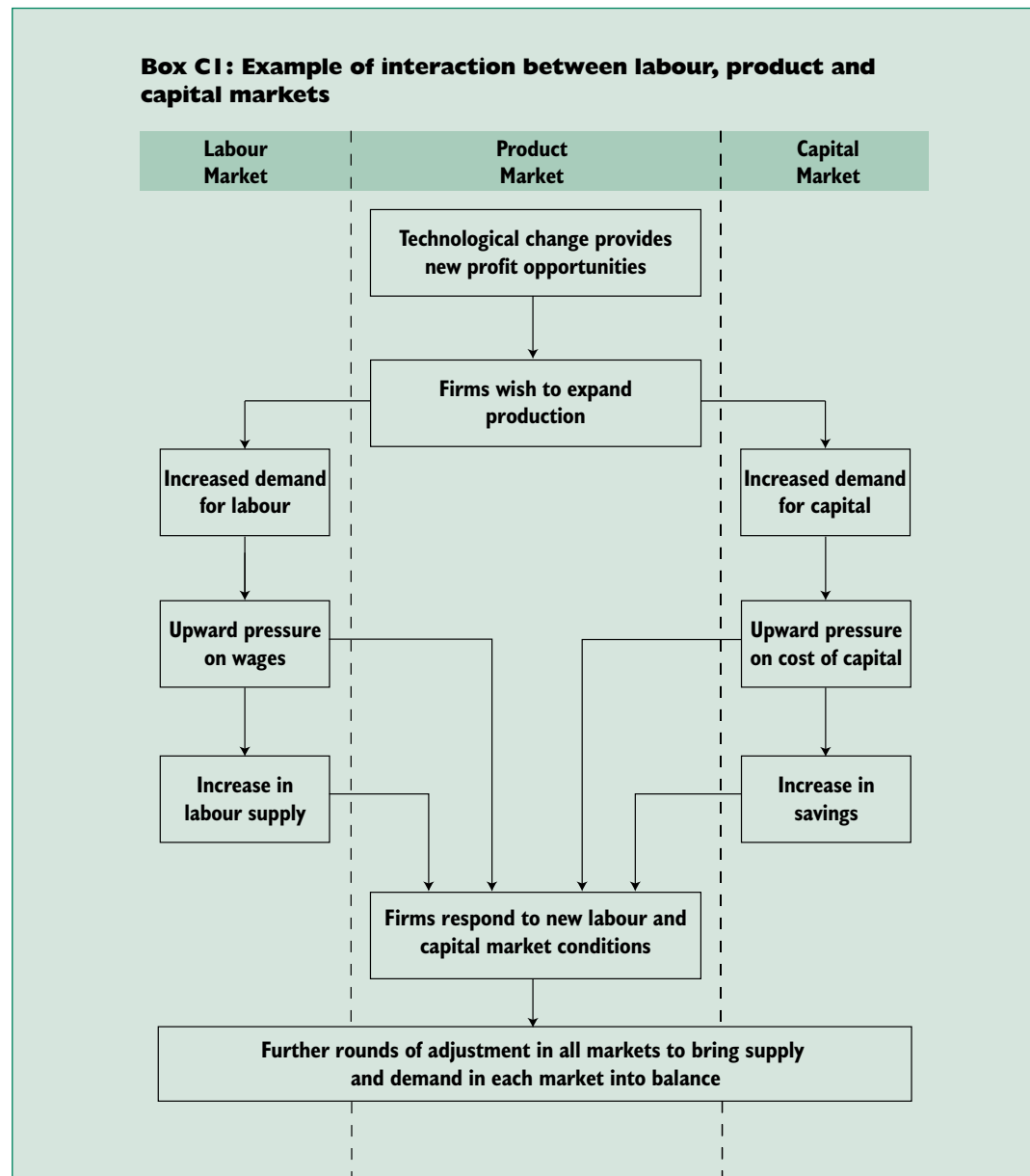
The UK's approach: combining flexibility and fairness

CI5 The Government's objective is to build a stronger, more enterprising economy and a fairer society, maintaining stability and ensuring rising living standards for all. This entails an approach to economic reform that advances flexibility and fairness together, combining the best features of the US and European systems. Investment in education and workforce skills help individuals adapt to change. Reforms to the tax and benefit system provide national guarantees through a National Minimum Wage and a national tax credit system that help to insure households against fluctuations in their incomes while at the same time strengthening incentives to participation in the labour market. The Welfare to Work strategy provides assistance with job search and training. The Government's approach to increasing employment for all is discussed in more detail in Chapter 4 of this Pre-Budget Report, and its strategy for building a fairer society is set out in Chapter 5. The Government's reforms to the competition regime encourage firms to respond quickly to changes in market conditions and help to ensure that key product markets work better for consumers. The Government has also

increased support for basic and applied research, encouraging innovation and helping businesses to harness the potential of new technologies. Policies such as the Savings Gateway, Child Trust Fund and ISAs have expanded access to capital markets and spread the benefits of saving and asset ownership. Investment in strong and flexible public services has helped to make them more efficient and responsive and extended opportunity and security for all.

