

Productivity is a key determinant of economic performance and living standards. The Government's long-term goal is that Britain will achieve a faster rate of productivity growth than its main competitors, closing the productivity gap.

The Enterprise Act gives full independence to the UK competition authorities and a new proactive role for the Office of Fair Trading to keep markets under review, strengthening the competition regime and seeking to bring down barriers to enterprise. The Pre-Budget Report sets out the further steps the Government is now taking to support the drivers of productivity growth, including:

- **the creation of 2,000 Enterprise Areas** in the most deprived parts of the UK, with extra support to help businesses start up, develop and grow;
- **a review of how business can better draw on the resources available in UK universities and a new DTI review of innovation**, to improve the UK's comparative innovation performance;
- **a new strategy to promote enterprise learning throughout the school and further education systems**, in line with the recommendations of the Davies Review of enterprise in education;
- **a new target to increase the participation of young people post-16 in full-time education and training**, including vocational programmes such as Modern Apprenticeships;
- **a new employer-led taskforce to support the expansion and improvement of Modern Apprenticeships** and other work-based training programmes;
- **£130 million to fund a second year of extended Employer Training Pilots** to continue to test new measures to improve access to training for low-skilled adults in the workforce;
- **extension of the Highly Skilled Migrant Programme**, and changes to the criteria to make the scheme a more effective source of highly skilled labour for the UK economy; and
- **further work to establish a modern and competitive business tax system, through simplified corporation tax rules for employee share schemes and further consultation on wider reform of corporation tax.**

## THE PRODUCTIVITY CHALLENGE

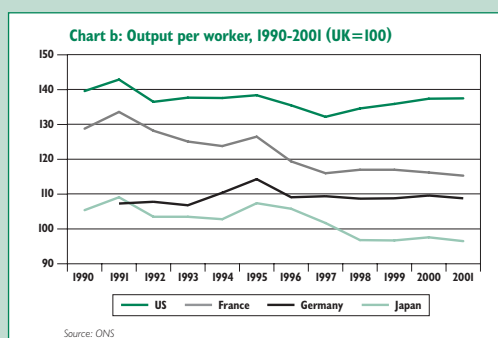
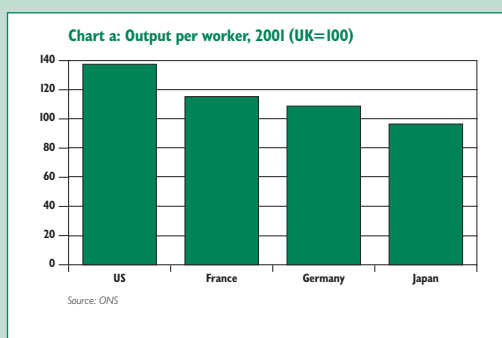
**3.1** Productivity growth, alongside high and stable levels of employment, is an important determinant of long-term economic performance and rising living standards. Increasing the sustainable rate of UK productivity growth is central to the Government's economic strategy.

**3.2** The UK has historically experienced low rates of productivity growth by international standards. Macroeconomic instability and microeconomic failures have inhibited competition, enterprise and innovation, and discouraged firms and individuals from long-term investment in human and capital resources. If the economy is to continue to deliver growing prosperity in a global marketplace for business, investment and skills, it is essential that faster productivity growth is achieved.

**Box 3.1: The productivity challenge**

Productivity is a measure of how effectively the economy uses resources to generate economic outputs. The Government's central measure of productivity is output per worker, a measure that is both relatively straightforward to quantify and is directly related to the Government's objective of raising the economy's trend rate of growth.

Chart (a) shows that, on this measure, US productivity is around 38 per cent higher than that in the UK, while productivity in France and Germany is 15 and 9 per cent higher respectively. Measured in terms of output per hour, the US and France both register 29 per cent higher productivity than the UK, while the gap with Germany is 27 per cent.



International comparisons of productivity should be made over the long term. Chart (b) shows that over the last ten years the gap relative to France has narrowed significantly, while that with the Japanese economy has closed altogether. However, this pattern is not repeated in comparisons with the US or German economies. Indeed, the productivity gap with the US has widened in recent years.

**The Government's approach**

**3.3** The Government is pursuing a wide-ranging strategy to tackle the barriers to productivity growth and close the productivity gap. Macroeconomic stability is helping businesses, individuals and the Government plan effectively for the long term, improving the quantity and quality of investment in physical and human capital. Microeconomic reform aims to remove barriers that prevent markets from functioning efficiently, allowing firms and workers to maximise their productive potential. The Government's programme of microeconomic reform targets historic weaknesses in five key drivers of productivity performance:

- strengthening the **competition** regime, to encourage firms to innovate and minimise costs, and to deliver better quality goods and services to customers;
- promoting **enterprise**, to help new and established businesses start up, develop and grow;
- supporting **science and innovation**, to utilise the potential of new technologies and to develop more efficient ways of working;
- improving **skills**, through better education for young people and greater training opportunities for those already in the workforce; and
- encouraging **investment** to improve the stock of physical capital in all sectors and industries.

**Long-term challenges** 3.4 This agenda presents some major long-term challenges that the Government will continue to address going forward:

- a critical productivity issue for the UK is to raise the performance of the weakest regions<sup>1</sup>. The productivity gap between the richest and poorest regions in the UK is large - over 30 per cent in 1999 - and has been remarkably persistent, with evidence suggesting that existing patterns of regional activity emerged during the 1920s;
- while policy is seeking to strengthen the enterprise culture across all UK regions, the proportion of the workforce involved in new businesses is almost twice as high in the US as it is in the UK. The long-term challenge is to raise new business creation throughout Britain and to provide opportunities for those in all regions to participate in enterprise;
- innovation is at the heart of productivity growth and social gain, and yet business expenditure on research and development (R&D) in the UK is lower than in other competitor countries, while investment in universities' capital infrastructure has historically failed to keep pace with research spending. Successful implementation of the Government's science strategy<sup>2</sup> is key to realising the UK's innovation potential;
- the flow of skills into the workforce has seen improvements as the performance of the school system has got better. However, the effect on the stock of adult skills is slow. A third of the workforce do not have level 2 skills (equivalent to five good GCSEs) and seven million adults lack basic literacy or numeracy. New ways of working with trade unions and employers, which go with the grain of their business needs, are required to address this;
- high quality infrastructure is a prerequisite for a developed economy that supports a competitive business environment and a productive workforce. UK workers commute furthest and face the most congestion in the EU, and there is a strong economic case for additional airport capacity to meet growing demand. There are also serious imbalances between the supply and demand of housing across the UK, with the lowest rate of house building since 1929;
- strong management performance in business is a key determinant of productivity<sup>3</sup>. The CBI-TUC Best Practice working group stated that although there are many examples of successful UK companies that have inspiring leaders and very able managers, evidence suggests strongly that in relation to leadership and management too many UK companies fall short of world class performance; and
- the UK must continue to learn from experience elsewhere. For instance, some US business sectors have experienced dramatic productivity gains in recent years driven by dynamic processes of competition and innovation<sup>4</sup>. It is important to learn from these experiences and to ensure that the lessons for the UK business environment are clearly understood.

<sup>1</sup> *Productivity in the UK: 3 - the regional dimension*, HM Treasury and the Department of Trade and Industry, November 2001.

<sup>2</sup> *Investing in innovation: a strategy for science, engineering and technology*, Department of Trade and Industry, HM Treasury and the Department for Education and Skills, July 2002.

<sup>3</sup> *Reviving UK manufacturing*, McKinsey & Company, October 2002; *Leadership: the challenge for all*, Institute of Management, December 2001; *Catching up with Uncle Sam*, EEF, December 2001; *Lessons from Uncle Sam*, EEF, March 2001.

<sup>4</sup> *US productivity growth 1995-2000*, McKinsey Global Institute, October 2001. For example, the retail and wholesale sectors together contributed more than half of the 1.33 percentage point acceleration in US productivity in the period 1995-99 compared with 1987-95.

**Public sector productivity** **3.5** As well as creating the right environment for improved productivity in the private sector, the Government is also striving for greater efficiency in the public sector. Increased public service productivity lays the foundations for a more productive economy. Improved education, health and transport infrastructure can help to raise private sector performance by producing a healthier, better skilled and more mobile labour force. Chapter 6 describes the Government's approach to reforming public service delivery in detail.

**CBI-TUC productivity campaign** **3.6** Improving the UK's productivity performance requires action by employers, employees and the Government. The CBI-TUC Productivity Group has an important role in monitoring progress against a range of productivity drivers and identifying the practical steps that all groups can take to raise productivity. Measures in this Pre-Budget Report build on the CBI and TUC recommendations for joint action to address basic and intermediate skills shortages in the UK and to strengthen the UK's innovation performance.

**Productivity across the regions** **3.7** The Government is committed to ensuring that the benefits of improved productivity are spread throughout the country, and has established a new Public Service Agreement target to reduce the persistent gap in growth rates between the regions over the long term, while delivering sustainable improvements in the economic performance of all English regions.

**3.8** Measures to raise productivity should often be focused at the regional or sub-regional level<sup>5</sup>. The Regional Development Agencies (RDAs) act as strategic leaders of economic development and regeneration in the regions, and are central to the Government's productivity strategy. A new, more flexible system of RDA funding was introduced in April 2002 to improve their ability to respond to regional productivity challenges. The 2002 Spending Review increased overall RDA funding to £2 billion by 2005-06, and gave the Agencies new responsibilities for regional tourism promotion and transport and consultative roles for housing and planning.

**3.9** From April 2003, **two pilot schemes will be launched giving RDAs in selected regions a wider role in driving forward economic development.** The schemes will last initially for two years and involve:

- improvements to the delivery, effectiveness and coordination of business support management at the regional level, including through RDA-led management and coordination of Business Link Operators; and
- RDA co-management, with the Learning and Skills Council, of funding for post-19 training. These pilots will bring together the different sources of funding for post-19 skills at the regional level, delivering a more effective match of skills demand and supply, and allowing a closer alignment of regional skills funding with Frameworks for Regional Employment and Skills Action.

