3 MEETING THE PRODUCTIVITY CHALLENGE

The Government's long-term economic ambition is that Britain will achieve a faster rate of productivity growth than its main competitors, closing the productivity gap.

The Government believes that the productivity gap can only be tackled over the long term and through a sustained effort across the economy as a whole. Closing the productivity gap requires a broader effort from employers and employees, as well as from government. The Government welcomes progress made by the CBI and the TUC in successfully working together to identify a range of key areas for action, such as improving UK skill levels and modernising the planning system.

To support further the drivers of productivity growth – strengthening competition, enterprise, innovation, skills and investment in every community and region across the country – the Government is now:

- **planning to introduce a** volume-based research and development (R&D) tax credit for large companies **in Budget 2002;**
- **taking further steps to modernise and reform the business tax system by** improving the capital gains tax business assets taper**, and publishing draft legislation for an exemption for capital gains and losses on substantial shareholdings and a new regime for providing relief for the costs of intellectual property, goodwill and other intangible assets;**
- piloting new measures to improve access to training **and enable employees to attain basic and level 2 skills;**
- **publishing a Green Paper on** planning reform **next month, setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;**
- **introducing** a package of measures to support small business, **improving access to finance, reducing the administrative burden of VAT and publishing Patrick Carter's review of payroll administration;**
- **taking further steps to support enterprise and investment in Britain's disadvantaged communities by introducing** a stamp duty exemption for all property transfers up to £150,000 in disadvantaged areas **and announcing further decisions on the new Community Investment Tax Credit;**
- **confirming a radical programme of** further enhancements to the UK's competition regime;
- enhancing Enterprise Management Incentives **by doubling the gross asset limit for companies which can qualify to £30 million. A Statutory Instrument will be laid before Parliament immediately to take effect from 1 January 2002; and**
- publishing a new analysis of Britain's regional productivity challenge.

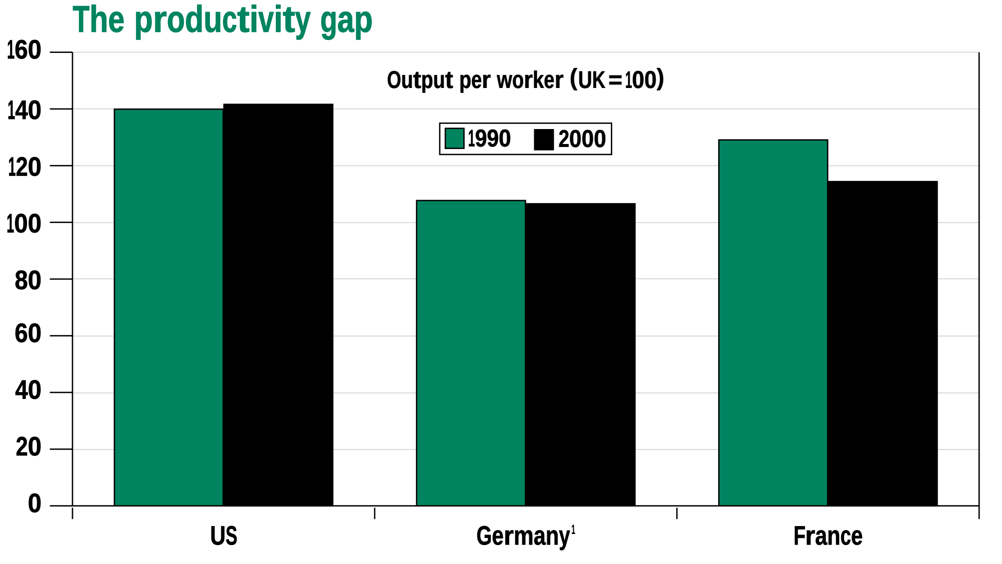
THE PRODUCTIVITY CHALLENGE

3.1 Increasing the sustainable rate of productivity growth is central to the Government's economic strategy. The nation's output depends on the number of people in work and how productive those people are. Productivity growth, alongside high levels of employment, is therefore essential to deliver rising living standards, and to achieve the Government's objectives to tackle poverty and improve public services.

3.2 The productivity performance of the UK economy has historically been weak. A legacy of macroeconomic instability and microeconomic failures has inhibited productivity growth and created a substantial productivity gap between the UK and many other advanced industrial economies. Box 3.1 describes trends in the UK's productivity performance relative to that of its main competitors.

Box 3.1: The productivity challenge

The UK has a poor track record on productivity. Using the Government's preferred measure of productivity, output per worker, US productivity is 42 per cent higher than that of the UK. Productivity in France and Germany is 14 and 7 per cent higher respectively.



[1]Note: 1991 figure, post reunification

Source: ONS

International comparisons of productivity should be made over the long term. During the last decade, the productivity gap has narrowed slightly against Germany and significantly against France, but increased marginally against the US.

UK productivity grew by 2.3 per cent in 2000 across the economy as a whole and by 5.8 per cent in manufacturing. However, UK productivity will clearly be affected by the general slowdown in the world economy. Much still needs to be done to address historic weaknesses in all areas.

Meeting the productivity challenge

3.3 The Government is implementing a comprehensive strategy for delivering stronger productivity growth and closing the productivity gap. The Government's strategy addresses issues at the regional, national and international levels and involves stakeholders from across all sectors of the economy.

3.4 The Government believes that the productivity gap can only be tackled over the long term. The UK economy registered an above-trend productivity performance during 2000, with output per worker rising by 2.3 per cent across the economy as a whole and by 5.8 per cent in manufacturing. The tendency of firms to retain labour despite weaker external demand has driven a cyclical slowdown in productivity growth during 2001. However, the continued strength of UK economic fundamentals should support a resumption of stronger productivity gains beyond the near term.

The drivers of productivity performance

3.5 The Government's approach to improving the UK's long-term productivity performance rests on two pillars: delivering macroeconomic stability to enable firms and individuals to invest for the long term, and implementing microeconomic reforms to remove the barriers which prevent markets from functioning efficiently. These microeconomic reforms address historic weaknesses in five areas that affect the rate of productivity growth:

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

Raising productivity across the economy

3.6 Government has an important role to play in creating the right environment and incentives to facilitate productivity growth within the private sector and to improve public sector productivity. However, the productivity gap cannot be closed without a wider effort across the economy as whole. The Government is therefore committed to working alongside business, trade unions and other stakeholders to raise productivity across all sectors of the UK economy.

CBI-TUC productivity campaign

3.7 In October 2000, the Chancellor invited the CBI and the TUC to work together to identify practical steps that could be taken by employers, employees and the Government to raise productivity. Four joint working groups were established and reported to the Chancellor in October 2001. The Pre-Budget Report takes forward reforms in a number of important areas identified by the CBI and the TUC for joint action:

- reflecting the conclusions of the skills group, the Government is now piloting new measures to improve access to training and enable employees to attain basic and level 2 skills;
- responding to the conclusions of the investment group, the Government is publishing next month a Green Paper setting out proposals to improve the flexibility, speed and responsiveness of the land use planning system;
- taking forward the conclusions of the innovation group and the CBI-TUC joint submission on the research and development (R&D) tax credit for large companies, the Government is planning to introduce a volume-based tax credit in Budget 2002; and
- consistent with the conclusions of the best practice group, the Government recognises the importance of supporting businesses in embracing change and learning from one another. The Government is supporting business-to-business transfer of best practice at national, regional, sector and company level.

3.8 Building on the success of joint working to date, the Government also welcomes proposals by the CBI and the TUC to create a new, permanent, CBI-TUC Productivity Group. This group will meet on a regular basis to monitor progress against the vision set out by the four working groups and to look at specific productivity issues. The Government will use the group as a sounding board for policy development on productivity.

DTI reviews

3.9 The Secretary of State for Trade and Industry last week announced further important developments in the Government's productivity strategy, with wide ranging proposals for change at the Department of Trade and Industry following reviews initiated in summer 2001. The Department's key role is to help drive the productivity and competitiveness of British business.

Working across the regions

3.10 The Government is committed to working across the regions to ensure that the benefits of improved productivity are felt throughout the country and that measures to raise productivity are designed and implemented at the level at which they have most effect – in many cases, below the national level. The Government's approach to tackling the regional productivity challenge is set out in detail in *Productivity in the UK: 3 – the Regional Dimension*, published alongside the Pre-Budget Report. The Government has set a Public Service Agreement (PSA) target to raise the rate of sustainable UK growth by increasing the trend rate of growth of GDP per capita in all regions, with a long-term regional economic ambition to reduce the persistent gap in performance between the regions.

3.11 The Regional Development Agencies (RDAs) are central to the Government's response to the productivity challenge. The RDAs operate as champions for economic development in their region, working in partnership with key regional, sub-regional and local bodies, such as Local Learning and Skills Councils (LLSCs) and the Small Business Service (SBS). RDAs are expected to exert strategic influence over the type, scale and combination of services delivered in their region from both the public and private sectors. They have drawn up regional economic strategies to cover:

- economic development and regeneration;
- the promotion of business, investment and competitiveness;
- the promotion of employment; and
- the enhancement, development and application of skills relevant to employment.