Flexibility in labour, product and capital markets

C16 The overall flexibility of the economy depends on the interaction of flexibility in the labour, capital and product markets, as illustrated in Box C1. This interdependence implies that the overall flexibility of the economy depends on each market working as effectively as possible. The diagram illustrates how changes originating in the product market are transmitted to the labour and capital markets and back to the product market. Further rounds of adjustment and feedback will occur until the balance of supply and demand is restored in each market. Changes originating in labour and capital markets, for example, as a result of tax and benefit changes which affect labour supply or a change in risk aversion affecting the cost of capital, will similarly be transmitted to other markets, with the economy's overall adjustment reflecting the interactions between all three markets.



Labour market flexibility C17 The performance of the labour market is central to the well being of the economy and society. A flexible and efficient labour market has the ability to adjust to changing economic conditions in a way that maintains high employment, low inflation and unemployment, and continued growth in real incomes. Backed up by policies which equip people to adjust rapidly to change and provide support for those who are not in employment, it implies an economy that is fairer, more competitive and more productive.

C18 The key characteristics of a flexible labour market are that:

- wages adjust to maintain the balance between labour supply and labour demand;
- the labour force is equipped with transferable skills that employers require, enabling the rapid redeployment of labour within or between firms when labour demand changes;
- firms do not find it prohibitively costly to create employment or to vary it when needed;
- workers are able easily to commute or move residence in order to find employment;
- working patterns meet the needs of both employers and employees, increasing labour supply; and
- there is an institutional environment that encourages labour force participation, equips people to adapt rapidly to change and provides support for those without employment, enabling them to remain active participants in the labour market.

C19 Chapter 4 of this Pre-Budget Report sets out the Government's overall strategy for ensuring employment opportunity for all. Achieving this aim requires a flexible labour market in which people are equipped to make effective and informed labour market choices. New measures introduced since Budget 2003 that promote flexibility and fairness in the UK labour market are summarised in the second section of this report.

Product market flexibility C20 Product market flexibility relates to the ease with which firms are able to respond to changing market conditions. For individual firms or industries increased flexibility enables them to respond rapidly, allowing firms to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment.

C21 The main characteristics of a flexible product market are that:

- there is a competitive environment which rewards efficiency, discourages waste and provides firms with strong incentives to adapt the range and quality of their goods and services to provide their customers with good quality products at competitive prices;
- there is a strong capacity for innovation, enabling firms to develop and implement new processes and products ahead of their competitors;
- there are low barriers to entry which allow new firms to challenge incumbents creating incentives for innovation and efficiency; and

- a regulatory environment in which the constraints on business yield clear benefits to the wider economy and are not disproportionately costly in terms of their effect on firms' incentives to hire, train, innovate and invest.

Capital market flexibility **C22** Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively. Efficient capital markets ensure that businesses, entrepreneurs and innovators have ready access to the funds that they require in order to develop their ideas. Capital markets also play an important role in balancing the risks and returns of different uses of capital, screening out projects that have an unacceptably high level of risk.

C23 Flexible capital markets can also play a role in underpinning flexibility in labour and product markets. They should, for example, allow individuals to borrow when necessary in order to enhance their education and skills, with beneficial effects on productivity and on the employability of the individuals concerned. In product markets, flexible access to finance should allow firms to reallocate resources efficiently and to invest as appropriate in new processes and products.

C24 A flexible capital market can also promote fairness by enabling all individuals to take advantage of educational and business opportunities. However, government intervention may on occasions be required to ensure that information asymmetries do not lead to some individuals being unfairly denied access to capital markets.

C25 The main characteristics of a flexible capital market are that:

- borrowers have a range of financing options available to them that allow them to access the capital they require at a competitive price and on competitive terms. This applies particularly to firms seeking capital for high risk projects, where efficient capital markets are best placed to price the risk appropriately;
- investors have the ability to hold a diversified portfolio of assets spread across regions and sectors, so that they can use income from these assets to insure against a fall in income that is specific to their own region and sector; and
- there is sufficient borrowing and lending capacity on credit markets to allow households and business to smooth fluctuations in income.

Flexibility and the productivity challenge **C26** Many of the important characteristics of a flexible economy are also key drivers of productivity growth. The ability to switch resources readily between firms and industries improves the economy's resilience in adverse market conditions and its capacity to develop and implement the technological advances and organisational changes that raise productivity and wages. Chapter 3 of this Pre-Budget Report sets out the Government's overall strategy for promoting productivity and enterprise in the UK economy through reforms which boost competition, enterprise, skills, innovation and investment. New measures introduced since Budget 2003 which promote product and capital market flexibility are summarised in the next section of this report.

MEASURES TO PROMOTE FLEXIBILITY

C27 This section of the report summarises the action the Government has taken since Budget 2003 and in this Pre-Budget Report to promote flexibility and fairness in the UK economy.