**3.10** The Government has invited RDAs in the East and West Midlands to develop proposals for the business support pilots, and those in the North East, East and South East to develop the skills pilots. The Government has also invited the Northwest Development Agency to develop arrangements for the piloting of both business support services and co-management of post-19 skills funding in this region, to exploit the synergies between the two areas of activity.

**3.11** To benefit from the regional perspective that RDAs can add to the development of central government policy, the Treasury has asked the Agencies to provide advice on policy relating to enterprise, innovation, regulatory reform and skills, in preparation for Budget 2003.

<sup>5</sup> *Productivity in the UK: 3 - the regional dimension*, HM Treasury and the Department of Trade and Industry, November 2001.

**3.12** Just as it seeks to raise domestic productivity, so the Government is also working to promote economic reform and productivity growth in Europe.

**European economic reform**

**3.13** In March 2002, the Barcelona Council gave renewed impetus to an ambitious agenda of reform, approving new commitments to liberalise non-domestic energy markets, complete the single market in financial services, boost levels of R&D and reduce regulatory burdens on business. Economic reform in Europe holds the potential to strengthen the drivers of UK productivity and the Government is committed to promoting change, building on the progress made in Barcelona. The Government's White Paper on economic reform<sup>6</sup> describes the next steps in this process, including:

- further reform of labour markets to meet EU employment targets and establish employment opportunity for all;
- less and better-targeted state aid;
- continued improvement of the EU's competition regime;
- work to deliver a genuine single market in services, including financial services, as well as in manufacturing; and
- the full opening up of gas, electricity and telecoms markets.

**3.14** The Government will report on developments since the White Paper in a progress report early in the new year.

## COMPETITION

**3.15** Competition is among the key drivers of productivity performance. Open and competitive markets encourage firms to innovate and strive for greater efficiency. They also provide incentives for firms to reduce costs and prices and to enhance quality and choice in the goods and services they deliver, ensuring that consumers receive the best possible deal.

### The competition regime

**3.16** The Government has taken important steps to strengthen the UK competition regime. The Enterprise Act grants full independence to the UK competition authorities and gives the Office of Fair Trading (OFT) a clear proactive role to keep markets under review. It improves the mergers regime, introduces a new regime for market investigations and allows for criminal sanctions to be imposed on those engaging in hard core cartels. The new provisions will come into effect in spring 2003 and have been matched with substantial increases in resources for the competition authorities. Together, the changes will increase the competitive intensity of the UK economy and bring down barriers to enterprise and innovation.

**Consumers 3.17** Active consumers are central to the competitive process and are an important driver of productivity at the firm level. Just as a vigorous competition regime is the best way to ensure that consumers receive a good deal, so an empowered, active consumer population is the best way to ensure that poorly performing firms improve or leave the marketplace, and that the best firms are rewarded.

<sup>6</sup> *Realising Europe's potential: economic reform in Europe*, HM Treasury, February 2002.

**3.18** The Government wants to see empowered consumers at the heart of the competition regime, and is committed to ensuring they have the skills and information needed to perform an effective role. A new national telephone consumer help-line, *Consumer Direct*, is being developed with £30 million of Government funding, and there is ongoing work to enhance the public information and education resources provided by the Trading Standards Departments, the OFT and various consumer bodies. **The Government is also carrying out a major consumer study to assess the current state of the UK and other regimes**, and to lay the foundations for future policy development.

### Promoting competition in specific markets

**3.19** The OFT has already successfully promoted competition in a number of markets. Last year, an OFT court action against the practice of setting minimum prices for branded medicines led major retailers to reduce prices on leading brands by between 25 and 50 per cent. The OFT's first completed market investigation into extended warranties for electrical goods found that competition was not working effectively and that consumers lacked adequate information. The Competition Commission will now consider remedies and report on this matter in summer 2003. The OFT is also investigating consumer IT services and estate agencies and, in response to super-complaints brought by consumers' associations, has launched new investigations into doorstep selling and the market for private dentistry.

**The professions** **3.20** Following the OFT's report into competition in the professions, the Lord Chancellor's Department (LCD) began consulting in July 2002 on matters falling to the Government, including conveyancing and probate, the multi-disciplinary environment for solicitors, legal professional privilege and the Queen's Counsel system. The LCD will report on the consultation in the spring. The Government is also reviewing the framework for regulating legal services with the aim of ensuring that the regulatory regime supports a dynamic and competitive market with appropriate levels of consumer protection.

**Small business banking** **3.21** Since the Competition Commission's report into the small- and medium-sized enterprise (SME) banking market, the eight largest banks have agreed to a number of steps designed to increase transparency and make it easier for small businesses to switch their accounts. As these measures will take time to improve competition in the market, the Competition Commission has also recommended that the four largest banks offer all their SME customers in England and Wales the option of receiving interest on their current accounts or an account free of money transmission charges. The banks have agreed to implement this by 1 January 2003.

**Payment systems** **3.22** **The OFT have decided to conduct an empirical study into recent payment system developments, starting early in 2003.** The Government is closely monitoring developments and will introduce legislation to give the OFT new powers to promote effective competition in payment systems as soon as parliamentary time allows. In the meantime, the Government welcomes moves by payment system participants to address the competition issues identified by the Cruickshank report, *Competition in UK Banking*, and urges the industry to continue with these reforms.

**New cars** **3.23** A major pro-competition reform of the new cars market was achieved in July, with the announcement of a new European Commission cars block exemption. The new rules will take effect from October 2003 and allow dealers to market their services freely across the EU and to sell multiple brands of car through their showrooms. Internet retailers will also find it easier to cooperate with dealers and individuals who wish to import cars, and the after-sales market will be opened to greater competition.

**The European trademark regime** **3.24** The Government is committed to reforming the European trademark regime to give business greater freedom to source goods from low price markets. By allowing brand owners to prevent the import of products marketed outside the European Economic Area, the current regime confers market power upon brand owners, preventing parallel importers from providing a competitive constraint on their pricing behaviour.

**The water industry** **3.25** The Government proposes to extend competition for non-household consumers using large quantities of water. These proposals form the basis of a new framework to be implemented through the forthcoming Water Bill.

**Energy** **3.26** Liberalisation of energy markets has delivered lower prices for consumers. Electricity and gas prices fell by 15 per cent between 1997 and 2001, saving consumers around £3 billion. Increased competition has also reduced the need for regulation, and price controls were removed from domestic gas and electricity supply in April 2002. The Government's Energy Policy White Paper will be published early next year, and will set out the next steps for secure and sustainable energy over the long term, building on the benefits of competitive and liberalised energy markets.

**3.27** The Government's existing credit facility for British Energy of £650 million will expire on 29 November 2002. The Secretary of State for Trade and Industry will therefore make an announcement about the outcome of the Government's discussions with the company shortly. The Government expects the loan facility to be managed within the planned totals for Departmental Expenditure Limits and the financial implications of any restructuring to be consistent with the forecast of the public finances and performance against the fiscal rules published in this Pre-Budget Report.

### Regulatory reform

**3.28** Whereas effective and well-focused regulation can help to correct market failures, promote fairness and ensure public safety, unnecessary or poorly enforced regulation can restrict competition, stifle innovation and deter investment. The Government is therefore committed to regulatory reform in the UK and EU.

**Competition and regulation** **3.29** The Government has empowered the competition authorities to challenge anti-competitive regulations, increase their scrutiny of new and existing regulation and to be as rigorous in assessing the impact of the public sector's commercial activities on competition as they are for the private sector. The OFT is already investigating pharmacies and taxis - markets in which the operation of entry licensing regimes may be restricting competition to the detriment of consumers. The pharmacies report will be published within the next few months and will be the first under the new competition and regulation arrangements. The Government will publish a full response within 90 days of receiving each report from the OFT and, if changes are agreed, will monitor progress every six months. Since October 2001, the OFT has scrutinised and provided competition advice to the Government on more than 100 proposed regulations.

**Public sector procurement** **3.30** The Government wants to see dynamic competitive markets operating throughout the economy. Strong competition encourages firms to bear down on costs and improve their efficiency, thereby enhancing their competitiveness at home and abroad. In markets where the Government is a major procurer of goods and services, its own actions may greatly influence how the market operates and therefore impact on competition and on the long-term value for money it can secure. So for procurement, ensuring value for money and encouraging strong competition go hand in hand.

**3.31** The Government has welcomed the Competition Commission's recent recommendations to improve competition in procurement and has asked **the Office of Government Commerce (OGC) to consider what further steps can be taken to increase competition and encourage better long-term capacity planning in markets where the Government possesses significant purchasing power.** This could include improving advance information for potential suppliers about forthcoming opportunities. The Government has also asked the OGC to build on their recent work to enable SMEs to compete for government contracts and deliver value for money. The OGC will take forward these points in consultation with a working group comprising the Department of Trade and Industry (DTI), the Small Business Service and the Treasury. The OGC will report to the Government in the summer.

**Exposing regulations to scrutiny**

**3.32** To strengthen further existing regulatory procedures, the Cabinet Office will issue revised guidance on Regulatory Impact Assessments later in the year, ensuring that the costs, benefits and risks of proposed regulations are fully considered. This approach is beginning to be applied in Europe, where the European Commission's Action Plan for simplifying and improving the regulatory environment is now being implemented. The Government's Regulatory Reform Action Plan, published in February, sets out 268 deregulatory proposals for reform to be delivered over the next three years. One quarter of these proposals have now been completed.

