3 MEETING THE PRODUCTIVITY CHALLENGE

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 main competitors. Building on the reforms and initiatives already introduced, the Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth and meet the long-term challenges of the global economy, including:

- giving employers the opportunity to access free and flexibly delivered training for their low-skilled employees through **a National Employer Training Programme**;
- **establishing an independent review to examine the future skills needs** of the UK economy, to be led by Sandy Leitch, (Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services);
- **reforms to reduce the regulatory burden on business**, including the extension of Common Commencement Dates to other areas of legislation, and progress on the Panel for Regulatory Accountability;
- **publication of the interim report of the Hampton Review** recommending improvements to the current system of regulatory inspection and enforcement to reduce the administrative burden on business;
- **setting out the vision of how significant reductions in compliance burdens for small businesses** will be delivered through the integration of HM Customs and Excise and the Inland Revenue;
- **implementation of the changes recommended by the Graham Review** of the Small Firms Loan Guarantee by end 2005; and
- **implementation of the ten-year Science and Innovation Investment Framework**, through strengthening the partnership with business on raising investment in UK R&D, and taking forward the recommendations of the Lambert Review on business-university collaboration including through the Northern Science and Industry Initiative.

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 to other major economies, partly due to past macroeconomic instability and historic under-investment in capital, skills and research and development (R&D). In recent years, however, data suggest that the UK's performance has improved. Box 3.1 suggests that the trend rate growth of productivity in the UK has increased in recent years, and that the productivity gap with major industrial competitors appears to be narrowing. However, there is still more to be done to match the productivity performance of countries such as the US.

The changing global economy

3.2 The Government is committed to further action to improve productivity both now and over the long-term, which will be key to the continuing success of the UK economy. *Long-term global economic challenges and opportunities for the UK*, published alongside this Pre-Budget Report and summarised in Chapter 1, sets out the challenges over the next ten years for the UK economy in an increasingly integrated global economy.

3.3 The global economy is undergoing a profound transformation, with far-reaching and fundamental changes in technology, production, and trading patterns. Faster information flows and falling transport costs are breaking down geographical barriers to economic activity. The boundary between what can and cannot be traded is being steadily eroded, and the global market is encompassing a greater number of services and goods. The rapid growth of large emerging markets, in particular China and India, is shifting the balance of global economic activity.

3.4 Global markets can deliver significant benefits, enhancing growth and living standards and providing new opportunities for UK businesses. *Trade and the global economy*, published by the Treasury in May 2004, explained that trade helps to drive economic growth and productivity, and the Government has prioritised making progress on multilateral trade liberalisation and seeks to strengthen economic co-operation with major partners, such as the US. Global change also puts a greater premium on economic flexibility. 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 which focuses increasingly on high value-added sectors. In this context, *Long-term global economic challenges and opportunities for the UK* identifies the policy challenges for the UK as enhancing skills, promoting enterprise and supporting science and innovation.

Meeting the long-term challenges

3.5 To meet these challenges, the Government is committed to taking the long-term decisions necessary to ensure the UK will succeed in the coming decades. This chapter sets out a new ten-year strategy to boost workforce skills, describes progress on the ten-year strategy for science set out in the 2004 Spending Review, and sets out further action to encourage enterprise and tackle excessive burdens of regulation. These reforms are described in the context of the five key drivers of productivity performance:

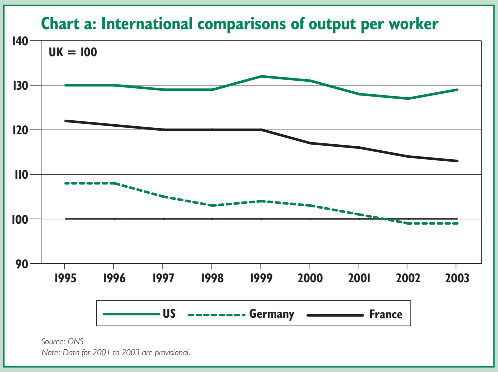
- improving *competition*, which promotes consumer choice and encourages flexible markets and increased business efficiency;
- promoting *enterprise*, by removing barriers to entrepreneurship and developing an enterprise culture. An enterprising and competitive economy will mean the UK is well-placed to respond to opportunities in a rapidly changing and increasingly integrated global market;
- 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. This need is reinforced by the rapidly rising skills levels in emerging markets such as China and India; and
- encouraging *investment*, to increase the stock of physical capital, including through stronger, more efficient capital markets. Capital markets are becoming increasingly integrated in the global economy.

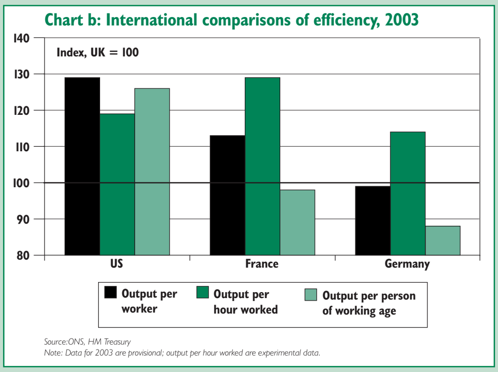
Box 3.1: UK productivity performance and the global economy

Productivity growth underpins strong economic performance and sustained increases in prosperity. In an open and competitive global economy, the success of developed countries will increasingly depend on rising productivity, and building a high value-added, innovative economy with a skilled workforce.

Between 1997 and 2001, the UK trend rate of underlying productivity growth (on an output per hour basis) is estimated to have grown by 2.7 per cent a year, compared with a growth rate in the previous economic cycle of just over 2.2 per cent a year. This improvement is encouraging, though it is too early to say whether it will be sustained.[a] The UK is also making progress towards narrowing the historic productivity gap with its competitors on both of the key measures of labour productivity – output per worker and output per hour worked – but a significant gap remains. In 2003, UK output per worker was 29 per cent lower than in the US (compared with 30 per cent in 1995), 13 per cent lower than France (22 per cent in 1995) and around the same level as Germany (8 per cent in 1995). The difference is greater on an output per hour basis. To produce the same output, UK workers work 14 per cent longer hours than German workers and 29 per cent longer than French workers.

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 10 per cent higher than Germany and similar to France. However, the UK again lags behind the US which combines high labour productivity with high employment.





The UK's current performance reflects in part historic under-investment in skills, infrastructure, physical capital and research and development. The UK's future prosperity is likely to depend increasingly on the capacity to translate its strong scientific research base into innovative products and better services. To realise the full potential of innovation the UK needs a highly skilled and flexible workforce, able to adapt to capture the benefits of new technologies and innovate further. While the proportion of people in the UK with high skills compares well internationally, many other countries, including India and China, are rapidly developing skilled workforces. The HM Treasury and DTI Productivity Indicators[b] show that the share of the UK workforce with intermediate skills is relatively low and the share with low skills relatively high, despite improvements over the last few years.

[a] Annex A includes a detailed account of the trend productivity and trend growth projections.

[b] Available at www.dti.gov.uk/economics.

Monitoring progress on the five drivers

3.6 At Budget 2004, the Government consulted on a focused suite of indicators that would monitor performance against these five drivers and progress towards the Government's productivity target. In October 2004 the Government published its response to the consultation. The new set of productivity indicators[1] highlights how the UK is performing relative to its major competitors on key dimensions of each of the five drivers of productivity. They will be used to help monitor progress on the productivity target, provide early warning of where more policy action may be needed and will highlight how the UK is performing relative to its major competitors on key dimensions of each of the five drivers of productivity.

European economic reform

3.7 The European Union also has a key role to play in improving economic performance. At the 2000 Spring Council in Lisbon, Europe's leaders committed themselves to making Europe *"the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion"* by 2010.[2] The increased pressure of globalisation means that the need for reform is more urgent than ever. The 2004 Spring Council therefore launched a Mid-Term Review of the Lisbon strategy.

3.8 In November 2004, as part of this Review, the former Dutch Prime Minister Wim Kok published a report calling on Europe to speed up the pace of reform and to act urgently to implement the Lisbon strategy.[3] As set out in Chapter 2, European economic reform will be a priority for the UK's Presidency of the EU in 2005, and the Government welcomes Wim Kok's report. The Government will work closely with its European partners to secure a positive outcome to the Mid-Term Review at the European Council in spring 2005, and will highlight that greater openness to trade and investment acts as a spur to growth, employment and productivity, reinforcing the structural reforms that are the core of the Lisbon agenda.

Productivity in the regions

3.9 The Government is committed to boosting productivity across all regions and countries of the UK. Reflecting their important role in promoting economic development, the nine Regional Development Agencies (RDAs) in England have been asked to contribute to the development of Budget 2005 in several areas: closer alignment of regional strategies for economic development, housing, planning and transport; embedding a culture of enterprise in disadvantaged communities; developing knowledge transfer and science cities; regional and national roles in sustainable development; engaging with the voluntary and community sector; providing focused tailored coaching to business; and strengthening regional partnerships for adult skills provision. Box 3.2 sets out the Government's initial response to the Northern Way First Growth Strategy Report published by the three northern RDAs and regional partners.

COMPETITION

3.10 A strong competition framework drives productivity because competition puts downward pressure on prices, increases the diversity and quality of products available to consumers, and drives innovation. A framework which encourages domestic competition will also prepare the UK to respond to the challenges of the global economy. International markets are becomingly increasingly competitive, as technological advances, a reduction in trade barriers, and falling trade costs expand the geographical scope and accessibility of markets.

[1] HM Treasury and DTI Productivity Indicators, available at www.dti.gov.uk/economics.

[2] *Lisbon European Council: Presidency conclusions*, March 2000.

[3] *Facing the Challenge: the Lisbon strategy for growth and employment: Report from the High Level Group chaired by Wim Kok*, November 2004.

