

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for Britain to achieve a faster rate of productivity growth than its main competitors. Productivity growth requires flexible markets and an economy which can promote enterprise and fairness together. Building on the reforms and initiatives already introduced, the Pre-Budget Report sets out the next steps the Government is taking to strengthen the drivers of productivity growth:

- **reforms to reduce the regulatory burden on enterprise**, including improvements to the VAT flat-rate scheme to ensure more businesses can benefit fully from compliance savings;
- **measures to overcome barriers to raising finance for small business**, including a pathfinder round of Enterprise Capital Funds and proposed enhancements to Venture Capital Trusts and the Enterprise Investment Scheme;
- **launching an independent review of the Small Firms Loan Guarantee**, to ensure its effectiveness;
- **measures to support regional growth**, including **details of the Local Authority Business Growth Incentives scheme**, which will boost the role of local authorities in promoting growth, and, in Enterprise Areas, a **Business Premises Renovation Allowance**;
- **measures to promote a step change in the UK's enterprise culture**, including **supporting a national campaign by Enterprise Insight**;
- **a new, clearer and more accessible R&D tax credit definition**, which will promote the development of science and innovation;
- **an extension of Employer Training Pilots** to encourage skills training for a third year and to cover over a third of England;
- **publication of the interim report of the Barker Review on the factors affecting housing supply in the UK**; and
- **consulting on the most appropriate structure for a tax transparent property investment trust**, as recommended in the interim report of the Barker Review.

MEETING THE PRODUCTIVITY CHALLENGE

3.1 Productivity growth, alongside high and stable levels of employment, is central to long-term economic performance and rising living standards. The UK has historically experienced low rates of productivity growth by international standards, as a result of macroeconomic instability and market failures. The Government's long-term goal is for Britain to achieve a faster rate of productivity growth than its main competitors.

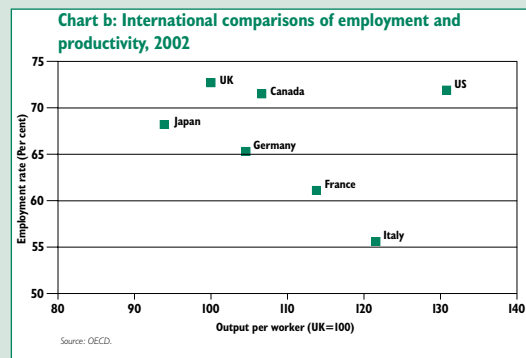
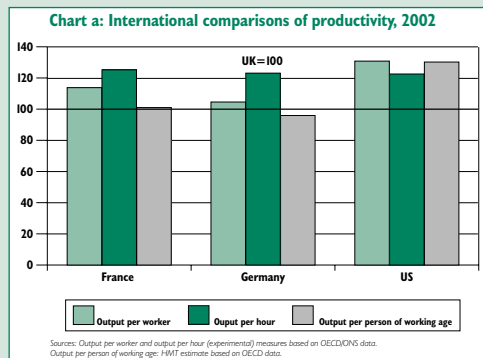
3.2 Productivity growth requires a flexible economy that can promote enterprise and fairness together. Product market flexibility represents the ease with which firms are able to adapt to changing market conditions. Increased flexibility enables individual enterprises or industries to respond rapidly to change, allowing them to exploit new opportunities and to deal with potential challenges effectively. Flexibility provides firms with the scope to succeed in a competitive market environment. Capital markets contribute to the flexibility of the economy by ensuring that capital is employed effectively and providing the finance needed to allow firms to cope with economic shocks. Annex C of this Pre-Budget Report describes progress in raising flexibility across the UK's labour, product and capital markets.

3.3 Chapter 4 describes how employment is currently at record highs, having risen by 1.7 million since spring 1997. Sustained employment growth has made the aim of raising overall productivity more challenging. New workers tend to have lower than average productivity as they take time to learn job-specific skills, an issue discussed in Box 3.1. This effect is likely to have resulted in lower productivity growth than would otherwise be the case in a growing economy. However, the Government is determined to achieve higher productivity growth alongside employment opportunity for all.

Box 3.1: Assessing UK productivity and employment performance

Productivity and employment are both important determinants of welfare. Chart (a) shows that UK productivity remains relatively low. US workers produce on average 31 per cent more than UK workers, French workers produce 14 per cent more and German workers 5 per cent more.^a The productivity gap, on an output per hour basis, is 23 per cent with Germany and the US, and 25 per cent with France.

However, Chart (b) shows that the UK has a higher rate of employment than any other G7 country. The UK's relative economic performance is therefore better under measures that take into account both employment and productivity. Chart (a) indicates that comparisons of output per person of working age significantly narrow the gap between the UK and its European counterparts. This measure indicates how effectively an economy includes all of its potential workers in productive employment.



Strong employment performance may dampen productivity growth. This is because new workers entering employment take time to learn the job-specific skills that are necessary to raise their productivity to the average level. However, increasing the labour supply reduces the amount of labour wasted and makes the economy as a whole more efficient. Performance on this basis is reflected in output per person of working age data.

The position of the US in Chart (b) shows that it is possible to combine both high employment and productivity. The challenge for the UK is to increase productivity while maintaining high employment, by continuing to promote competition, enterprise, innovation and investment in the economy.

^a Based on most recent OECD and ONS data. Estimates by the Treasury suggest that recent revisions to ONS population estimates would change productivity gaps to 31.6 per cent for the US, 14.5 per cent for France and 5.2 per cent for Germany.

3.4 This chapter describes the steps the Government is taking to raise productivity and promote enterprise in the UK. It focuses on five key drivers of productivity performance:

- improving **competition**, which promotes flexible markets and increases business efficiency and consumer choice;
- promoting **enterprise**, through measures aimed at removing barriers to entrepreneurship and developing an enterprise culture;
- supporting **science and innovation**, to promote the development of new technologies and more efficient ways of working;
- raising **skills levels**, to create a more flexible and productive workforce; and
- encouraging **investment**, to increase the stock of physical capital through stronger, more efficient capital markets.

Monitoring progress on the five drivers

3.5 The Government is considering options for further developing the monitoring of progress on the drivers of productivity. In the new year, the Treasury and the Department of Trade and Industry will publish a consultation document proposing a short set of indicators for monitoring the UK's performance against the drivers. These indicators will build on the *UK productivity and competitiveness indicators 2003*¹ and wherever possible will include indicators that are annually updated and benchmarked internationally. International comparisons of productivity figures are based on OECD purchasing power parity data. While this provides a useful measure of the productivity gap, it is not ideal for comparisons over time – the consultation document will examine other methods.

Productivity in the regions

3.6 The Government is committed to ensuring that the benefits of improved productivity are spread throughout the country. Its goal is to make sustainable improvements in the economic performance of all UK regions and, over the long run, reduce the persistent gap in growth rates between the regions. The Regional Development Agencies (RDAs) are an important part of the Government's strategy for delivery of this goal. They are the strategic leaders of economic development and regeneration in the regions, and work in partnership with key national, regional, sub-regional and local bodies, such as the local Learning and Skills Councils and the Small Business Service (SBS). Building on these partnerships, the Government launched pilot schemes in April 2003, giving RDAs in selected regions a wider role in driving forward economic development.

¹ *UK productivity and competitiveness indicators 2003*, DTI Economics Paper No.6, November 2003.

3.7 Recognising the pivotal role that they have in promoting economic development, the RDAs have been asked to contribute to the development of Budget 2004 in five areas:

- barriers to business start-ups;
- provision of government services to small businesses;
- access to finance for small and medium-sized firms;
- barriers to skills provision; and
- knowledge transfer between businesses and universities.

3.8 The RDAs have also been asked, in advance of Budget 2004 and the 2004 Spending Review, to identify the top ten institutional and administrative barriers that are hindering effective coordination of policy decisions and service delivery in the regions.

European economic reform

3.9 The Government is continuing to press for changes that will improve the flexibility of the European economy and so enhance its productivity performance. In the past, Europe has sometimes adopted economic strategies that were insufficiently responsive to changing economic circumstances, overly uniform, or too insular. The Government believes that the EU needs to be flexible, reforming, open and globally orientated. In the context of globalisation, it needs to capitalise on the diversity of its economies and the Government will work for further progress at next spring's European Council on economic reform.

International trade and productivity

3.10 Alongside regional, national and European reforms, the Government is determined to promote productivity by increasing international trade. Openness to trade helps to drive economic growth and productivity by encouraging a more efficient allocation of resources, heightening competitive pressures and encouraging firms to adopt new technologies and better management practices. Chapter 5 describes the action the Government is taking to revive the Doha Development Agenda talks to reduce trade barriers. It is also pressing for enhanced economic cooperation between the EU and US, to address unnecessary non-tariff barriers hindering transatlantic trade.

COMPETITION

3.11 Competition is a key driver of productivity and promotes more flexible product and capital markets. Competition provides opportunities for entrepreneurs to start and develop new businesses and creates incentives to innovate and invest for the future. Competitive markets and empowered consumers put downward pressure on prices and give consumers greater choice.