**Liability insurance**

**3.33** Premiums for Employers' Liability Compulsory Insurance (ELCI) have increased substantially in recent months, affecting many businesses, and especially SMEs in high-risk sectors. Following a request from the Government, the Association of British Insurers (ABI) and trade associations are working to ensure that affordable cover is available. The Government has engaged with a wide range of stakeholders including the CBI, TUC and ABI to discuss the long-term issues affecting ELCI. **The Department for Work and Pensions will now undertake a formal review of the operation of ELCI.** Full details of this review will be announced shortly.

## ENTERPRISE

**3.34** Enterprise is essential for productivity growth. New and successful businesses increase competitive pressure and facilitate the introduction of new ideas and technologies. There is, however, clear scope to raise levels of enterprise. The proportion of the workforce involved in entrepreneurial activity in the US is nearly twice as high as that in the UK, and business start-up rates in the UK's least enterprising communities are ten times lower than in the best-performing areas.

**3.35** The Government's strategy for promoting enterprise is described in *Enterprise Britain: a modern approach to meeting the enterprise challenge*, published alongside this Pre-Budget Report. In addition, the Small Business Service will publish shortly a framework for government policy towards small business, which will also set out its refocused and enhanced role. The Government is committed to:

- building an enterprise society in which people from all backgrounds consider and act upon enterprise opportunities;
- providing extra support to tackle barriers to small business growth in skills, finance and innovation;
- creating a fertile business environment through a modern and competitive business tax system; and
- removing the obstacles to, and raising levels of, enterprise and investment in the UK's most disadvantaged areas.

### Creating an enterprise society

**3.36** Strengthening the links between education and business is essential to encourage entrepreneurial activity among young people, to transform attitudes and to create an enterprise society.

**Davies review of enterprise and education** **3.37** In February 2002, Sir Howard Davies, Chairman of the Financial Services Authority (FSA), reported to the Chancellor and the Secretaries of State for Trade and Industry and Education and Skills on the steps needed to promote a better understanding of business, the economy and enterprise throughout the school and further education systems.

**3.38** The Government shares and accepts the review's recommendations and its assessment that efforts to build a deeper and wider entrepreneurial culture must begin in schools, and **will ensure that by 2005-06 every secondary school can offer five days' enterprise activity to pupils**, discussing with OFSTED the best way of assessing performance in this area. **The Government will provide £60 million in 2005-06 for this and, in preparation, intends to test a number of approaches through pilot schemes**, allocating £5 million in 2003-04 and £10 million in 2004-05. This investment will be supported by a number of measures, including new guidance for teachers on enterprise learning, along with new teaching materials, and a new national benchmark of enterprise capability among young people.

### Supporting small business

**Corporation tax and business rates** **3.39** To support new and growing businesses, Budget 2002 introduced reforms to reduce the corporation tax bills of over 90 per cent of all taxpaying companies in the UK. In April 2002, the corporation tax starting rate was reduced from 10 per cent to zero and the small companies' rate from 20 to 19 per cent. As a result of these changes around 150,000 small companies no longer pay any corporation tax. The Government is now legislating to reduce business rates for more than half of all small businesses by up to £700 per year.

**Simplifying VAT for small businesses** **3.40** The Government has also taken steps to allow small and newly-registered businesses to reduce their VAT administration burden, improve their cash flow and manage their entry into the VAT system. Budget 2002 announced the Government's intention to extend eligibility for the optional flat-rate scheme to businesses with a taxable turnover of up to £150,000 from April 2003, and to ensure that more businesses are offered advice and support before they face penalties. A targeted information campaign to raise awareness of the benefits of the VAT flat-rate scheme among eligible businesses is being launched. The Government will also seek views on whether the scheme could be further extended or improved to enhance the benefits to the small business sector.

**Improving service delivery** **3.41** New entrepreneurs need clear information on the services available to them, what is required of them and where they can access help and advice. The cross-cutting Review of Government Services for Small Business<sup>7</sup> found that some businesses have difficulty accessing basic information on government services and requirements. The Government is committed to addressing this problem through:

- understanding small firms' needs and treating them as customers;
- making it easy for small firms to find advice and support;
- ensuring that information provided to small firms is concise and appropriate to the audience;

<sup>7</sup> Available on the SBS website.

- enforcing rules in a proportionate way, recognising that prevention is better than prosecution;
- better coordinated delivery of related services; and
- actively considering alternatives to regulation.

**The role of the Small Business Service** **3.42** The Government is also enhancing the role of the Small Business Service (SBS). The SBS has a key role in improving the business environment and removing barriers to enterprise, particularly among disadvantaged groups. The cross-cutting Review identified that a wide range of public sector institutions come into contact with small business, spending some £2.5 billion a year on services for the sector<sup>8</sup>, but that they do not always fully recognise the benefits and particular needs of small business. In its enhanced role, the SBS will be the centre of expertise on small business in government, championing their needs and working with the range of government service providers to raise standards.

**Advice and communication** **3.43** The SBS and others across government intend to take further steps to improve the quality of their interactions with small business by:

- **publishing next spring a new start-up pack**, bringing together information on all government requirements and support for those setting up in business;
- **launching a series of Personal Enterprise Shows** to encourage start-ups and publicise the services and support available for business;
- **making it easier for small business to understand and comply with government regulations through the development of a single web portal**, designed around customer needs, by summer 2003;
- **completing the national manufacturing advisory service networks**, providing free and subsidised advice for all manufacturing businesses; and
- helping central and local government enforcement agencies to follow the agreed priorities of good practice set out in the Enforcement Concordat and to take action to ensure that companies being regulated are aware of these principles.

**3.44** The Inland Revenue's *Starting Up In Business* initiative also offers a range of guidance and support to new businesses, and has encouraged start-ups to view the Inland Revenue as a source of advice and assistance. An evaluation of the initiative is published alongside this Pre-Budget Report.

**Small business university** **3.45** The Government welcomes a proposal from high street banks to provide leadership support for prospective and existing businesses by creating a virtual university for small businesses with ready access to information, advice, support and mentoring through the internet and more specialist training courses.

**Improving access to finance** **3.46** The Government is also committed to improving access to finance for small business. While macroeconomic stability means that the vast majority of businesses are able to access the finance they need, small businesses with high growth potential still have difficulty raising risk capital, particularly sums of less than £1 million. The Government is therefore taking action to address the funding gap and improve access to finance for new and growing businesses, by:

- launching Regional Venture Capital Funds in every English region, with investment of £270 million. Seven of the nine funds are now running and three have already made their first investments. The remaining two are due to be launched by the end of the financial year;

<sup>8</sup> Excluding agricultural support payments.

- **improving the administration and take-up of the Small Firms Loan Guarantee Scheme.** From April 2003 eligibility for the scheme will be extended to firms in the retail and catering sectors - sectors which make an important contribution to enterprise activity within disadvantaged communities and some ethnic minority groups; and
- providing tailored educational programmes through investment readiness demonstration projects, to help small businesses and intermediaries understand and access different finance options.

**Small business accounting** 3.47 In July 2000, the Secretary of State for Trade and Industry announced an increase in the turnover threshold for statutory audit of company accounts from £350,000 to £1 million. This allowed a further 150,000 companies to be released from the obligation to undertake an audit. As set out in the July 2002 White Paper, *Modernising company law*, DTI ministers will shortly announce a programme of research to assess the impact of this increase before making decisions on further increases, inviting key stakeholders and other interested parties to contribute their views and experiences. In the light of conclusions drawn from the assessment, **the Government will consult by summer 2003 on whether the audit exemption threshold should be increased or maintained at the current level.**

### A modern and competitive business tax system

3.48 To provide stability for business, allow the UK to compete effectively in global markets and ensure that the rewards to successful enterprise are commensurate with the risks that business owners must bear, the Government has introduced significant reforms to the business tax regime, including:

- a reduction in the main rate of corporation tax to 30 per cent;
- a generous capital gains tax (CGT) taper for business assets to encourage investment and entrepreneurial activity, and render the UK regime among the most favourable to enterprise in the world;
- an exemption from corporation tax for gains and losses on most substantial shareholdings in trading companies to ensure that business decisions are driven by commercial rather than tax factors; and
- a new regime for providing tax relief for the costs of intellectual property, goodwill and other intangible assets, to encourage business to take advantage of opportunities in the knowledge-based economy.

**Corporation tax** 3.49 To maintain and build upon the UK's position as an internationally competitive location for business, and to make further progress in removing tax distortions to business decision-making, the Government has recently consulted on further reform of the corporation tax system. The consultation addressed the tax treatment of capital assets not covered by earlier reforms, rationalisation of the schedular system and the scope for greater alignment between the tax treatment of trading and investment companies. Over 150 written responses have been received and **the Government intends to consult further on the corporation tax regime once these have been analysed in detail.**

3.50 In the meantime, to enable and encourage companies to offer equity remuneration schemes to their employees, **the Government is simplifying the corporation tax rules for employee share schemes.** The new rules provide a statutory corporation tax deduction for the cost of providing shares for employee share schemes, removing existing complexity and