Box 3.2: The Northern Way Growth Strategy

The three northern RDAs, along with other regional partners, published the Northern Way First Growth Strategy Report[a] in September 2004. This sets out an ambitious strategy to establish the North of England as an area of exceptional opportunity with a world-class economy and a superb quality of life. The Government has welcomed this report and will respond in full in January 2005. The 2004 Spending Review announced several measures devolving more freedom, flexibilities and funding to support economic growth in the North. The Government is now building on this through a number of measures covered in more detail elsewhere in the Pre-Budget Report that respond to Northern Way proposals, including:

- **increasing regional role in national decisions, through a consultation on proposals for regional funding guidelines for transport, housing and economic development, described in full in Chapter 6;**
- **providing a more demand-led approach to skills provision in the North, tailored to the specific needs of the regions, through rolling out the Employer Training Pilots (ETPs) in a National Employer Training Programme providing free and flexibly delivered training for low-skilled adults. The Northern Way Report recognised the contribution that ETPs have made to improving workforce training and skills in the region. The Government has indicated that it will consider favourably proposals for 'dual key' arrangements for planning and funding adult skills, training and workforce development, where the RDA, LSC and other partners in the region want it. The three Northern Way regions have indicated that they plan to start using a 'dual key' arrangement by April 2005, working with the LSC, which the Government will consider favourably. The Government has asked all regions to report on progress ahead of Budget 2005;**
- **significantly extending the Pathways to Work pilots in the North, meeting the Northern Way's recommendation as part of a major expansion of the Pathways to Work pilots for incapacity benefits claimants, described in full in Chapter 4;**
- **ensuring that the Northern Way regions can take full advantage of support from the national strategy for Enterprise in Education, while welcoming the priority they put on this area through the Northern Enterprise in Education Programme; and**
- **welcoming the commitment of the three northern RDAs to promote science cities starting with Manchester, Newcastle and York, as part of their £100 million investment in university-business collaboration over the next six years.**

[a] *Moving Forward: The Northern Way: First Growth Strategy Report*, The Northern Way Steering Group, September 2004.

3.11 The Government has significantly reformed the UK competition framework. The reforms have created independent competition authorities with strong powers to combat anti-competitive activity as well as the power to investigate proactively markets that are not working well for consumers. The effectiveness of these reforms is monitored in regular peer reviews commissioned by the Government. The latest review published in 2004,[4] ranked the UK regime third globally behind the US and Germany, and described the UK competition authorities as having all the necessary powers to develop a world-class competition regime.

[4] *Peer Review of Competition policy*, KPMG and the Department of Trade and Industry, May 2004. Available at www.dti.gov.uk

Competition in specific markets

3.12 The Pre-Budget Report also sets out further steps to improve competition in particular sectors.

Spectrum use **3.13** The Government is the single biggest user of UK radio spectrum. Professor Martin Cave's 2002 Review of spectrum management[5] set out the case for introducing market mechanisms including trading and liberalisation of spectrum management. The Government's response recognised the potential efficiency gains from providing financial incentives to minimise public sector spectrum holdings and Ofcom is in the process of implementing the Review's recommendations. **Building on his 2002 Review, the Government announces that Martin Cave will conduct a comprehensive audit of public sector spectrum, with the aim of releasing the maximum amount of spectrum** to the market and increasing opportunities for the development of innovative new services.

Legal services **3.14** Sir David Clementi's independent review of the regulatory framework for legal services will be published by the end of the year, following wide consultation earlier this year. The Government set up the review to consider what regulatory framework would best promote competition, innovation and the public and consumer interest in an efficient, effective and independent legal sector because the current framework was found not to be meeting the demands of today's market place.

Payment systems **3.15** The Office of Fair Trading's (OFT) Payment Systems Task Force is working to identify and seek to resolve competition, efficiency and incentive issues relating to payment systems. The Government believes it is vital that this important market is efficient and open to real competition. It welcomes the industry's commitment to this process and expects it to continue to engage constructively with the Task Force on issues of mutual concern. The Government remains committed to legislating unless there has been a significant improvement in competition by the end of the Task Force's four-year lifespan.

Financial services **3.16** As part of the Treasury's Two-Year Review of the Financial Services and Markets Act 2000 (FSMA), the OFT has assessed the impact of the FSMA on competition in financial markets. Released today, the OFT's study concludes that there are no indications of areas where the Act might have had a significant adverse impact on competition in the activities and markets that it covers, and that the Act has had a positive effect on competition by improving how markets in the financial sector work.

Consumers

3.17 Consumers can play an important role in driving the development of competitive markets and consequently business performance. To help consumers understand their rights *Consumer Direct* was launched in summer 2004, providing consumers with clear, practical advice on consumer issues, and will cover the whole of Great Britain by early in 2006. The Government has reviewed the UK consumer framework and consulted[6] on proposals for empowering consumers and improving the legislative framework, access to redress, consumer representation in regulated industries, and enforcement of a fair and safe trading environment. The Government will produce its final proposals next year.

3.18 Consumer groups have an important role to play in ensuring markets are competitive. The 'super-complaints process', introduced in the Enterprise Act 2002, is a fast-track system for designated consumer bodies to make complaints about dysfunctional markets. The first super-complainants – the Consumers' Association, National Consumer Council and Citizens Advice – were designated in July 2004. The OFT is already addressing informal super-complaints on issues including private dentistry, home-collected credit and care homes.

[5] *Review of Radio Spectrum Management*, Professor Martin Cave, March 2002.

[6] *Extending Competitive Markets: Empowered Consumers, Successful Business*, DTI, July 2004.

Competition in the supply of goods and services to the public sector

Public procurement

3.19 As described in Chapter 6, the Government is committed to achieving greater value for money through better procurement across the public sector. This will also improve competition in the supply of goods and services to the public sector. The Office of Government Commerce (OGC) is implementing the recommendations of Sir Christopher Kelly's report[7] on increasing competition and capacity, and is working with the Office of Fair Trading (OFT) to spread best practice identified in the OFT's recent report[8] on procurement and competition. The OGC is completing its first market review covering the construction industry, working with the industry to identify capacity issues and to signal future demand to potential suppliers. It is also working with departments to improve client capability and commercial skills.

3.20 The Government will ask a leading business figure to work with OGC to ensure the full implementation by departments of the Kelly Review with an emphasis on ensuring adequate commercial skills and dealing with the barriers that prevent innovative solutions being adopted in the public sector. The Government has also decided that, from April 2005, OGC's remit should be expanded beyond central civil government to the wider public sector, to help to improve client capabilities in organisations outside central government, and to enable it to take a whole public sector approach in assessing future demands and competition issues in individual markets.

Improving access to public sector markets in Europe

3.21 The Government is also committed to improving access to public sector markets in Europe, and welcomes Alan Wood's report, published in November 2004, on the experiences of UK businesses in gaining access to public contracts in other EU Member States. Further detail on the Wood Report is given in Box 3.3.[9]

Enabling SMEs to compete for public sector business

3.22 Improving access to government procurement for small and medium-sized enterprises (SMEs) is important to improving competition, innovation and value for money in the delivery of public services. The OGC recently completed a project in the West Midlands, piloting solutions to help SMEs overcome barriers to competing for public sector business. The pilot successfully tested a number of measures with SMEs and procurement staff in the public sector, demonstrating that significant increases in the numbers of SMEs competing for and winning contracts can be achieved. The Government will implement nationally a number of the successful measures.

3.23 All government departments and agencies should have the right procurement systems in place to deal with SMEs. To support this objective the Small Business Service (SBS) will work with departments, including OGC, to review the pattern of existing government procurement from SMEs, enabling departments to improve the effectiveness of their procurement systems, reporting on progress by Budget 2005; and will collate and publish this information on an annual basis.

[7] *Increasing Competition and Improving Long-Term Capacity Planning in the Government Market Place*, December 2003.

[8] *Assessing the impact of public sector procurement on competition*, Office of Fair Trading, September 2004.

[9] *Wood Review – Investigating UK business experiences of competing for public contracts in other EU countries*, Office of Government Commerce, 2004.

Box 3.3: Wood Review of European public procurement

In the 2003 Pre-Budget Report the Government asked Alan Wood, chief executive of Siemens plc, to review the experiences of UK businesses in gaining access to public contracts in other EU Member States. Alan Wood's report, which was published in November 2004, shows that a range of obstacles stand in the way of effective competition in EU public procurement markets, to the detriment of UK and other EU businesses. Despite the existence of single market rules in awarding public contracts, the report identifies complex public procurement procedures, cultural differences, and wavering commitment to competition and market liberalisation as key factors holding back the creation of a competitive and dynamic EU public procurement market. The report proposes a range of steps to improve the functioning of public procurement markets across the EU and to ensure that UK firms can compete effectively for contracts, including:

- **action to identify, spread and report on best practice among EU Member States;**
- **action by Member States to open up more markets to public procurement and remove barriers to effective competition, as well as to raise the skills of procurement practitioners and to eliminate bad practice; and**
- **support from the Government through the Office of Government Commerce and UK Trade & Investment to help business compete successfully.**

The Government will work with the Commission and other Member States to implement the recommendations of the review. Improvements in public procurement practice will deliver better value for money and put EU firms in a better position to compete in global markets.

ENTERPRISE

3.24 Enterprise is a key driver of a modern, high-productivity economy in which opportunity is open to all. The Government believes it is essential to make the UK a more entrepreneurial economy, so that it is well placed to meet the long-term opportunities and challenges of an increasingly globalised economy.

3.25 The Government is committed to improving the UK business environment. The UK also needs to do more to promote enterprise across all regions of the UK. Rates of entrepreneurial activity in the UK compare favourably with those of other European economies, but lag behind those in the United States.[10] UK business creation is still half that of the United States. If the UK had the same level of entrepreneurial activity as the US, then up to 1.8 million more people could be engaged in entrepreneurial activities. Business start-up rates in deprived areas are up to 10 times lower than in the most successful areas of the UK.

3.26 To help close the productivity gap over the next decade, the UK must remove barriers to competition and enterprise to encourage individuals and firms to move into new markets to capitalise on the new opportunities created by the expansion of global economic activity. This Pre-Budget Report sets out further action to addresses these long-term policy challenges.

3.27 *Long-term global economic challenges and opportunities for the UK* explains how the global economy has become more open and competitive, as communication and technology continues to improve. Production processes are becoming increasingly flexible, with production dispersed across continents and accompanied by an increasing level of

[10] Global Entrepreneurship Monitor, Executive Summary, 2003 and HM Treasury and DTI Productivity Indicators, 2004, available at www.dti.gov.uk/economics.

specialisation. This means that new sectors are opening up to international trade and developing countries increasingly have the means to compete in global markets. Rising entrepreneurship in China and India is expanding markets and creating new avenues for trade.

3.28 The Government is committed to ensuring that British firms can act upon the expanding opportunities to trade provided by falling global barriers and the rapid growth of Asian markets. **To maximise the potential gains for British businesses and develop education, science and technology links, the Government will introduce an Asia Task Force.** The Asia Task Force will aim to deliver the benefits of greater cooperation with China, India and other emerging economies to UK businesses and individuals, raising awareness of the potential market opportunities. It will expand on the lessons learned from the successful China Task Force by utilising the expertise of leaders in industry, education, and science.