The competition framework

3.12 The Government has worked to ensure that the UK consumer and competition regime ranks among the best in the world. The 2003 Global Competition Review² ranked the UK competition regime joint second in the world behind the US, as shown in Table 3.1. With implementation of the Enterprise Act in June 2003, this regime has been strengthened further and the focus is now on ensuring that the benefits of the new regime are realised quickly.

Table 3.1: Global Competition Review rankings of competition regimes

Rank	G7 comparison			
	2000	2001	2002	2003
1st	Germany	US (DoJ)	US (DoJ) US (FTC)	US
2nd	US (DoJ) ¹ Italy	Germany Italy	UK France ⁵ Germany	UK Germany
3rd	US (FTC) ² UK (CC) ³ EU	UK (CC) UK (OFT) US (FTC)	EU Italy	EU
4th	UK (OFT) ⁴ France	Canada EU France	Canada Japan	Canada France Italy Japan
5th	Japan			

¹ US (DoJ) – Department of Justice, Antitrust division.

² US (FTC) – Federal Trade Commission.

³ UK (CC) – Competition Commission.

⁴ UK (OFT) – Office of Fair Trading.

⁵ France's rating for 2002 covered agencies working without the burden of compulsory merger notification.

Source: Global Competition Review annual survey.

Note: This survey ranks the performance, transparency and accountability of international competition enforcement agencies, based on the views of businesses that have had dealings with them. This table shows the rankings for G7 members. US competition institutions were assessed separately until this year, and UK institutions were assessed separately until 2002.

² Global Competition Review, The International Journal of Competition Policy and Regulation, 2003.

Competition in specific markets

3.13 The Enterprise Act has significantly strengthened Britain's competition regime. In particular, it has given the competition authorities a flexible tool to investigate markets where there may have been no explicit breach of competition law but where the market may not be working well for consumers. The Office of Fair Trading (OFT) can also carry out market studies on Government regulation. The Government is committed to addressing their findings.

Professions 3.14 Following the OFT's report on competition in the professions,³ the Department for Constitutional Affairs (DCA) announced in July 2003 that David Clementi would lead an independent review into regulation of the legal services market. The review, which will report in December 2004, aims to promote competition and innovation, and improve services for the customer. In July 2003, the DCA also published a consultation paper on the future role of Queen's Counsel, a system identified by the OFT as potentially distorting competition. The consultation closed in November 2003 and **the Government will announce its policy decisions in February 2004.**

Taxis 3.15 The Government welcomes the OFT study into the Taxi and Private Hire Vehicle market.⁴ Taxi services are an important provider of local transport, particularly for those on lower incomes and in rural areas. Work is already under way in the Department for Transport to implement the recommendation on quality and safety rules. The OFT also concluded that quantity restrictions on taxi licenses, which 45 per cent of local authorities apply, act as a barrier to entry, increase waiting times and have a negative impact on personal safety. Stakeholders are being consulted so that a rapid decision can be made about the way forward. **An announcement will be made in early 2004.**

Payment systems 3.16 The Government welcomes moves made by payment system participants to address some of the competition issues identified by the Cruickshank report on competition in UK banking.⁵ However, the Government considers that problems remain and that an increased focus on competition in the industry would deliver significant benefits. It believes that the OFT could provide this focus and address the remaining concerns, in advance of any legislation. **The OFT will shortly take on an enhanced role in relation to payment systems for a period of four years.** The Government will then review competition in the industry and will legislate unless there has been a significant improvement. Further details on these proposals will be announced by the OFT in due course.

Employers' liability compulsory insurance 3.17 The Department for Work and Pensions published a review of the operation of employers' liability compulsory insurance this month. It concludes that the market has not failed, but recognises the difficulties many businesses face due to rapid increases in premiums and sets out an agenda for action by the Government and stakeholders to improve the working of the market. The OFT will keep the liability insurance market under review.

³ *Competition in professions*, A report by the Director General of Fair Trading, March 2001.

⁴ *The regulation of licensed taxi and private hire vehicle services in the UK*, Office of Fair Trading, November 2003.

⁵ *Competition in UK banking: a report to the Chancellor of the Exchequer*, Don Cruickshank, March 2000.

Competition in regulated industries

Energy 3.18 Liberalisation in energy markets has boosted competition, delivered lower gas and electricity prices, and reduced the need for regulation. The Energy Bill, currently before Parliament, will extend New Electricity Trading Arrangements to the Scottish electricity market by April 2005, giving Scottish consumers the competitive benefits enjoyed by those in England and Wales, while allowing generators fair and open access to the market.

Water 3.19 The provisions of the Water Act, which received Royal Assent in November 2003, will extend opportunities for competition to non-household consumers who use large quantities of water. The Office of Water Services (Ofwat) will invite applications from prospective new licensees from summer 2005, with the new regime fully in place from autumn 2005. A review of the competition framework, including the 50 megalitre threshold above which competition applies, will be undertaken within three years of the commencement of the regime.

Communications 3.20 From December 2003, Ofcom will have powers to investigate abuses of competition within broadcast markets in addition to exercising the powers in telecommunications markets previously held by the Office of Telecommunications. The Communications Act aligns the merger regime for newspapers and media ownership with general merger processes, while ensuring that the principles of media plurality and freedom of speech are maintained.

Financial services 3.21 The market environment in financial services is rapidly evolving. Small businesses represent just under 90 per cent of the firms regulated by the Financial Services Authority (FSA). The Government has announced a review of the Financial Services and Markets Act two years after it came into force. The review will consider three key issues: the impact of the Act on competition; changes to the FSA and possible changes to the operation of the Financial Ombudsman Service; and simplifying the boundary of FSA regulation.

Empowering consumers

3.22 Empowered consumers are able to make effective market choices, promoting competition and driving business and economic performance. To fulfill this role effectively, consumers need the right tools, including the right to take action, access to redress for damage and good quality information.

3.23 The DTI is currently reviewing the UK consumer framework and in October 2003 published a comparative report on approaches in different countries. The report found that the UK had some important strengths, including strong consumer rights, good advice to consumers, and consumer representation at a national level. The regime has also been strengthened by the recent Enterprise Act, which introduced Stop Now Orders, and allowed the competition authorities to investigate markets that are not working in the interest of consumers. However, the report did identify areas for improvement, including the absence of a general duty to trade fairly underlying all transactions, poor mechanisms for redress and the fragmented nature of the UK enforcement regime. **The Government will publish the conclusions of this review in 2004.**

3.24 The Government is committed to excellent consumer representation in regulated industries and has made reforms to put consumer interests at the heart of sectoral regulation. To test the effectiveness of these reforms, the DTI and the National Audit Office (NAO) have jointly commissioned a benchmarking study of Energywatch and Postwatch, as part of a wider review of the operation of these bodies, with a view to maximising the benefits they bring to consumers. **It will be completed in spring 2004.**

Competition in the supply of goods and services to Government

3.25 The Government is committed to achieving value for money through improving procurement (as set out in Chapter 6). The Office of Government Commerce (OGC) has today published a report, *Increasing competition and improving long-term capacity planning in the Government market place* and an associated Action Plan. These identify measures to improve the way the public sector engages with potential suppliers, including:

- increased consultation with business so that supplier lead times and information requirements are better understood. For example, a **'suppliers/buyers' forum led by OGC will maintain regular dialogue with industry representatives**, who will help to develop the Action Plan;
- professional relationship management, such as the **implementation by September 2004 of public sector plans to improve the information given to suppliers about future requirements**. This will involve the use of a broader range of tools such as bid conferences, websites and trade fairs; and
- **the Government will also take action to strengthen public sector procurement infrastructure**, to deliver stronger leadership and enhance commercial skills.

3.26 The joint Cabinet Office and OGC report, *Making a difference: reducing bureaucracy in central civil Government procurement*, to be published on 15 December 2003, will make other improvements to the Government market place, for example by setting targets for reducing bureaucracy and supplier costs.

3.27 The Government is committed to encouraging small businesses to compete for contracts to supply the public sector. It has accepted the recommendations made by the Better Regulation Task Force and the Small Business Council in their report, *Government: supporter and customer?* The OGC and SBS have now begun to pilot measures to help small- and medium-sized enterprises (SMEs) overcome barriers to doing business with government. Results will be reported in the summer and, taking into account lessons learnt, **measures for small businesses will be rolled out nationally**.

3.28 The Government is working for strong markets and competition in overseas markets as well as in the UK. **It has therefore asked Alan Wood, Chair of the Economic Policy Committee of the Engineering Employers' Federation and Chief Executive of Siemens in the UK, to review UK businesses' experiences of accessing public contracts in Europe** and to report back in summer 2004 on how to improve the ability of UK firms to compete effectively for public procurement contracts in other EU countries.

