3 MEETING THE PRODUCTIVITY CHALLENGE

Productivity growth underpins strong economic performance and sustained increases in living standards. The Government's long-term goal is for the UK to achieve a faster rate of productivity growth than comparator economies. Building on the reforms already introduced, the 2005 Pre-Budget Report sets out the next steps the Government is taking to drive productivity growth and meet the long-term challenges of the global economy, including:

- **taking forward the goals of the ten-year Science and Innovation Investment Framework** with measures to create a world-class environment for health research, to enable the UK to maintain a leading role in stem cell research, and a strengthened partnership with the biomedical industry to increase private investment in medical R&D by up to £500 million in the short to medium term, rising to £1 billion per year in the medium to long term;
- **setting out the Government's strategy for tackling the long-term lack of supply and responsiveness of housing,** responding to Kate Barker's independent review of housing supply, and bringing forward Real Estate Investment Trusts to improve efficiency in the UK's commercial and residential property investment markets;
- building on the planning reforms already put in place by **launching a review, led by Kate Barker, to consider how planning in England can better deliver sustainable economic development in a timely and transparent manner;**
- progress **implementing the recommendations of the Hampton Review to reduce the costs on business of administering regulations**. HM Revenue & Customs (HMRC) will set a target for reducing administrative burdens in the tax system in Budget 2006, and, as a first step towards this target, plans have been announced for £300 million savings for business through reforms to tax administration;
- **measures to reduce costs on business by removing unnecessary regulatory burdens** including: the abolition of Operating and Financial Reviews for quoted companies; a ten-point action plan to reduce regulatory burdens in the financial services industry; greater consistency in local authority regulation and a review of gold-plated regulations derived from Europe;
- **announcing an Independent Review, led by Andrew Gowers,** to ensure that the UK's intellectual property framework is appropriate for the digital age;
- **publishing the interim report of the Leitch Review of Skills** advancing the evidence base on the UK's existing skills profile and highlighting the need for the UK to raise its ambition if it is to have a world-class skills base by 2020; and
- additional **support for higher education exports** to sustain the UK's world-leading position and attract more highly-skilled overseas students.

3.1 Productivity growth, alongside high and stable levels of employment, is crucial for securing long-term economic performance and rising living standards. The UK has historically experienced low levels of labour productivity compared with other major economies. In recent years, however, the UK's performance on the Government's headline measure of productivity – output per worker – has been improving. As set out in Box 3.1, the gap with Germany has now closed and the gap with France has been narrowing. There remains a significant gap with the US. The Government's aim is to achieve a faster rate of productivity growth without compromising the strong employment performance of recent years.

The global economy

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

Meeting long-term challenges

3.3 *Long-term global economic challenges and opportunities for the UK,* published alongside the 2004 Pre-Budget Report, identified the challenges posed by increasing global competition, shifting economic activity and technological change. To meet these challenges and to promote growth, employment and productivity, the UK economy must be dynamic and entrepreneurial and be supported by a flexible and responsive welfare state.

3.4 The Government's strategy for improving productivity in this global environment has two broad strands: maintaining macroeconomic stability to help businesses and individuals plan for the future; and implementing microeconomic reforms to remove the barriers that prevent markets from functioning efficiently. *Globalisation and the UK: strength and opportunity to meet the economic challenge,* published on 2 December 2005, considers the factors affecting businesses' decisions as globalisation continues, including comparative advantage and the benefits of clustering, which influence trade and location patterns; and the importance of flexibility and macroeconomic stability in providing a foundation for a prosperous domestic economy. It identifies areas in which the UK is already well placed to meet the challenges of globalisation and where the Government is committed to doing more. This Pre-Budget Report sets out the Government's plans in these areas, in particular on skills, science and innovation, regulation, planning and land use, and transport infrastructure.

The five driver framework

3.5 These reforms are described in the context of the five key drivers of productivity:

- improving *competition,* which promotes consumer choice and encourages flexible markets and increased business efficiency;
- promoting *enterprise,* by removing barriers to entrepreneurship and developing an enterprise culture. An enterprising and competitive economy will mean the UK is well placed to respond to opportunities in a rapidly changing and increasingly integrated global market;
- supporting *science and innovation,* to promote the development of new technologies and more efficient ways of working. Increasing rewards to innovation mean that the UK's economic success will depend on its ability to create new knowledge and translate it into innovative goods and services;