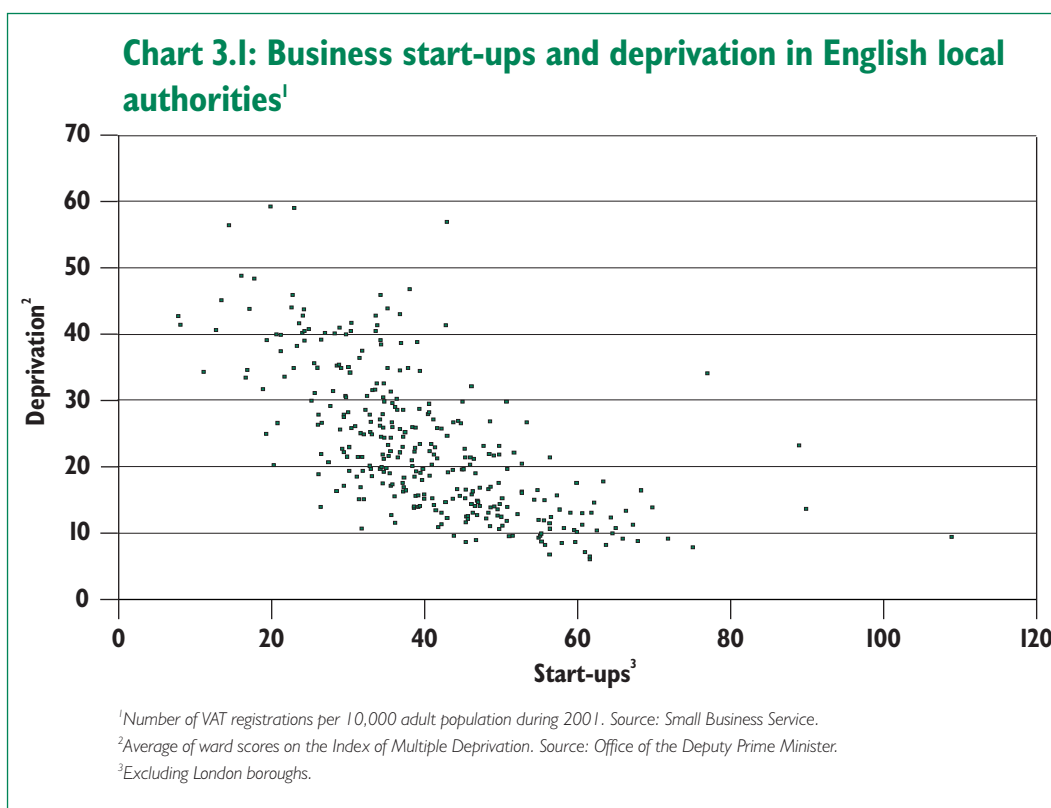
duplication in the tax treatment of these schemes. The timing of the deduction will be aligned with the point at which the employee is taxable on the share award and will apply to accounting periods starting from 1 January 2003.

### Reducing compliance burdens

**3.51** Budget 2002 introduced a series of measures to simplify the tax system and reduce compliance burdens on businesses and investors, including reform of the rules governing withholding tax at source and simplification of the CGT regime. To reduce further compliance burdens on business, **the Government will now consult on options for reform of the Construction Industry Scheme and will continue to consult on simplified VAT rules for imports.** As part of its strategy for encouraging VAT compliance, set out in Chapter 5, the Government will also increase the advice and support it offers to help businesses manage their VAT affairs correctly.

### Promoting enterprise in disadvantaged areas

**3.52** Levels of enterprise vary dramatically across the UK, with far lower levels of business start-up activity in deprived areas compared with elsewhere. In these areas, enterprise plays a critical role in helping to deliver sustainable neighbourhood renewal. Long-term change in these neighbourhoods depends not only on delivering improvements in public services and to the physical environment, but also on revitalising economic activity, driving up educational standards and building a sound economic base.



### Enterprise Areas

**3.53** Local Strategic Partnerships (LSPs) are responsible for coordinating and driving forward neighbourhood renewal on the ground, consistent with the regional economic strategies of the RDAs. The Government is committed to working with LSPs to improve the delivery of key public services in deprived areas and to tackle barriers to enterprise. To this end, **the Government has designated 2,000 Enterprise Areas in which measures to boost enterprise are now being concentrated.** These areas cover the most deprived communities in the UK, which already qualify for stamp duty exemptions. The full range of measures in these areas is set out in *Enterprise Britain*, published alongside this Pre-Budget Report.

**3.54** In England, the Government is providing extra support to help businesses in these areas across the full range of their activities. This support is underpinned by a target for the DTI to promote enterprise in disadvantaged communities, narrowing the gap in business start-up rates between the most deprived and the most affluent wards in the country. However, many elements of business support and enterprise policy are areas of devolved responsibility and the devolved administrations will pursue their own policies, including to increase the supply of equity finance to small businesses in their countries.

**3.55** In addition to this support, **the Government will consult on a proposal to allow local authorities to retain some or all of the increases in business rates revenue as a result of economic growth in their area.** Such a scheme would provide incentives for local authorities to encourage enterprise and growth throughout the country, including in the 2,000 Enterprise Areas. Chapter 7 provides further details of this proposal.

**Starting and growing a business**

**3.56** To reduce the costs to business of investing in deprived areas, the Government has exempted from stamp duty all property transactions up to £150,000 in the 2,000 Enterprise Areas and **will exempt all commercial property transactions in these areas from stamp duty**, irrespective of value. The Government is now actively seeking EU state aids clearance for this measure. As described in Chapter 7, **the Government will also introduce a new tax incentive to encourage donations toward the running costs of Urban Regeneration Companies** that support regeneration strategies in urban areas, including some of the 2,000 Enterprise Areas.

**3.57** Business incubators nurture start-ups and early stage SMEs, and have been shown to enhance the chances of their survival and growth. In addition to providing loans for business incubator projects, **the Business Incubation Fund will now offer grants to cover the costs of feasibility studies to increase the number of quality incubator proposals, with extra funding for deprived areas.** In the most deprived wards in England, including the Enterprise Areas, grants of up to £30,000 covering 70 per cent of the cost of a feasibility study will be available. In other areas, up to £20,000 will be available to cover 50 per cent of the cost of the study.

**3.58** The Government is also taking steps to reduce red tape for growing businesses and **intends to give local authorities new powers to create Business Planning Zones (BPZs)** in which there will be no requirement to apply for planning permission where predetermined criteria are met. The Government wishes to encourage the widespread adoption of BPZs, and will expect local authorities, RDAs and Regional Planning Bodies to give active consideration to the potential for BPZs in their region. Where they do not, the Government will have powers to direct local authorities to establish BPZs. BPZs may be attractive to local authorities as a means of stimulating economic activity in Enterprise Areas. The rules for BPZs will ensure that development is of high quality and low environmental impact. The Government is also considering an intermediate package of planning flexibilities for Enterprise Areas where a BPZ is not felt to be appropriate.

**3.59** To support small businesses in deprived areas, and to encourage entrepreneurial activity among women and ethnic minorities, the 2002 Spending Review allocated a further £50 million to the Phoenix Fund. This is in addition to the £96 million already invested in the Fund, which supports organisations that promote enterprise in disadvantaged communities. The Government is also supporting the Inner City 100 index which provides entrepreneurial role models for those living in deprived urban areas.

**Trading and employing**

**3.60** Small businesses in deprived areas benefit from a wide range of support, including rates relief, payroll incentives and the flat-rate VAT scheme. In recognition of the higher barriers to enterprise in deprived areas, **the SBS will include in its new start-up pack information tailored to the needs of firms in Enterprise Areas. The Inland Revenue will also provide firms in these areas with a special package of targeted support**, including help and advice on payroll requirements and extra assistance from Business Support Teams. Over the next few

months, HM Customs and Excise will work with the SBS and others to examine how their support services for businesses, in particular with regard to VAT, can be enhanced and targeted more effectively in disadvantaged areas.

**Box 3.2: Encouraging development in Enterprise Areas**

As it may not be appropriate to establish the full flexibility of BPZs in all Enterprise Areas, the Government is considering the feasibility of a number of additional measures for these areas, including:

- modifying the planning application and building regulations fees regimes to make special arrangements for developers in Enterprise Areas to take account of the effect that fees, even for minor development such as changes of use, can have on expansion;
- better targeting, from 2004-05 onwards, of the Government's new resources for planning authorities to ensure that developers in Enterprise Areas get an improved service;
- using the Best Value regime to ensure that developers in Enterprise Areas get an improved service;
- requiring local planning authorities to draw up Action Area Plans for development within Enterprise Areas as part of the Local Development Framework. This would ensure that developers have a clear understanding of planning requirements; and
- encouraging local authorities to introduce Local Development Orders to relax planning control in Enterprise Areas, as part of their Action Area Plans.

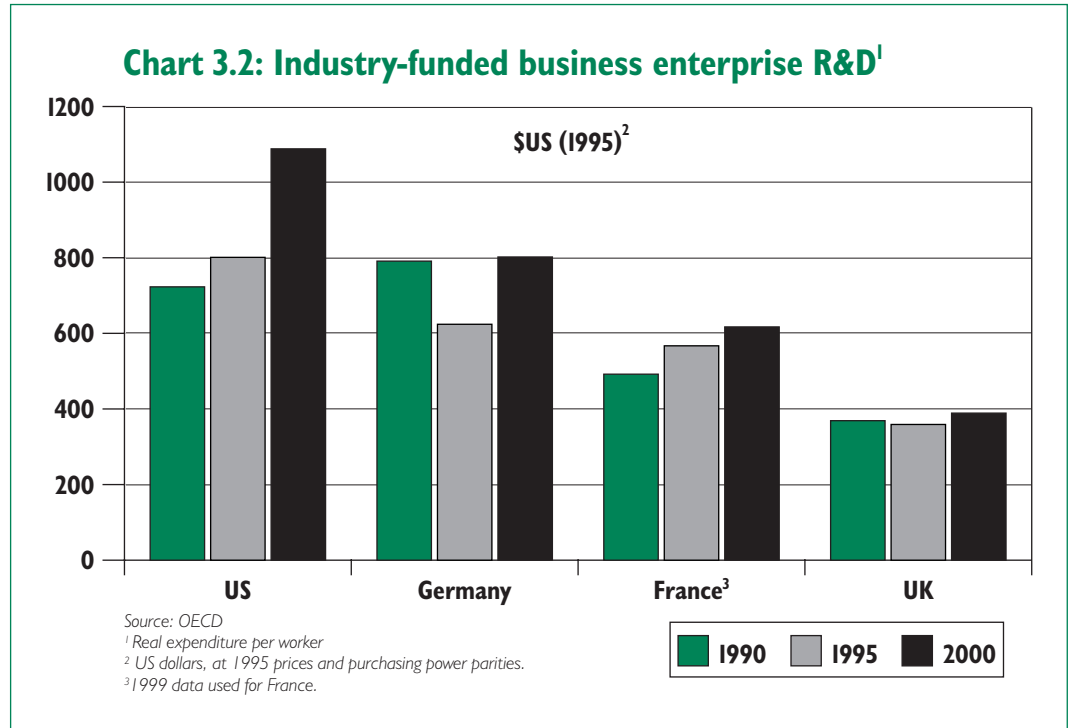
The Government will also consult, as part of its review of Planning Policy Guidance Note 4 (Commercial and Industrial Development and Small Firms), on whether a 'sequential approach' for business development in favour of Enterprise Areas should be introduced.