Competition in the EU

3.29 Revised European competition laws will come into effect over the next few months. These revisions modernise the European regime for dealing with anti-competitive agreements and abuses of dominant positions. They include a number of improvements to strengthen the involvement and responsibilities of national competition authorities, with the European Commission able to adopt a more proactive and strategic role. This provides an opportunity for the Commission to develop its capacity to investigate markets, as well as respond to cases. It has already taken some steps in this direction, announcing a study of European competition issues in the market for professional services. The Government welcomes this and would like to see this approach taken further in future.

3.30 New EU merger rules have recently been agreed which should improve handling of merger cases. In particular, the test that mergers are considered against will change to prohibit all mergers which would significantly impede effective competition. This will make the test simpler, more economically grounded and closer to practice in other jurisdictions such as the US and UK. Alongside improvements to competition policy, the Government continues to press for reform of the state aid regime to underpin strong competition across the EU, described further in Box 3.2.

Box 3.2: EU state aid reform

Strong and effective regulation of state aid is central to a competitive and prosperous European economy. The Government has three key objectives for state aid reform within the EU, aimed at achieving less and better state aid:

- **to reduce state aid that undermines competition, focusing especially on the most distorting aids;**
- **to target state aid on promoting structural reform, by addressing clearly identified market failures; and**
- **to ensure the state aid system operates efficiently and effectively.**

Good progress has been made at the EU level, both in bringing aid levels down and in shifting the balance of state aid away from specific firms toward ‘horizontal objectives’ which target specific problems or market failures.

In the UK, this shift has been reflected in schemes such as the Regional Venture Capital Funds, approved under recently introduced horizontal risk capital guidelines, which were an important step in allowing capital market failures to be tackled. The European Commission has also approved a number of important UK state aid schemes to support regeneration. These now enable the UK to address market failures that prevent the regeneration of brownfield sites.

While the EU rules on state aid have been improved over recent years, more needs to be done. In particular, the Government has actively promoted proposals for a significant impact test to allow aid which does not significantly distort trade and competition to be approved quickly. It will use the forthcoming review of regional aid to press for a regime which allows the economic causes of under-performance to be tackled at the local level wherever they occur.

ENTERPRISE

3.31 A strong entrepreneurial base is an essential driver of growth and prosperity in a modern economy. The Government's vision is that anybody with the talent, potential and drive to succeed in business should have the opportunity and support to do so, regardless of their background, in a culture which values and supports entrepreneurship. A thriving and dynamic small business sector is also key to economic flexibility, as new businesses bring new or improved products and services to consumers, increasing competition and challenging existing businesses to improve their own performance.

Services to small businesses **3.32** The SBS is responsible for working across government to deliver this vision, ensuring that the UK is the best place in the world to start and grow a business. The SBS is the Government's centre of expertise on small business issues, developing innovative new approaches to meeting the needs of small business at the national, regional and local levels. The SBS will shortly publish a Government Action Plan, developing its strategy and setting out the measures that government as a whole will take to make this aim a reality.

3.33 To succeed in business, current and potential entrepreneurs need to know where to find the right advice, information, training or funding. Business Link, the publically funded service providing help, information and advice to businesses across England, has achieved a substantial increase in take-up of its services and an improvement in customer satisfaction during 2003, with 43 per cent more enquiries from people seeking advice on starting up new businesses. Improvements in Business Link will be reinforced in 2004 with a new service to advise and support anyone setting up in business.

businesslink.gov.uk **3.34** In April 2004, the Government will launch the new businesslink.gov.uk website, which will provide an online service for business advice, helping users to understand the regulatory requirements on their business together with the support that is available.

3.35 The website, businesslink.gov.uk will include a new online training directory for SMEs. As announced in Budget 2003, a steering group chaired by Sue Brownson has been advising the Government on the establishment of this service. It will be available to all firms, offering a choice of online courses provided by *learnirect* and a directory of other courses across the UK. It will be promoted to business customers by banks and the Business Link network working together.

Encouraging SMEs to export **3.36** Even though they make up 99 per cent of UK firms, less than three quarters of exporters are small businesses. The Government wants more small businesses to take advantage of export opportunities. The internet is opening up new markets and making cross-border trade easier, but SMEs can face particular barriers when exporting. Access to advice and information is particularly important, as is the availability of external sources of finance to ensure smooth cash flow. The Government is taking steps to help small businesses expand into export markets, including:

- the businesslink.gov.uk website, which will provide a new gateway for firms seeking a one-stop source of advice on how to expand into export markets;
- the range of training, information and advisory services provided by UK Trade and Investment, which supports UK companies trading internationally, is particularly relevant to the needs of SMEs. Its Passport programme, delivering training, planning and ongoing support on a regional basis for new and inexperienced exporters, has recently been expanded; and
- helping small businesses overcome barriers to accessing finance, the measures outlined below will help firms access financial support that many firms need to grow, including into overseas markets.

Improving access to finance

3.37 For enterprise to thrive, innovative businesses need access to finance. The joint SBS and Treasury consultation paper, *Bridging the finance gap*, published alongside Budget 2003, presented evidence that a small but important minority of innovative growth-oriented businesses continue to face difficulties in attracting funding.

3.38 The Government is already working to stimulate private sector provision of risk capital. Over £3 billion of investment has been made through the Enterprise Investment Scheme (EIS) in the past five years, and Venture Capital Trusts (VCTs) have raised over £1 billion in the same period. The Regional Venture Capital Funds, the UK High Technology Fund and the Early Growth Funding programme will collectively invest around £400 million in businesses otherwise affected by the equity gap at the sub-£500,000 level. The Government has also introduced specific measures to improve access to finance in the UK's least prosperous communities, including the Phoenix Fund and Community Investment Tax Relief, and has supported the Bridges community development venture fund. Nevertheless, responses to the consultation *Bridging the finance gap* broadly agreed that an equity gap continues to exist. It appears to be most acute for investment between £250,000 and £1 million, but also affects businesses seeking up to £2 million.

Enterprise Capital Funds

3.39 The Government's response to the consultation is published alongside this Pre-Budget Report in *Bridging the finance gap: next steps in improving access to growth capital for small businesses*. To address the equity gap, **the Government intends to launch a competitive bidding process for a 'pathfinder' round of Enterprise Capital Funds (ECFs)**, subject to state aid approval. ECFs will be private sector, commercially-managed entities that adapt the US Small Business Investment Company model for the UK by investing a mix of public and private sector capital in businesses with growth potential affected by the equity gap.

3.40 Details of the bidding process for this first round of pathfinder ECFs will be published in spring 2004, subject to receiving EU state aid clearance. Pathfinder ECFs will be allowed to invest in SMEs in funding rounds of up to £2 million and will put the private sector on the same risk basis as public sector capital. The design of any future round of ECFs will take into account market developments and lessons from the pathfinder bidding process.

Venture Capital Trusts

3.41 Following this consultation, the Government is also bringing forward proposals to target structural factors that contribute to volatility in fundraising for VCTs. In particular, the balance of respondents supported a move towards enhanced income tax relief under the scheme. The Government is in favour of a less cyclically sensitive set of incentives for investors. Subject to discussion with industry, **it will consider withdrawing, from 6 April 2004, the current capital gains tax relief for investments in VCTs, and replacing it with an enhancement, of equivalent value, to the incentives to invest through income tax relief.**

3.42 The Government is also mindful of the recent relative weakness of the VCT market and intends, subject to discussion with the industry, to provide a temporary stimulus to VCT fundraising for two years. **The Government's favoured option is a temporary increase in the effective rate of income tax relief from 20 per cent to 40 per cent, with the value of the additional 20 per cent relief paid directly to the VCT rather than the investor.** The expected cost of such a temporary measure would be in the region of £50 million per year, with further details to be provided in Budget 2004.

Enterprise Investment Scheme **3.43** Subject to discussion with the industry, the Government intends to raise to £200,000 the annual investment limit for VCTs from 6 April 2004. It also plans to raise to £200,000 the threshold for income tax benefits under the EIS, which has not experienced weakness in fundraising to the same extent as VCTs.

Debt finance for small firms **3.44** Enhancements to the Small Firms Loan Guarantee (SFLG) announced in the 2002 Pre-Budget Report have proved popular, and take-up has increased by more than 40 per cent since their introduction in April 2003. The Government is nevertheless aware that the market in which businesses raise debt finance is more sophisticated now than when the SFLG was first introduced in 1981. The Government believes that the SFLG continues to play a valuable role, and wishes to build upon the recent success of the scheme by examining its effectiveness in this changing market environment. **It has asked Teresa Graham, a member of the Small Business Council, to conduct a review of the SFLG** to ensure that it is working effectively, and that through the SFLG and other interventions, start-ups and small firms have all the help that they need to overcome the obstacles that they face when raising debt finance.