3.12 The RDAs have been given significant budgets – rising to £1.7 billion in 2003-04 – and unprecedented flexibility to deliver these objectives. From 1 April 2002, RDAs will receive a "single pot" of funding from sponsor departments rather than different streams of funding tied to specific programmes. In return for this greater flexibility, they will be expected to meet stretching targets, derived from the relevant PSA targets of sponsoring departments. Targets for 2002-03 have already been agreed with RDAs for raising the level of sustainable economic performance, reducing deprivation, promoting urban and rural regeneration, raising employment and promoting enterprise. They have also been set a specific productivity target to "work with regional partners to enable an increase in productivity measured by Gross Value Added (GVA) per hour worked in the region".

3.13 The 2002 Spending Review, described in detail in Chapter 6, will look to consolidate and build on the RDAs' funding arrangements, taking into account their new targets as well as performance against existing targets.

The European dimension

3.14 The Government is committed to raising productivity across Europe through economic reform. At the Lisbon European Council in spring 2000, Europe's leaders committed themselves to an ambitious ten-year strategy for reform. The vision agreed at Lisbon is of a dynamic, job-creating Europe that delivers on both economic and social objectives to become the leading knowledge-based economy in the world. Recognising the UK's interdependence with other EU countries, and in close co-operation with its European partners, the Government has been at the forefront of developing this new policy framework. The next step is to build on the progress made at Lisbon by:

- opening up European networks, including gas, electricity and telecoms;
- cutting the cost of investment capital, including liberalisation of financial services;
- promoting more open trade, both within the EU and with the rest of the world;
- ensuring more competition and lower prices and removing unnecessary or over-burdensome regulation, in particular through modernisation of state aids;
- creating more jobs through labour mobility and labour market reforms; and
- establishing a real stimulus to innovation, including development of patents and e-Europe.

3.15 The Government will publish a White Paper on economic reform in Europe for the Spanish presidency.

Supporting manufacturing

3.16 The Government recognises the importance of the UK's manufacturing base, which accounts directly for 20 per cent of GDP and 14 per cent of all employment. Manufacturing has a crucial role to play in the Government's ambition to close the UK's productivity gap, not least because of the sector's importance as a source of innovation in the economy. The Government is committed to supporting manufacturers in their efforts to raise productivity, and has acted to:

- introduce the R&D tax credit for small and medium-sized enterprises (SMEs) in April 2000;
- consult on extending R&D tax credits to larger companies. The Government plans to legislate in Finance Bill 2002 and will shortly be consulting on final options for detailed design, as set out later in this chapter;
- establish the Manufacturing Advisory Service to provide advice, knowledge and support to industry. Regional Centres for Manufacturing Excellence are being established in every English region and in Wales, and these will be supported by a National Network of Centres of Manufacturing Expertise;
- disseminate best practice across manufacturing and between the manufacturing and service sectors. The Fit for the Future campaign, launched in December 1998, provides a focal point for UK best practice activities, helping business to learn from business. The Government is also funding a three year programme of up to ten Industry Forum initiatives to build on the success of the Industry Forum of the Society of Motor Manufacturers and Traders; and

- support new product development in the aerospace sector, including launch investment of up to £250 million for Rolls Royce's Trent 600 and Trent 900 engines, following a commitment of £530 million to Airbus UK for wing development for the Airbus A380.

Public services productivity

3.17 As well as creating the right environment for business to increase productivity, the Government is directly responsible for a substantial part of the economy. Productivity within the public sector has a significant impact on productivity across the economy as a whole. Increasing public services productivity is also important because it gives people the public services they deserve and require, provides taxpayers with better value for money and is fundamental in laying the foundations for a high productivity economy. The Government's public spending framework lays the foundation for raising public services productivity by providing greater certainty for long-term planning, removing the past discrimination against investment and delivering a sharper focus on the quality and outcome of public services. This approach, and the range of further steps the Government is taking to improve the performance and productivity of public services, are described in Chapter 6.

Box 3.2: Productivity and sustainable development

The challenge of sustainable development is to find ways of combining environmental objectives, social progress, and high and stable levels of growth and employment. The Government's sustainable development strategy, *A Better Quality of Life*, published in May 1999, sets out a range of initiatives across government to achieve a balance between these objectives.

In addition, the Performance and Innovation Unit (PIU) recently published a report, *Resource Productivity: Making More with Less*, highlighting the importance of pursuing economic growth that uses natural resources and the environment more productively.

The report argues that the definition of resources should include the way in which the environment absorbs waste and pollution, in what are commonly referred to as "pollution sinks", as well as natural resources such as fossil fuels, minerals and land for agriculture. These environmental resources are typically under greater pressure than most natural resources, with climate change and waste being two of the most pressing problems.

Using policy to deliver sustainable development means appraising the environmental impact of policy measures and ensuring that environmental objectives are achieved in an efficient and cost-effective way. Government policy appraisal must take account of economic, social and environmental effects, even when these cannot easily be costed. Where environmental problems are identified, the Government will tackle them using the most appropriate instrument, or combination of instruments, including taxation and other economic instruments such as tradable permits.

Chapter 7 describes in detail the range of Government policies designed to protect and, where possible, improve the environment.

COMPETITION

3.18 Competition is central to the Government's strategy for closing the productivity gap. Research shows that vigorous competition between firms helps to drive productivity growth by stimulating innovation and encouraging greater efficiency.[1] Competition also ensures that consumers get a good deal. In a competitive environment, firms must strive to win customers, encouraging lower prices and higher quality goods and services.

[1] See, for example, Geroski: *Innovation, Technological Opportunity and Market Structure*, Oxford Economics Papers 42, July 1990, and S Nickell: *Competition and Corporate Performance*, Journal of Political Economy, 104 (4) 1996.

The UK competition regime

3.19 Since 1997, the Government has introduced a range of measures to improve radically the UK's overall competition regime. The Competition Act 1998 strengthened the powers of the Office of Fair Trading (OFT) to identify and address anti-competitive practices across the economy and introduced strong financial penalties for firms that breach competition law. The Government has also appointed a new Director General of Fair Trading, John Vickers, who has adopted a new mission for the OFT of "making markets work for consumers".

3.20 The July 2001 White Paper, *Productivity and Enterprise: A World Class Competition Regime*, outlined the next steps required to increase the competitiveness of the UK economy, strengthen the competition regime and ensure that those who may seek to distort markets and disadvantage consumers are effectively deterred. Following consultation on the White Paper, and in line with its principles for reform of the competition regime, the Government now intends to:

- give full independence to the UK competition authorities, so that they will take decisions free from political interference in the overwhelming majority of cases;
- give the OFT a clear proactive role to keep markets under review and enable it to refer markets to the Competition Commission where it appears they may not be working well. The Government will give legislative weight to the new right for consumer associations to bring super-complaints to the OFT where consumers are being harmed;
- make a series of improvements to the mergers and monopolies investigations regimes, giving greater certainty through clearer timetables and a more transparent decision-making process;
- replace the tests applied by the Competition Commission in merger and monopolies investigations with a more competition-focused regime, requiring the Competition Commission to identify clearly – and where appropriate take action to remedy – features of the market which have a detrimental effect on competition. In setting remedies the Competition Commission will be able to take account of consumer benefits;
- introduce new criminal penalties for individuals who engage in cartels, covering the most serious forms of anti-competitive activity – price-fixing, market sharing, limitation of production and bid-rigging – but excluding vertical agreements between firms. Only those who have acted dishonestly will be liable for the new criminal penalties. Those found guilty could face a prison sentence of up to five years. The Serious Fraud Office (SFO) will be the main prosecuting body for criminal offences, working closely with the OFT; and
- widen the remit of the Competition Commission Appeal Tribunals, enabling it to hear claims for damages brought by harmed parties and allowing actions to be brought for damages on behalf of named consumers who have suffered harm as a result of anti-competitive behaviour.

3.21 The Secretary of State for Trade and Industry will publish further details of the outcome of consultation shortly. These changes to the competition regime, together with proposed modernisation of the rules for insolvency (described later in this chapter), will be introduced in the Enterprise Bill. Together, this package of reform will bring down barriers to enterprise, provide greater opportunity for all and help to create a truly entrepreneurial culture.

3.22 At the time of the Enterprise Statement, the Government announced that the OFT would receive additional funding in order to deliver such a radical programme of change. The OFT will receive an extra £7 million of funding for this financial year and £17.5 million for next year. This additional money underlines the Government's commitment to building a world-class competition regime in the UK. The Government has also agreed in principle to increase the Competition Commission's budget for the coming year.

Promoting competition in specific markets

3.23 The Government has acted to promote competition in a number of specific markets, including banking, the water industry and the professions.

Banking

3.24 The Competition Commission's report on banking services was delivered to the Government on 19 October 2001. The Government is currently considering the proposals set out in the report and will publish its response in due course.