Leading regulatory reform

3.29 The Government recognises that over-burdensome regulation imposes a significant cost on business. Inefficient regulation diverts businesses' time and resources from developing opportunities, innovating, investing and growing; especially for small businesses, where owner-managers' time and energy is both their greatest asset and their scarcest commodity. Since 1997, the Government has pursued an agenda of better regulation, applying the five principles of good regulation: proportionality, accountability, consistency, transparency, and targeting.[11] The Government's approach focuses on:

- minimising the burdens on business of paperwork, inspection and enforcement, particularly for SMEs, by ensuring that the administration of regulations and business taxes is efficient;
- ensuring that regulation is used only where necessary to achieve policy outcomes for which there is a clear rationale and where alternatives to regulation are not feasible; and
- pursuing an agenda of regulatory reform in Europe.

3.30 Substantial progress has already been made. Measures to reduce the administrative burden of regulation have included rationalising regulatory structures, including the creation of the Financial Services Authority from nine bodies, and Ofcom from five previous regulators; while over 400 deregulatory measures from the 2003 Regulatory Reform Action Plan have been delivered. The Panel for Regulatory Accountability (PRA), now chaired by the Prime Minister, provides strategic oversight to departments' regulatory activity and challenges regulations with a high cost to business.

3.31 However, the Government recognises that there is more to do to keep the UK at the forefront of regulatory reform. It is taking steps to identify and respond to businesses' concerns, and welcomes the role businesses are playing in identifying specific areas in which the regulatory system can be improved, and influencing regulatory proposals at an early stage. This Pre-Budget Report sets out the next steps on the Government's agenda to improve the UK's regulatory system and business tax administration.

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

Minimising administrative burdens on businesses: Hampton Review

3.32 In Budget 2004, the Chancellor asked Philip Hampton to lead a review into regulatory inspection and enforcement with a view to reducing the administrative cost of regulation to the minimum consistent with maintaining the UK's excellent regulatory outcomes. The Government welcomes the interim report of the Hampton Review, *Reducing administrative burdens: effective inspection and enforcement*, published alongside this Pre-Budget Report, and looks forward to the final report in spring 2005.

Box 3.4: Hampton Review of regulatory inspection and enforcement

The interim report of the Hampton Review finds many positive elements in UK regulators' approach to reducing administrative costs on business. The UK performs well in many international comparisons of regulatory reform, but the review also concludes that reform and best practice must be embedded and shared across all bodies involved in inspection and enforcement activity. The review identifies a range of possible reforms, including:

- **general use of comprehensive risk assessment methodologies so that no inspections take place without a reason;**
- **better tailored advice for businesses;**
- **rebalancing advice and inspection because good advice-giving leads to better regulatory outcomes, especially for small business;**
- **more effective incentives for compliance including reform of the penalty regime;**
- **more joint working including information sharing and cross-training between regulators;**
- **measures to consolidate information resulting in fewer, simpler forms, and for Government to have a single data-set on businesses in the long-term; and**
- **continuing the recent trend of consolidation of functions into national regulatory bodies.**

The review also identifies the need to ensure that the right structures are in place for local consistency and national standards, for example for trading standards. The interim report contains a number of consultation questions, on which responses are sought by 4 February 2005. The review will take forward this analysis and produce a final report with recommendations in spring 2005.

Reforming the administration of business taxes

3.33 To reduce administration burdens on businesses in the tax system, the Government announced in Budget 2004 that payment of Working Tax Credit by employers would in due course be phased out and replaced by direct payment by the Inland Revenue. The Government is consulting on the detail of implementation.

3.34 The integration of HM Customs and Excise and the Inland Revenue provides an opportunity to reform further the administration of the tax system to deliver compliance cost savings for businesses, in particular small businesses. The Government is setting out steps that the new department will take in delivering its long-term goal of significant deregulatory benefits, consistent with the interim findings of the Hampton Review: reducing the burden of compliance visits and inspections; moving towards a single account for all payments and repayments; examining the practicability of a single return for all taxes; reducing the number of forms and returns; and providing more advice to those starting up to help them get things right from the start. Further details are set out later in this chapter.

Transparency and predictability

3.35 The Government is taking a number of other steps to minimise the administrative burden on businesses:

- the Government has asked the Better Regulation Task Force (BRTF) to study the system used by the Dutch Government to measure and reduce their administrative burden. The BRTF is working closely with the Hampton Review team and will make recommendations in spring 2005; and
- frequent changes to regulation cause uncertainty for business about which rules they need to comply with, and when. Following a consultation led by the SBS and the success of the DTI pilot for employment law, the Government will now extend common commencement dates for new and amended domestic legislation that impacts on business, starting with health and safety, work and pensions, company and consumer legislation from 2005. New regulation in these areas will in future be introduced on two dates each year, 6 April and 1 October, unless there are exceptional reasons for not doing so. This approach will be introduced to other areas of legislation as far as is possible and practical from 2005.

Regulating only where necessary

3.36 The Prime Minister's Panel for Regulatory Accountability (PRA) was established at Budget 2004 to reduce the flow and improve the quality of regulation at UK level ensuring that regulation is used only where necessary. Under new arrangements announced in Budget 2004, the PRA scrutinises all new regulations likely to impose a significant cost to business before they can become law. Clearance is based on a thorough impact assessment of the proposal, agreed by the Regulatory Impact Unit. The PRA has already rejected or delayed a significant proportion of regulatory proposals, where departments had not properly justified extra burdens on businesses, and will increasingly provide strategic oversight of regulatory activity, challenging departments to tackle the cumulative burden of their regulations.

3.37 For example, following PRA scrutiny, Defra will build upon the deregulatory reform of the Common Agricultural Policy by ensuring that the number and burden of inspections that farmers face are minimised. The DTI will look to simplify existing regulation in the consumer area to take account of the duty not to trade unfairly that will be introduced through the Unfair Commercial Practices Directive. DTI has agreed there will be no extension of the coverage of the Operating and Financial Review regulations beyond quoted companies and, across its regulatory remit, will set out deregulatory measures to reduce businesses' costs by more than £1 billion over the lifetime of its five-year plan.

3.38 The BRTF has been asked to conduct a feasibility study on the 'one in, one out' model, which will look at how the Government might bring forward compensatory deregulatory and simplification measures when it seeks to introduce new legislation. It will report in spring 2005, and the Government will consider whether this model could be used to complement existing systems for managing the overall regulatory burden on businesses, including the PRA.

Reviewing the effects of regulations

3.39 As well as driving up the quality of Regulatory Impact Assessments (RIAs) conducted before regulations are introduced, the Government believes that regulations should be reviewed after they are implemented to ensure that they are having the intended effect. RIAs will in future specify how and when new regulations will be monitored and reviewed. The Better Regulation Task Force (BRTF) will be asked to monitor this requirement, and to report on each department's compliance in its annual departmental assessments of regulatory performance.

Regulating only where necessary: EU legislation

3.40 The Government does not go beyond the minimum requirements of European legislation unless there are exceptional circumstances, justified by strong cost benefit analysis and extensive consultation with businesses. A good example is the 2001 Money Laundering Directive. The Government is putting in place safeguards to ensure that strict adherence to this approach will be continued in the future, and in addition the Foreign and Commonwealth Office has proposed a range of measures to ensure that Parliament has a greater and more effective role in scrutinising draft EU legislation. Following the Bellis report[12], commissioned by the Foreign Secretary, which compared transposition practices across Member States, the Chancellor and the Foreign Secretary are today setting out new measures to continue to ensure that businesses do not face unnecessary burdens from European law. In future:

- all emerging European legislation, and measures to implement this legislation in the UK, with significant costs for businesses, will be given tough scrutiny by the Prime Minister's Panel for Regulatory Accountability (PRA);
- the transposition of European directives into UK law must avoid costly additions to the requirements for businesses, meet only the minimum standards and scope necessary to comply with the European legislation, and take advantage of derogations when less burdensome for business, except where there is a strong cost benefit rationale for doing otherwise, specifically approved by PRA. Transposition should mirror as closely as possible the original wording of the directive except where there is a clear justification for doing otherwise, having regard to the impact on business and the workability and fit of the legislation in its domestic context. The Government will publish revised transposition guidelines for European legislation early next year;
- a comparison with other Member States' approaches to transposition will be required during implementation so that the relative burdens of different approaches are well understood, and the Government will be exploring the scope for introducing this on a comprehensive basis, and for sharing best practice across Member States, with the Commission;
- all departments will publish annual implementation plans for European legislation, so that the effects on UK businesses are transparent;
- legal advice will take into account the policy context consistently and rigorously, with specific consideration of the costs and benefits for businesses;
- the Government will take into account the approaches taken by other Member States when implementing directives and the potential impacts on the competitiveness of UK businesses; and
- the Government proposes to work with the European Commission and other Member States to create stronger enforcement mechanisms, which will provide incentives for Member States to implement legislation on time.

Improving clarity and accountability

3.41 The BRTF recently published *Avoiding Regulatory Creep*, a report which examined instances of regulation or compliance with regulation that goes beyond its original source of authority. The report concluded that while there has been progress across government to meet the principles of good regulation, there are nevertheless a number of factors which can lead to unintended additions to the scope or impact of regulation. These include: lack of clarity about the intention of regulation, ambiguity on the status of guidance, and enforcement arrangements which can encourage over-compliance. The BRTF recommendations – for the Government, independent regulators and industry bodies – call for greater clarity, consistency and better communication to make regulation less burdensome. The Hampton Review is addressing a number of these issues, and the Government will respond fully to the report early in the new year.

[12] *Implementation of EU legislation, an independent study for the Foreign and Commonwealth Office by Robin Bellis.* November 2003.

Delivering better regulation

3.42 The Government is also taking forward other steps to improve the design and quality of regulations:

- a new industry/Government regulatory forum will be established for the food industry;
- in response to concerns expressed by the construction industry, especially SMEs, a review of Part II of the Housing Grants, Construction and Regeneration Act 1996 was announced at Budget 2004. The first stage, chaired by Sir Michael Latham, is now complete. DTI will issue a consultation paper early next year on measures to improve payment practices and the adjudication process for business in the construction sector;
- the Government has now implemented more than 400 of the measures identified for reform in its Regulatory Reform Action Plan published in December 2003. For example, the Business Tenancies Regulatory Reform Order came into force in June of this year, modernising procedures for renewing or terminating tenancies, saving businesses £6.5 million per annum; and
- several initiatives are being introduced to deliver a culture change towards better regulation across Government and other public sector bodies. These include, for example, improved trainintg policy-makers, board-level regulation champions in each government department and, sponsored by the BRTF, a new award for public servants who develop innovative and deregulatory solutions to policy problems. The new award will be included in the Public Servants of the Year Award Scheme, with the first winners announced in April 2005.