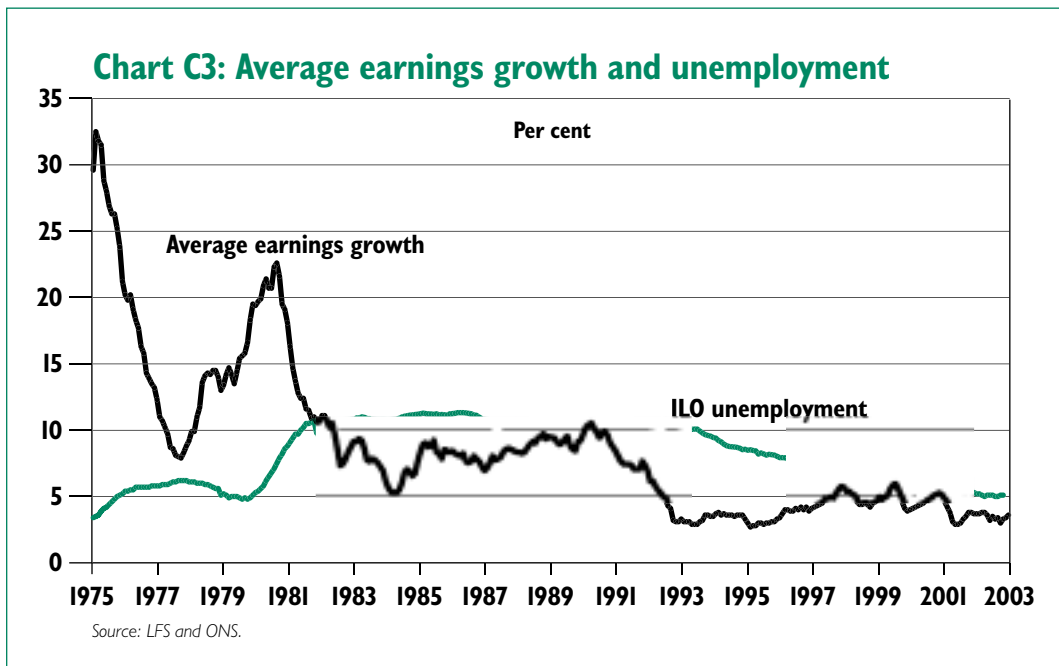
Measures to promote flexibility and fairness in labour markets

C28 The Government's long-term goal is employment opportunity for all – the modern definition of full employment. Its strategy involves maintaining macroeconomic stability and promoting an enterprising economy with a dynamic and flexible labour market in which people are able to make effective and informed labour market choices. The Government has introduced a range of measures to advance flexibility and fairness in the UK labour market.

Enhancing wage flexibility

C29 In the labour market, as in other markets, price adjustment is an important factor that ensures that the market mechanism functions effectively. Wage levels are a major determinant of the supply of and demand for labour. A dynamic and flexible labour market requires wages to respond flexibly to shocks and to imbalances between supply and demand, both at the aggregate and sectoral level.

C30 Historically the UK has had to contend with accelerating wage inflation in the face of low levels of unemployment. However, as Chart C3 shows, in the most recent labour market upswing unemployment has fallen to historically low levels but the rate of wage growth has remained consistent with the inflation target and trend productivity growth of 2 per cent – a development consistent with the estimated fall in the structural unemployment rate since the early 1990s. This improvement in part reflects the successful reintegration of the long-term unemployed and marginalised groups into the labour market, which helps to ensure that the economy does not run into labour supply bottlenecks. This strategy is discussed later in this annex.



C31 In an efficient labour market, wages should move to balance the supply of, and demand for, labour in regional and local labour markets. This process can be impeded by national pay agreements that fail to take account of local and regional conditions. The Government has amended the remits for the Pay Review Bodies to include a stronger local and regional dimension and is working with the rest of the public sector to increase the focus on respecting local pay conditions, side by side with UK-wide guarantees of a National Minimum Wage and the tax credit agenda.

Allsopp Review C32 In light of the growing regional productivity and flexibility agenda, Christopher Allsopp was asked in February 2003 to undertake a review of statistics for economic policy-making and to produce a first report by the time of the Pre-Budget Report:

- the first report, described in more detail in Annex A, makes a number of recommendations **to improve the quality and availability of regional data**, including price and labour market data, to satisfy the growing demand for such data over the medium-term.

Promoting geographic mobility C33 A labour force that is able to move within and between regions enhances labour market flexibility by enabling workers to move to available employment opportunities. In the UK geographic labour mobility is low compared to the US, as is the case elsewhere in Europe. The Government has been introducing a number of policies that aim to raise the ability and willingness of workers to commute or move location in order to find employment.

C34 The current Housing Benefit system is complex and can reduce work incentives and create barriers to geographic mobility. The Government has announced a number of Housing Benefit reforms to address these problems, discussed in more detail in Chapter 4. These include the piloting of a new local housing allowance (LHA) for tenants in the private sector in nine Pathfinder areas. This will give recipients greater certainty as to their level of entitlement and so increase their ability to choose where to live. In this Pre-Budget Report the Government announces:

- the intention to begin **LHA Pathfinders in the social sector** as soon as practical.

C35 The Government has introduced housing and planning reforms to increase housing supply and in turn make it easier for households to access employment opportunities wherever they occur. Analysis of the importance of housing market flexibility is provided in Box C2. The Deputy Prime Minister's Sustainable Communities statement in February 2003 detailed plans for a significant increase of 200,000 homes over and above existing plans by 2016. This will be backed by planning reforms to ensure local authorities make plans for at least ten years potential supply of housing, while prioritising brownfield development and driving up density. In this Pre-Budget Report, the Government:

- welcomes **the interim report of the Barker Review** on the factors affecting housing supply in the UK, discussed in more detail in Chapter 3, and looks forward to the final report in spring 2004;
- announces its intention to issue a consultation document on **tax transparent property investment trusts** at Budget 2004; and