Awareness and access to finance **3.45** Respondents to *Bridging the finance gap* identified a number of barriers deterring SMEs with high growth potential from seeking the finance that best suits their needs, including small amounts of equity finance. *Bridging the finance gap: next steps in improving access to growth capital for small businesses* identifies the need to match improved supply of risk capital with measures to ensure that firms understand the finance options available to them and how to access them. The Government therefore intends to:

- **publish a no-nonsense guide to finance for start-ups and small and growing firms**, to raise businesses' awareness of their financing options;
- work with the RDAs to **build on the findings of six 'investment readiness' demonstration projects** at the local level;
- work with the accountancy profession and other business bodies to **develop the proposals of the the Accountancy Working Group**, chaired by Michael Snyder, which is considering how best to enhance the role of business advisers in providing financial advice to firms; and
- work with the Small Business Investment Taskforce to **examine barriers to the growth of affordable financial intermediation focused on small-scale risk capital**.

Modernising and simplifying the business tax system

VAT flat-rate scheme 3.46 The Government has introduced a series of measures to reduce the compliance costs which small businesses face as a result of the VAT system, while improving their cash flow. Building on these measures, from 1 January 2004 the Government will introduce improvements to the VAT flat-rate scheme, helping more small businesses to take advantage of the scheme. **These include new, lower flat rates, simplified administration to make it easier to join the scheme, and a new discounted rate, 1 percentage point below the normal flat rates, for newly-registered small businesses.** Following detailed consultation since Budget 2003, the Government now confirms that all businesses approved for simplified import VAT accounting can benefit from 100 per cent reduction in deferred payment guarantees, and that third party agents are eligible to apply, allowing the smallest and occasional importers to benefit.

Corporation tax 3.47 In Budget 2003, the Government announced further consultation on reform of the corporation tax system aimed at removing tax distortions, assisting business decision-making and ensuring that the UK remains an attractive place for business to locate. Two proposals considered in the consultation are being taken forward today, with the publication alongside this Pre-Budget Report of draft legislation for further consultation with businesses:

- in its August 2003 consultation document the Government set out proposals to amend the transfer pricing and thin capitalisation rules, to remove uncertainty about the application of European law. The Government now announces measures to ensure that **the extension of the transfer pricing rules to transactions between related entities in the UK will not result in a disproportionate administrative burden for smaller businesses;** and
- **the Government proposes to extend corporation tax relief for expenses of managing investments by lifting the requirement to qualify as an investment company.** This will further facilitate businesses' compliance with the extended transfer pricing regime.

Review of construction industry 3.48 **The Government will introduce a revised Construction Industry Scheme from April 2006.** This will reduce the regulatory burden on the industry, improve compliance, help to get the status of workers right, and replace the present cards, certificates and vouchers with an Inland Revenue verification service and monthly returns. The Government has delayed implementation from April 2005 to April 2006 to ensure a smooth and orderly introduction for the new scheme.

International Accounting Standards 3.49 From January 2005, all companies with securities traded on a regulated market will be required to use International Accounting Standards (IAS) to draw up their consolidated accounts, and will be permitted to prepare their individual company accounts using IAS. Other companies will be permitted to use IAS for their consolidated and annual accounts. **The Government intends that such accounts should be acceptable for tax purposes.**

SME qualification threshold 3.50 The Government announced in the last Budget that the company law thresholds for small and medium-sized companies would be increased to the maximum possible under EU regulations⁶. The new EU maxima have now come into force so the Government can today announce that legislation will be introduced shortly. The new thresholds are expected to apply from January 2004.

3.51 The increase in the qualification thresholds will double the amount of investment eligible for 40 per cent plant and machinery first year capital allowances, providing a cash flow benefit for smaller firms investing in plant and machinery of nearly £400 million over the next three years. Businesses falling under the revised small company threshold will also be eligible for the 100 per cent information and communication technology allowance, until it expires on 31 March 2004. The increased thresholds will also allow more companies to take advantage of less onerous accounting and filing requirements.

Regulatory reform

Reducing the regulatory burden 3.52 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and driving up standards. However, unnecessary or poorly implemented regulation can be an obstacle to flexibility, restricting employment growth and competitiveness, particularly for smaller firms. Where appropriate, the Government is reducing the regulatory burden and considering well-targeted exemptions, including:

- **improving the VAT flat-rate scheme**, as set out above;
- increasing the statutory audit turnover threshold to £5.6 million – the maximum allowed under EU law - providing a further 69,000 companies with the flexibility to opt out of an independent audit;
- **publication today by the Cabinet Office of a revised Regulatory Reform Action Plan**, taking to over 650 the total number of deregulatory measures identified, with one third already implemented;
- **accepting in full the recommendations of September's Better Regulation Task Force report, *Imaginative thinking for better regulation***, and encouraging policy makers to consider alternatives to prescriptive regulation. Departments will report on their regulatory performance this year, to feed into the 2004 Spending Review;
- targeted reviews, led by private sector secondees, of regulation in transport, construction and environmental services;
- publishing a draft Bill to remove unnecessary restrictions on gambling, while ensuring a greater emphasis on the protection of the vulnerable particularly children; and
- introducing, in November 2003, the National Insurance Contributions and Statutory Payments Bill to streamline the administration of tax and NICs.

⁶ The new EU maximum thresholds for small businesses are 50 employees, £5.6 million turnover and £2.8 million balance sheet total. For medium-sized companies, the EU maximum figures are 250 employees, £22.8 million turnover and £11.4 million balance sheet total.

Simplifying regulation 3.53 Where regulations are necessary, the Government is committed to making them comprehensible and easy to implement, and to communicating effectively with business. **It will produce 'see at a glance' guidance on all new regulations** to reduce the time that entrepreneurs spend establishing whether a regulation applies to them. To provide businesses with a single, accessible source of advice and guidance on equality legislation, the new Commission for Equality and Human Rights will replace the existing equality commissions. A White Paper setting out detailed proposals will be published in spring 2004. Furthermore, last week the Government launched a consultation on proposals for streamlining employment tribunal procedures.

Stability and certainty 3.54 The Government will continue to pursue deregulatory measures and simplify the regulatory framework for businesses. However, it also recognises that businesses want stability and certainty in the regulatory environment. To aid regulatory certainty, the Government announced in Budget 2003 its intention to introduce changes to employment regulation only on two fixed commencement dates each year. The DTI is now piloting this approach, with the intention that it will be rolled out for employment regulation across all Departments. **Once the pilot has been evaluated, the Government will consider widening this approach to other areas of regulation.** The Government will also publish details of forthcoming changes to EU environmental policies and employment regulations to assist firms in contributing to, preparing for and managing those changes.

3.55 The Government welcomes the recommendations made in the Better Regulation Task Force report, *Independent regulators*, published in October 2003, and will respond in full next month. The report encourages good practice, including adoption of the Enforcement Concordat and the completion of Regulatory Impact Assessments for all major new policies and initiatives.

European regulation 3.56 Many EU Member States are increasingly aware of the dangers of disproportionate or burdensome regulation. At the level of European law, the EU is introducing a new system of impact assessments to test the effect of new legislation on the economy, and its social and environmental effect. The Government will work closely with the European Commission and other Member States to ensure that this action plan has real bite. In particular, the Government believes it is important that impact assessments and consultations are of a high standard and subject to a proper process of scrutiny.

3.57 The principles that apply to new legislation should also extend to that which is already in force, and the European Commission is now looking to simplify existing laws. The Government believes that it is essential that this process of simplification makes a real difference to the regulatory framework in Europe. It looks forward to working with other Member States to ensure that added momentum is given to the review and that substantial progress is made during 2004 and 2005. There must be adequate external input – including from business – in this process of simplification. To help provide that input, the Better Regulation Task Force will select an area of EU legislation for investigation.

Creating an enterprise society

3.58 There is strong evidence that cultural and social constraints inhibit enterprise activity in the UK. The Government believes that efforts to build a deeper enterprise culture must start with young people. More people between the age of 16 and 25 years consider starting up their own business than in any other age group, although few young people actually go on to do so. New measures to support the implementation of the Davies Review⁷ include:

- **supporting a national campaign by Enterprise Insight to create a step change in enterprise culture**, building up to Enterprise Week in November 2004;
- **providing opportunities for selected participants in the New Entrepreneur Scholarship scheme to attend a US business school**; and
- **setting up a forum for US and UK experts to share best practice on enterprise education, work-related learning and professional development for teachers.**

National Council for Graduate Entrepreneurship

3.59 In Budget 2003, the Government announced that it was considering establishing a National Council for Graduate Entrepreneurship. **The SBS and the Department for Education and Skills are collaborating to establish the Council, which will be backed by a budget of £700,000. A Chief Executive will be appointed in the new year.** The Council will act as a central information source for students and graduates. Its principal aim will be to engage career advisers, academics, institutions and organisations to raise the profile of entrepreneurship within universities and Higher Education Institutions. The Council will promote the idea of starting up in business as a viable career option with the objective of increasing the number of students and graduates who give serious thought to starting their own business.

Social enterprise

3.60 Social enterprises are businesses with primarily social objectives, whose surpluses are principally reinvested for that purpose. The Government believes that they have a distinct and valuable role to play in helping to create a strong, sustainable and socially inclusive economy. Measures to support the social enterprise sector include introducing legislation to create Community Interest Companies as part of a Companies Bill, and opening the way for legislation enabling Industrial and Provident Societies to commit their assets in perpetuity for the public good.