**Investing 3.61** To promote private investment in enterprises in disadvantaged communities, the Government has legislated to implement the Community Investment Tax Credit (CITC) and has published a draft prospectus for organisations wishing to gain accreditation. State aids approval has now been obtained and the SBS will allocate the first round of tax credits under the CITC by the end of 2002-03.

**3.62** In May 2002, the Chancellor launched the Bridges Community Development Venture Fund to boost the provision of risk finance for firms operating in disadvantaged areas in England. The £40 million Fund is a matched funding partnership between government and the venture capital industry. The Government and private sector investors have both committed £20 million and the Fund is now actively seeking investment opportunities in deprived areas.

## SCIENCE AND INNOVATION

**3.63** Innovation is a key catalyst for productivity growth. New ideas, products, services and technologies can open up markets and opportunities for firms, generating significant productivity gains and helping to deliver a better deal for consumers. The strength of the science base, the level of business investment in R&D and other aspects of innovation, and the degree of knowledge transfer from universities to business are key elements of market-driven innovation. By international standards, levels of innovation in the UK have historically been low.



### Supporting science and research

**3.64** The UK science base needs to compete in a global market for science and research. The Government is committed to supporting the science base to ensure that the UK retains its tradition of scientific excellence and has a good supply of new ideas and skilled people. Details of the Government's strategy for supporting UK science were set out in *Investing in Innovation*, published in July. The strategy builds on the recommendations of Sir Gareth Roberts' review of the supply of scientists and engineers<sup>9</sup>, and on the conclusions of the Government's cross-cutting Review of Science and Research in the UK. It focuses on:

- investing in the UK's science base, upgrading capital infrastructure and increasing research funding;
- moving the funding of university research onto a financially sustainable footing;
- improving the supply of people with science and engineering skills, and increasing the attractiveness of science and engineering careers in both business and universities; and
- encouraging the translation of research into business innovation, through the new Higher Education Innovation Fund (HEIF) and the R&D tax credits for small and larger companies.

**3.65** To support implementation of this strategy, the 2002 Spending Review announced the largest sustained increase in the science budget for more than a decade. Overall science spending will increase by around £1.25 billion by 2005-06 compared with 2002-03.

<sup>9</sup> SET for success: the supply of people with science and mathematics skills, April 2002.

**UK science base 3.66** These resources will help to fund a comprehensive new approach to boosting the UK science base, including:

- increasing the funds earmarked for capital investment and improved infrastructure in higher education to £500 million a year by 2004-05;
- establishing principles for the relative roles of government, business and charities in funding science and engineering research;
- increasing by £244 million a year by 2005-06 government funding for university research departments through the Higher Education Funding Council for England;
- adding £300 million a year to Research Council funding by 2005-06, with an additional £120 million to enhance the contribution of this funding stream to universities' research infrastructure;
- providing extra funds for schools to improve their laboratories and attract more science teachers;
- establishing a National Centre for Excellence in Science Teaching, co-funded with the Wellcome Trust, to provide continuing professional development for science teachers, as well as programmes to bring university science students into schools to support science teaching; and
- improving the career paths for academic scientists, including better training for PhD and post-doctoral researchers, improved pay, an increase in minimum PhD stipends for Research Council students, increased pay flexibility in high-demand subjects and funds to improve teaching laboratories.

**Business-university collaboration 3.67** Strong business innovators naturally draw on the knowledge and skills in UK universities to further their own growth, and some UK universities are playing an increasing role as the knowledge hub of their regional economy, as the major US universities do. As the Government increases public investment in the UK's science and engineering research base, there is a major opportunity for business in the UK to reap far greater benefits from universities' research and teaching outputs. However, to be effective in boosting UK innovation, increased supply of technological knowledge and skills must be matched by stronger demand and capabilities from within business in the UK to draw on and exploit this resource produced by universities. There needs to be better dialogue and interaction between the two sectors, with a stronger pull from business and more responsive supply from universities.

**3.68** To identify how this might best occur and to draw on the widest possible international practice, **the Government is commissioning an independent review into how, over the coming decade, business can better draw on universities to the mutual advantage of both sectors.** The aim is to enable business-university interaction in the UK to provide a greater contribution to UK productivity growth and innovation performance.

**3.69** The review will consult widely with businesses, universities and national and regional administrations in the UK and overseas. The aim of the review will be to identify the benefits to business of greater interaction with higher education, how this can be promoted and how any barriers holding back business demand for universities' knowledge and skills outputs can be addressed. The review will examine a range of important issues, including:

- the national, regional and local economic impacts of business-university interactions, including how RDAs and Sector Skills Councils can best support such interactions;
- lessons to be learned from business-university interaction across a range of countries and from best practice in the UK;
- how business employers can better communicate to a responsive university sector their skills requirements and can improve the attractiveness of career paths to graduates and postgraduates, especially in technology; and
- the effectiveness of measures, such as the R&D tax credits, on business demand for research and skills.

**3.70** The review will report by summer 2003, to inform decisions on funding for business support, university research and knowledge transfer over the coming decade. It will build on the Higher Education Strategy which the Department for Education and Skills (DfES) is launching in January 2003, and will feed into the work of the DTI Innovation Review.

**DTI Innovation Review** **3.71** Building on the Government's science strategy and the growing level of resources for DTI innovation programmes, **the Government is launching a wide-ranging review of business innovation and its contribution to UK productivity growth.** The review, led by the Science and Innovation Minister working across Government with the DTI, the Office of Science and Technology, the Treasury and other stakeholders, will set out a clear strategy for improving the UK's comparative innovation performance. The review will report by summer 2003.

**Knowledge transfer** **3.72** Improved knowledge transfer is a key element of the Government's strategy for supporting science and research, and is starting to deliver stronger business-university collaboration. Funding for the HEIF will rise to £90 million by 2005-06, and the Fund will form the basis of a third permanent funding stream for universities, in addition to teaching and research. The HEIF will work with the RDAs to encourage links between universities and business, support universities in transferring knowledge into business and the community, and fund spin-out companies and the development of commercial enterprises to support knowledge transfer. The Government has also increased funding for other DTI knowledge transfer activities to £300 million by 2005-06.

**Research and development tax credits** **3.73** To encourage commercial R&D in the UK, the Government has introduced two new tax credits for small and large companies. A series of national roadshows has promoted take-up of the credits and the Inland Revenue is now preparing guidance for companies on how to utilise them. In its first year, the Government invested £80 million in R&D through the small companies' tax credit and take-up has continued to rise. The Government hopes that larger companies will follow suit, and **will continue to collaborate with business in developing guidance for the credits and considering options for changes to improve their operation.**

**Scientific Research Organisations** **3.74** **The Government also intends to consult on options to modernise the tax exemption for Scientific Research Organisations (SROs).** SROs are privately funded, not-for-profit organisations that promote technology transfer and innovation within industry. The Government believes that there may be a case for improving the existing tax rules to allow SROs to undertake a wider range of R&D activity beyond scientific research while remaining within the conditions for exemption from tax.

**Box 3.3: Commercialisation of science and technology research**

Technology transfer between the public and private sectors operates through many channels, including collaborative research, training, licensing of intellectual property and the creation of spin-off companies. To enhance public sector support for the creation of spin-off companies, the Government has funded the creation of 15 University Challenge Seed Capital Funds, along with the Wellcome Trust and the Gatsby Foundation. These provide a total of £65 million of initial investment capital to which 31 universities and 7 Research Council institutes have access. The programme has been recently expanded, with 19 Seed Funds now involving 57 institutions across England. The Proof-of-Concept Fund in Scotland and the Wales Spinout Programme operate to achieve similar goals.

This investment is now starting to bear fruit. By its third year of operation, the University Challenge programme had helped to finance the creation of 150 spin-off companies. Initial investment of £30 million by the Funds has attracted an additional £40 million from private sector sources. The best performing universities are now establishing a strong record in commercialising research through company formation, leading to growing portfolios of equity holdings in technology companies. Universities hold some £180 million of equity in spin-off companies, the total market value of which is now around £3 billion<sup>1</sup>.

<sup>1</sup>Annual UNICO-NUBS Survey on University Commercialisation Activities, financial year 2001.

**Broadband 3.75** The Government's goal is that the UK should have the most extensive and competitive broadband market in the G7 by 2005, with significantly increased connections to schools, libraries, further education colleges and universities. Take-up of broadband in the UK is growing substantially, the number of broadband subscribers having trebled since the beginning of the year. One million households and businesses are now connected and prices for consumers are as cheap or cheaper than those in the US, Germany and France.

**3.76** The continuing broadband challenge is primarily one for the industry, the role of government being to set the right framework for the market, above all by promoting competition and providing appropriate regulation to tackle significant market power. Government also has important, but tightly defined, roles as a purchaser for public services and as a source of assistance to help firms and other users make the most of new technology. The Government is investing in networking public services, with connectivity for schools, the National Health Service and the criminal justice system. A new UK broadband taskforce will focus on promoting broadband availability and take-up, and will support effective public sector broadband procurement.