The water industry

3.25 On 30 March 2001, the Government announced its intention to introduce further competition in the water industry for the benefit of consumers. The Government is developing proposals that will be the subject of consultation early next year.

The professions

3.26 Following the OFT's report into competition in the professions, the Government announced that it would act to remove Schedule 4 to the Competition Act, which provides a special regime for the exclusion of professional rules from competition law. This legislation will be repealed in the Enterprise Bill. In the meantime, the Government notes that the professions are conducting reviews of their own rules in light of the OFT report and that some bodies have already announced positive changes as a result. The Government will consider what further steps might be needed in respect of the market for legal services to ensure that the competition issues are fully addressed.

Regulatory reform

3.27 Effective and well-focused regulation has important economic benefits. Properly framed, regulation can play a vital role in correcting market failures, promoting fairness and ensuring public safety. In contrast, unnecessary or inefficient regulation imposes serious economic costs, restricting competition, stifling innovation and deterring investment. The Government is committed to maintaining high standards of regulation in the UK and throughout Europe by ensuring that regulation is transparent, accountable, well-targeted, consistent and proportionate.

3.28 As part of the process of building a more effective regulatory regime in the UK, the Government has implemented a range of major reforms in key sectors. For example, the Government has established a new framework for the regulation of electricity and gas markets and proposes to set up a single regulator for communications – OFCOM. Changes to the structure of utility regulation have been accompanied by an increasing focus on regulatory performance, with reviews conducted by W.S. Atkins for the Treasury and by the Better Regulation Task Force.

Box 3.3: The aviation industry

The aviation industry is important to the growth of the UK economy and to UK consumers. The uncertain global economic outlook and decline in global passenger traffic has intensified following the events of 11 September. The Government has worked with its European partners to minimise distortions to the single market and has supported guidelines which limit airline compensation to the exceptional impact of the four-day closure of US airspace as a direct consequence of terrorist actions on 11 September.

As with other sectors, the Government is committed to ensuring that regulation of the aviation industry is effective and well-focused, competition policy vigorously applied and market distortions minimised. The Government's aviation policy is therefore underpinned by the principles of liberalisation and normalisation. Consistent with its principles, the Government has:

- **taken a lead in Europe in pressing for the regulatory barriers to structural reform in the industry to be dismantled. Airlines are responding to the new market conditions by restructuring their businesses, but progress towards consolidation is held back by obsolete international regulations, to the detriment of passengers; and**
- **tackled temporary market failure, by stepping in quickly and decisively to provide third party war and terrorist cover for the UK aviation industry. The Government has committed to withdrawing completely as a properly functioning market returns.**

3.29 To drive forward reform of outdated, overlapping and over-burdensome regulation, the Government introduced the Regulatory Reform Act in April 2001. This gives ministers a new power to use orders to reform primary legislation and a reserve power to set codes of good practice in enforcement. Consultation exercises have been completed on nine proposed reforms with two orders already laid for parliamentary scrutiny. These measures alone could save business in excess of £40 million. In a further important reform, the OFT will play a new role in assessing the effects on competition of existing and proposed new regulations.

ENTERPRISE

3.30 In a modern economy, enterprise and entrepreneurship are key drivers of productivity. New businesses entering the marketplace increase competitive pressures and facilitate the introduction of new ideas and technologies and more efficient ways of working. In common with other European countries, the UK has failed to achieve the levels of enterprise and entrepreneurship seen in the US economy. To address this gap, the Government is therefore taking steps to promote enterprise throughout the economy, including in some of Britain's most disadvantaged areas.

Encouraging enterprise across the economy

3.31 To promote a stable and attractive environment for enterprise and investment across the economy, supporting business in a period of slower global growth, the Government has radically reformed the business tax regime, including:

- reducing the main rate of corporation tax to 30 per cent – the lowest in the history of the UK;

- introducing a 10 per cent starting rate for small companies – the lowest in the European Union – to provide an incentive for enterprising individuals to start up their own companies. As previously announced, the Government is committed to extending the starting rate in Budget 2002 to reduce further the corporation tax bills of smaller companies;
- introducing a generous capital gains tax (CGT) taper for business assets to encourage entrepreneurial investment and activity; and
- abolishing the requirement to withhold tax on interest and royalties between companies in the UK.

Modernising the business tax system

3.32 The Government is continuing to build on these reforms to ensure that the tax system recognises the realities of the modern business environment and to help UK companies compete effectively at home and abroad. Building on announcements in Budget 2001 and measures put forward in the Enterprise Statement, the Government is:

- **publishing draft legislation for an exemption for gains and losses on substantial shareholdings** to ensure that important business decisions on corporate restructuring and reinvestment are made for commercial, rather than tax, reasons. It is proposed, subject to further consultation, that this legislation will take effect for disposals from 1 April 2002;
- **publishing draft legislation for a new regime for providing tax relief to companies for the costs of intellectual property, goodwill and other intangible assets** to encourage business to take advantage of new opportunities in the emerging knowledge-based economy. It is proposed, subject to further consultation, that this legislation will take effect from 1 April 2002;
- **modernising and simplifying the tax regime for corporate debt, financial instruments and foreign exchange gains and losses for accounting periods starting on or after 1 October 2002,** to create a coherent regime governing the taxation of debt and derivative contracts. This will provide long-term stability and transparency for business. Draft legislation will be published shortly;
- **publishing a review of Inland Revenue's links with business;**
- **seeking views on an optional scheme for companies to pay cross-border royalties without deducting tax at source;** and
- helping companies in the Construction Industry Scheme (CIS) by **making changes from 6 April 2002 to allow CIS deductions to be set-off against PAYE, NICs or CIS liabilities that companies are due to pay to the Inland Revenue**.

3.33 To encourage investment and promote enterprise, the Government is also **introducing further improvements to the CGT business assets taper for disposals from 6 April 2002.** These improvements will mean that the effective rate of tax for a higher rate taxpayer is reduced to 20 per cent after one year of holding an asset and 10 per cent after only two years, making the UK regime among the most favourable in the developed world.

3.34 The Government is considering the various proposals it has received in response to the consultation launched in June 2001 on value for money options to simplify CGT within the existing policy framework. It is also considering whether there is any case for changes to the CGT regime for non-business assets.

Supporting small business

3.35 In seeking to make Britain one of the most competitive environments for business in the world, the Government recognises the importance of helping small businesses to develop and flourish.

Easing administrative burdens on small businesses

3.36 The Government is committed to reducing regulatory and administrative burdens on small business and has consulted on proposals to reduce their compliance costs. It now intends to **consult further on the scope for minimising compliance costs through closer alignment of tax and accounts.** The aim is to identify specific proposals that offer simplification while maintaining incentives and fairness.

Payroll

3.37 The Government recognises that running payroll services can be a significant undertaking, especially for smaller businesses. In June 2001, the Government asked Patrick Carter to undertake a review of the market for payroll services in the UK, to identify ways of helping employers meet their payroll obligations. **The Government is now publishing the review.**

3.38 The Government accepts the review's conclusion that better and more consistent use of information technology is the key to enabling businesses to deal with the complexity of payroll. To advance the use of IT, the review recommends that smaller employers should receive cash incentives for electronic filing of end-of-year returns with the Inland Revenue for a period of five years. Electronic filing would become mandatory during this period for larger employers (over 50 employees), and at the end of it for all employers.

3.39 The Government considers that the review sets out a package that is challenging but that also has attractions. The Government welcomes this important contribution to the debate on payroll and endorses in principle the proposals put forward by the review. The Government recognises, however, that the proposals raise issues that would benefit from wider debate before final decisions are taken. It therefore **invites comments on the detail of the review's recommendations by 31 January 2002**.

VAT

3.40 In Budget 2001, the Government implemented a package of measures designed to allow small and newly-registered businesses to manage their entry into the VAT system, reduce the administrative burden of VAT and improve their cash flow. A consultation document, *Easing the Impact of VAT on SMEs*, was issued in June 2001 setting out further proposals. As a result of this consultation, and additional changes to HM Customs and Excise's own administrative operations, the Government is now:

- **introducing an optional flat-rate scheme in Budget 2002**, under which more than 300,000 small businesses can avoid having to account for VAT on each individual purchase and sale, cutting their compliance costs by up to £1,000 per year;
- **introducing changes in Budget 2002 that will simplify and increase participation in the VAT annual accounting scheme**, which offers improved cash flow and lower compliance costs to around 900,000 businesses;
- **pressing ahead with reforms to the VAT penalties system** to ensure that small businesses are first offered advice and support when they are late with payments, rather than facing an automatic penalty; and
- **establishing an outreach business support programme**, through which HM Customs and Excise will offer proactive advice and support to businesses before they get into difficulties. The programme will be developed in the light of the help given to businesses affected by the Foot and Mouth outbreak, described in Chapter 7.

Encouraging business start-ups

3.41 The Government recognises the importance of providing targeted help and support to facilitate the establishment of new businesses. In June 2001, it announced that the Small Business Service (SBS) would consult on a comprehensive strategy to bring together the different activities designed to support business start-ups. Development of this strategy will form a major part of the Government's cross-cutting review of services to small business in preparation for the 2002 Spending Review.