Advancing regulatory reform in Europe

3.43 Half of significant new regulations affecting businesses in the UK originate in EU law. The 2004 Four Presidencies initiative, launched by the Chancellor and the Finance Ministers of Ireland, the Netherlands and Luxembourg, set out a series of joint proposals designed to place regulatory reform at the heart of these EU Presidencies, spanning 2004 and 2005.

3.44 Significant progress has been made. Strengthened procedures for competitiveness-testing new EU regulations have been developed and Member States have agreed new proposals for simplifying existing EU law in 2005. Consistent with the Government's commitment to minimise the administrative burden on business in the UK, Finance Ministers have also called for further action to measure and control the administrative burden associated with new and existing laws, which the Commission will implement in a pilot phase starting early in the new year. The Government welcomes these developments and will continue to work with other Member States and the European Commission to advance European regulatory reform, in particular by:

- ensuring that the administrative costs of EU regulation are included in all impact assessments, and clear and measurable objectives and goals are established for controlling the administrative burden associated with all EU regulation;
- ensuring the effective implementation of competitiveness testing to ensure that the implications of proposals for business and the wider European economy are fully taken into account;
- strengthening external input into the regulatory process in Europe, with enhanced quality control of EU impact assessments and improved consultation and input from business; and
- identifying further priority areas of EU regulation for simplification during 2005.

3.45 The Government also supports the Commission's consultation on priority areas for closer EU-US cooperation to break down barriers to trade and investment flows caused by differences in regulatory approaches on both sides of the Atlantic.

Modernising and simplifying the tax system

3.46 The Government is currently implementing the recommendations of the O'Donnell Review,[13] published alongside Budget 2004. In May 2004, it announced that the new department integrating HM Customs and Excise and the Inland Revenue would be called Her Majesty's Revenue and Customs (HMRC) and David Varney was appointed as the first Executive Chairman of the new department. The Commissioners for the Revenue and Customs Bill was introduced on 24 November.

Simplifying tax administration for small business

3.47 The Government is determined to deliver a fair and efficient tax system for small business. The integration offers a unique opportunity to simplify the administration of the tax system, and to deliver a package of major deregulatory gains and reductions in the costs associated with compliance. The O'Donnell Review highlighted how small businesses, many of which are customers of both existing departments, have the most to gain from a co-ordinated approach to support and compliance. Tackling areas of tax administration and compliance that are unnecessarily burdensome, as well as providing enhanced support and education to improve the capacity of firms to comply with their obligations, will be a key priority for the new department, as described further in Box 3.5.

[13] *Financing Britain's Future*, Review of the Revenue Departments, HM Treasury, March 2004.

Box 3.5: Delivering a simpler tax system for small business

The new department's long-term goal, consistent with the interim findings of the Hampton Review on reductions to the administrative costs of regulation described earlier in this chapter, will be to enable its support and compliance staff to have a 'whole view' of any customer with whom they are dealing and to minimise the burden of paperwork and contact by providing:

- a reduced number of forms and returns and examining the practicability and advantage of moving to a single return for all taxes;
- a single account through which all payments and repayments may be made;
- an integrated approach to audit informed by better risk assessment, with a single visit to inspect records rather than separate inspections for different taxes; and
- more effective support and streamlined access to information in ways that better suit customers, including better use of information technologies.

This vision of a fully integrated relationship with business will require enabling legislation, as well as new information and IT systems that will take a number of years to build. In the meantime, significant steps will be taken to improve delivery of the tax system for small businesses, through:

- **creating a small business unit** at the heart of the new department led by a senior official to champion the needs of small businesses;
- **setting up a high level advisory group with strong private sector membership** to guide the unit's work and ensure the department's activities harness the business community's ideas for improved compliance at lower cost;
- **carrying out research into small business customers' needs and attitudes**, to inform the detailed implementation of the vision set out above, and responding to small businesses' concerns that the tax system creates or adds to their cash flow difficulties; and
- **publishing details of a review of links with medium sized businesses**, focusing on future channels of communication between those businesses and the revenue department.

Work has already started on a number of early pilots, the results from which will inform thinking in the new department on how best to deliver this step change in small businesses' experience of the tax system. The pilots include looking at:

- integrated support on indirect and direct taxes for small businesses at key stages of their development;
- helping people who have drifted into the informal economy to set their affairs in order and gain all the benefits of being legitimate businesses; and
- paving the way for co-ordinated audit and enquiry work through improved targeting of compliance.

3.48 The new department will ensure that tax policy development in HM Treasury is fully informed by its experience of providing services to small business customers and from its compliance activities. It will publish further details of their proposals to integrate and streamline services to small businesses at Budget 2005, and a report on progress in the autumn.

Business tax reform

3.49 Modernising the structure and administration of the tax system as it applies to businesses is a key component in maintaining competitiveness. A modern business tax system should avoid creating barriers to innovation and business activity, and keep pace with changes in the global economy. It should also ensure that businesses contribute their fair share to funding public services – measures to guarantee this are set out in Chapter 5.

3.50 To meet the challenges of an increasingly knowledge-driven global economy, the Government is keen to ensure that people who choose to set up in business have the flexibility to adopt the legal structure that will best suit their commercial requirements, quickly and efficiently, and that this decision is not distorted by tax planning. The Government has therefore today published a discussion paper[14] on the strategic issues relating to the tax treatment of small businesses and invites comments from interested parties. Further details are set out in Chapter 5.

Corporation Tax reform

3.51 The Government is committed to maintaining a modern, fair and competitive corporation tax system and is taking forward consultation on a range of issues, including reform of the schedular system for companies. As described in Chapter 5, following a period of consultation, the Government will modernise the treatment of leased plant and machinery. **The Inland Revenue has today also published a Technical Note including draft legislation on schedular reform and leasing.**[15]

International Accounting Standards

3.52 As part of the modernisation of financial reporting in the UK, International Accounting Standards will be adopted from 1 January 2005. The Government has considered carefully the transitional adjustments arising from the change and has decided to defer any tax effects from this transition until the impact can be determined and managed. **Measures will be introduced in Finance Bill 2005 to enable securitisation vehicles to continue applying existing UK accounting standards for tax purposes for a further year and to address specific technical issues.**

Further business tax reform

3.53 In addition this Pre-Budget Report also announces:

- a report on the review of tonnage tax, together with draft legislation, will be issued by the Inland Revenue shortly. Following consultation **the Government will put forward legislative amendments in Finance Bill 2005**. The Government **has also decided that leasing reform should apply to tonnage tax leases not on ships within tonnage tax**;
- **a consultation into the conditions that property owners should meet, from 2009, in order to revoke their option to charge VAT to tenants**. Setting the conditions early will give certainty for businesses that are already planning the use of their property in 2009 and beyond; and
- following an announcement in Budget 2004, publication shortly of a technical note and draft clauses detailing changes to UK tax law that will **allow companies based in the UK formed under the European Company Statute to be taxed on a similar basis to UK companies**.

[14] *Small companies, the self-employed and the tax system: a discussion paper*, HM Treasury, December 2004.

[15] *Corporation Tax reform: Technical Note*, Inland Revenue, December 2004.

Creating an enterprise society

3.54 The Government believes that the UK needs a stronger culture of entrepreneurship to compete in the global economic market. Creating a climate of enterprise for all, in which entrepreneurial achievement is valued underpins a strong business sector and is critical in providing economic opportunity to all. The Government believes that anyone with the initiative, drive and talent to succeed in business should be able to do so.

3.55 The UK's first national Enterprise Week in November 2004 was organised by Enterprise Insight with support from the business community, schools, Government and others. More than 1,000 events were held in the UK, with the aim of raising the profile of enterprise in society and encouraging young people to consider entrepreneurship as a career option. Building on this year's success, the Government looks forward to Enterprise Week in 2005.

Enterprise in education

3.56 The Government is taking action to equip people with the skills and confidence to engage in entrepreneurship, in particular through enabling young people to acquire entrepreneurial skills and to prepare them for an ever-changing employment market:

- DfES have launched draft web-based guidance for schools, in advance of the national roll-out of enterprise education in September 2005; and
- from February 2005, the National Council for Graduate Entrepreneurship will offer 15 individuals or groups from each region across the UK places on a new 'Flying Start' business support programme to develop their business ideas.

3.57 The Government is also promoting the role of enterprise in driving productivity growth and opening opportunity to all, including through:

- making regional nominations for Enterprising Britain, the competition to find the UK's most enterprising city. The national winner will be announced early next year. Developing this model, the Government has called for a European Centres of Enterprise competition;
- Isabella Moore, former President of the British Chambers of Commerce, will head a new national Women's Enterprise Panel, working closely with the Small Business Council to advise government and champion female entrepreneurs;
- a new Transatlantic Enterprise Partnership with the US, to share best practice on approaches to entrepreneurship and productivity; and
- the Chancellor will host *Advancing Enterprise*, a conference for business leaders in London in February 2005, focusing on the role of entrepreneurship in meeting the opportunities and challenges of globalisation.

Supporting small businesses

3.58 The 2004 Spending Review announced a new approach to supporting SMEs. It gave the nine Regional Development Agencies (RDAs) in England devolved powers to lead the provision of government support for small businesses including, from April 2005, responsibility for delivering the Business Link service.

3.59 Devolution provides a new opportunity for the RDAs to go beyond the one-size-fits-all business support of the past, and to target additional focused coaching towards ambitious start-ups and tailored business development programmes for firms with high-growth potential. Evidence shows that well-designed focused programmes of support can significantly enhance the survival and growth prospects of new and growing business. The RDAs will help these firms to address specific barriers to growth such as raising risk capital, managing rapid growth, understanding regulations and taxes, planning investment and selling into wider markets. Brian Jackson, the new chairman of the East Midlands Development Agency, will work with each RDA to develop a framework by Budget 2005, drawing on evidence from existing programmes across the UK, to ensure that focused, tailored coaching is provided to businesses that will most benefit from it, enhancing the prospects for rapid business growth in every region. Additionally the Government is:

- supporting two projects in the North East and East Midlands to **join-up different business support services providers at the local level** and maximise the benefits of devolution by making it easier for businesses to find the support they need;
- addressing the hurdles that all successful businesses eventually face when their ownership changes. As a result of the review by Martin Wyn Griffith of the Small Business Service into the barriers to effective business transfer,[16] announced in Budget 2004, **new measures will be brought forward to address constraints that may inhibit the smooth succession of business ownership;** and
- welcoming the report published by the Small Business Council (SBC) on encouraging businesses out of the informal economy.[17] The SBS will convene a cross-departmental group to consider the Council's recommendations and will respond to them next year.