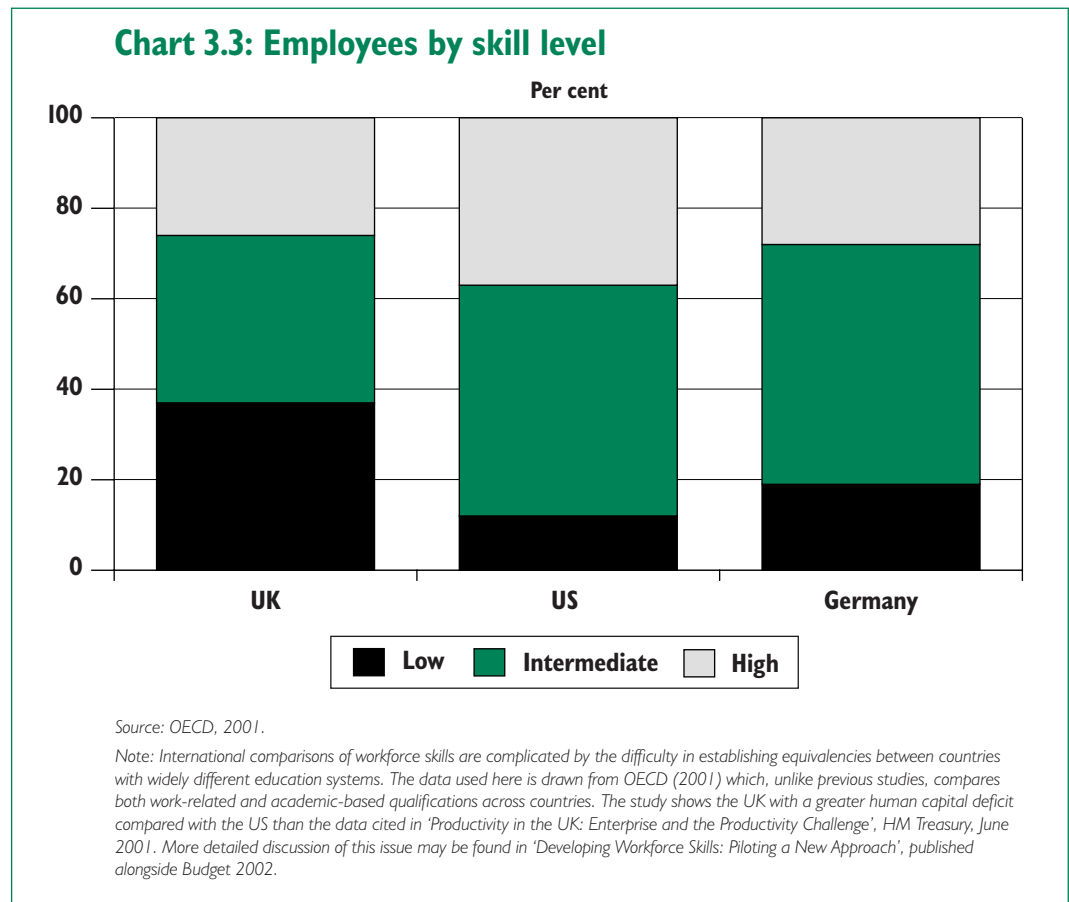
**Managing the radio spectrum 3.77** Radio spectrum is a valuable national asset of growing economic importance. However, new technologies and services are increasing the demands on this finite resource. The Government has taken steps in recent years to improve the management regime, increasing its responsiveness to market developments and establishing incentives for innovation and efficient spectrum use. The Communications Bill will build on this work, bringing responsibility for spectrum management within the remit of the Office of Communications (Ofcom) and introducing secondary trading of spectrum licences.

**3.78** The Government published its response to Professor Martin Cave's independent review of spectrum management on 15 October. The review recommended that all spectrum users should face incentives to promote efficiency and innovation by being exposed to the value of the asset under their control, and that this could be achieved through greater use of market-based mechanisms such as auctions, trading and pricing. The Government welcomes the conclusions of the review and is committed to implementing its recommendations. It agrees with the review that in some cases – for example, where spectrum is needed to provide

essential public services – applying the full range of market-based mechanisms may not be practical or desirable. In such instances, the Government believes that pricing and charging can ensure that public sector users face similar incentives for efficiency and innovation as comparable users in the private sector.

## SKILLS

**3.79** The quantity and quality of skilled labour available in an economy are important determinants of economic performance and productivity growth. A highly skilled workforce allows firms to update working practices and products at the rate demanded by rapidly changing markets, making the economy more flexible and productive in the long term. International evidence suggests that the UK suffers from significant skills shortages, especially at the lower-intermediate level. To raise UK skill levels and increase productivity, the Government is therefore 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** **3.80** The Government is determined to raise standards across the education system. Between 1997 and 2002, 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 51 per cent in 2002.

**3.81** To maintain progress, the Government has set demanding new targets, including minimum attainment targets for schools, to ensure that the education system meets the needs of all. The minimum attainment targets mean that up to 5,000 primary schools and over 1,000 secondary schools – mainly located in the most challenging localities, and especially in urban areas – will need to improve their performance significantly over the next five years. Planned reforms to the funding of Local Education Authorities will help to support increased local reforms in these schools. The new Leadership Incentive Grant will also enable secondary schools in challenging areas undertake a wide range of measures to develop excellent leadership.

**Post-16 participation**

**3.82** The skills and qualifications acquired by a young person through post-16 academic or vocational education are vital if they are to enter skilled employment. While reform in secondary education has led to a marked increase in attainment at GCSE level, the Government recognises that more work must be done to increase participation and attainment beyond the age of 16 towards the levels seen in competitor countries. In 2000, 86 per cent of 18 year-olds in Germany were enrolled in full-time or part-time education, compared with 56 per cent in the UK. The Government is concerned about the high number of 16 year-olds that do not currently continue in full-time education or training, but instead go directly into low-skilled, often part-time, employment without training, or that are not in education, employment or training at all – it is estimated that this is the case for 14 per cent of 16 year-olds in the UK.

**3.83** The Government is therefore setting an ambitious new target to increase post-16 participation in education and training that, by 2010, 90 per cent of young people will have participated in a full-time programme fitting them for entry into higher education or skilled employment by the age of 22. This will increase the proportion of young people expected to participate in such programmes from the current rate of around 80 per cent. Achievement of the target will require a significant reduction in the number of 16 year-olds not currently in full-time education or work-based training, and more support for those that need to progress further with their learning to reach the threshold for skilled employment. This target reinforces the Government's commitment to delivering quality vocational programmes, such as Modern Apprenticeships, and does not change the Government's continued commitment to ensure that, by 2010, participation in higher education increases toward 50 per cent of those aged between 18 and 30, as set out in the 2002 Spending Review.

**Modern Apprenticeships and work-based learning**

**3.84** To widen the vocational choices available to young people, and increase participation in work-based learning, the Government has reformed, strengthened and expanded the Modern Apprenticeships (MA) scheme by establishing:

- a target for 2004 that 28 per cent of young people should enter an apprenticeship by the age of 22;
- an entitlement, from 2004, to an apprenticeship place for all 16 and 17 year-olds with five or more GCSEs at A\*-G, including maths and English;
- a national framework to ensure world class standards, with a network of high quality Apprenticeship Agents to help more employers, including SMEs, deliver apprenticeships; and
- a major three-year marketing campaign to promote apprenticeships to young people and increase take-up.

**3.85** While recent measures have done much to improve the MA system, and reforms in secondary and further education are raising standards and participation in work-focused learning, more work is needed to ensure that standards are consistently high, that more young people are able to participate and complete their courses, and that more employers become involved in training young people.

**3.86** Employer involvement in MAs is critical to ensuring that the new post-16 participation target is met, and that MAs continue to meet the needs of UK firms while providing young people with high quality training opportunities in a work environment. **The Government is therefore launching a National Modern Apprenticeship Taskforce to champion the MA scheme and report on key policy issues.** The taskforce will be led by Sir Roy Gardner, CEO of Centrica, and will include individuals from across business and the education and training sector. It will report to the Chancellor, the Secretary of State for Education and Skills and to the Chairman of the Learning and Skills Council (LSC) on a range of important policy issues, building on the work of Sir John Cassels and his committee. These issues will include the involvement of SMEs in MAs, the MA framework, particular problems faced by some sectors in recruiting and training young people, and measures to support improved completion rates. The taskforce will be supported by its own secretariat.

#### Higher education

**3.87** Higher education is central to the development of a highly skilled workforce. The Government's aim is that, by 2010, 50 per cent of young people will have the chance to participate in higher education. To achieve its target, the Government is seeking to widen access to higher education and to improve the current funding system to ensure that universities are better able to sustain teaching and research excellence. The 2002 Spending Review provided additional resources to support improvements in the UK's international research competitiveness. Increased funding per student and targeted pay incentives will allow institutions to improve teaching and to recruit and retain key staff. However, questions remain about the longer term funding requirements of higher education, the appropriate balance between Government and private contributions to tuition costs, and the financial arrangements for students. The Government will publish its Higher Education Strategy document in January 2003.

#### Improving workforce skills

**3.88** Improving the skills of young people will help to lay the foundations for long-term improvements in the UK skills base. To deliver faster improvements, the Government is taking steps to improve training opportunities for those already in the workforce. New policies are starting to have an impact. The Skills for Life Programme has already supported nearly 250,000 adults to improve their basic skills, while the University for Industry, which offers flexible and convenient learning opportunities to meet adult training needs, has reached over 500,000 learners through *learnirect*.

**3.89** Although progress is being made in developing adult skills, workforce training is inhibited by a range of market failures. Businesses may be unable to gain the full returns to investment in employer training, and many individuals face financial barriers or are poorly informed about the value of training. Evidence suggests that these market failures affect low-skilled workers and those who work for small firms most of all.