3.42 The chances of business start-ups and early stage SMEs surviving and growing will be boosted by a new £75 million business incubation fund. Business incubation provides hands-on support for small firms at a time when they are most vulnerable. The fund was opened by the SBS on 1 October 2001 and will contribute to the financing of incubation projects to help a wide variety of business start-ups.

Improving access to finance

3.43 In February 2001, the Government announced a new programme of Early Growth Funding, committing up to £50 million to help a minimum of 1,000 businesses over the next three years. This programme will stimulate the supply of risk capital for start-ups and growth firms. After consulting with major banks, the venture capital sector and RDAs, **the SBS is now issuing bidding guidance for proposals to deliver this programme**. Early Growth Funds will help provide small amounts of risk capital – for example £50,000 – in businesses' early stages, complementing the larger amounts available from the Regional Venture Capital Funds and other sources. Early Growth Funds should be up and running next year.

3.44 To help plug the "equity gap" faced by small firms seeking finance to boost growth, the Government is supporting Regional Venture Capital Funds in every English region. The funds will operate as public/private partnerships, with the Government investing up to £80 million and the European Investment Fund up to £60 million. The first two funds are expected to be launched by the end of the year, and the majority should be up and running by the end of the financial year. Together with private sector funding, the Government expects that the funds will provide up to £270 million of extra finance for small firms. The Regional Venture Capital Funds are a major step towards achieving the Government's £1 billion target for public-private venture capital funding, announced in Budget 2000 .

Investment readiness

3.45 The availability of equity finance is not the only obstacle to small firm development. Businesses also need to be aware of the potential benefits and how to access it. However, the availability of specialist advice remains patchy. The Secretary of State for Trade and Industry will shortly announce steps to improve the provision of advice in this area.

Encouraging employee share ownership

3.46 Employee share schemes align employees' interests with their employer's business, providing significant incentives for productivity improvement. Finance Act 2000 introduced a new All Employee Share Ownership Plan (AESOP), now known as the Share Incentive Plan (SIP). The Plan is designed to encourage all staff of both large and small firms to hold shares in the company for which they work. The scheme was enhanced in Finance Act 2001 with a stamp duty exemption for SIP shares. Over 220 companies already have approved SIPs, potentially involving over one million employees in share ownership.

Enterprise management incentives

3.47 Finance Act 2000 also introduced Enterprise Management Incentives (EMIs) which are designed to help smaller, higher risk companies. This scheme was improved in Finance Act 2001 by removing the limit on the number of employees who can qualify. To date, over 1,600 companies have granted more than 13,000 awards under EMI to recruit and retain high calibre employees. To build on the success of the scheme, in June 2001 the Government announced a consultation on doubling the gross asset limit, from £15 million to £30 million. Following the consultation, **the Government is now introducing measures to double the gross asset limit to £30 million. A Statutory Instrument will be laid before Parliament**

immediately to take effect from 1 January 2002. The change will be of particular help to small, dynamic manufacturing enterprises, which are more likely to have assets in excess of the current limit.

Share options

3.48 Under present arrangements, businesses are not always able to deduct the cost of share options and awards against their corporation tax liabilities. To encourage more businesses to consider awarding shares and share options to their employees, the Government is considering whether a corporation tax deduction should be made available and how access to it could be streamlined.

Modernising insolvency

3.49 Many potential entrepreneurs are dissuaded from starting new businesses by the perceived costs of failure. A modern and flexible bankruptcy regime which reduces the cost of financial failure and enhances the prospects for rescue of insolvent companies can therefore play an important role in stimulating enterprise and entrepreneurship. The Government is committed to taking forward the reforms set out in the July 2001 White Paper, *Insolvency – A Second Chance*, as part of the Enterprise Bill, including by:

- replacing the current "one size fits all" approach to bankruptcy with a new regime under which the cost and stigma of failure will be substantially reduced, while the sanctions available to protect the public and wider business interests against the dishonest and unscrupulous will be reinforced;
- improving the prospects for company rescue by ensuring that company insolvency is conducted in the interests of all creditors, both secured and unsecured, and through an updated and streamlined process of administration; and
- ending Crown preference, which enables certain tax debts to be paid first in an insolvency. In future, the Government will take its place in the queue alongside other unsecured creditors. Steps will be taken to ensure that the benefit of this change goes mainly to unsecured creditors.

3.50 The Government is also committed to modernising the financial regime of the Insolvency Service. This will create a simpler, more transparent fee structure. The Insolvency Service account will be reformed so that creditors receive the maximum possible investment return and insolvency practitioners administering voluntary liquidations will no longer be compelled to use the account.

Davies review of enterprise and education

3.51 In June 2001 the Chancellor of the Exchequer and the Secretaries of State for Trade and Industry and Education and Skills appointed Sir Howard Davies, Chairman of the Financial Services Authority, to conduct a review of enterprise in schools and further education. The review is considering how to promote better understanding of business, the economy and enterprise throughout the school and further education systems and has been examining the stepping stones to careers in business and the development of enterprising attitudes more generally. Sir Howard will report to the Government by the end of January 2002.

Management

3.52 In view of the links between management and productivity performance, the Government created the Council for Excellence in Management and Leadership (CEML) at the time of Budget 2000. CEML is due to report by March 2002. The joint CBI-TUC investment working group has also identified the importance of management issues and recommended that, building on the work of CEML, "leadership and management skills in the UK are addressed specifically by a systematic survey and research to identify UK strengths and weaknesses". The Government will take this recommendation forward in the light of the CEML report.

Encouraging enterprise in disadvantaged communities

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

Community Investment Tax Credit

3.54 The Social Investment Taskforce, chaired by Sir Ronald Cohen, reported to the Chancellor in October 2000. The report recommended a new Community Investment Tax Credit (CITC) to encourage private investment in not-for-profit and profit-seeking enterprises in under-invested communities. In response to this recommendation, the Government published a consultation document in March 2001 proposing a CITC including the following elements:

- a tax credit for those investing in enterprises in disadvantaged communities through Community Development Finance Institutions (CDFIs). The tax credit would be set against investors' tax liabilities, and be worth 25 per cent of investment, spread evenly over five years; and
- a competitive tax credit allocation process among CDFIs.

3.55 Around 100 organisations took part in the consultation process. Feedback was overwhelmingly supportive of the Government's proposal for the tax credit, although respondents suggested modifications to aspects of the scheme. In July 2001, the Financial Secretary to the Treasury announced the Government's intention to proceed with the CITC, with decisions on two major aspects of the scheme:

- individual investors as well as corporates will be allowed to benefit from the tax credit; and
- both debt and equity investments will be allowed to attract the tax credit.

3.56 The consultation document asked respondents to comment on the likely level of demand for the CITC, given the Social Investment Taskforce's aspiration of £1 billion of investment over five years. While projections in this area are highly uncertain, the consultation indicated constraints on the capacity of intermediaries and businesses to absorb this level of investment in the short to medium term. The Government's view is that the key criterion for success should be whether Government intervention enables the development of an economically and socially valuable new business model.

3.57 Alongside the adjustments already announced, the Government additionally proposes to make substantial amendments to the proposed competitive allocation process for tax credits in order to increase access to the CITC, reduce administrative costs for CDFIs and increase the efficiency of the mechanism. In particular, the Government intends to:

- **remove the overall cap on the amount of investment that can attract tax credits in any year.** This means that CDFIs will compete against a standard rather than against each other;
- **set a limit or cap on the amount of investment attracting the tax credit which any successful CDFI may raise.** This will limit the cost of the incentive should the amount of investment significantly exceed current estimates; and

- **ensure that the caps are sufficiently high to give CDFIs enough credit to raise two to three years' volume of investment.** This will minimise the bureaucratic burden involved.

3.58 **The Government also proposes that the SBS administer the accreditation process for CDFIs that wish to raise investment qualifying for tax credits, in consultation with the RDAs and devolved administrations.** The SBS has existing experience of working with the community development finance sector and administers several UK-wide schemes. Work is currently under-way on the detailed structure of the accreditation process, which is likely to include the use of an advisory panel of experts. In this work the SBS will engage fully with their counterparts in the devolved administrations.

3.59 Final decisions will be made on other issues in time for Budget 2002. The Government aims to publish draft legislation before Budget 2002 and to legislate in Finance Bill 2002, with the scheme starting thereafter, subject to state aids approval.

Community Development Venture Fund

3.60 The Social Investment Taskforce also recommended that the Government help set up a Community Development Venture Fund – a matched funding partnership between Government and the venture capital industry to provide finance for firms operating in disadvantaged areas. The Government has committed £20 million in matching funding to a £40 million fund and responses from the private sector have been positive. The Government hopes to see the fund up and running by the end of the financial year, again subject to obtaining state aids clearance.