Small Firms Loan Guarantee

3.60 For new and innovative businesses to succeed, they need to be able to raise finance to invest and grow. The Small Firms Loan Guarantee scheme (SFLG) exists to help individuals overcome the problems they face in obtaining debt finance to start new businesses and to help small businesses to expand. The 2003 Pre-Budget Report announced that the Government had asked Teresa Graham to review the scheme, and in particular to consider whether it remained effective in tackling the financial barriers faced by start-ups and small businesses.

3.61 The Government accepts in full the recommendations set out in the Review's final report,[18] described in Box 3.5. They will be fully implemented, and the new scheme made operational, by the end of 2005.

[16] *Passing the Baton: Encouraging successful business transfers*, Small Business Service, December 2004.

[17] *Small Businesses in the Informal Economy: Making the Transition to the Formal Economy*, Small Business Council, November 2004.

[18] *Recommendations, Graham Review of the Small Firms Loan Guarantee*, September 2004. (www.hm-treasury.gov.uk/graham).

Box 3.5: Graham Review recommendations

The final report of the Graham Review of the Small Firms Loan Guarantee was published in October 2004. The review found that some start up and young SMEs with growth ambitions continue to find a lack of collateral a barrier to accessing debt finance, and set out a range of recommendations designed to maximise the support the scheme offers to small firms.

The review recommended that the SFLG offer more generous, but better targeted, support to small firms, and also made recommendations to widen availability of the scheme and to modernise and deregulate its administrative structure. Key recommendations included:

- **expanding lending limits to £250,000 per business;**
- **raising the turnover limit to £5.6 million for all eligible businesses;**
- **allowing serial entrepreneurs to benefit by removing the current £250,000 limit on lending to any individual;**
- **reducing bureaucracy by making radical changes to the operation of SFLG;**
- **targeting SFLG at start ups and young businesses by introducing a maximum age limit of three years' full trading;**
- **encouraging new lenders to join the scheme; and**
- **incentivising wider availability of SFLG throughout branch networks.**

Enterprise Capital Funds

3.62 In May 2004, the Government published draft guidance for investment managers interested in bidding to establish one of the new pathfinder Enterprise Capital Funds (ECFs). The Government hopes to receive European state aids clearance in time to launch the funds early in 2005, when final guidance will be published and the formal ECF bidding process will begin.

Delivering financial interventions

3.63 The 2003 Pre-Budget Report announced that any full-scale ECF programme would be managed at arms-length from Government by a new publicly-owned company. The Government also accepts the recommendation of the Graham Review that such a company should be responsible for managing delivery of the reformed SFLG scheme. Furthermore, it believes that the ongoing delivery of all of the DTI's risk-capital interventions for SMEs would be most effectively delivered by such a company.

3.64 While the decision to establish a delivery company remains dependent upon the establishment of a full ECF programme, the DTI are advertising for an advisory panel in the interim period. The principal role of this panel will be to provide expert advice to the Government on the implementation of the pathfinder round of ECFs and the Graham Review recommendations for SFLG. Should a full ECF programme go forward, the board of the new company will take over the role of the advisory panel.

Demand for finance

3.65 The Government recognises the need to match improved supply of risk capital with measures to ensure that firms understand the financial options available to them and is therefore:

- asking the RDAs to incorporate the lessons from the SBS's investment readiness programme as part of their strategies for providing focused business coaching to enhance business growth in each region, as outlined above;
- endorsing the recommendations set out in the *Facilitating Finance* report[19] of the Government and Accountants Working Group, led by Michael Snyder. **The accountancy profession and the Government will work together to establish a new self-accreditation programme for accountants and other business advisers who are able to provide advice to small businesses seeking finance to grow;** and
- **publishing a new no-nonsense guide to raising finance for business.**

[19] *Facilitating Finance*, The Government and Accountants Working Group, September 2004. (www.sbs.gov.uk/finance).

Financial regulation

3.66 Business angel investment provides finance to an estimated 3,000 to 6,000 UK businesses a year, which otherwise would have difficulty raising the necessary investment capital. Responses to the consultation on the Financial Promotion Order[20] highlighted the difficulties faced by small firms in identifying investors certified as sophisticated or high net worth, who are exempt from rules that restrict the ability of businesses to promote investment opportunities. **From January 2005, the Government will introduce self-certification for sophisticated or high net worth investors, making it easier for small firms to raise finance from these business angel investors**. Self-certification, based on objective tests, strikes a balance between allowing small firms to raise capital, and appropriate protection for investors.

Promoting local enterprise

3.67 Raising levels of enterprise and economic activity is essential for sustainable neighbourhood renewal and enabling opportunity for all. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas in which policies to boost enterprise would be focused. The toolkit of measures available in Enterprise Areas is set out in Box 3.6.

Box 3.6: Enterprise Areas

Enterprise and business activity are essential to achieving sustainable regeneration of communities through higher employment and wages. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas where policies to boost enterprise would be focused. Measures currently available to Local Authorities and Regional Development Agencies to integrate with their regeneration strategies include:

- **stamp duty exemptions on property transactions to stimulate local property markets;**
- **Community Investment Tax Relief to improve access to finance for small business;**
- **City Growth Strategies to encourage a business-led approach to regeneration;**
- **Bridges Community Development Venture Fund to finance fast-growing small businesses;**
- **Phoenix Development Fund for business support services in disadvantaged areas; and**
- **New Entrepreneur Scholarships providing a package of support and training for young people looking to start their own business.**

The Planning and Compulsory Purchase Act 2004 will also enable local authorities to use Local Development Orders (LDOs) in Enterprise Areas. These will deliver automatic planning permission for types of development specified in the Order.

3.68 As powers and capacities at the local and regional level grow, the Government is keen to ensure that Enterprise Areas and other national measures support and complement local and regional regeneration strategies. The Government would welcome a dialogue with key stakeholders, particularly local authorities and RDAs, about how to maintain the attractiveness of the Enterprise Area package while increasing its responsiveness to local and regional needs.

Business Premises Renovation Allowance

3.69 The Government has today **published a consultation document and draft legislation for a Business Premises Renovation Allowance scheme**.[21] This would 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 consultation period ends on 1 March 2005 and will be followed by Finance Bill legislation.

[20] *Informal capital raising and high net worth and sophisticated investors: A consultation on proposed changes to the Financial Promotion Order*, HM Treasury, January 2004. (www.hm-treasury.gov.uk/consultations).

[21] *Capital allowances: renovation of business premises in disadvantaged areas*, Inland Revenue, December 2004.

Local Authority Business Growth Incentives

3.70 To create a direct financial incentive for local authorities to promote local business growth the Government is introducing the Local Authority Business Growth Incentives (LABGI) scheme, starting in April 2005. This will allow local authorities to receive a proportion of increases in local business rate revenues to spend on their own priorities. Based on historical data, the Government estimates that local authorities in England and Wales could gain up to £1 billion over the three years of the 2004 Spending Review. The Government's second public consultation on LABGI concluded in October 2004, and results will be published shortly. The revised Comprehensive Performance Assessment from 2005 will include an assessment of local authorities' acheivement against the shared priority of promoting the economic vitality of localities.

3.71 Kingston upon Thames recently became the first local authority to secure voted agreement from local businesses to the introduction of a Business Improvement District (BIDs) scheme. BIDs allow local authorities and businesses to work together on agreed projects to improve their local area, additional to those already funded by local authorities, and are funded by a levy raised on business rates.

SCIENCE AND INNOVATION

3.72 In the global economy, the UK's future prosperity will depend increasingly on the capacity to expand knowledge through science and translate it into innovative products and better services. Countries at the forefront of research and innovation will be best placed to move into high-value added, technology driven areas, which can provide new sources of growth. Science and innovation are therefore key drivers of productivity growth. Recent OECD research found that a 1 per cent growth in public R&D leads to a 0.17 per cent increase in total factor productivity in the long run.[22] The UK already has a strong science base and is in a leading position in terms of the quantity and quality of its research output compared to other advanced industrialised countries.[23] However, the UK has been less effective at realising the commercial potential of research, and business expenditure on research and development (R&D) is currently below the OECD average.[24]

3.73 UK R&D intensity fell during the 1980s and 1990s as GDP growth outstripped growth in R&D. 2002 figures show that UK business is now investing 1.24 per cent of GDP in R&D, compared to 1.37 per cent invested by French businesses, 1.73 per cent by German businesses and 1.87 per cent by US businesses.

3.74 For the UK's science base to capitalise on its historical strength in research, the Government must tackle the market failures that can slow the diffusion and generation of new ideas, in order to encourage businesses to be innovative in their approaches and use of new technologies and, together with academic institutions work to further links between research and commercialisation.

3.75 In July 2004, the Government set out its goals for science and business innovation in the UK in the *Science & Innovation investment framework 2004-2014*. This section describes progress on implementing the framework.

3.76 The ten-year science framework set an ambitious target for the UK's spending on R&D to reach 2.5 per cent of GDP by around 2014, from a current level of 1.9 per cent – intended to place the UK in a strong position amongst its competitors. The 2004 Spending Review announced £1 billion in extra funding for the UK science base by 2007-08, an average annual increase of 5.8 per cent over the period of the 2004 Spending Review. The framework also set out a number of measures to promote knowledge transfer into the economy, support university research and enhance science and maths teaching and learning.

[22] *R&D and Productivity Growth: Panel data analysis of 16 OECD countries*, Guellec and van Pottelsberghe de la Potterie, 2001.

[23] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

[24] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

Business and public engagement

3.77 Delivering the Government's overall ambition for wealth creation and productivity growth from innovation will require sustained business investment in R&D, and increased business engagement with the UK science base. Over the past year, the Government has benefited from main board-level business input into the formation of the science and innovation investment framework, including through the group of chief executives of major R&D employers chaired by Sir Tom McKillop of AstraZeneca. To help secure a strong business voice in the allocation of R&D support, the DTI has now established a business-led Technology Strategy Board, which will advise Government on cross-sectoral technology priorities with commercial potential for the UK in order to shape Government support for collaborative R&D and knowledge transfer networks.

3.78 To strengthen this partnership between Government, business, universities and other R&D stakeholders behind the UK's science and technology mission, the Government will establish a regular forum between the Chancellor of the Exchequer, the Secretary of State for Trade and Industry and the Minister for Science and Innovation, with business leaders and scientists. The Chancellor has asked Sir Tom McKillop to chair the group which will meet with Ministers twice yearly.