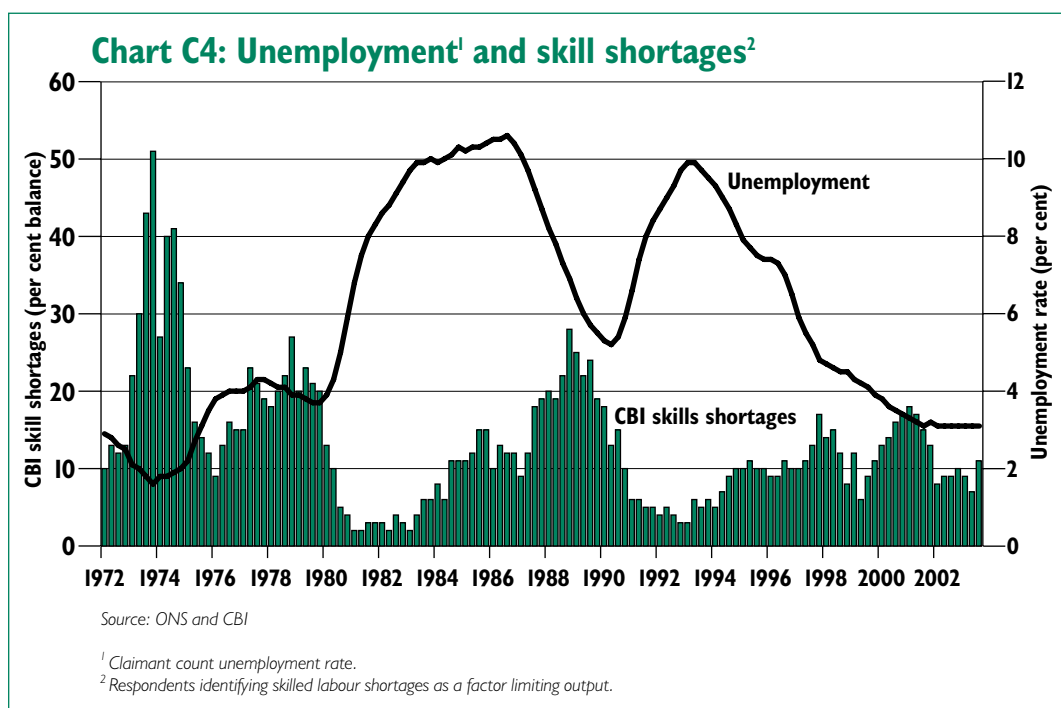
- welcomes Professor David Miles' interim review of the supply and demand side factors limiting the development of the fixed rate mortgages in the UK, discussed in detail in Chapter 2, and looks forward to the final report at the time of Budget 2004.

Box C2: Housing and flexibility

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

The Government is committed to a comprehensive programme of action to improve the functioning of the UK housing market and to ensure a better match between the supply and demand for housing. The objective is to reduce the extent to which housing considerations may constrain labour market adjustment. The Government's reform programme is discussed in detail in this Pre-Budget Report and summarised in this annex.

Developing skills C36 The quantity and quality of skilled labour in an economy are important determinants of economic performance and productivity growth. Skilled workers adapt faster and more effectively to change. They increase the ability of a firm to update its practices and products at the rate demanded by changing markets, making the economy more flexible. Chart C4 illustrates that in the past skills shortages have acted as a significant constraint on economic growth. While shortages have been less acute in recent years, improving skills acquisition remains fundamental to the long-term health of the economy.



C37 The Government is committed to further action to develop skills. This Pre-Budget Report sets out a number of steps the Government has taken to develop workforce skills and so enhance flexibility in the UK, discussed in more detail in Chapter 3:

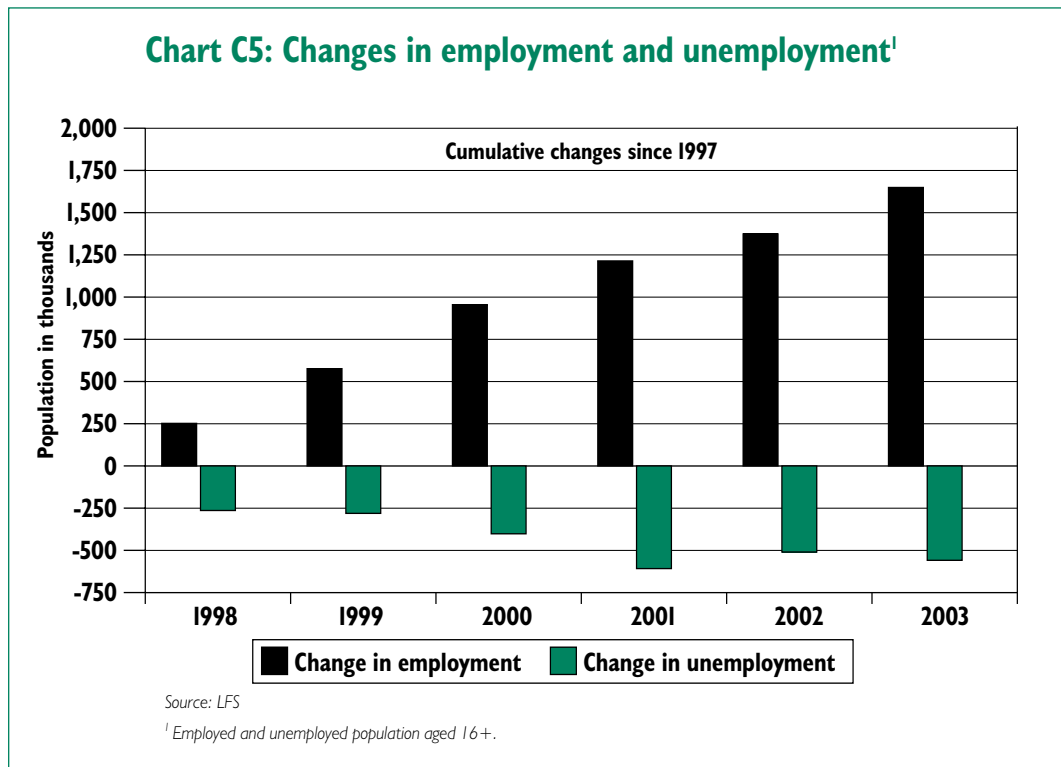
- the **extension of Employer Training pilots** to encourage skills training for a third year and to cover over a third of England;
- the publication of a **discussion paper on delivering incentives for membership bodies to provide workforce development**; and
- implementing measures announced in Budget 2003 to support the contribution migration makes to creating a skilled and flexible workforce, including changes to enhance the **Highly Skilled Migrant Programme**, and a new entitlement for international science and engineering students to work in the UK after graduation.