Land and property in deprived areas

3.61 Following Lord Rogers' report, *Towards an Urban Renaissance*, the Government is implementing a number of measures described in the Urban White Paper to encourage the development of land and property in deprived areas. These will help reduce the cost to business of investing in these areas and so boost local enterprise and employment. In particular, **an exemption from stamp duty for both residential and commercial property transfers up to £150,000 will be available in the UK's most disadvantaged areas from 30 November 2001.** The intention is to raise the limit significantly or abolish stamp duty for all non-residential transfers in these areas next year, subject to state aids clearance. This will make investment in these areas more attractive and encourage households and firms to look more favourably upon them as places to live and do business. Details of further measures described in the Urban White Paper are set out in Chapter 7.

Inner City 100

3.62 The Inner City 100 project is identifying and publicising the fastest-growing 100 companies in the UK's most deprived inner cities. The Government has provided funding to the project which was launched by the Chancellor in February. More than 300 nominations have been received and final awards are being presented on 27 November.

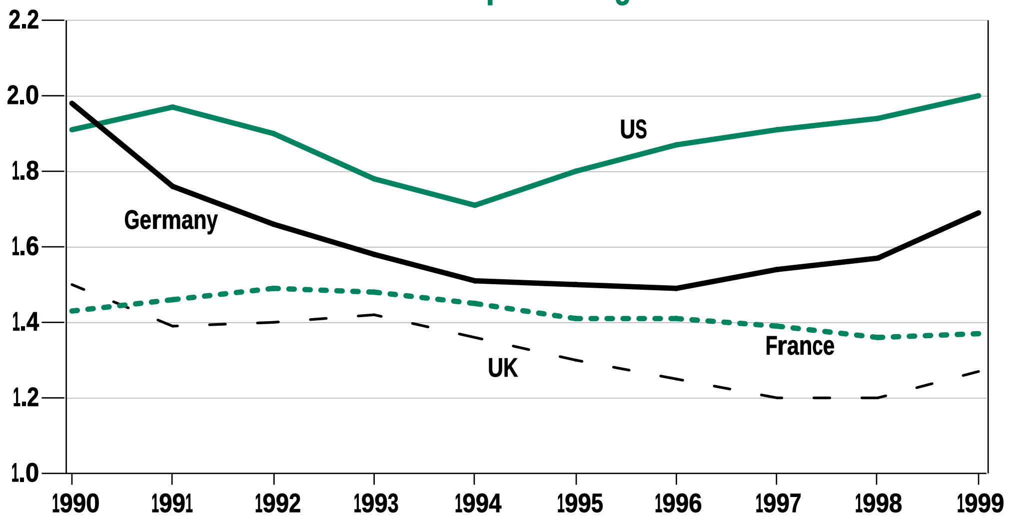
City Growth Strategies

3.63 The SBS is supporting pilot projects for City Growth Strategies which will strengthen the links between enterprise and urban renewal. Drawing on experience from the US, the pilots will explore ways of putting business creation and development at the heart of regeneration in towns and inner cities, focusing on their competitive advantage rather than their social disadvantage. The location of the pilot projects will be Nottingham, Plymouth, St Helens and deprived areas of London.

INNOVATION

3.64 International comparisons show that the UK business sector under-invests in research and development (R&D) relative to its major competitors. This translates into lower levels of innovation, which is an important catalyst for productivity and growth. Weaknesses in the UK's innovation performance were also identified by the CBI-TUC innovation group. For the UK economy to deliver its full potential, companies must be able to compete at the cutting edge of technological change. Encouraging innovation is therefore an important part of the Government's strategy for improving the UK's productivity performance.

Chart 3.1: Business R&D as a percentage of GDP



Source: OECD

Encouraging research and development

3.65 Despite a strong science base, UK firms are often unable to harness innovation to raise productivity and build commercial success. To address this issue, the Government has put in place a range of measures to promote commercial R&D in the UK. As part of this support, Budget 2000 introduced a tax credit to encourage investment in R&D by small companies.

3.66 Budget 2001 launched a consultation on extending this tax credit to all companies. The proposals were welcomed by a broad cross-section of industry. The design of the credit will reflect the important contributions made by companies, representative bodies and others who responded to the consultation. **The Government therefore proposes to legislate for an R&D tax credit for larger companies in Finance Bill 2002 following a second round of detailed consultation.**

3.67 The original consultation document set out a choice between a simple volume credit, which rewards all qualifying R&D expenditure, and an incremental credit, which rewards only increases in expenditure. Overwhelmingly, respondents favoured a volume approach, for the following principal reasons:

- a volume approach is more predictable than the incremental design set out in the consultation document. Many respondents saw this predictability as key to the ability of a tax credit to influence investment decisions;

- the volume approach is simpler, reducing administrative burdens on companies; and

- a volume credit incentivises those companies with already high but relatively stable levels of R&D expenditure, as well as those that are increasing expenditure.

3.68 **The Government recognises the advantages of a volume-based credit over an incremental credit, and has consequently decided to adopt a version of a volume credit.** However, within this broad definition, a number of choices remain that will have important consequences for the operation of the credit and its ability to target extra R&D. Building on the success of the original consultation, the Government will be seeking views on options for the design of the credit in a further consultation to begin next week, in advance of Budget 2002.

3.69 The UK benefits from some of the strongest university based research in the world. To encourage better links between business and universities, the Government will ensure that the R&D tax credit provides tax relief for companies that enter into collaborative research with universities. In this way the new credit will enhance technology transfer between universities and business, and help give companies access to the latest university-based research in developing new and better products.

The Roberts review

3.70 Businesses, universities and the public sector need to be able to recruit and retain skilled scientists and engineers to underpin their R&D activities. In Budget 2001 the Government appointed Sir Gareth Roberts to lead an independent review into the provision of skilled scientists and engineers in the UK, reporting back by February 2002.

3.71 Since Budget 2001, Sir Gareth and his review team have undertaken a wide ranging consultation with interested parties and have extended the analytical evidence base for the review. This work has revealed that, although the UK has a strong overall science base compared to other industrialised countries, more needs to be done to strengthen the future supply of scientists and engineers. In particular, Sir Gareth has indicated that the review's recommendations will seek to:

- address issues in the recruitment and retention of design and technology, maths and science teachers, and in the quality of laboratories and other factors influencing practical work in schools; and to encourage participation (particularly by women) in science and engineering study through appropriate course design and careers advice;

- examine any financial barriers to the uptake of science and engineering study at undergraduate level; and to address the quality of the learning experience, including undergraduate teaching laboratories, in science and engineering;

- address the funding and training available to postgraduate students and contract researchers; and to address issues in the recruitment and retention of academic staff through, for example, considering their remuneration in the context of the overall forces of demand and supply; and

- examine the opportunities for scientists and engineers working in R&D in industry; to improve the perception of careers in science and engineering; and to address the coherence of the communication between employers and universities.

3.72 The Government welcomes the independent assessment provided by Sir Gareth and looks forward to receiving his proposals for addressing the issues highlighted by the review.

Supporting science and research

3.73 In June 2001, the Chief Secretary to the Treasury announced a cross-cutting review on science and research. The review – which will feed into the 2002 Spending Review – will examine funding of the UK science base, including universities, and the effectiveness of government departments' own science and research programmes to ensure that they deliver long term benefits to the economy and quality of life in the UK. Details of other cross-cutting reviews ahead of next year's Spending Review can be found in Chapter 6.

Box 3.4: Broadband

The UK is one of the most connected economies in the world, with higher internet use than any other major European country. Broadband provides new opportunities and the Government's ambition is for consumers, firms and the public sector to take the fullest advantage of its potential benefits.

Take-up will undoubtedly rise as the benefits become available. The challenge is therefore primarily one for industry – to stimulate demand for innovative services, to be responsive in satisfying that demand and to offer choice. The market is the best mechanism for achieving this. The Government's broadband target is to have the most extensive and competitive broadband market in the G7 by 2005, with significantly increased connections to schools, libraries, further education colleges and universities.

The Government's role is to set the right framework for that market, promoting competition where possible and regulating effectively where not. The Government also has important, but tightly defined, roles as a purchaser in its own right for public services and in helping firms and others make the most of new technology. The Government is already taking action in a range of areas:

- teleworking: **personal benefits' taxation was relaxed in 2000 in relation to employees working at home, assisting in the provision of broadband connectivity to home teleworkers;**
- capital allowances for broadband: **small enterprises can now take advantage of 100 per cent first year capital allowances up to 2003, and SMEs permanent 40 per cent first year allowances, for capital costs of broadband connections. Firms can obtain tax relief on non-capital expenditure incurred in establishing and maintaining broadband connectivity. These rules also apply to employers paying for broadband connectivity at an employee's home;**
- regional schemes: **£30 million has been allocated to the RDAs and the devolved administrations to take forward innovative schemes to extend broadband networks and encourage the use of broadband by business and consumers; and**
- public purchasing: **the Office of Government Commerce has been asked to look at what more might be done to help government departments buy broadband more effectively.**

In addition, the Government has been working with the Broadband Stakeholders Group to develop a long-term strategy based on this pro-competition, market-based approach.