3.79 This forum will support the goal of improving the UK's R&D and innovation performance, and will contribute directly to the evidence informing future public spending decisions on investment in the science base and technology development. Investment in UK science and innovation, by both the public and private sector, and individuals' career choices, will be influenced by social attitudes towards scientific research and its application in new technologies. To provide context for the discussion of science and society issues in this forum, the Council for Science and Technology will report on this subject in March 2005. In addition, **the Government will publish at Budget 2005 an updated assessment of UK business R&D and innovation including analysis across sectors and a comparison of global trends to inform debate at the forum's first meeting.** This assessment will also form a key measure of progress set out in the ten-year framework.

3.80 To complement this work, **Government will also be seeking to understand, through bilateral discussions between now and next spring, the forward commitments to UK R&D of the leading R&D businesses in the UK**, with the aim of deriving an aggregate indicator of future business investments in order to track progress towards the 2.5 per cent R&D intensity ambition.

R&D tax credits

3.81 Take-up of R&D credits has been very strong, with over 95 per cent of eligible SMEs making a claim in 2002-03. The tax credit has already provided over £600 million in support of SMEs since its inception. The Government is committed to ensuring the best possible delivery of the credits. Updated guidance has now been published, which forms part of a joint Inland Revenue and DTI programme to tackle the perceived complexity of the credit and ensure consistent treatment of claims. In-depth customer research will inform and shape future improvements in delivery.

3.82 In 2005, the Government will examine evidence on the impact of the credits on firms as they grow beyond the SME threshold. It will also look at the impact on companies in technology-based manufacturing and service sectors, where the latest evidence suggests that UK mid-sized firms lag behind their US counterparts in R&D intensity. In light of emerging evidence over the next 18 months, the Government will examine how it can best help those firms that are key to boosting R&D, including through R&D tax credits.

University spin-offs

3.83 The Government attaches great importance to the technology transfer sector and its potential to contribute to UK productivity and enterprise, and is committed to creating an environment that enables universities and public sector research establishments to grow companies based on their research. **The Government will introduce legislation effective from today to remove the tax uncertainty for researchers involved in these spin-off companies**. This legislation will provide the flexibility the sector needs to restore higher levels of spin-off activity. A draft Partial Regulatory Impact Assessment and a Technical Note[25] have been published today to enable consultation with the sector on the details of the legislation.

Accelerating energy-efficient technology

3.84 The Government recognises that energy efficiency and the development of low-carbon energy sources will be central to the UK's productivity performance in the future. The UK has world-class research strengths in future energy-efficient technologies, which will be a key part of the transition to a low carbon economy. The Government is developing a stronger research infrastructure through the Research Councils' programmes, including the UK Energy Research Centre and Towards a Sustainable Energy Economy. It is also growing support for business-focused collaborative R&D, primarily through the DTI Technology Programme.

3.85 The UK's business and research response to the challenge of developing a low-carbon economy relies on investment across multiple research disciplines, business sectors and Government agencies. Against this background, the Government will now help focus the growing public and private investment in this arena by investing in **a £20 million fund to help foster a new partnership to accelerate energy-efficient technology.**

3.86 This fund will be managed by The Carbon Trust, with the aim of securing matched funding from private sector sources for its programmes. It will capitalise on the UK's R&D strengths and commercial potential in the field of energy efficiency and bring together stakeholders from the business, research, and policy-making community to define and co-finance the challenges for R&D in this area over the next 5-10 years. It will draw on, and help to implement, the conclusions of the joint Treasury/Defra Energy Efficiency Innovation Review also announced in this Pre-Budget Report and outlined in Chapter 7.

Lambert Review

3.87 The Government accepted the recommendations of Richard Lambert's review of business-university collaboration in July 2004, and its response was reflected in the 2004 Spending Review outcomes and the science and innovation investment framework. A business-university group chaired by Richard Lambert is working to improve the way in which intellectual property arising from collaborative research is handled, reducing cost and uncertainty for businesses when working with universities. Practical guidance on intellectual property should be produced by spring 2005. Responding to another recommendation to share best practice in governance across the Higher Education sector, the Committee of University Chairmen published in November 2004 a voluntary code of good governance for the Higher Education sector.

Regional Innovation

3.88 The 2004 Spending Review enhanced the role of the RDAs in supporting business-university collaboration, a part of the Government's response to the Lambert Review. This will be reflected in the new strategic RDA "tasking framework", which will be published shortly. The RDAs will set out their contribution to promoting knowledge transfer in each region this spring. The three Northern RDAs have already committed in July to fund business-university collaboration and business innovation across the North by more than £100 million by 2010, enhanced by the creation of a Northern Science and Industry initiative, as part of the Northern Way plan described in Box 3.2. The Government has also asked RDAs for views on how they can best develop knowledge transfer and science cities, ahead of Budget 2005.

[25] *New tax measure to help researchers acquiring shares in spinout companies created with universities and research institutions*, Inland Revenue, December 2004.

3.89 Cities and urban areas can attract a critical mass of knowledge-based businesses and industries which improve prospects for growth, through mutually reinforcing factors, such as the availability of skilled workers, a strong research base, urban infrastructure and supportive locally-driven policies. High-performing universities and research establishments can contribute to such an effect, and Government has been encouraging universities to work with RDAs to exploit synergies and so help foster knowledge-based clusters around city university hubs. The Government encourages further cooperation between universities and RDAs when planning future research capital investments, commercialisation strategies and regional economic strategies. As part of their £100 million investment in university-business collaboration over the next six years, the Northern RDAs will be promoting science cities, starting with Manchester, Newcastle and York. The Government encourages other RDAs to do the same.

Science and maths skills

3.90 The ten-year investment framework highlighted the importance of ensuring a strong supply of those studying science and related subjects at every stage of the education system, and set out a range of measures to this end. Described further in Chapter 6, Mike Tomlinson's report on the curriculum for 14-19 year olds was published in October 2004. In considering its response, the Government will give careful consideration to the role of science and maths as an important part of the 14-19 curriculum.

Higher education finance

3.91 The ten-year framework also set out measures to improve the financial sustainability of universities, accompanied by significant extra resources. Government is keen to enhance the financial independence of higher education institutions by increasing and broadening their sources of funding. A recent report from a Task Force[26] set up by the DfES has noted that, in striving for excellence, there is further scope for universities to build their financial independence and add value to core funding through raising income from donations. Although the report identifies enhanced fundraising as a key responsibility for individual higher education institutions themselves, the Government would like to encourage this development, and intends to trial a **three year matched funding scheme to support the sector to build its capacity to increase the voluntary giving it receives**.

EU R&D

3.92 The UK, France, and Germany published a joint paper in February 2004,[27] setting out priorities for action at the European and Member State level to raise the EU's innovation performance. The Commission will shortly present a proposal for its 7th research Framework Programme (FP7), effective from 2007. The UK's main priorities for the use of this fund are to raise the EU's capacity to conduct the very best research, improve industrial competitiveness, and ensure that EU policies are properly supported by research. FP7 should also provide funding for a range of cross-cutting activities, in particular on human resources and skills, knowledge transfer, and key research infrastructures. The UK welcomes the Commission's plans to create a European Research Council (ERC) as part of FP7. The ERC should enable systematic competition between the best research teams in Europe, allocating funding on the basis of scientific excellence as determined by peer review. To ensure the transparency and credibility of the ERC, the Government believes it should be independent from the Commission.

3.93 The UK will work with other Member States to ensure that FP7 has a simplified structure, and adds genuine value to the efforts of individual Member States, as well as being consistent with an overall EU budget of no more than 1 per cent EU Gross National Income (GNI).

[26] *Increasing voluntary giving to higher education*, Task Force on Voluntary Giving to Higher Education, May 2004.
[27] *Towards on Innovative Europe: A paper by the UK, German and French Governments*, February 2004. (www.hm-treasury.gov.uk).

SKILLS

3.94 UK unemployment is now the lowest of the G7 economies and employment levels are at record highs. Chapter 4 describes the Government's strategy for promoting employment opportunity for all, building on this strong performance. However, the UK's skills levels compare less well with other major economies.[28] While the proportion of people in the UK with high skills compares well internationally, the share of the workforce with intermediate skills is relatively small and the share with low skills relatively high, despite improvements over the last few years.

3.95 *Skills in the global economy*, published alongside this Pre-Budget Report, sets out the Government's ambition for enhancing skills and provides details of new proposals to build on success in this area. As described in Box 3.7, enhancing skills is an increasingly important long-term economic challenge for developed countries, and there is a clear economic case for Government to address market failures that exist around investment in skills.

Box 3.8: Enhancing skills in the global economy

***Skills in the global economy*, published alongside this Pre-Budget Report, explains that in the long run, the prosperity of an economy depends upon how productive it is. In turn, productivity depends in part upon the skills of the workforce, known as human capital. As set out in Box 3.1, the UK is less productive than many other countries and relatively poor skills explain part of the gap.**

The increasing importance of skills in the global economy

Structural change is inevitable in a well-functioning, flexible economy. As some sectors decline, so other sectors – requiring different skills – will expand. More integrated global markets and cross-border trade and investment are likely to lead to an increased pace of change. This places an increased premium on ensuring everyone can update their skills. In addition, while the comparative advantage of emerging economies will still lie in labour-intensive industries, their relative importance in knowledge-intensive industries will also rise. For example, each year China and India together produce more than 4 million graduates, compared with 265,000 in the UK. Global changes will create great opportunities for the global economy, but for the UK to take advantage of these it needs to ensure it has a highly-skilled, flexible workforce.

The case for Government intervention to improve skills

The benefits to businesses, from more productive workers, and to individuals, from better work prospects and higher pay, suggest that both should have an incentive to invest in skills. However, investment by firms can be constrained by lack of information about the benefits and the direct and indirect costs of allowing workers time to train. In addition, surveys show many individuals face barriers to learning such as cost, time to train and a lack of information about the opportunities available. This suggests that investment in training is lower than optimal, constrained by the following broad categories of market failure:

- **externalities that occur as firms cannot capture the full benefits of investment in training (for example, in industries where staff retention is low);**
- **imperfect information that means employees and employers cannot correctly judge the benefits of training; and**
- **credit and time constraints, particularly for the lower paid and small organisations.**

The Government's approach, set out in more detail in *Skills in the global economy*, is to focus funding where there is market failure. These market failures are particularly prevalent at low skill levels.

[28] Data available from HM Treasury and DTI Productivity Indicators, www.dti.gov.uk/economics.