Promoting enterprise in the regions and in disadvantaged areas

Enterprise and economic development

3.61 Sustainable economic growth cannot be achieved in all regions and localities of the country through top-down policy making by central government. The Government has consulted extensively with the RDAs and the Local Government Association (LGA) on how they can drive progress together towards regionally balanced growth. At the LGA conference in July, the Chancellor and the Deputy Prime Minister launched a consultation on the Local Authority Business Growth Incentives scheme, which will give local authorities a direct financial incentive to maximise economic growth in their areas. Analysis based on historical growth rates shows that the scheme could be worth up to £1 billion to local authorities over a three-year period, by allowing them to retain a proportion of increases in local business rate revenues. The extra resources will be entirely additional to local authorities, with no ring-fencing by central government. Furthermore, no business will pay more under the scheme.

⁷ *A review of enterprise and the economy in education*, Howard Davies, February 2002.

3.62 The Government set out three key principles for the scheme in the consultation document. These were that the incentive must be applicable to all authorities, that the distribution of benefits must be fair, and that the scheme should be as intelligible as possible. Following the consultation, two thirds of those who expressed clear preferences favoured basing the scheme on either the national historic growth model or the sub-regional model. **The Government has decided to take the scheme forward based on the national historic growth model as this is fairer on local authorities in different regions with similar growth rates.**

3.63 However, the Government intends to adapt the model by dividing authorities into seven rather than five groups, based on historical rates of growth. This takes on board the strengths of the sub regional model and improves the incentive for most authorities, particularly those with higher rates of growth, while retaining the advantage of relative simplicity. Baselines, floors and ceilings will be announced in Budget 2004 and authorities will be able to benefit from the incentive from April 2005. The Welsh Assembly Government has also finished consultation on a similar scheme.

3.64 The Government is continuing to work closely with the LGA, local authorities, the Core Cities and the RDAs to develop the local economic growth agenda, including through:

- continuing to improve the strategic direction of the planning system, and helping local authorities to speed up and simplify the planning process;
- considering how further to develop the advantages of collaborative working and local flexibility by building on the regional business support pilots of RDA-led Business Links announced in 2002; and
- boosting enterprise in the most disadvantaged areas of the country through a focus on the Enterprise Areas and the proposed Business Premises Renovation Allowance, outlined below.

Enterprise Areas 3.65 The Government believes that raising levels of enterprise and economic activity is essential to sustainable neighbourhood renewal in the UK's most disadvantaged communities. The 2002 Pre-Budget Report designated 2,000 Enterprise Areas in which measures to boost enterprise are being focused to reinforce local economic development. Further measures may be introduced as more information becomes available about the scale of market failures in these areas. In Budget 2003, the Government announced the removal of the cap on stamp duty relief for non-residential property purchases where transactions were completed on or after 10 April 2003. Since the announcement, over 5,000 transactions have benefited from the relief.

3.66 In Budget 2003, the Government announced that it was considering how enhanced capital allowances might be used to tackle specific market failures in Enterprise Areas. **The proposed Business Premises Renovation Allowance scheme would provide 100 per cent first-year capital allowances for the capital costs of renovating business premises vacant for a year or more in Enterprise Areas.** The Government is discussing the state aid aspects of the scheme with the European Commission.

3.67 The Phoenix Development Fund is providing resources for several measures focused on Enterprise Areas. In November 2003, the SBS invited bids of up to £30,000 for feasibility studies for business incubators in the 88 neighbourhood renewal areas that are also Enterprise Areas. The SBS is undertaking a pilot with the Housing Corporation and the National Housing Federation to provide advice and support to existing or potential businesses within their tenant groups. In addition, following the success of the first round of City Growth Strategy pilots, towns and cities with Enterprise Areas were invited to participate in the second round in early December.

Land Remediation Tax Credit 3.68 The Contaminated Land Tax Credit provides business with a stronger incentive to clean up land made unusable and compensates them for the wider environmental and social benefits that the remediation could bring. **The Government will therefore examine the possibility of extending the relief to include remediation of land that is long-term derelict, which could have similar positive spillover effects.**

SCIENCE AND INNOVATION

3.69 Innovation is an important source of productivity growth. The UK has an excellent science base but has been less effective at realising the commercial potential of its research. The Government is determined to address this, and last year commissioned two complementary reviews to shape future innovation policy – the Lambert Review⁸ and the DTI Innovation Report.

3.70 The findings of the Lambert Review are set out in Box 3.3. The Government will consider the Review, consult interested parties, and make a full response to the recommendations by summer 2004.

Box 3.3: The findings of the Lambert Review

In the 2002 Pre-Budget Report, the Government asked Richard Lambert to undertake a review to examine whether the links between universities and business in the UK could be improved. The Review gives an overview of current collaborations - including case studies of successful collaboration - and identifies opportunities for greater interaction. It concludes that there are significant benefits to be gained from collaboration for the university sector, businesses and the economy as a whole. Key recommendations include:

- a greater role for the Regional Development Agencies in facilitating knowledge transfer in their regions;
- a new funding stream for business-relevant research, along with increased and improved 'third stream' funding for knowledge transfer;
- that universities should develop a code of governance, and demonstrate good management and strong performance in return for a lighter regulatory touch from the Government and the Funding Councils;
- the development of model contracts and a protocol for intellectual property (IP) to speed-up IP negotiations;
- the encouragement of new forms of formal and informal networks between business people and academics, including the establishment of a business-led R&D employers' forum; and
- that universities should provide more information on student employability, and businesses take a greater role in influencing university courses and curricula.

⁸ Lambert review of business-university collaboration: final report, Richard Lambert, December 2003.

DTI Innovation Report 3.71 In November 2002, the Chancellor and the Secretary of State for Trade and Industry launched a wide-ranging review of business innovation and its contribution to productivity growth. After consultation with key stakeholders, the forthcoming Innovation Report will set out the need for a coordinated approach by Government across a range of policy areas, including procurement and regulation, to improve the UK's innovation performance. A key issue will be to raise the level of R&D in business, which will involve a longer-term and more strategic approach to focus Government support on key technologies and markets. The economic analysis underlying the report was published by the DTI in November 2003.⁹

Investing in innovation 3.72 The implementation of the Government's science strategy, published in July 2002, is now well advanced, with measures in place to ensure the sustainability of university science research. Systems are being put in place to ensure that universities recover the full economic costs of the research they conduct.¹⁰ Furthermore, allocations to universities were made in August 2003 for the latest round of the Science Research Infrastructure Fund, a dedicated capital stream for infrastructure that will build to £500 million by 2005-06. The Government is also promoting knowledge transfer through the Higher Education Innovation Fund, comprising £187 million for investment between 2004 and 2006, and the Public Sector Research Establishments Fund, a £15 million knowledge-transfer fund for other research establishments.

Supply of scientists 3.73 The Government is taking forward the key recommendations of the Roberts Review¹¹ and published an update on progress in implementing the Review's recommendations in October 2003.¹² Measures underway include a £51 million partnership with the Wellcome Trust for a national network of Science Learning Centres to train science teachers and technicians. In order to improve the recruitment and training of researchers, the Government has allocated funds to increase the minimum Research Council PhD stipend to £12,000 by 2005-06, and to increase the Research Council postdoctoral salaries by an average of £4,000 by 2005-06.

R&D tax credits 3.74 To promote commercial R&D in the UK, the Government introduced R&D tax credits for SMEs in 2000 and extended this to large companies in 2002. Though it is too early for data on the large company scheme, the take up of the SME scheme has been significant, with over 8,000 claims since its inception, giving around £500 million of support for innovative companies.

3.75 A consultation document, *Defining innovation*,¹³ published in July 2003, sought views on how the current definition of R&D could be improved. The responses showed strong support for R&D tax credits as a spur to promote greater levels of innovation and provided valuable recommendations on how the definitions could be made more effective. The Government is committed to ensuring that the tax credits are soundly based, internationally competitive and will deliver a real incentive for new R&D. It has today published a summary of the responses to the consultation, together with:

- **a new draft definition of R&D**, giving greater clarity and certainty about what activities constitute R&D for tax credit purposes;
- **details of an extension of qualifying costs** from the current 'consumable stores' to include materials, software, water and fuel directly used in the R&D, and discussion will continue with business on the appropriate boundaries for 'direct costs'; and
- confirmation that there will be **a new generic definition for qualifying bodies**, including Public Sector Research Establishments.

⁹ *Competing in the global economy: the innovation challenge*, DTI Economics Paper No. 7, November 2003.

¹⁰ *The Sustainability of University Research: a consultation on reforming parts of the Dual Support System*, Office of Science and Technology, May 2003.

¹¹ *SET for success: the supply of people with science, technology, engineering and mathematics skills*, The Report of Sir Gareth Roberts' Review, April 2002.

¹² *Update on UK science skills post-Roberts Review*, DfES information note, October 2003.

¹³ *Defining innovation: a consultation on the definition of R&D for tax purposes*, HM Treasury, DTI, and Inland Revenue, July 2003.