Making the most of the radio spectrum

3.74 Radio spectrum is a major national asset of growing importance to the communications industry and to a wide range of public services which affect the quality of life and safety of all UK citizens. The Government has taken steps in recent years to improve the spectrum management regime, making it more responsive to market developments and creating incentives for efficient spectrum use.

3.75 In March 2001, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry appointed Professor Martin Cave of Warwick Business School to conduct an independent review of spectrum management in the UK. The review launched a wide-ranging consultation process in June 2001, involving representatives from the private sector and from relevant government departments and agencies. Professor Cave intends to submit his final report to the Government by December 2001, with recommendations for what more needs to be done to ensure that all users, including non-commercial ones, are focused on using their spectrum as efficiently as possible.

INVESTMENT

3.76 Empirical studies show that levels of physical capital stock are closely correlated with productivity performance.[2] The UK has long suffered from under-investment and is today significantly less capital intensive than its main competitors. The unexpected severity of the world economic slowdown will clearly impact on investment levels in the short term, although strong economic fundamentals and a proactive macroeconomic policy response are expected to give rise to an acceleration in investment as the global economic recovery gathers pace.

3.77 In addition to maintaining macroeconomic stability, to create the conditions for future sustained increases in investment it is also necessary to address a number of market failures at the microeconomic level. The Government has introduced a range of measures aimed at remedying such failures, ensuring that funding for investment is available to those who need and can best make use of it.

The Myners review of institutional investment

3.78 At the time of Budget 2000, the Government asked Paul Myners, chairman of Gartmore Investment Management, to lead a review into potential distortions affecting institutional investment decision-making in the UK. The final report of the review was published in March 2001. The Government issued its formal response in October 2001, confirming that it would be taking forward all of the recommendations of the review. The Government now plans to launch consultations on a range of issues, including legal change to trustees' duties, and a legal duty of shareholder activism. In March 2003, the Government will conduct an assessment of progress made by the industry in implementing the changes proposed by the Myners review.

The Sandler review of retail savings

3.79 In response to the recommendations of the Myners review, in June 2001 the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the long-term savings industry. The review is examining the markets for medium and long-term savings products purchased by retail customers, identifying the competitive forces and incentives that drive the industries concerned and analysing potential policy responses. The review issued a consultation document on 30 July which has received over 200 responses. The review will report to the Government next year.

Company law and corporate governance

3.80 The Government is committed to modernising the framework of company law so that it is up to date and promotes enterprise and productivity. The final report of the independent Company Law Review was published in July 2001. The Review's recommendations include a radical simplification of the requirements for small firms, a statutory statement of directors'

[2] See, for example, N Oulton: *Why do foreign-owned firms in the UK have higher labour productivity?* in N Pain: *Inward Investment, Technological Change and Growth*, Macmillian Press 2000.

duties to clarify the obligations of directors under company law, and improved transparency and accountability for large firms. The recommendations have been widely supported, including by the CBI-TUC best practice working group. The Secretary of State for Trade and Industry will be consulting on draft legislation.

3.81 The Secretary of State for Trade and Industry has also announced that the Government will legislate to require quoted companies to disclose annually the details of their remuneration policy as well as individual directors' remuneration packages. Companies will also be required to put a resolution to shareholders each year on the remuneration report. The DTI will publish next month a consultative document setting out the proposals in detail.

3.82 The Myners review highlighted the importance of non-executive directors in UK corporate governance. The Company Law Review drew attention to a growing body of evidence from the US suggesting that companies with a strong contingent of non-executives produce superior performance. The Government recognises the importance of continued progress in this area, and of developing further the role of strong, independent non-executive directors within the present best practice framework of corporate governance for quoted companies.

Modernising the planning system

3.83 Many investment decisions are closely affected by the land use planning system. Currently, the system is unable to deliver the level of speed, certainty and responsiveness that businesses need to make successful investment decisions in a modern economy. Reflecting the conclusions of the CBI-TUC investment group, the Government will reform the planning system to address its current inadequacies, which include:

- uncertainty stemming from inconsistencies between planning policies set out at national, regional and local levels;
- the complexity of national planning guidance which is set out in 25 long and opaque Planning Policy Guidance notes;
- the unresponsiveness of the system, resulting from the fact that local development plans take an average of five years to produce;
- very slow decision-making, with only 23 per cent of planning decisions on major commercial applications being made within the statutory eight week period; and
- the handling of major infrastructure projects, which currently involve delays of many years.

3.84 The Government has already announced a series of measures to improve the handling of major infrastructure projects, including new parliamentary procedures to approve projects in principle while allowing detailed issues to be considered by public inquiries, and reforms to introduce stricter timetabling and more focused terms of reference to inquiry procedures. A consultation paper setting out the Government's proposals in detail will be published shortly. To further limit unnecessary debate at inquiries, the Government will also issue national policy framework statements for projects before they are considered in the planning system.

3.85 **The Government believes that wider change is necessary and will publish a Green Paper on planning reform next month, setting out proposals to improve dramatically the flexibility, speed and responsiveness of the land use planning system, while also strengthening community participation.** Alongside the Green Paper, the Government will publish a consultation paper setting out options for reform of the planning obligations system.

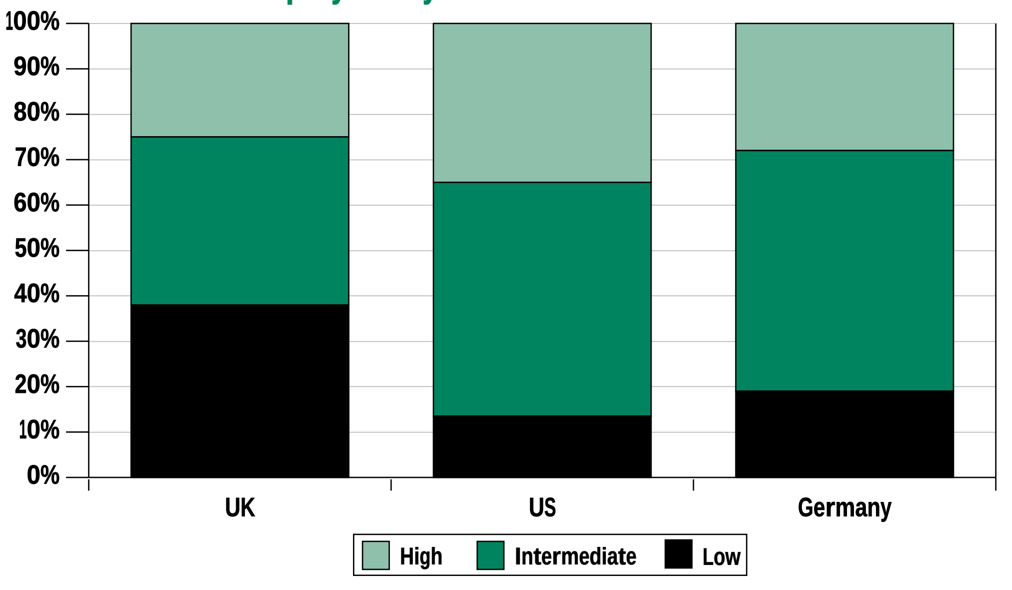
SKILLS

3.86 In an increasingly knowledge-based economy, there is a strong link between productivity and the quantity and quality of skilled labour. A more highly skilled workforce can generate greater innovation, increase flexibility in the workplace and enable better adaptation to new technologies.

3.87 The CBI-TUC joint working group on skills identified skill shortages at the lower-intermediate level as a critical issue for the UK's productivity performance. The group concluded that "too many adults in the UK have low or no qualifications in relation to those of our major competitors". Recent work by the Performance and Innovation Unit (PIU) also highlights the particular problems the UK faces in terms of lower-intermediate skills. This analysis is supported by the international evidence summarised in Chart 3.2 which suggests that:

- the UK has relatively fewer people with intermediate skill levels than Germany, other European countries and the US; and
- a far higher proportion of the UK population lack basic skills compared with other industrial countries. The International Adult Literacy Survey, for instance, found that over 20 per cent of the adult UK population lacks functional literacy. Of the thirteen countries surveyed, only Ireland and Poland fared worse.

Chart 3.2: Employees by skill level



Source: OECD, 2001

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

3.88 The UK skills base is not static. As a result of the Government's prioritisation of education, young people entering the workforce today are far more likely to have qualifications of at least level 2 (5 GCSEs A*-C or equivalent) than previous generations.