Employment flexibility C38 Employment flexibility describes the provision of a range of working patterns that allow both employers and employees to find an arrangement that best meets their respective needs. Part-time and temporary work gives employers the flexibility to vary capacity levels and employees scope to balance their work and other responsibilities. Diverse patterns of employment can achieve a more efficient matching of labour demand and supply.

C39 The UK labour market shows a significant degree of employment flexibility, with a high incidence of part-time work, a wide distribution of hours worked and widespread adoption of flexible working practices, all of which are primarily a result of employee choice. However, employment flexibility can be increased further. The Government is keen to promote diverse forms of employment including the take up of self-employment. It is currently introducing a number of measures to promote employment flexibility, discussed in more detail in Chapters 4 and 5:

- a Small Business Services Review of the **routes off benefits into self-employment**, to report in spring 2004;
- promoting the **provision of employer supported childcare**; and
- an increase in the returns from **deferring the state pension**, promoting choice for those who wish to extend their working lives.

Improving labour market opportunities C40 Since 1997, unemployment in the UK has fallen to levels last seen in the 1970s, the number of people in jobs has risen by 1.7 million and the employment rate is the highest in the G7, as illustrated in Chart C5.



C4I While this performance is strong both by historical and international standards, not all groups have shared equally in the success. Employment opportunity for all means that everybody is given the right assistance and the right choices to return to the labour market while at the same time ensuring support for those that cannot work. Chapter 4 describes the measures the Government has introduced to provide opportunity and choice for all, including extensive programmes of support for those groups with special circumstances, such as the long-term unemployed, lone parents, partners of benefit claimants and sick and disabled people. The Government is also targeting support for people in disadvantaged areas and for ethnic minorities. In Chapter 4 of this Pre-Budget Report the Government announces further help for these groups:

- **enhanced help for lone parents**, increasing the number of work-focused interviews lone parents with children aged 14 or over are required to attend, and providing help with childcare costs in the week before starting work;
- **improving work incentives** in London by extending pilots of the £40 per week in-work credit to parents, including lone parents, who have been on certain benefits for a year or more;
- **extra support to help the unemployed**, by piloting mandatory short intensive work-focused courses at the six-month stage;
- an extension of eligibility for the **enhanced New Deal for partners**;
- **an extension of back to work help for those aged 60 and over and on the Pension Credit** by October 2004;
- **extra help for sick and disabled people**, enabling Jobcentre Plus personal advisers to provide additional voluntary support to Incapacity Benefit customers who want to return to work; and
- the existing Action Teams will be extended, two additional **Action Teams** will be introduced and Action Teams will have greater discretion to direct resources towards the most disadvantaged people.

Measures to promote flexibility and fairness in product markets

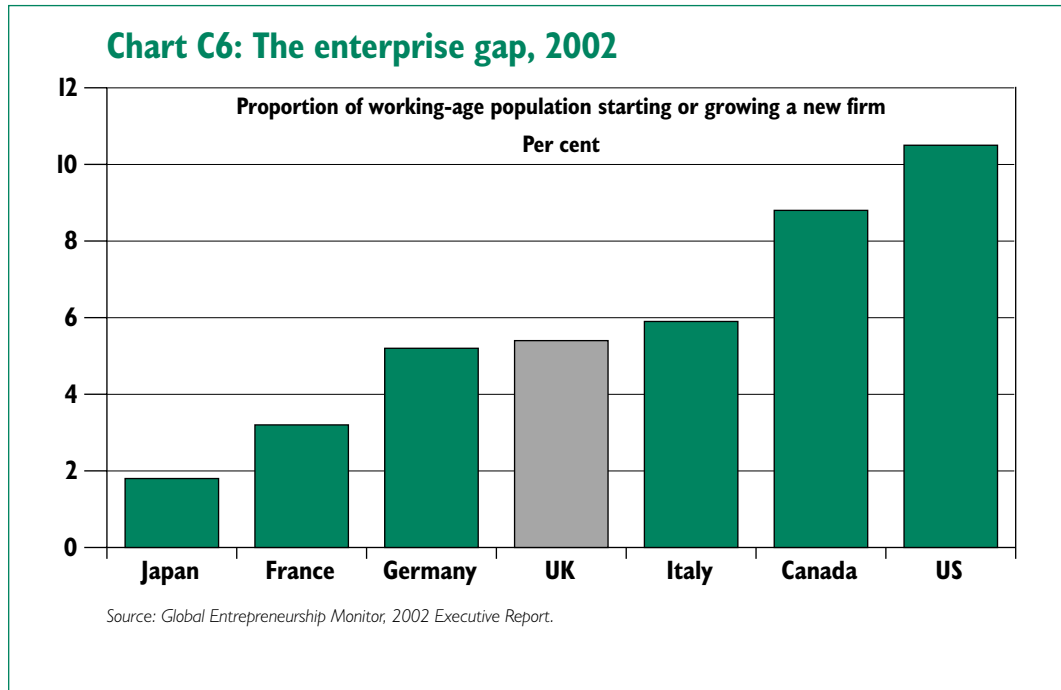
C42 Chapter 3 of this Pre-Budget Report sets out the Government's programme of reform aimed at promoting flexibility and boosting productivity growth in the UK economy by focusing on measures which boost competition, enterprise, innovation, skills and investment.