3.76 These changes represent significant further investment in R&D tax credits. Provisions to implement the measures will be in the forthcoming Finance Bill.

**Scientific
Research
Organisations**

3.77 The Government, jointly with the Economic and Social Research Council, has commissioned independent research into the contribution Scientific Research Organisations make to innovation and knowledge transfer and their distinctive role in stimulating collaborative research. The Government will bring forward proposals at Budget 2004 aimed at refining the tax treatment of Scientific Research Organisations, to foster the wider economic benefits that such organisations can provide to UK businesses.

Box 3.4: The changing shape of the global economy

Increasing globalisation brings opportunities in the form of new export markets for firms and better value goods and services for consumers. It also brings new challenges, including increased competition, in particular from emerging economies such as China and India, an issue discussed further in Box A1 in Annex A.

UK businesses must adapt to prosper in this new environment and can no longer rely on relatively low labour costs to compete. The challenge they face is to compete on high value-added products which are driven by innovation and design. The key to success in this respect will be the quality and skills of the UK's labour force and the willingness of managers to invest in innovation. These issues are among those analysed in detail in the recent DTI economics paper, *Competing in the global economy: the innovation challenge*.^a

The UK economy has already experienced significant change. Alongside modern manufacturing strength, high quality services will be essential for the future. In the same way that an innovative process adds value to a manufactured product, a creative idea or new branding concept can also increase value and profit. Producing services that are valued by consumers abroad is essential to the UK's future prospects.

Creative industries will therefore become an increasingly important component of the economy, not just as a sector that exports in an increasingly integrated world economy, but by adding value to products and services in the wider UK economy.

^a*Competing in the global economy: the innovation challenge*, DTI Economics Paper No. 7, November 2003.

**Science and
innovation in the
regions**

3.78 The Government recognises the value that regional bodies can add in promoting R&D and innovation, and in facilitating knowledge transfer. All RDAs are now investing in science and innovation, with an estimated £240 million invested in 2002-03.¹⁴ Sir Tom McKillop, Chair of the first Regional Science and Industry Council, has been working with the RDAs at the request of the Secretary of State for Trade and Industry to ensure that best practice is spread rapidly between the regions, and has reported that most RDAs have now established, or are in the process of establishing, their own versions of Science and Industry Councils.

**Science and
innovation in
Europe**

3.79 Action is also needed at European level to boost R&D. In March 2002, the Barcelona European Council declared an aspiration that the EU's R&D and innovation spending should approach 3 per cent of GDP by 2010, with two-thirds of this new investment coming from business, an aspiration that has been taken forward in the R&D Action Plan of April 2003. The measures outlined above constitute the UK's own contribution.

¹⁴ 'Memorandum by the Regional Development Agencies', in *Science and the RDAs: SETting the regional agenda - Evidence*, 5th Report of the House of Lords Science and Technology Select Committee, Volume II, July 2003.

SKILLS

3.80 Skills underpin a productive economy. International evidence suggests that the UK suffers from significant skills shortages, especially at lower skills levels. Skilled workers are more able to adapt and respond to change, making the economy more flexible. The Government is seeking to improve both the skills of young people entering the workforce and the opportunities available to those already in the workforce to acquire new skills.

Developing the skills of young people

Primary and secondary education **3.81** The Government is determined to raise pupil attainment across the education system. Between 1997 and 2003, the proportion of 11 year-olds reaching expected levels in reading and maths rose by 12 per cent and 11 per cent respectively. The proportion of 16 year-olds achieving five A*-C grades at GCSE also rose, from 45 per cent in 1997 to 52 per cent in 2003.

Post-16 learning **3.82** The Government is working to increase the number of young people continuing in post-16 education and training, and has set an ambitious target that by 2010, 90 per cent of young people will have participated in a full-time programme preparing them for entry to higher education or skilled employment by the age of 22. The Government has established a working group, led by Mike Tomlinson, to investigate the reform of education for 14 to 19 year olds. Its initial proposals, published in July 2003, include the creation of a diploma that will prepare young people for different types of further education, training or employment. Chapter 5 describes the measures the Government is taking to support young people in post-16 education, and its wider review of the financial support system for 16 to 19 year olds.

Improving workforce learning

3.83 Improving education will lay the foundations for a better UK skills base in the future, two-thirds of today's workforce will still be in the labour market in 2020 and more than one-third have no skills. The Government is therefore also taking steps to improve training opportunities for those already in the workforce.

3.84 The UK's investment in workforce training has historically been low, and has been inhibited by a range of market failures. Businesses, particularly small businesses, are unwilling to release valuable staff for training, and may be unable to gain the full returns of training. Individuals may face financial barriers or be poorly informed about the value of training. Although voluntary approaches have increased participation in workplace training, they have not been sufficient given the scale of the problem.

3.85 Addressing these problems is a priority and will require a step change on the part of employers, individuals and the Government. The Government is therefore introducing a range of policies to help individuals and employers to meet their responsibilities in this area.

New Deal for skills **3.86** The National Skills Strategy recognises the need to support and encourage individuals to start learning and then continue to improve their skills. This can often be challenging, for example, some may have had negative learning experiences at school, which they need to overcome. To lift these barriers, the Government has committed to a package of measures that gives adults in the labour force a free entitlement to train in order to obtain a good foundation of skills. The entitlement reflects the different needs of potential learners and subsidises learning towards:

- basic skills in literacy, numeracy and information and communications technology;
- a first level 2 National Vocational Qualification (NVQ) or equivalent; and
- increased support for higher level skills in areas of sectoral or regional skill priority.

Modern Apprenticeships **3.87** The number of young people participating in Modern Apprenticeships (MAs) has more than doubled since 1997 and now stands at around 235,000. The Government's aim is that 320,000 young people will be participating by 2006. A National Modern Apprenticeship Taskforce was established in February 2003 under the chairmanship of Sir Roy Gardner, CEO of Centrica. This employer-led taskforce seeks to increase the number of apprenticeship opportunities available and ensure that the MA framework is fit for purpose. The Task Force is working closely with the national Learning and Skills Council (LSC) on how to improve the marketing, delivery and design of MAs. It will present formal recommendations on promoting greater employer engagement in MAs in a report in Spring 2004, focusing on a number of specific sectors such as retail, construction and health.

Further Education **3.88** In November 2002, the Government launched the Success for All reform strategy to promote further improvements in quality and performance in the Further Education sector. This year the national Learning and Skills Council has introduced a tougher accountability framework setting out minimum standards for the sector. Each local LSC must agree three-year development plans with its providers based on stretching targets to improve learner success rates and professionalise the Further Education workforce.

Employer Training Pilots 3.89 Employer Training Pilots (ETPs) were introduced in September 2002 to test new measures to improve access to training. ETPs offer a package of support to help low-skilled people in work gain basic skills or their first level 2 qualification. Employers that offer their low-skilled staff paid time off to train are being provided with compensation for wage costs (varying according to pilot area and size of firm). Training is free or heavily subsidized, and is delivered in the way that most suits the employers' business. Both employees and employers are offered free information, advice and guidance.

Box 3.5: Employer Training Pilots

An independent evaluation of the first year of Employer Training Pilots (ETPs) was published on 4 December 2003. The evaluation showed that over 3,000 employers and 14,000 learners had registered to take part by the end of first year, August 2003. Three months later, over 5,000 employers and 20,000 learners are involved.

The scheme is reaching workplaces where training has not been a high priority in the past. Over 70 per cent of the employers taking part had fewer than 50 employees, and 40 per cent of employers had no previous involvement with a government agency. Elements of the scheme that employers found particularly valuable were the free and flexibly provided training. Overall almost 90 per cent of employers were either very or fairly satisfied with the scheme.

A variety of sectors are participating in the scheme. In particular, take-up has been high in the health and social work, distribution (which in the evaluation includes, retail, hotels and catering and transport) and manufacturing sectors.

Of the participants, 55 percent of learners were female, 59 per cent were aged between 26 and 45, and 75 per cent worked full time. 75 per cent of learners had left school at or before the age of 16, and almost 50 per cent reported that they had not been given the opportunity to train by their employer before. Through their employers, these pilots are giving learners an important second chance to gain vital skills. Over 80 per cent of learners said they were satisfied with the training.

3.90 The 2001 Pre-Budget Report announced the launch of the first ETPs in six local LSC areas (Greater Manchester, Derbyshire, Essex, Tyne and Wear, Wiltshire and Swindon, and Birmingham and Solihull). They were extended for a further year and doubled to cover six new areas (Shropshire, Leicestershire, Kent, East London, Berkshire and South Yorkshire) in the 2002 Pre-Budget Report.

3.91 ETPs demonstrate the Government's commitment to a new relationship with employers and individuals. The Government is accepting its responsibility to provide the finance for courses and to compensate employers who provide training opportunities for their low-skilled staff. Providers are taking on board their responsibility to deliver flexible training at the workplace tailored to employers' needs. Local colleges are being encouraged to adopt new methods of delivering training to fit the needs of individual businesses, while brokers offer a wide choice of providers to employers. Employers are delivering new training opportunities for their staff without either basic or level 2 skills. With the support of their employers, employees are taking up new training choices and opportunities with greater success rates than in the past.