Box 3.5: Conclusions of the CBI-TUC working group on skills and the PIU study on workforce development

The joint CBI-TUC working group on skills reported to the Chancellor in November 2001, identifying a range of issues and areas for action in addressing the UK skills gap. The Performance and Innovation Unit (PIU) has also recently published a report setting out proposals for a national strategy for workforce development. Both the reports focus on the importance of training in improving the skills of the adult workforce. They conclude that:

- **without basic skills, individuals cannot start to develop a career path and may be trapped in low pay/no pay cycle;**
- **only a joint approach by government, employers and individuals will deliver real change;**
- **existing training is received disproportionately by workers with higher skills. Government intervention in this area needs to focus on ensuring that more of the workforce achieves basic skills and level 2 qualifications because this is where the most significant market failures exist;**
- **most employees without basic skills or skills below level 2 are employed by small firms for which the market failures are more significant than for larger firms. Policy needs to focus on providing incentives for smaller firms to train their workers; and**
- **the Government must also take responsibility for improving the supply-side, including the accreditation of individuals' skills and Investors in People status, and ensuring that training providers are responsive to the needs of business.**

However, this improvement will only have a gradual effect on overall UK skills levels. Two-thirds of today's workforce will still be in the labour market in 2020, and more than one third – over eight million people – have qualifications below level 2, with many of these also lacking basic skills. A faster improvement in the UK skills base can therefore only be achieved by updating and improving the skills of people already in the workforce.

Training

3.89 Although some data suggest that the UK has a relatively high training participation rate by international standards, training opportunities are unevenly spread, as highlighted by the PIU in their recent report on workforce development in the UK:

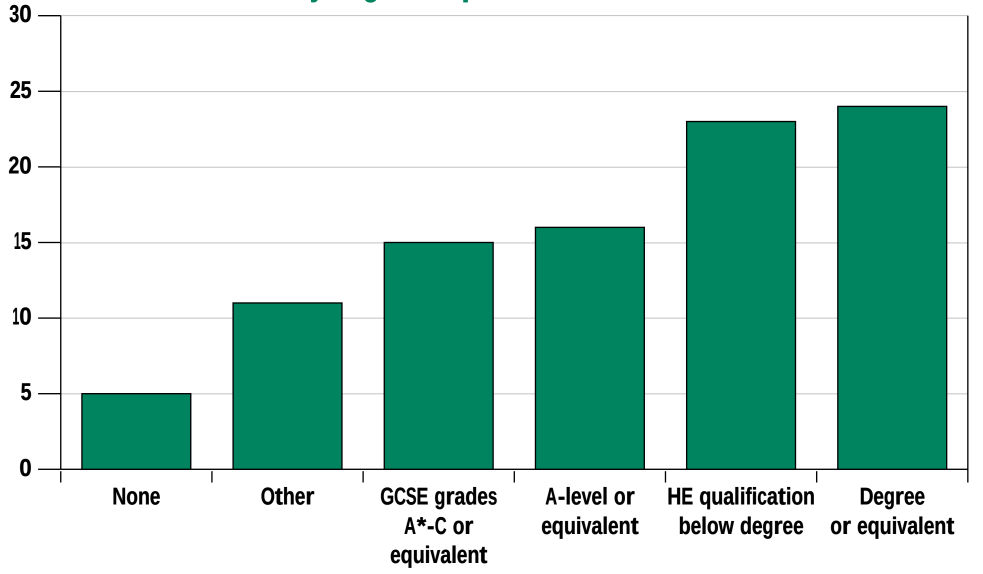
- people with higher qualifications are more likely to receive training than those with lower qualifications, as shown in Chart 3.3; and
- employees of small firms are much less likely to receive training than those working for large firms. Only 36 per cent of firms employing fewer than 25 people provide off-the-job training, compared with 92 per cent of firms with more than 200 employees.

3.90 The uneven spread of training opportunity reflects significant market failures in the provision of workforce training, which have been further analysed by the PIU in their recent work. For example:

- employers may under-invest in training because they may not be able to capture all the benefits of their investment, for example if trained employees leave. Unless training pays off quickly or is not very transferable, firms may therefore be reluctant to provide training to their workers;[3]

[3] R Cassan and G Mavrotas: *Education and Timing for Manufacturing Development,* in M Godfrey: *Skill Development for International Competitiveness*, Institute of Development Studies, University of Sussex, 1997.

Chart 3.3: Percentage of employees receiving training in the last four weeks by highest qualification



Source: Labour Force Survey, Autumn 2000

- information problems increase the likelihood that employees may not be able to judge the quality of their training or appreciate the benefits, therefore reducing their willingness to accept lower wages during the training period or to receive any training at all.[4] This is supported by the fact that motivation to train is higher among those with more training;[5]
- insufficient information is also likely to cause firms to provide less training if they are uncertain about the benefits of training in terms of increased worker productivity. As a result of the difficulties firms have in assessing improvements in productivity, they are more likely to offer training to those employees who have already demonstrated that they can achieve higher skill levels, meaning that those workers with the fewest qualifications receive the least training; and
- credit market imperfections can restrict training as low-paid employees are likely to be credit-constrained and unable to obtain loans to finance training. Small firms may also face credit constraints and cash flow problems which inhibit their willingness to contribute to training.

A vision for UK skills

3.91 To deliver a long-term improvement in workplace training, and to tackle the market failures that restrict training opportunities, government, employers and individuals must all play a role, as emphasised by the PIU and the CBI-TUC in their recent work. While training offers significant benefits for both individuals and employers – through higher wages for individuals and higher productivity for employers – the existence of market failures, especially at lower skill levels, and the social benefits of a more highly skilled workforce, provide a strong justification for government intervention. The PIU report on workforce development concludes, and the Government agrees, that although the top priority is to target individuals who need to aquire basic skills, the long-term ambition should be that all adults have the opportunity to achieve a level 2 qualification.

3.92 In order to realise this ambition, it is necessary to increase the demand for training. The PIU set out options for a workforce development strategy in their recent report on the subject which has stimulating demand as its key objective. The Government strongly

[4] M Stevens: *Human Capital Theory and UK Vocational Training Policy*, Oxford Review of Economic Policy, Volume 15, Number 1, pp. 16-32.

[5] National Skills Task Force, 2000, Third Report p. 28.

supports this analysis, and the policy approach explored below places increasing demand at its centre. The CBI-TUC skills working group have also noted that "the importance of increasing demand [for training] cannot be overstated".[6] It is, of course, also necessary to ensure that supply is efficient and tailored to the needs of learners – this is also explored below.

3.93 The Government shares the vision set out by the PIU that: "In 2010, the UK will be a society where government, employers and individuals actively engage in skills development to deliver sustainable economic success for all". The UK needs to achieve a step-change in workforce training if it is to achieve the improvements in skills required to help close the productivity gap. The Government is committed to encouraging a culture of work where training is available to all who need it, and where workforce development is a priority for all firms.

3.94 In the Enterprise Statement, the Government made a commitment to set a new ambition for adult skills. The Government has already set a target to reduce the number of people without basic skills by 2004. In the 2002 Spending Review, it will consider what targets should be set for the future to reduce the numbers of adults in the workforce both without basic skills and who have not achieved level 2 by 2010. These targets will be delivered both through increasing the demand for training among individuals lacking basic skills and level 2 qualifications and improving the quality and efficiency of supply (the proportion of demand that is converted into skills and qualifications). In setting the targets, the Government will work closely with the Learning and Skills Council (LSC).

3.95 There is considerable scope for working towards such targets through the better use of existing resources. Demand for training can be increased through continuing to improve the effectiveness of current initiatives such as the basic skills strategy "Skills for Life", the University for Industry and Union Learning Representatives. Improving supply can be achieved through continuing improvements in the success rates (the numbers of people who reach the end of a course and obtain a qualification) of the Further Education (FE) sector. The flow of better qualified school leavers into the labour market as a result of the Government's investment in education will also have an impact, but there will remain a large percentage of the workforce without level 2 qualifications.

3.96 To make a significant difference in the number of people without basic skills and level 2 qualifications, which would allow the UK to begin to close the skills gap with its main competitors, would require the Government to introduce a new training policy that minimises deadweight through ensuring that employers and individuals also meet their responsibilities in this area.

Increasing the demand for training

3.97 In Budget 2001, the Government made a commitment to consider ways in which training for those with lower levels of skills could be encouraged, through the tax system and other mechanisms. Since then, the PIU report has been published and, building on the PIU analysis, the Government is considering the case for a range of options including a tax credit or other financial incentive as part of the pre-Budget process, alongside the continuing work of the PIU leading up to the 2002 Spending Review.

3.98 In Budget 2001, the Government also said: "the current voluntary approach has secured increased participation in workplace training since 1995, but this is not enough. The scale of the problem is significant and the Government agrees with the National Skills Task Force that tackling this 'chronic UK problem of low skilled adults' must be a priority, and that a step change on the part of all – employers, individuals and government – is required".

3.99 It is clear that, on the basis of current measures alone, the UK is unlikely to attain the levels of human capital which could provide the basis for productivity growth to close the

[6] CBI-TUC submission to the productivity initiative, p. 20.

productivity gap. This is an issue of training type and quality as well as of volume. Voluntary training policies of the past have often failed to reach those with the lowest levels of skills who need most government support to train. The Government will be especially concerned to ensure that any tax credit or other financial incentive avoids high deadweight costs by encouraging training by those individuals who would not otherwise be offered the opportunity by their employers.

3.100 Government must play its part to ensure that all workers have access to the training they need by dealing with market failures, and supporting individuals and employers in their efforts to increase skill levels. The Government has already announced, and allocated very substantial resources to, a basic skills strategy to tackle the high levels of poor literacy and numeracy among adults.