Competition C43 Competition boosts flexibility by providing incentives for firms to respond quickly to changes in market conditions, technology and costs. Competition increases the incentives for firms to adopt more efficient working methods and to develop new products and services that meet the changing demands of consumers. The Government is committed to promoting competition in the UK economy and has taken significant steps to ensure that the UK competition regime ranks among the best in the world. The Enterprise Act (2002) has given full independence to UK competition authorities and given the Office of Fair Trading (OFT) more proactive powers to investigate markets where competition may be restricted or distorted. Empowered consumers promote competition in markets by providing signals and incentives for firms to respond quickly. Since Budget 2003 the Government has taken further steps to enhance competition, empower consumers and promote flexibility, discussed in more detail in Chapter 3:

- an independent review into regulation of the **legal services market** aimed at promoting competition and innovation will report in December 2004;
- a review of the **Financial Services and Markets Act (FSMA)** including an assessment of its impact on competition; and
- measures to **improve competition in the supply of goods and services to the Government**.

C44 Government is also introducing a number of measures to promote competition in specific markets, discussed in further detail in Chapter 3.

Enterprise C45 The Government is committed to building an enterprise society in which people from all backgrounds can consider and act on opportunities for enterprise. A strong entrepreneurial culture means that the economy is better equipped to identify and develop the opportunities offered by new technologies, new products and new markets, and generate new sources of income when existing production techniques and products lose their competitiveness. Chart C6 illustrates that the entrepreneurial culture in the UK is not as highly developed as in the US and Canada, where a much higher proportion of the population is engaged in starting or growing new firms.



C46 In this Pre-Budget Report the Government has taken the following new steps to promote enterprise in the UK economy, discussed in more detail in Chapter 3:

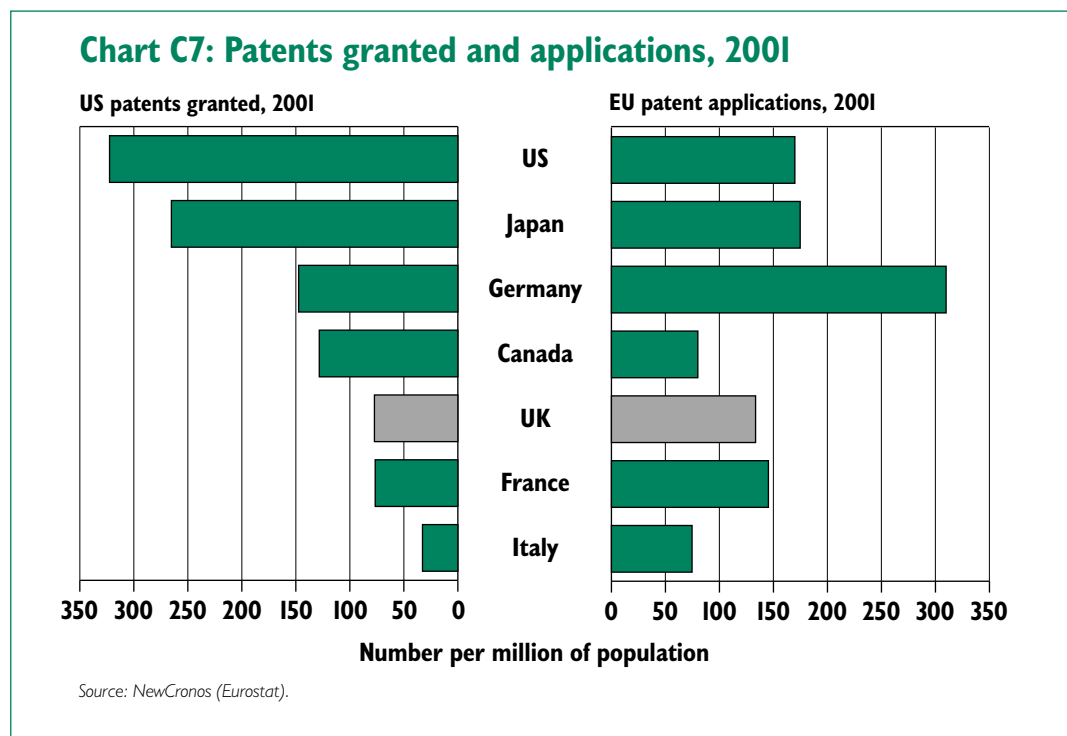
- the **launch of a new businesslink.gov.uk website**, which will provide an online service for business advice;
- measures to support regional growth, **including details of the [Local Authority Business Growth Incentives Scheme](#)**, which will boost the role of local authorities in business growth;
- **reforms to reduce the regulatory burden on enterprise**, including the recent announcement of an increase in the statutory audit threshold to £5.6 million; and
- measures which will ensure **greater stability within the regulatory system** such as considering an extension of the common commencement date commitment for employment law to other areas of regulation, subject to the findings of the current DTI pilot.