**3.90** As set out in Budget 2001, the Government believes that, although voluntary approaches have secured increased participation in workplace training, they have not been sufficient given the scale of the problem. Addressing this problem is a priority and will require a step-change on the part of employers, individuals and government. The Government is therefore seeking to develop policy which helps employers and individuals to meet their responsibilities in this area.

**Box 3.4: Employer Training Pilots**

To test new measures to improve access to training, the 2001 Pre-Budget Report announced the launch of Employer Training Pilots from September 2002. Further details were published alongside Budget 2002<sup>1</sup>. The pilots are now operating in six local LSC areas. Firms that offer their low-skilled staff paid time off to train are being provided with subsidies (of up to 150 per cent of wage costs for small firms) to cover the costs involved in releasing staff to train, free training courses up to NVQ level 2 (including basic skills) and information and guidance on training.

The Employer Training Pilots are operating in Birmingham and Solihull, Derbyshire, Essex, Greater Manchester, Tyne and Wear, and Wiltshire and Swindon. Early evidence suggests that the model being tested in the pilots is proving successful in engaging low-skilled individuals in training, and employers have responded positively to the pilots. At the end of October, only two months into the pilots, nearly 500 employers had signed up to participate and almost 900 employees with low levels of qualifications and skills had committed to undertaking basic skills or NVQ level 2 training. Over 40 per cent of individuals signed up to the pilots so far work in firms employing fewer than 50 people.

<sup>1</sup>Developing workforce skills: piloting a new approach, HM Treasury and the Department for Education and Skills, April 2002.

**Increasing the demand for training**

**3.91** To gather further evidence on these methods of supporting training for low-skilled adults, the Government is now providing £130 million in England to enable the Employer Training Pilots to be extended for a second year, including resources from the Windfall Tax Margin as set out in Table 4.1. This will enable the Government to further explore the impact of existing pilots on the demand for training and allow the testing of a wider range of policy packages in different areas, with the pilots extended to around a quarter of the 47 local LSC areas.

**3.92** Employer Training Pilots are an important strand of wider Government work to improve workforce skills. The Cabinet Office Strategy Unit recently published its second report on workforce development and increasing the demand for training among employers and individuals. In addition, the DfES will publish a Skills Strategy in June next year, describing in detail the Government's plans to address UK skills shortages.

**Improving the supply of training**

**3.93** The performance of the further education sector is critical to the success of work to increase training and skills in the workforce. The 2002 Spending Review significantly increased the resources devoted to further education, with an additional £1.2 billion to be invested over the next three years. To match this increase in resources, the Government is introducing a series of reforms, including:

- a three-year budget and full 100 per cent end-year flexibility for the LSC, cascaded in full to local LSCs and in turn to providers, allowing them to plan on a longer-term basis;
- a new approach to funding which rewards colleges that deliver on their targets and provides clear incentives for all college staff to improve services;
- greater specialisation with more distinct provision for 16 to 19 year-olds, and more Centres of Vocational Excellence to meet employers' skills needs;
- raising the number of fully-qualified teachers, managers and leaders in the sector, ensuring better rewards for high performing staff and a major programme of teacher training; and
- pilots to improve the coordination of skills budgets and activities between local LSCs and RDAs at the regional level, as described earlier in this chapter.

**3.94** The Government is also reviewing the funding of adult learning to ensure that training providers have the incentives and capacity to respond to the needs of local employers. The review will examine how the entire post-19 learning budget could be more effectively deployed to:

- increase incentives for employers to engage in training;
- make institutions responsive to the needs of individuals and employers, in particular through building their capacity to work with businesses and organisations;
- widen participation in learning among low-skilled people; and
- enable the RDAs to play a full and effective role in developing and implementing regional skills strategies.

**Management 3.95** Strong management performance is a central determinant of productivity performance. In its report to the Government in May, the Council for Excellence in Management and Leadership (CEML) concluded that the UK faces pervasive management problems. The CEML report made 30 recommendations, including that the evidence base on management and leadership should be improved. As a result, the DTI and the Economic and Social Research Council have asked Professor Michael Porter of Harvard Business School to oversee a short research project as part of a broader study into UK competitiveness. Professor Porter will report in January 2003.

**Migration 3.96** Migration has always been a source of skills and labour in Britain, and over time has helped to improve productivity, raise economic growth and cover shortages in domestic skills. The Government has taken a number of steps to help employers facing skills shortages in the UK recruit from overseas. The work permit system has been reformed so that permits now last for up to five years and are processed more quickly – 95 per cent of complete applications are now dealt with in less than 24 hours. Steps are also being taken to ensure that employers – especially small businesses – and individuals have access to appropriate information on UK migration routes, improving the effectiveness of the system.

**3.97** The Government is now taking further steps to improve the service offered to SMEs by the work permit system. To ensure that SMEs can benefit fully from the system, **the Government is creating a new Small Business Unit in Work Permits UK to enable SMEs to access information about work permits and use the system more effectively to meet their skills needs.**

**3.98** To provide a further source of skills for the UK economy a pilot Highly Skilled Migrant Programme was launched in January 2002, allowing highly skilled individuals to enter the UK to seek and take work. Applicants to the scheme may demonstrate their eligibility by educational qualifications, work experience, achievements in their field or past income. Since its introduction, the scheme has helped many highly skilled individuals enter the UK to live and work, making a valuable contribution to the economy. In view of its success, **the Highly Skilled Migrant Programme will be extended.** To improve its effectiveness still further, the criteria for awarding points in certain categories will be revised from 28 January 2003. In particular, the past earnings category will be updated to better reflect income differences between countries.

**3.99** The Government recognises that those with very high skills are not the only people who contribute to the economy. Migrants with lower or intermediate skills may also complement the skills of the domestic population and help to raise productivity. Last month, the Home Secretary announced new sectoral migration schemes to help address skills shortages in specific sectors, such as the hospitality and food processing sectors. In the light of experience with these schemes, the Government will consider the case for further policy development in this area, working with other sectors where employers are facing labour shortages.

**Box 3.5: The economic effects of migration**

Migration affects a wide range of Government objectives and has a positive impact on growth and productivity, the public finances and on meeting labour and skills shortages in the public and private sectors. It can also have localised impacts on public services and community cohesion, which Government policy must recognise and manage.

Migration affects aggregate economic growth through its contribution to growth in the working-age population. It also affects growth in other ways. For example, evidence on the wages of the foreign-born population suggests that, overall, migrants are productive members of the workforce<sup>1</sup>. Through spillover effects, and as a potential source of innovation and entrepreneurship, migrants may also have a positive impact on the productivity of domestic workers and may therefore help to improve per capita income growth.

Labour at all skill levels can help to fill vacancies and avoid bottlenecks, increasing efficiency and productivity. Linked to this, evidence suggests that migrants' success in the labour market is not at the expense of the domestic population. Research in the UK finds little indication of a negative impact on domestic employment and suggests that immigration may, if anything, have a positive impact on domestic wages<sup>2</sup>.

Research by the Home Office has also found that migrants made a net positive fiscal contribution of £2.5 billion in 1999-2000, paying more in taxes than they received in benefits<sup>3</sup>. The full extent of the fiscal contribution made by migrants is difficult to calculate accurately, and depends on migrants' ages, economic activity, wages, skills and how long they stay in the country. However, the Home Office study states that £2.5 billion may, if anything, underestimate the contribution that migrants make.

<sup>1</sup> LFS data suggest that foreign-born weekly wages are around 19 per cent higher than the wages of people born in the UK (figures refer to an average over the period June 2001 to May 2002).

<sup>2</sup> *Secure borders, safe haven: integration with diversity in modern Britain*, CM 5387, Home Office, February 2002.

<sup>3</sup> *The migrant population in the UK: fiscal effects*, Gott and Johnston, RDS Occasional Paper No. 77, Home Office, 2002.

**INVESTMENT**

**3.100** Productivity growth relies on investment in physical capital to augment the productivity of labour. In the past, the capital stock of firms and the stock of public infrastructure in the UK has fallen well below those of competitor countries. These shortfalls help to explain the UK's relatively poor labour productivity performance, and reflect years of low investment in both the public and private sectors.

**Planning 3.101** An effective planning system is vital for successful and speedy development. The Government's proposals for reform of the planning system were set out by the Deputy Prime Minister in July 2002. The proposals include clearer and shorter central government guidance, statutory regional spatial strategies and more flexible local development plans. As described earlier in this chapter, **the Government also proposes to establish Business Planning Zones to facilitate business development in local areas.**

**3.102** The 2002 Spending Review allocated an extra £175 million by 2005-06 to secure a step change in the effectiveness of the planning system. A new Planning Delivery Grant will be introduced to incentivise improved performance by local planning authorities. The Grant will reward authorities in proportion to the extent of their performance improvement. Next year there will be additional funding from the Grant for regional planning bodies to strengthen the quality of regional planning, and for planning authorities in London and the South East to support delivery of existing housing targets. The Deputy Prime Minister will shortly set out full details of the new grant.

**3.103** The Government has set Best Value targets for 2002-03 for local planning authorities for handling planning applications, with separate targets for major applications, minor applications and other types of application. The Government has stated that it will be ready to intervene in cases of poor performance if there is no evidence of improvement, and has set standards for the poorest performing authorities. Last year 15 authorities were subject to standards and intensive monitoring because of poor performance, and the majority of these authorities have since improved significantly. This year 78 authorities are being monitored, with a particular focus on performance in dealing with major planning applications. The Office of the Deputy Prime Minister (ODPM) will publish a Service Delivery Agreement by the end of the year, setting out stretching targets for the period from 2003 to 2006.

**3.104** The Government is also committed to speeding up the process for consideration of major infrastructure projects that make a significant contribution to economic growth, and is considering how public inquiries into such projects can be made more efficient. Legislation will be brought forward to ensure inquiries can deal with issues concurrently rather than sequentially to save time. The Government will also examine whether these process improvements can be applied to other types of infrastructure inquiry.