3.101 Sir Claus Moser's 1999 report, *A Fresh Start*, highlighted the UK's basic skills deficiencies. This estimated that up to seven million adults (one in five) in England have literacy skills at or below those expected of an average 11 year old, and that even more (one in four) have a problem with numeracy. To tackle this problem, the Government has introduced successful strategies to improve literacy and numeracy results in primary schools and also launched "Skills for Life", a national strategy for improving adult literacy and numeracy, in March 2001. "Skills for Life" includes a new basic skills infrastructure, extensive information and publicity and free courses for learners. In the short time that it has been in place this strategy has proved successful, with at least 70,000 learners having improved literacy and numeracy skills by the end of August 2001.

3.102 While basic skills has rightly been at the centre of the first stage of the Government's skills agenda, and must continue to be the first priority, it is right also to make a start at supporting individuals to progress onwards from basic skills. Level 2 is effectively the minimum standard that 19 year olds are now expected to have acquired. The Government wants those in the adult workforce who, possibly through no fault of their own, have not attained level 2 qualifications, to have the opportunity to do so.

3.103 In order to achieve the kind of culture shift which will be required to have an impact on training and productivity in the UK, and avoid the deadweight costs which have undermined previous policy initiatives, the Government is now considering new policy approaches to encourage training for lower-skilled workers in the UK, building on the recent work of the PIU in this area. The Government is already looking at possible fiscal measures to improve UK skills. The PIU set out a range of options to overcome barriers to training, one of which is a statutory right to time off for training and development. The Government is considering this suggestion as one of the possible ways of taking forward the commitment made in Budget 2001 and will carry out a full regulatory impact assessment and wide consultation on the development and implementation of any new policy.

3.104 One approach being considered by the Government, to follow on from the work of the PIU and build on existing basic skills policy, life-long learning initiatives, and the commitment shown to improving education since 1997, would consist of four complementary, linked elements, which would require commitments by all stakeholders – government, employers and individuals:

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

- free learning provision and accreditation for employees without level 2 qualifications, to work towards recognised qualifications in areas which could raise productivity, up to the level 2 standard, with approved providers. This would build on the current provision of free courses for basic skills under the Government's "Skills for Life" initiative;

- some form of arrangement for individuals to take up training – such as a minimum entitlement for all employees who have not attained basic skills or level 2 qualifications to paid time off each year to train towards the standard. The Government will explore through pilots different possible time periods. Such arrangements would also help ensure the effectiveness, and minimise the deadweight cost, of any tax credit or other financial support to employers; and

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

3.105 No one of these four elements alone would be able to deliver a step-change in UK skills: each of the elements is interlinked. As the PIU concluded, there are many factors which limit the amount of training undertaken by workers in the UK, and different policy responses are required to deal with different barriers to training.

3.106 **Alongside the wider work being done by the PIU and DfES leading up to the 2002 Spending Review, the Government will launch pilot initiatives in April 2002 (to begin in September 2002) to test out a range of approaches to increasing training levels among those lacking basic skills and level 2 qualifications.** The pilots will cover a mix of basic skills alone, and both basic skills and level 2.

3.107 These pilots will test different possibilities to provide evidence with which the Government can take any decisions about a future national policy. The Government, alongside the PIU, will carry out detailed work on proposals for the pilots. The Government will consult employers and other stakeholders on the detailed design and implementation of the pilots, which will be cash limited, to ensure that they are as effective as possible. The pilots will focus on both basic skills and progression to level 2. To identify the most effective and efficient way forward, different pilots will test a number of elements:

- the level of financial support needed to compensate employers for the time their employees spend on training. Different pilots will offer compensation of 100 per cent or more of wage costs, up to 150 per cent, for small employers, with less than 100 per cent for the largest employers;

- the amount of time low-skilled employees would be entitled to devote to training on full pay. The pilots will test periods of between 35 and 70 hours of paid time off each year;

- incentives and rewards for successful completion of courses; and

- levels of subsidy, up to 100 per cent, for course and accreditation costs.

3.108 Possible structures for pilots would be:

- **pilot 1:** where all employees without basic skills were entitled to 35 hours (5 days) of paid time off each year for free courses to acquire these skills, the pilot would offer employers financial support equivalent to, say: 125 per cent of wage costs in the case of small firms; less than 100 per cent for the largest firms; and

- **pilot 2:** where all employees who have not attained skill level 2 were entitled to 70 hours (10 days) of paid time off each year for free courses to acquire these skills, the pilot would offer employers financial support equivalent to, say: 150 per cent of wage costs in the case of small firms; less than 100 per cent for the largest firms.

3.109 The Government will also be considering the other proposals in the CBI-TUC report on skills.

Improving the supply of training

3.110 If employers, government and individuals are to see an effective return on increased investment, the UK needs a network of high quality responsive training providers who can translate increased demand into successful learning outcomes. The PIU report recognised this. The Government has a responsibility to ensure that publicly funded provision offers value for money; and that learners benefit from a challenging and rewarding experience which ultimately leads to successful outcomes. The UK needs provision which encourages individuals to take control of their learning, helping to deliver the Government's objective of developing in everyone a commitment to lifelong learning.

3.111 The Government has radically reformed the framework for the provision of training. The new Learning and Skills Councils (LSCs) will be able to form regional and national strategies which ensure that the needs of employers are met by training. However, there is more that must be done. As the PIU report has emphasised, government needs to ensure that the institutions providing training are delivering high quality training and learning. The FE sector caters for around 3.8 million students studying for about 5.3 million qualifications. Of these students, around 20 per cent are aged 16-19, the rest being adult learners. The FE sector currently provides around 54 per cent of vocational qualifications, and its performance is crucial to the success of any attempt to increase training and skills in the UK workforce.

3.112 Performance in the FE sector has improved in recent years and the best FE colleges perform very well, with success rates of over 70 per cent. However, average success rates remain too low and performance is too varied. Average success rates for learners older than 19 are only 51 per cent and there are a number of colleges whose success rates are lower than 45 per cent. Achievement rates[7] vary between 63 per cent in colleges in the 10th percentile and 89 per cent in colleges in the 90th percentile. There is room for improvement in the sector if those colleges which perform less well could be brought up to the level of the rest. Variation in performance seems to be closely connected with leadership and governance, focus and mission in individual institutions, and the quality of teaching.

3.113 The introduction of the LSC makes possible a much more targeted approach to improving the supply-side, with the LSC taking a strategic role in enhancing workforce development capacity at the sub-regional level. The Government will consider in the lead up to the 2002 Spending Review how to support change in the sector, to encourage investment in modernisation, and to reinforce and spread excellence, provided that the supply-side responds to the opportunities and challenges it faces. This will help deliver the improved success rates and transformed relationships between providers and local labour markets which are needed to make the UK's workforce development system world-class.

[7] Achievement rates express the proportion of those completing a course who achieve a qualification.

Modern apprenticeships

3.114 Foundation and Advanced Modern Apprenticeships provide young people with a high quality, work-based route to national vocational qualifications at levels 2 and 3 respectively, increasing the supply of skills at craft, supervisory and technician levels within industry. The Government is committed to building on the strong foundations of Modern Apprenticeships by raising their status and quality: increasing the knowledge and understanding content of the scheme and offering an entitlement to a place for all those young people with the necessary ability and aptitude who meet the entry criteria.

Higher education

3.115 Higher education is central to the development of a highly skilled workforce in the long term and has wider social and economic benefits. The Government has therefore set an ambition that 50 per cent of young people will have the chance to participate in higher education by 2010. To fulfil this ambition, it is pursuing three objectives:

- **widening access to higher education:** people in lower socio-economic groups remain far less likely to go to university than those in higher groups and the discrepancy is expanding. In 1997-98 the higher education participation rate among those in Social Class 1 (professional) was 80 per cent, compared with just 14 per cent for people in Social Class 5. To address this imbalance, the Government is currently conducting a review of student finance arrangements to consider how best to support students from poorer backgrounds. The Government will consult on proposals during 2002;

- **improving teaching funding:** the current funding system restricts the ability of universities to respond to demand and to build on their comparative advantages. The Government is committed to creating a set of funding incentives which allows universities to play to their individual strengths; and

- **minimising regulation:** The Higher Education Funding Council has consulted on proposals for reducing the administrative burden on universities to ease pressures in the sector. The Government is now considering additional options for ensuring that prospective students can access comparable information on university performance and for ensuring that all universities meet minimum standards of academic quality.

Work Permits

3.116 The Government is committed to developing a modern system of managed migration that will meet the UK's labour needs in an increasingly competitive global marketplace. The number of work permits issued has risen significantly since 1997, with applications rising from 60,000 to an estimated 145,000 for this year. From January 2002, highly skilled individuals living abroad will be able to apply for a new points-based programme – the Highly Skilled Migrant Entry Programme. The Government is also consulting on lower skilled entry routes to alleviate pressures on sectors facing recruitment difficulties, and has established a Ministerial Committee on illegal working.