3.92 The pilots are involving all local partners in delivering skills and training and are demonstrating the Government's commitment to the devolution of control over skills training to meet regional and sub-regional priorities and the needs of local business and employees.

3.93 ETPs are also encouraging local colleges and providers to adopt new methods in response to employers' needs. Demand-driven funding is already encouraging providers within ETP areas to work on employers' premises, fitting in with the patterns of their business, and tailoring training to fit the skills needs of individual employees – as well as exposing the need for more qualified instructors in key areas.

3.94 Building on the success of this programme, **the Government is now extending ETPs for a third year.** ETPs will launch in six further local LSC areas, bringing the total to 18, which covers over a third of England. This measure is funded through the Windfall Tax (as set out in Table 4.3). This will enable the Government to explore further the impact of the existing pilots on the demand for training.

**Raising skills
through
professional
bodies**

3.95 Budget 2003 announced the Government's intention to review the tax treatment of fees and subscriptions to professional and other approved bodies, to establish whether the current system makes a sufficient contribution to the wider training and skills agenda. As part of the review the Government will consider whether there are alternative models that might achieve these objectives more effectively. **The Government is publishing a discussion paper on these issues, *Delivering an incentive for membership bodies to provide workforce development*, alongside this Pre-Budget Report.**

Migration

3.96 Migration helps to raise productivity and boost economic growth by increasing labour supply and reducing domestic skills shortages. The Government is taking further steps to maximise the contribution of migration to a skilled and flexible workforce and to help employers facing recruitment difficulties.

3.97 Since January 2002, the Highly Skilled Migrant Programme has enabled approximately 5,000 talented individuals to seek and take up work in the UK, using their skills in areas as diverse as medicine, academia and music. Budget 2003 announced that the Programme would be strengthened to attract a wider range of skilled applicants. The new criteria came into effect in October 2003.

3.98 Budget 2003 also announced a new entitlement for foreign students, the Science and Engineering Graduates' Scheme. From summer 2004, students in shortage science, maths and engineering subjects will be able to work for a year after graduating from UK institutions without the need for a work permit. Students will be able to access detailed information on their eligibility for the scheme by March 2004, and to apply following confirmation of their results.

3.99 Migration may have a role to play in helping employers to overcome recruitment difficulties at lower skills levels. New schemes for migration below NVQ level 3 began in May 2003 to alleviate labour shortages in the hospitality and food processing sectors. Full evaluation of these pilots will contribute to wider research on the economic impact of low-skilled migration and its role in tackling illegal working. The Government is also considering the potential role of migration in addressing skills shortages at NVQ level 2, as announced in Budget 2003, and will issue a public consultation document early in 2004.

3.100 In a speech in November 2003, the Home Secretary set out the Government's approach to migration, and underlined the need to harness the innovation, skills and productivity that new migrants can bring. Earlier this month, the Home Office launched a new website dedicated to legal migration,¹⁵ which will ensure that both individuals and employers can access information on recruiting, working and settling in the UK.

¹⁵ www.workingintheuk.gov.uk

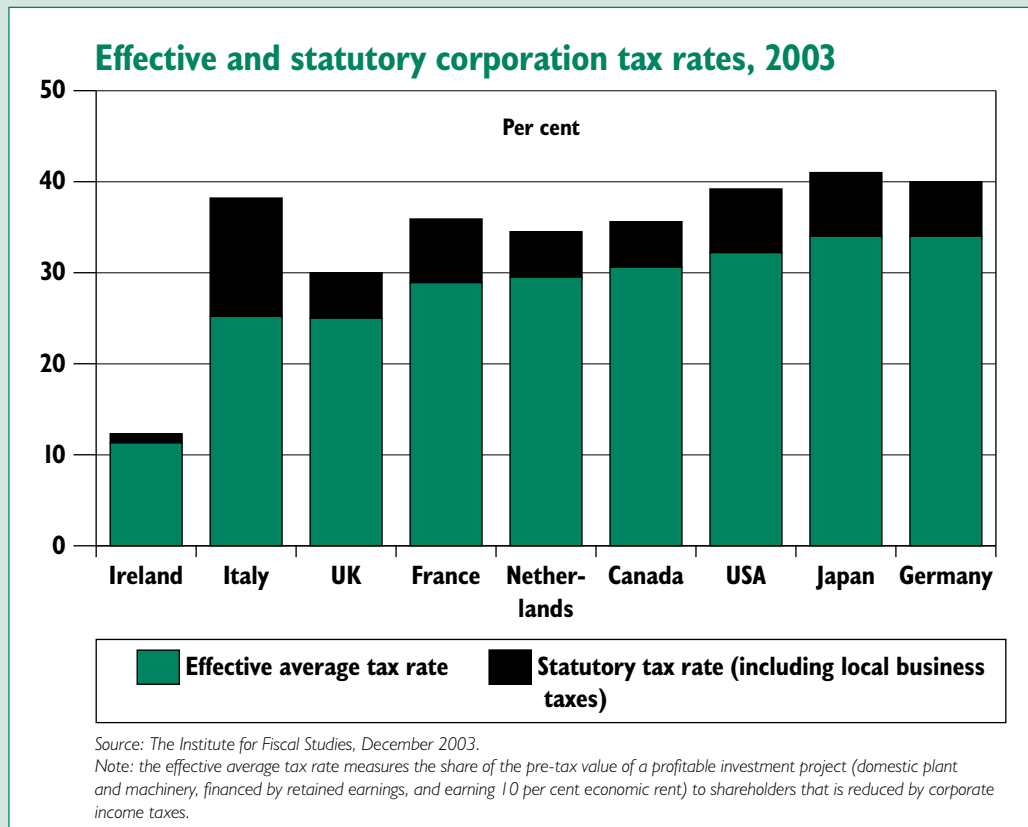
INVESTMENT

3.101 Alongside a skilled labour force, investment in physical capital is vital to support a productive, enterprising economy. The UK has relatively low levels of physical capital. Research suggests that US and German workers have access to over 45 per cent more capital than UK workers, and French workers over 75 per cent more.¹⁶ The Government is taking steps to reverse this long-term trend, improving the environment for private investment and investment decision-making through macroeconomic stability, promoting flexibility in capital markets, and addressing specific failures in transport, planning and the property market.

Box 3.6: Taxation and international investment

A competitive corporate tax regime can help boost foreign direct investment (FDI) and encourage domestic investment. A number of factors influence decisions about the location of FDI in a particular country: macroeconomic stability, labour market flexibility, quality of infrastructure, the nature of regulation and relations between government and business. As economic activity becomes increasingly globalised, corporation tax is also considered in an international context by multinational enterprises.

A feature of company taxation over the past twenty years has been a trend towards lower statutory corporation tax rates in most OECD countries. The UK's *statutory corporation tax rate* (a measure which includes any local as well as central government corporate income taxes) compares well internationally, as does its *effective average tax rate* - a more accurate measure of the extent to which multinational enterprises' profits are taxed, including the effect on companies of both capital allowances and the statutory corporation tax rate. The chart compares the statutory tax rate and the effective average corporation tax rate in selected OECD countries.



¹⁶ Britain's relative productivity performance: updates to 1999 NIESR, O'Mahony and de Boer, March 2002.

Retail and planning

3.102 The Government is committed to promoting investment in town centres, to support its objectives of achieving sustainable communities, productivity growth and improved accessibility for all. In recent years, there has been increased investment in town centres, which has helped to revitalise towns and cities. **The Government intends to build on that success when the Office of the Deputy Prime Minister releases a revised planning policy statement on town centres in England for consultation next week.** It will encourage local planning authorities to:

- plan for growth in town centres;
- expand the boundaries of town centres where this will facilitate further development;
- promote consumer choice through the planning system; and
- promote social inclusion and, where appropriate, regenerate deprived areas with new and additional employment.

Housing

3.103 A stable and flexible housing market is essential to a healthy and productive economy. Housing market imbalances are a potential brake on economic development. The cost and availability of housing influences the geographical distribution and mobility of the labour force and may affect capacity levels in local labour markets. Housing is a key asset for households and consumer spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability. The Government is committed to a comprehensive programme to improve the functioning of the UK housing market and to ensure a better match between supply and demand.

Sustainable communities

3.104 In February 2003, the Deputy Prime Minister set out the Government's new approach to creating and maintaining sustainable communities in a growing and changing economy, with £22 billion being invested over the next three years. The Government's strategy places key housing, planning and regeneration policies in the context of wider requirements for sustainable communities including jobs, quality public services, transport, a safe and healthy local environment, and sound local government. Development in the Thames Gateway and three other growth areas is expected to deliver 200,000 more homes over and above existing plans.