C47 The Government has introduced significant reforms to modernise the business tax system and promote enterprise and flexibility. The Government has already cut the main and small companies' rates of corporation tax from 33 and 23 per cent to just 30 and 19 per cent. It has also introduced a generous capital gains tax taper for business assets – so that the UK now has one of the most favourable Capital Gains Tax (CGT) regimes in the world. This Pre-Budget Report announces further measures, discussed in more detail in Chapter 3:

- **improvements to the VAT flat rate scheme**, including new lower rates, to enable more businesses to benefit fully from compliance savings; and
- a package of other **measures to improve the business tax system**.

Science and Innovation C48 Through innovation business can harness the potential of new technologies and promote more efficient ways of working. Successful innovation extends the range of products that the economy can produce and reduces the costs of existing production methods. Both developments increase the productive potential of the economy and improve its resilience to global competition. However, the UK lags behind its major international competitors in some important aspects of innovation performance, for example, in terms of patents applied for and granted (Chart C7). The Government is pursuing various measures to promote innovation in the UK economy, discussed in more detail in Chapter 3. This Pre-Budget Report describes the steps the Government is taking including:

- a new, clearer and more accessible **R&D tax credit definition**; and
- the publication of the **Lambert Review of Business-University collaboration**.



Investment C49 Investing in new technology and capital is important if firms are to respond to new opportunities in a competitive and entrepreneurial way. Where there are financial or structural barriers to new investment, firms' competitiveness will be constrained. In addition, investment in underlying infrastructure can help to facilitate flexibility in wider labour and product markets by making both labour and products more mobile. The Government has today announced the following steps to promote investment in the UK economy, discussed in more detail in Chapter 3:

- an increase in the **qualification thresholds for SMEs** to allow more businesses to benefit from higher first year capital allowances; and
- a proposed scheme for a **Business Premises Renovation Allowance**, subject to state aid approval.

Planning reform C50 The Government is committed to reforming the planning system to make it more strategic, streamlined and flexible, helping to deliver the Government's objectives of increasing enterprise and productivity and promoting investment. Key measures will be introduced in the first Planning Bill for more than a decade, which is expected to receive Royal Assent by Spring 2004. The reforms include the abolition of county structure plans, the introduction of a more flexible local development plans system and legislation for Business Planning Zones to speed up development in disadvantaged areas. The Government will be issuing a revised planning policy statement on town centres in England, for consultation, which aims to encourage investment and growth in town centres. It is also undertaking reform of planning obligations, addressing potential delays in negotiated section 106 agreements by proposing a new optional planning charge which developers could choose to pay in place of a conventional negotiated agreement. The planning system is also one of the important factors considered by the Barker Review in its study of housing supply in the UK.

Measures to promote flexibility and fairness in capital markets

C51 Capital markets contribute to the flexibility of the economy by providing entrepreneurs and firms with the finance that they require to fund their activities. A flexible capital market ensures that finance is provided at the lowest price appropriate to the investment risk borne by the provider. Efficient capital markets enable individuals to smooth out fluctuations in their income by offering a wide range of saving vehicles and allowing individuals to borrow prudently against future income.

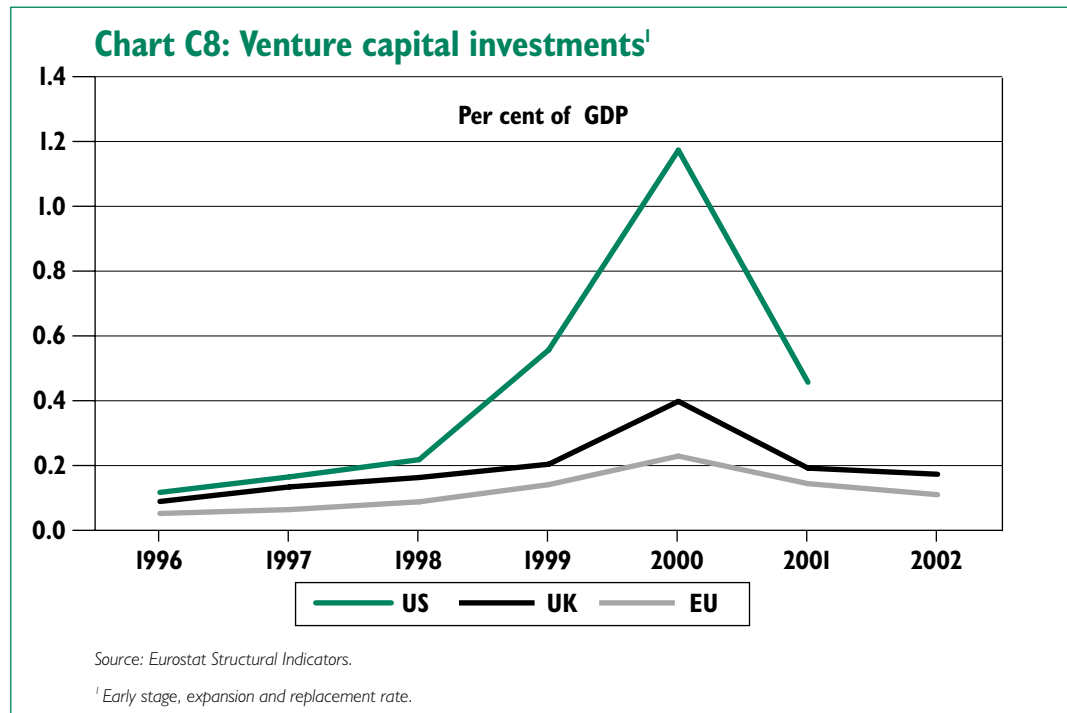
Securities settlement C52 The ability of companies to raise capital in a cheap and flexible manner is important in allowing them to respond to market developments and to drive forward their efforts to raise their business performance. An important part of achieving cheap and flexible access to capital is having an efficient securities settlement system. Electronic settlement can bring cost savings for issuers and investors, and increase flexibility in the issuance of securities. In 1998 the Bank of England produced a Securities Settlement Priorities Review. In response to the review's final outstanding recommendation the Government:

- legislated in June 2003 to allow for the **electronic settlement of money market instruments, and migration of money market instruments** to an electronic settlement system was completed in October 2003.

SME Finance C53 The ability to access external sources of finance is essential if small businesses are to take full advantage of the investment opportunities available to them. Access to funds enables entrepreneurs and innovators to develop their ideas, contributing to improvements in productivity and ensuring that resources get directed to where they can be most profitably employed. Chart C8 shows that the UK has a large venture capital market compared to European countries but a smaller market than the US. However, the Government believes there is more to do to promote access to finance for small business. The Government has published *Bridging the finance gap: next steps in improving access to growth capital for small businesses* alongside this Pre-Budget Report which announces:

- measures to overcome barriers to raising finance for small business, including a pathfinder round of **Enterprise Capital funds** and proposed enhancements to **Venture Capital Trusts and the Enterprise Investment Scheme**;

- launch of an independent **review of the Small Firms Loan Guarantee**; and
- a package of measures to enhance **small firms' awareness of the range of finance options** open to them.



Investment and Corporate Governance

C54 A good framework for investment decisions and corporate governance ensures that savings are put to their most effective use and reallocated on a timely basis. Improving transparency of market signals and enhancing institutional responsiveness to competitive pressure are key elements of flexibility. This helps to promote better company performance, higher returns to investors and a lower cost of capital. The Government has taken a series of steps to aid this process by promoting greater accountability and transparency in the links between investors and companies, which is discussed in further detail in Chapter 3 of this Pre-Budget Report. Most recently the Government has:

- endorsed the introduction of the **new Combined Code**, which was issued in July 2003 and takes effect for listed companies with reporting years beginning on or after 1 November 2003;
- introduced a bill, based on the **legislative recommendations of the Coordinating Group for Accounting and Audit (CGAA) and the Swift Review**, to enhance auditor independence and to strengthen financial reporting;
- engaged with the industry on key issues still outstanding from the **Myners review of institutional investment**; and
- worked on measures **to improve the competence of pension fund trustees**, to be included in the forthcoming Pensions bill.

Sandler Review C55 Flexible capital markets provide an effective range of products for saving and investment to smooth consumption in response to fluctuations in income. In July 2002, a report for the Government by Ron Sandler recommended improvements in savings vehicles through the development of low-cost and risk-controlled stakeholder products. To take forward the agenda in the Sandler Report, the Government has:

- published a **response paper** in July 2003 in which it announced specifications for a simple set of low cost products;
- announced **that all Sandler stakeholder medium-term products and life insurance products** will be brought into the stocks and share components of ISAs from 2005; and
- worked to ensure that the **EU Investment Services Directive** takes account of product regulation as a middle way between full advice services and execution-only services.

Capital Markets integration C56 Greater integration of international capital markets should make capital allocation more efficient. This will ensure savers get the best return on their money and are able to hold a diversified portfolio of assets while funds flow to firms offering the best investment opportunities thereby encouraging innovation. To this end the Government will continue to work towards the creation of an integrated EU capital market and greater integration of EU-US capital markets. Recent important steps in this direction have included:

- the adoption by the EU in July 2003 of the **Prospectus Directive**, which will enable companies to raise capital across the EU on the basis of a single prospectus; and
- the UK encouraging a more intensive **EU-US dialogue on financial services issues**, in particular to look beyond the short term to ensure that issues are dealt with before they become pressing concerns.

CONCLUSIONS

C57 The ability of economies to adjust flexibly to changes in technology and in market conditions has been an important characteristic of successful economies since the Industrial Revolution. It is especially true of the current era, in which rapid technological change and globalisation provide increased opportunities to dynamic and flexible economies, but have also increased the costs arising from inflexibility and slow adjustment. As was highlighted in the Treasury's economic assessment of the case for joining EMU, a high level of flexibility is especially important when a country needs to adjust to country-specific shocks within a monetary union, since a country-specific monetary policy response is not an option.

C58 The Government recognises that it is important to ensure that the institutional and regulatory environment supports flexible adjustment in labour, product and capital markets, equipping the economy to respond to current and future opportunities and challenges. The Government also recognises that flexibility should be accompanied by policies that support individuals as they respond to change, so that flexibility is accompanied by fairness.

C59 This report highlights a range of specific measures that the Government is undertaking in pursuit of these objectives. A review of progress on the Government's reform agenda will be published at the time of Budget 2004.