Workforce development

3.96 As described in Box 3.8 a range of market failures limits workforce training in the UK. These market failures affect low-skilled workers in particular – people with lower qualifications are much less likely to receive training. Reducing the number of people with low skills is a key priority for the Government. Nearly 30 per cent of the workforce do not have a level 2 qualification (equivalent to five good GCSEs). Over 5 million people have basic skills needs in literacy, numeracy or IT. The White Paper *21st Century Skills* set out the Government's national strategy for improving adult skills.[29] In particular it set out a new entitlement to free training for any adult with basic literacy, numeracy and ICT skills needs and for any adult to gain their first full level 2 qualification. *Skills in the global economy*, published alongside this Pre-Budget Report, sets out how the Government will build on this approach through the New Deal for Skills and a new National Employer Training Programme.

New Deal for Skills

3.97 The New Deal for Skills, announced in Budget 2004, is a package of measures to support low-skilled adults to gain the skills necessary for sustainable and productive employment, as well as to help them progress to higher skill levels. **From April 2005 'skills coaches' will be piloted in eight Jobcentre Plus districts, providing low-skilled benefits claimants face-to-face, personalised advice on training – continuing this support as they make the transition into work. From April 2006 the Government will pilot the approach of allowing longer-term unemployed benefit claimants, along with economically inactive adults, with the agreement of their personal advisor, to take up free, full-time training where this is judged by their personal advisor to be the best way to help them into work.** More details of pilots of the Learning Allowance are set out in Chapter 4.

Employer Training Pilots

3.98 Employer Training Pilots, launched in September 2002, provide a package of support to encourage employers to train their low-skilled employees. This includes free or heavily subsidised training, information and advice for employers and learners, paid time for training for employees and, in most pilot areas, support for employers to meet the costs of giving staff paid time to train. The partnership approach tested in the pilots has proved very successful and the pilots now cover over one third of the country, with over 15,000 employers and over 100,000 employees participating. Most employees involved in the pilots left school at or before age 16 and half have no qualifications at all. 70 per cent of all firms participating have less than 50 employees.

A National Employer Training Programme

3.99 Building on the success of the pilots, the Government will **roll out a National Employer Training Programme from 2006-07 that will cover the whole country by 2007-08. The Government will now guarantee that, as part of the national programme, where employers are prepared to offer their low-skilled employees paid time to train up to level 2, the costs of this training will be fully subsidised.** The Government will allocate a further £197 million over 2006-07 and 2007-08 to fund this national programme. Further details of the national programme are set out in *Skills in the global economy*. The key features of the national programme are:

- brokers who will act for employers and their employees to assess training needs, and source high quality training provision that can be delivered flexibly in the workplace;
- fully subsidised costs of training to level 2 where employers are prepared to offer their low-skilled employees paid time to train;
- financial support – equivalent to that for a level 2 qualification – towards the cost of a level 3 qualification for those who can jump straight to level 3;
- support from brokers to design and source training packages at level 3 and higher; and
- creation of links with Jobcentre Plus in order to support adults making the transition into work to get training in a way that meets the requirements of their employer.

[29] *21st century skills: Realising our potential*, Department for Education and Skills, July 2003.

3.100 Most of the pilots tested the impact of compensating employers for the paid time that their employees take to train – 'wage compensation'. The evidence on wage compensation is mixed, but early evidence suggests that it may be more important as a way to initially engage 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.

The Leitch Review of Skills

3.101 To inform the Government's view of how to respond to the long-term challenges set out in *Skills in the Global Economy*, **the Government has asked Sandy Leitch, Chairman of the National Employment Panel and formerly a Chief Executive of Zurich Financial Services, to undertake an independent review to examine the nature of the UK's long-term skills needs and priorities of business and the economy**.

Regional skills partnerships

3.102 In the 2004 Spending Review, the Government restated its commitment to tackle differences in regional and sub-regional economic performance across the UK. Evidence shows variations in the skills of different regions are a key factor in explaining these differences. To help address this issue, Regional Skills Partnerships (RSP) were announced in July 2003 to bring together the work of a number of bodies, including the Regional Development Agencies (RDAs), on skills, training and business support. By April 2005, each RSP will have published a prospectus setting out the partners' shared vision; what they will do to improve regional skills, enterprise and employment needs; how they will stimulate demand for skills and how their impact will be measured.

3.103 The effectiveness of RSPs will be reinforced by closer links between RDAs and Learning and Skills Councils (LSC). The Government has already committed to consider proposals for further integration of planning and funding of adult skills and workforce development at the regional level, including, where the partners in the region want it, 'dual key' arrangements for planning and funding adult skills, training and workforce development. As described in Box 3.2, the three Northern Way regions have indicated that they plan to start using a 'dual key' arrangement by April 2005, working with the LSC, which the Government will consider favourably. For each region, the RDAs, the LSC and the RSP have also been asked to contribute to Budget 2005 with an update of progress in aligning regional priorities for adult skills provision. Where regional partners identify obstacles to further integration of skills provision in supporting regional economic development the Government has already committed to working with them to remove obstacles.

Migration

3.104 As the global economy integrates, labour markets are becoming increasingly globalised. To remain competitive it is important that the UK continues to attract and retain talent. Alongside work-permits, the Highly-Skilled Migrants Programme (HSMP), introduced in 2002, has proved successful in enabling highly-skilled individuals to enter the UK to seek and take up work. To help tackle particular shortages in science and engineering, UK graduates in these subjects are now able to seek work for a year after graduating without the need for a work permit. Budget 2004 announced a new provision for MBA graduates from 50 of the world's top business schools to come to the UK and seek work for up to a year after graduating. **A list of eligible institutions is now available and graduates from these institutions will benefit from a streamlined HSMP process from April 2005**.

Developing the skills of young people

Primary, secondary and higher education

3.105 High standards of primary, secondary and further education provide the foundation for a productive and highly-skilled workforce. Chapter 6 describes the Government's programme for driving improvement at all levels of the education system, and the significant progress that has been made so far.

Post-16 learning

3.106 Post-16 qualifications and skills are vital if young people are to benefit from, and contribute to, a modern, highly-skilled and productive economy. Post-16 participation rates are rising and a smaller proportion of young people are not in education, employment or training – but more must be done to meet the Government's goal of moving the UK from being among the worst performing OECD nations in terms of post-16 participation rates to one of the best. The 2004 Spending Review acknowledges this ambition and has set challenging targets to improve educational achievement.

Education Maintenance Allowances

3.107 The roll-out of Education Maintenance Allowances (EMAs) will help achieve these targets. EMAs provide a regular weekly payment of up to £30 to those continuing in post-16 education, with further bonuses paid to students on satisfactory academic progression. EMAs also form a key part of the Government's framework of financial support for young people. Reform in this area is ongoing, and Chapter 5 outlines in more detail other changes to the systems of financial support for young people.

Apprenticeships

3.108 The Government has continued to develop the apprenticeship route for young people wishing to combine vocational learning with work experience and has set a target of 28 per cent of young people to enter an apprenticeship by the age of 22. The Government is on course to meeting this target, and in May 2004 there were over 250,000 participating apprentices. To build on this progress, in May 2004 the Government announced a comprehensive new apprenticeship structure to expand opportunity. To improve apprenticeship completion rates the Government has introduced a quality improvement strategy involving the Learning and Skills Council, Adult Learning Inspectorate and the DfES, and a new performance indicator has been adopted to drive reform.

3.109 Important work in reforming, improving and expanding the apprenticeship learning route is being taken forward by the Apprenticeships Taskforce, under the leadership of Sir Roy Gardner. The Taskforce is considering a range of issues affecting apprenticeships including the involvement of small and medium-sized companies in apprenticeship schemes, the overall apprenticeship framework as well as sector specific challenges faced by employers and learners. The Government welcomes the publication of the Taskforce's interim report, and particularly its recognition and articulation of the benefits to business of participation in the apprenticeships scheme. The Taskforce will publish its final report in 2005.

INVESTMENT

3.110 Capital investment is a crucial driver of productivity. The UK economy has historically lagged comparable economies both in terms of the overall level of investment, in part due to consistently low levels of investment in public infrastructure, and in the capital intensity of production. Evidence suggests that this 'capital gap' is an important explanatory factor in the UK's relatively poor productivity performance.[30]

3.111 The past twenty years have seen a huge increase in the scale of international capital flows and financial integration, with capital increasingly able to flow across national borders to the most attractive investment opportunities. These trends are likely to intensify over the next decade. In this environment, macroeconomic stability and a strong investment climate are prerequisites for attracting and retaining new business and investment, either domestic or foreign. To address this challenge the UK will need to consolidate and strengthen its performance in certain areas, while addressing historical weaknesses in others. In particular there is a need to ensure that capital markets are operating efficiently and providing funds to worthwhile investment projects, by ensuring:

[30] *Britain's Relative Productivity Performance: Updates to 1999*, National Institute of Economic and Social Research, O'Mahony and de Boer, 2002,

- the right skills are being supplied in the economy to stimulate investment and to enable workers to respond flexibly to technological change;
- the tax system and the regulatory environment supports business investment and entrepreneurial activity;
- barriers to knowledge creation, innovation and technology transfer are removed to ensure that the UK economy is at the leading edge of translating new technologies into investment opportunities; and
- the UK enjoys a world-class public infrastructure of sufficient quality to attract and support high quality business investment.

The investment chain

3.112 UK institutional investors manage almost half of UK equities, investing much of the long-term wealth of British savers and exercising indirect control and significant influence over much of British 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.

3.113 The chain is complex: in pensions, for example, pension fund trustees – stewards on behalf of pension fund sponsors and members – are themselves advised by investment consultants; assets are in turn invested through fund managers and brokers with whom companies have crucial relationships; and companies' financial statements are verified by auditors acting on behalf of shareholders – such as pension funds.

3.114 Since the 1998 Pre-Budget Report, the Government has systematically investigated how well the investment chain works, notably through the Myners,[31] Sandler[32] and Higgs[33] reviews. These reviews have identified critical and inter-connected areas where the chain has not been functioning as well as it should, including its various principal-agent relationships. Further analysis is in train through Sir Derek Morris' wide-ranging review of the actuarial profession, which provides key advisory services to pension funds and investment institutions; and Paul Myners will shortly be concluding his review of the governance of mutual life insurance offices.