3.105 Greater public investment is being complemented by fundamental reforms to the planning system to unlock land and private development. The centrepiece of this is the Planning Bill, now before Parliament, which contains a wide range of measures designed to improve the speed, predictability and certainty of the planning system.

Urban coding

3.106 The Government is promoting new urban design principles to speed the planning process and deliver better quality design. It aims to achieve consistent, high quality design in larger developments by developing urban codes in discussion with the community before development takes place that, once approved by the local authority, allows buildings constructed in compliance with the code to be fast-tracked through the planning system.

Planning obligations 3.107 The Government is currently consulting on proposals for reforming and improving planning obligations. This aims to provide greater transparency and certainty to help enable developers and local planning authorities to avoid the delays that sometimes occur under the current system by establishing a new optional planning charge as an alternative to negotiated planning obligations.

Barker Review of housing supply 3.108 Building on reforms to housing and the planning system, which are already underway, the Chancellor and Deputy Prime Minister jointly commissioned Kate Barker to lead a review of the factors affecting housing supply in the UK. The Government welcomes the interim report of the Barker Review, *Securing our future housing needs*, published alongside this Pre-Budget Report, and looks forward to the final report in spring 2004. The Chancellor also asked Professor David Miles to undertake a review of the supply and demand factors limiting the development of fixed rate mortgages in the UK, as described in Chapter 2.

Box 3.7: The Barker Review of housing supply

The interim report of the Barker Review was published today. The Review finds that the UK housing market is not working as well as it should. In particular there is a problem of weak supply with major implications for the UK's economic well-being:

- over the past ten years the number of new dwellings built has been 12.5 per cent lower than in the previous decade;
- the current rate at which the housing stock is replaced implies that houses built now need to last 1,200 years;
- only 37 per cent of new households could afford to buy in 2002 compared to 46 per cent in the late 1980s; and
- undersupply of housing constrains economic growth. Had housebuilding rates been higher and UK house prices risen in line with the European average since 1975, the UK would have been £8 billion better off.

The Review identifies a range of factors which reduce UK housing supply:

- the housebuilding industry is characterised by low levels of responsiveness to demand, low levels of investment in brownfield, and low levels of innovation;
- competition tends to focus on land, once land is acquired housebuilders have little incentive to compete for consumers or innovate;
- local authorities have few positive incentives to build and few sanctions if they fail to meet targets;
- infrastructure barriers hold up construction of over 40,000 dwellings in the South East alone; and
- institutional investment in property is limited, the Review suggests Government should consider a tax transparent vehicle to encourage investment.

The Review will take forward this analysis and produce a final report with recommendations in spring 2004.

Private rented sector **3.109** The private rented sector (PRS) provides a flexible form of housing that contributes to labour market mobility and an efficient housing market. However, its 10 per cent share of the UK housing market is low in comparison to the US and many European countries. Institutional investment in the sector is low and over 70 per cent of the PRS stock is run by landlords managing only a few properties. The reputation of the PRS is often undermined by the actions of a minority of rogue landlords, the mishandling of some tenant deposits, and the poor condition of almost half of the stock.

3.110 There is scope for the PRS to make a bigger contribution to meeting individuals' housing needs. However, making the sector a desirable tenure of choice in the UK will require greater investment and reforms in a number of areas. **The Government is therefore considering the role of specific fiscal and other measures in encouraging a stronger and better PRS and will be reporting back on fiscal measures at Budget 2004.** This Pre-Budget Report announces consultations on a tax transparent property investment trust, described below, that could lead to greater investment in the PRS. The Government is also considering a Domestic Business Tax Allowance, described in Chapter 7, and the case for a Tenancy Deposit Scheme. It is also introducing licensing for PRS landlords in certain situations.

An efficient property investment market **3.111** Following Budget 2003, and in line with the interim conclusions of the Barker Review, the Government has also concluded that a tax transparent property investment trust would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector. Evidence from other countries suggests that these vehicles have worked particularly well where they are publicly listed, internally managed, closed-end companies, with a requirement for high distributions. In order to protect the Exchequer against loss of revenue, the Government also intends to apply a charge on conversion of property into a new vehicle. **A consultation document, which will consider the most appropriate structure, alongside related property investment products, will be issued at Budget 2004.**

3.112 The Government has also considered how tax reform might help the development of a market in property derivatives, which would also improve the overall efficiency and liquidity of the property investment market. As a result of informal discussion with industry **the Government has today published draft legislation** showing how a model for the taxation of property derivatives might operate, which also addresses certain tax problems in relation to equity derivatives.

Commercial lease flexibility **3.113** The Government has been working with the commercial property industry to promote a voluntary code of conduct on commercial leases to improve the flexibility of lease terms for businesses. The code is intended to tackle inflexible lease terms, which can restrain business growth and expose businesses to undue risk. As noted in Budget 2003, the impact of the code on flexibility in the commercial lease market is being independently evaluated. The Government expects to receive the interim findings of the evaluation by the end of 2003 and remains committed to consulting in 2004 on possible legislative options, if those findings show that the code is having little impact on flexibility in the commercial lease market.

Investing in transport

3.II4 Investing in a modern, effective transport system is crucial to UK economic performance. The Government's 10-year plan for transport set out a programme of substantially increased investment, amounting to over £180 billion of public and private spending over the current decade. As described in Chapter 6, the Department for Transport is currently reviewing the plan in the light of progress so far and in conjunction with the 2004 Spending Review.

3.II5 Air transport contributes significantly to the national economy. It is not only a high value sector in its own right, but also helps to boost productivity and growth across many other sectors, and supports a large number of jobs. Later this month, the Government will set out its thirty-year vision for UK aviation in an Air Transport White Paper.

Investing in British films

3.II6 Building on the tax measures introduced by the Government in 1997, and extended in 2001, to promote investment in British films, **Budget 2004 will announce the results of discussions with the industry and others to extend support through the tax system beyond 2005.** In doing so, the Government will consider the scope for further simplification, and ensure that the extended support is targeted effectively.

Encouraging North Sea investment

3.II7 The Government is committed to maximising recovery of UK oil and gas reserves by encouraging new investment and making full use of existing infrastructure to ensure all economically viable reserves are developed. Budget 2003 announced the removal of Petroleum Revenue Tax from 1 January 2004 on all new third-party tariffing business under contracts completed on, or after, 9 April 2003.

3.II8 Budget 2003 also launched a consultation on the current low levels of oil and gas exploration. The consultation is now complete and **the Government will introduce a new Exploration Expenditure Supplement to reduce barriers to entry for new North Sea companies that do not receive the full benefit of current 100 per cent exploration and appraisal capital allowances.** Full details will be announced in Budget 2004. The consultation has also resulted in significant progress on non-tax issues such as terms and conditions for third party access to infrastructure. The Government will continue to monitor levels of exploration and work with industry to tackle barriers to investment that hinder maximum economic recovery of UK hydrocarbon reserves.

Flexibility in capital markets

The Myners Review of institutional investment **3.I19** The Myners Review of institutional investment in the UK was published in March 2001.¹⁷ The Government promised to review progress against the recommendations after two years. Qualitative research into the progress made by pension scheme trustees, commissioned as part of that review, was published in November 2003. It showed that, while some progress has been made, particularly by larger schemes, further progress is necessary against many of the Myners' principles:

- enhancing the expertise trustees are able to bring to bear on investment issues;
- clarifying the respective roles of trustees and investment consultants;
- increasing the proportion of resources devoted by pension funds to asset allocation decisions;
- securing greater clarity in the investment time horizons which trustees set; and
- promoting greater shareholder activism.

3.I20 Measures to strengthen trustees' competence in relation to investment matters, and to replace the Minimum Funding Requirement with scheme-specific funding standards, will be included in the forthcoming Pensions Bill. In addition, **the Government will, in the coming months, undertake discussions with the industry on the potential for further progress in these areas**, before it concludes the current follow-up review.

3.I21 In addition, following the Myners Review, the Institutional Shareholders Committee (ISC) and its members have committed to incorporating the ISC's best practice principles into fund management mandates. The Government has said that it will review the extent to which this has delivered behavioural change towards the end of 2004.

Higgs Review **3.I22** The Higgs Review,¹⁸ which reported in January 2003, examined the role and effectiveness of non-executive directors. Its recommendations have been substantially incorporated into a revised Combined Code, which applies to listed companies with reporting years starting on or after 1 November 2003. The Government will examine how the new Combined Code has affected behaviour and outcomes. It remains committed to a review of progress after two years.

Accountancy and audit **3.I23** The Companies (Audit, Investigation and Community Enterprise) Bill was introduced earlier this month. It takes forward recommendations of the Swift Review¹⁹ into the reform of regulation in the auditing profession and the Co-ordinating Group for Accounting and Audit. These improvements enhance auditor independence and strengthen financial reporting.

¹⁷ *Institutional investment in the United Kingdom: a review*, Paul Myners, March 2001.

¹⁸ *Review of the role and effectiveness of non-executive directors*, Derek Higgs, Jan 2003.

¹⁹ *Review of the regulatory regime of the accountancy profession*, Jane Swift, October 2003.