**Housing 3.105** In recent years, serious imbalances between supply and demand have emerged in regional housing markets. In the North and Midlands nearly a million homes are afflicted by low demand and abandonment, while in other areas demand is not being met, with house building now at its lowest level since the 1920s and insufficient to meet the growth in household numbers. The Government has set a challenging new target to achieve a better balance between housing availability and demand in all regions.

**3.106** In his July statement on housing and planning, the Deputy Prime Minister acknowledged the scale of the challenge and emphasised the Government's commitment to achieve a step-change in housing supply, including by accelerating existing proposals to deliver significant growth in the South East. The Government is also committed to ensuring, through intervention if necessary, that local authorities in areas of high demand deliver the housing numbers set out in Regional Planning Guidance. These measures are being supported by substantial new investment. By 2005-06, investment in housing will have risen by £1.1 billion to £5.9 billion from this year's level, supporting a substantial increase in new provision of affordable housing. It will also allow nine pathfinder projects in areas of low housing demand to implement market renewal strategies, benefiting over 400,000 blighted properties and providing a boost to the economic regeneration of these areas.

**3.107** Reforming the way decisions on housing are taken is integral to successful delivery of the Government's objectives. The Deputy Prime Minister has therefore announced that **new regional bodies will be established, bringing housing investment within a single regional pot and ensuring better coordination with planning, transport and regional economic growth strategies**. Joined-up regional decision-making is essential to ensure that the supply of housing does not become an unnecessary constraint to regional economic development, and that growth is delivered in a sustainable way. These new regional bodies will provide the right conditions for delivery and facilitate the smooth transition of responsibilities and funding to Elected Regional Assemblies when these are established. The first steps towards this will be taken in 2003-04 when shadow structures, including RDA and English Partnerships representation, will be formed and arrangements agreed to facilitate joint working on Regional Housing and Spatial Strategies and associated regional investment plans.

**3.108** A key role of the planning system is to enable the provision of new homes in the right place and at the right time. This is important to ensure that everyone has the opportunity of a decent home and to maintain the momentum of economic growth, which should not be frustrated by a lack of homes for those wishing to take up new employment opportunities. The Government therefore expects regional planning bodies and local planning authorities to provide sufficient housing opportunities to meet the likely housing requirements of their areas. In doing so, they should provide a choice of sites which are both suitable and available for housebuilding. Local authorities must be realistic in their expectations of when sites will be ready for development. This will be a key element of the scrutiny of local plans by Government Offices. In revising its planning guidance on commercial development and industry, the Government will make clear that redundant commercial buildings and land currently allocated for employment should be considered for housing or mixed use development, unless a convincing case for retention of commercial use can be made.

#### Investing in transport

**3.109** Good transport links have an important role in promoting investment. They connect businesses and individuals to wider markets, and can open up new opportunities for employment, production and distribution. The Government's Ten-Year Plan for Transport sets out plans for public and private spending in excess of £180 billion to create a modern transport network across the UK. The Secretary of State for Transport will report shortly on progress toward delivering the ambitious objectives of the Plan. The Department for Transport (DfT) is also conducting a review of the Ten-Year Plan to reassess the way ahead, and roll forward the Plan into the next decade. The DfT and ODPM will work together to explore whether the process for taking the results of transport studies through the planning system can be streamlined so that, for example, the same issues are not consulted on twice.

**3.110** The Deputy Prime Minister's July statement announced reforms to improve the operation of the compulsory purchase system and the levels of compensation for those directly affected in this way by development, including transport infrastructure. The ODPM will continue work with other departments, including the DfT, on the compensation code, including compensation for indirect effects. A final report from the Law Commission on these issues is expected during 2003.

#### Airports

**3.111** Air travel offers significant economic benefits to the UK. Many thousands of jobs depend on the industry, and businesses rely on air links to provide access to markets and to bring in investment. Despite these benefits and continued growth in demand for air travel, UK airport capacity is fast falling behind that of other European competitors and many of the UK's largest airports are already reaching full capacity. These capacity constraints particularly affect airlines' ability to sustain 'hub' operations that allow a wide range of destinations to be served with high frequency. The Government is consulting on how best to maximise the benefits of growth in aviation, while striking the right balance between the social, economic and environmental impact of any airport development. These issues will be addressed in the Government's Air Transport White Paper, to be published next year.

#### Public enterprises

**3.112** As well as providing efficient public services, the performance of public enterprises has an important role to play in raising productivity in the UK. The challenge for government is to better fulfil its role as shareholder of these businesses. To achieve this **the Government has decided to create a Shareholder Executive located in the Cabinet Office**, bringing together departmental and external expertise including secondees, that will both advise and work with government departments. It will help them to distinguish and set out their long-term commercial and policy objectives for businesses, scrutinise and assess departmental capability and processes to fulfil their role as shareholder, and develop and monitor action plans to enable departments to implement change to structurally improve their ability as shareholder.

**The Myners review of institutional investment** **3.II3** The Myners review of institutional investment in the UK was published in March 2001. The Government confirmed last year that it would take forward all the recommendations of the review, including that for Codes of Investment Principles to encourage diversity in investment approaches. The Government will conduct an assessment of the effectiveness of these principles in delivering change, beginning in March 2003. Details of this review will be announced later this year.

**3.II4** Following the recommendations of the Myners review, the Government has consulted on three areas of proposed legislation:

- shareholder activism. The Institutional Shareholders' Committee has produced a new statement of principles that sets out strengthened responsibilities of institutional shareholders and agents, and outlines best practice on the part of institutional investors to promote their members' interests through more active engagement as shareholders. The Government welcomes this approach and the proposal to review the impact of the principles after two years. At that point the Government will review whether the non-legislative approach has been successful in delivering behavioural change;
- independent custodians. The review proposed increasing pension fund members' security by requiring funds to have an independent custodian. However, in the light of consultation, the Government has concluded that the existing regulatory requirements in this area are satisfactory and that further legislation would not be appropriate; and
- pension scheme trustees. Pension funds' investment decisions are of vital importance to the future security of their members and to the health of the wider economy, and the Government is committed to legislating to require trustees to have appropriate expertise. The forthcoming Pensions Green Paper, described in Chapter 5, will provide further detail on this issue.

**The Sandler review of retail savings** **3.II5** In June 2001, the Government appointed Ron Sandler, former CEO of Lloyd's of London, to conduct a review of the medium- and long-term savings industry, building on some of the recommendations of the Myners review. The review, which reported in July, examined the markets for medium – and long-term retail savings in the UK, identifying the competitive forces and incentives that drive the industries concerned and analysing the potential policy responses. Chapter 5 describes the review in detail.

**Accountancy and audit** **3.II6** Corporate crises in the US have highlighted the vital importance of strong frameworks for corporate governance, financial reporting and audit regulation in underpinning strong and efficient national and international capital markets. The Government has acted quickly to ensure that the UK's own arrangements are thoroughly reviewed and further strengthened where necessary. The objective is to rebuild investor confidence while acting proportionately. These issues have global implications and should not be considered merely in a domestic context. The Government has therefore encouraged the search for global solutions that will not hinder the growing and beneficial integration of international capital markets, working through the Financial Stability Forum and the EU.

**3.II7** In the UK, a number of core issues are being addressed by the Company Law Review. In addition, the Treasury and the DTI have established a Coordinating Group on Audit and Accounting Issues (CGAA) to review the UK accounting and auditing regime. An interim report by the CGAA contained a number of recommendations which the Government supports, and the DTI is now reviewing the regulatory arrangements for the accounting and audit professions. The CGAA also proposed that the Government should consider whether

competition in the market for large company audit and accountancy is currently too constrained. Following an examination of the competition issues, the OFT decided not to refer the market to the Competition Commission or to launch its own investigation at this stage, but to keep the market under review. Work to develop the Combined Code guidance for audit committees, commissioned by the CGAA, is taking place alongside Derek Higgs' Review of the role and effectiveness of non-executive directors, and the FSA is currently consulting on the role and practices of financial analysts.

**Box 3.6: The Higgs Review of the role and effectiveness of non-executive directors**

Effective non-executive directors play a central role in raising corporate performance. From the point of view of increasing productivity and competitiveness, a progressive strengthening of the role of non-executive director is strongly desirable. In April 2002, the Chancellor and the Secretary of State for Trade and Industry appointed Derek Higgs to lead a short independent Review into the role and effectiveness of non-executive directors.

Over 260 responses have been received to the Review's consultation document. The overwhelming majority converge on the view that the existing corporate governance framework in the UK, though fundamentally sound in its essentials, would benefit from progressive strengthening. The 'comply-or-explain' approach of the Combined Code is widely supported. A number of core themes emerged from the consultation:

- a need for greater clarity in defining the role of the non-executive director in the context of the Board as a whole;
- the important position of the Chairman of the Board, widely regarded as essential to facilitate effective individual director and overall Board performance, and the nature of the relationship between Chairmen and companies and their executives;
- the importance of independence, and the existence of a number of competing definitions of "independence" which is seen to be confusing;
- the need for a nominations and appointments process which is open, fair and rigorous to promote meritocracy;
- the fact that the current population of non-executive directors does not necessarily include all talented individuals with the right mix of skills, knowledge and attributes who could make a strong contribution;
- widespread recognition that relationships between shareholders and non-executive directors could be improved; and
- the potential value of appraising the mix of skills, knowledge and expertise needed on a Board, including more formal evaluation of individual and Board performance.

The majority of submissions are available publicly on the DTI's website.

In addition to the consultation process, more than 700 directors have been surveyed or interviewed in the course of the Review's work. The Review will also include a detailed review of the current population of non-executive directors and the composition of Boards in UK listed companies.

Derek Higgs will report to the Government in January next year.