3.115 For example, issues identified at the 'owner' end include:

- as Paul Myners' review identified, pension fund trustee boards are in general weak customers. Typically unpaid, part-time and with little in-house investment support, many pension trustees lack the necessary investment expertise to act as strong and discerning customers of the investment consultants and fund managers who sell them services;
- a number of problems have resulted, including poor evaluation of advisers and their advice; a reliance by trustees on a small number of investment consultants, supplying actuarial and investment advice bundled together; insufficient resources devoted to the process of asset allocation; unclear contractual structures which generate strong and unnecessary incentives for herding and short-termism in investment; and insufficient focus on the potential for adding value through active shareholder engagement; and

[31] *Institutional investment in the UK: a review*, Paul Myners, March 2001.

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

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

- as Ron Sandler's review identified, competition in medium and long-term savings tends to revolve around access to distribution and product tax features, rather than superior underlying investment performance. Moreover, consumer understanding of what drives long-term investment performance is itself weak, and the advisers' minimum standards of knowledge on investment issues are also low. As with pension funds, therefore, incentives for efficient and innovative investment management are weaker in the retail market than they could be.

3.116 Issues identified at the 'company' end include:

- Sir Derek Higgs' review identified substantial scope for improvement in the UK's corporate governance regime, in the role and independence of UK non-executive directors, and in the responsiveness of UK boards to the concerns of shareholders; and
- the Co-ordinating Group on Audit and Accounting highlighted scope for improvement in the UK's audit regulation framework, the approach to auditor independence and the enforcement of accounting standards.

3.117 The complex interactions between the issues at different points in the chain mean that each needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. In response to this analysis and the recommendations made by the reviewers, the Government has undertaken a comprehensive programme of reform. In particular:

- *to improve the quality of trustees' investment decision-making processes*, and the way they interact with their advisers and fund managers, the Government endorsed the 'Myners principles' as a voluntary best-practice framework. Its assessment of the progress made to date and of the further steps that need to be taken, will report before the end of the year. This assessment will look particularly at areas where progress has been slower, including trustee expertise and governance, ensuring more effective use is made of advisers, improving the quality of asset allocation activity, providing greater clarity on funds' investment time horizons, and getting more effective shareholder engagement;
- the new Pensions Act 2004 will require trustees to have appropriate knowledge and understanding of investment matters, and the Occupational Pensions Regulatory Authority is currently developing a detailed code of practice to provide trustees with guidance;
- to *tackle the problems of retail product complexity, poorly informed consumers, and adviser conflicts of interest*, the Government has worked with the Financial Services Authority (FSA) to develop a suite of simplified and more transparent products, which should increase the focus on investment performance. More generally, new FSA rules will enhance disclosure to consumers of the cost of the advice associated with a packaged product;
- the *bundling of services by investment consultants* has been addressed by Myners' recommendation that trustees should tender separately for actuarial and investment advice. Sir Derek Morris' work will provide further analysis of both the actuarial and investment consultancy markets;

- *to promote more active engagement on the part of shareholders*, in exercising their rights particularly where they have concerns about management, strategy or performance, the Government welcomed the Institutional Shareholders' Committee principles in October 2002, and the commitment to reflect these principles in fund management contracts and insurance fund practice. The Government will be reviewing their impact on engagement shortly. Shareholders now have an advisory vote on directors' pay, through the Directors' Remuneration Report Regulations. The Government is also working closely with the Shareholder Voting Working Group to improve the efficiency of the shareholder voting process;
- *the role and independence of UK non-executive directors, and their responsiveness to shareholders*, will be strengthened by the revised Combined Code on Corporate Governance, which incorporates Sir Derek Higgs's recommendations, and Sir Robert Smith's proposals to improve the way the audit committee works. Progress will be reviewed after two years; and
- *the quality, and transparency of information flows along the investment chain – vital if owners are to act effectively – have been significantly improved*. For example, the Government has reformed the regulation of the audit profession, enhanced audit transparency and auditor independence and strengthened the scrutiny of financial reporting. From April 2005, listed companies will be required to produce a forward-looking Operating and Financial Review of their business environment. The FSA is developing with the industry a rigorous transparency regime for broking transaction costs.

Investment in housing and property

3.118 A stable and flexible housing market is essential to a healthy and 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.

3.119 At Budget 2004, the Government welcomed Kate Barker's final report *Delivering Stability: Securing Our Future Housing Needs*.[34] The report made a number of recommendations for improving the functioning of the housing market and delivering greater macroeconomic stability and greater affordability. The Government accepted the central recommendation that there should be a step change in housing supply and has committed to implementing a wide-ranging programme of reform. As described in Chapter 6, the 2004 Spending Review provided additional funding to begin to address the need for additional investment in housing and related infrastructure.

3.120 In addition to providing significant additional resources for housing, the Government is committed to bringing forward a series of major reforms to ensure the effective implementation of the Barker Review. The Government will review progress in delivering this package of reforms by the end of 2005, the principal features of which include:

- merging Regional Planning Bodies and Regional Housing Boards to create integrated bodies responsible for managing regional housing markets, supported by a new and independent national advice unit. Following consultation, the Government will announce its conclusions early in the new year, with the new arrangements in place by autumn 2005;

[34] *Delivering Stability: Securing Our Future Housing Needs*, Kate Barker, March 2004.

- introducing a long-term national goal for affordability in the housing market, incorporated within the PSA process, and reflected at the regional level through regional targets as part of the process of setting regional housing numbers. The Government will consult on the national goal in summer 2005, introducing it by the end of the year;
- increasing the planning system's responsiveness to housing market signals by reforming Planning Policy Guidance on Housing (PPG3) to provide improved guidance on balancing local housing markets. Consultation will take place by summer 2005; and
- working with the development industry to ensure that it makes a substantive response to the challenges laid down in the Barker report to improve productivity, design and customer satisfaction.

Planning reform

3.121 This programme builds on the significant steps the Government is taking to make the planning system work more quickly and predictably. The 2004 Planning and Compulsory Purchase Act put in place a new statutory framework for regional planning and a reformed more flexible local planning system. The new Regional Spatial Strategies will be closely aligned to Regional Housing Strategies and will make provision for social housing and determine the amount of market housing to be delivered through the planning system by local planning authorities. The Government will also shortly bring forward changes to PPG3 (planning for housing) to influence the household mix and provision of affordable housing so as to better balance housing demand and supply. It will also encourage local authorities to allow unneeded employment land to be used for housing or mixed use development.

3.122 The Planning Delivery Grant (PDG) will complement these reforms by rising to £150 million during 2005-06. This will help drive up the performance of the planning system. In 2004-05, £10 million was allocated specifically for the delivery of housing in areas of high demand. For 2005-06, the Government is planning to increase the allocation for housing in high demand areas.

Sustainable development

3.123 The Government's commitment to achieving 60 per cent of new development on previously developed land, and using higher average densities of 30 dwellings per hectare ensures that the land take and potentially adverse environmental impacts from new development are minimised. In 2003, this resulted in 67 per cent of new development being on brownfield land, up from 56 per cent in 1997, while the density of new dwellings rose from an average of 25 dwellings per hectare in 1997 to 33 dwellings per hectare in 2003. At the same time the Government is committed to protecting and enhancing the Green Belt. In 2003, designated Green Belt land in England amounted to 1,672,000 hectares, about 13 per cent of the land area. This was 19,000 hectares more than in 1997, when the extent of Green Belt was last measured. A further 12,000 hectares of Green Belt are proposed in new draft local development plans. Plans to extend the contaminated land tax credit are described in Chapter 7.

Implementing the Miles Review

3.124 Good progress has been made in taking forward the recommendations addressed to the FSA, Government and industry made in the Miles Review of the UK mortgage market, published in March 2004. The FSA has produced an improved mortgage information leaflet, as recommended by Miles, and has also developed a new factsheet on switching mortgages. The Financial Capability Steering Group has set up a working group focused on borrowing. The Group has considered its priorities, and understanding the risks of mortgage borrowing will be part of its work on risk messages. The FSA has also confirmed that it will start to review the effectiveness of the new statutory regime by the end of 2005, as part of which consideration will be given to further changes to the provision of advice and disclosures required by firms, as recommended by Miles. In addition, the FSA has committed to considering the recommendations on cross-subsidy within the mortgage market – potentially as part of its Treating Customers Fairly initiative.

3.125 Progress has also been made on work to remove potential supply side barriers to a long term fixed rate mortgage market as identified by Miles, including a Government decision to legislate to remove a constraint on the future ability of building societies to own securitised assets. Detailed work is also ongoing on the tax treatment of potential products to help consumers manage their interest rate risk. In addition a joint Treasury and Debt Management Office investigation into the viability of Government issued interest rate derivatives which could help lenders more effectively fund long-term fixed-rate lending is underway. A final statement on these recommendations will be made at the time of Budget 2005.

Property Investment Funds

3.126 The Government launched a consultation *Promoting more flexible investment in property* at Budget 2004[35] to consider the introduction of Property Investment Funds, equivalent to Real Estate Investment Trusts (REITs), common to many economies around the world. The consultation closed in July 2004 and the Government is grateful for the participation of a wide range of industry experts and individuals. The Government is continuing to explore whether the introduction of a REIT in the UK, as envisaged in many consultation responses, would meet the objectives set out alongside Budget 2004.

3.127 The Government continues to believe that tax reform in this area has the potential to improve the efficiency of the property market. **While the Government will not legislate in 2005, it will report back with a discussion paper by Budget 2005, for further dialogue with industry representatives. A summary of responses to the summer consultation will be published at the same time**.

Commercial lease flexibility

3.128 The Government has been working with the property industry to promote a voluntary code of practice on commercial leases aimed at improving flexibility. ODPM has consulted on possible legislative measures to address upward only rent reviews,[36] following the interim findings of an independent evaluation of the impact of the code.[37] **The Government is considering the results of that consultation and will decide upon the merits of a legislative approach in light of the full independent evaluation of the code of conduct, expected by the end of 2004**.

Encouraging North Sea investment

3.129 The Government is committed to working with industry to maximize economic recovery of UK oil and gas reserves. The Government supports the new Voluntary Code of Practice on Third Party Access to Infrastructure, launched in September, and will be working with the industry to ensure that the Code is effective and succeeds in improving the productivity of the UK continental shelf. The Government will continue its commitment to the joint industry and Government Task Force, PILOT, as it takes forward work on brownfields and other issues.

[35] *Promoting more flexible investment in property*, HM Treasury and Inland Revenue, March 2004.

[36] *Commercial property leases: options for deterring or outlawing the use of upward only rent review clauses*, ODPM and the Welsh Assembly Government, June 2004. (http://www.odpm.gov.uk/urbanpolicy).

[37] *Monitoring the code of practice for commercial leases: interim report*, ODPM and the University of Reading, April 2004. (http://www.odpm.gov.uk/urbanpolicy).