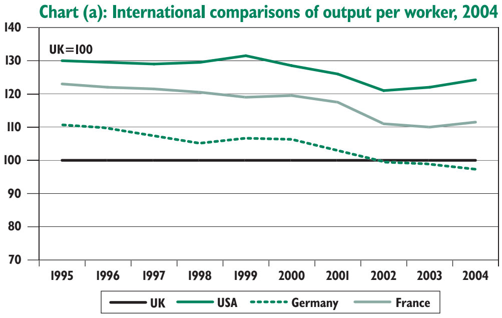
- raising *skills* levels, to create a more flexible and productive workforce, which can adopt innovative technologies and enable individuals to move into new areas of work. This need is reinforced by the rapidly rising levels of skills in emerging markets such as China and India; and
- encouraging efficient *investment* by the private sector, including through stronger capital markets. Capital markets are becoming ever more integrated in the global economy, and the UK economy increasingly competes with other economies for high quality investment.

Box 3.1: UK productivity performance and the global economy

Productivity growth is a key source of prosperity because, in the long run, it determines real wage growth. Over the second half of the twentieth century UK productivity performance has lagged that in the US, France and Germany. In recent years the gap has been narrowing, but new global challenges and opportunities are emerging. Increased global interaction and intensified competition will increase the speed of innovation and technological development, making the ability to absorb and develop new ideas and processes key to productivity growth. This in turn requires a skilled and flexible workforce to adopt and develop new technologies and processes. The UK has a world-class scientific research base, but increased global competition heightens the importance of translating more of this research into innovative products and services.

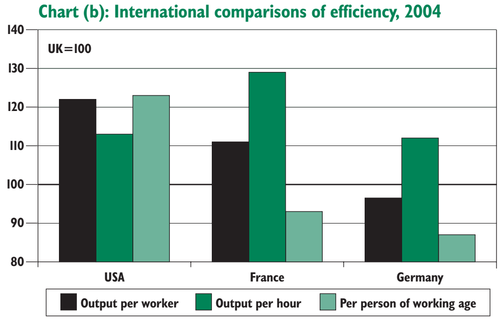
The latest data suggest that the UK has made some progress in its relative productivity performance. As chart (a) shows, over the past decade the UK has narrowed the gap in productivity with comparator economies and has closed the gap with Germany.

Chart (a): International comparisons of output per worker, 2004



Source: ONS
Note: Data for 2004 is provisional and subject to revision.

Chart (b): International comparisons of efficiency, 2004



Source: ONS, HM Treasury.
Note: Data for 2004 is provisional; output per hour worked is experimental data.

There are some encouraging signs that the UK's productivity performance is improving compared with recent past performance. From 1997 to 2005, actual trend productivity growth has grown at the rate of 2.35 per cent a year, compared with 2.03 per cent over the previous cycle.

There are several different ways to measure labour productivity, with the most common being output per worker and output per hour. However, as a measure of wider prosperity, it is useful to see how well the economy is using all of its potential labour resources, not just those in employment. Chart (b) shows the UK performs relatively well on this wider prosperity measure of productivity but that a gap remains on output per worker and per work hour. The challenge for the UK is to maintain its impressive employment performance while simultaneously boosting growth in output per worker.

European economic reform

3.6 Strengthening economic reform in Europe has been a key priority of the UK Presidency of the EU. The Government believes that structural reforms to promote greater flexibility in European labour, product and capital markets are crucial to ensuring that the EU can adapt to the challenges of globalisation and promote growth, employment creation and productivity.

3.7 In the autumn of this year, member states submitted their first National Reform Programmes (NRP) setting out the polices they intend to pursue to meet the challenges of globalisation; the Government presented the UK NRP to Parliament on 13 October 2005. During the UK Presidency, further steps have also been taken to reduce the burden of EU regulation on businesses, strengthen the transatlantic economic relationship, and deliver greater integration in European financial services markets.

Productivity in the regions

3.8 The Government's goal is to make sustainable improvements in the economic performance of all English regions and reduce the persistent gap in growth rates between the regions. Regional Development Agencies (RDAs) were therefore set up with a statutory remit to lead the strategic economic development in their regions. The Government believes that the best way to improve economic performance and overcome disparities in the regions is to invest in the drivers of productivity and encourage greater regional and local flexibilities in line with the *Devolving Decision Making Review*.[2]

3.9 Local areas, cities and regions all play an important role in promoting economic development, for example in:

- setting strategic growth priorities across a region and tackling regional market failures on enterprise, innovation, investment and other productivity drivers;
- ensuring that cities maximise their contribution to regional competitiveness; and
- developing local regeneration and growth schemes.

3.10 The Government has strengthened capacity at each of these levels for promoting economic development and regeneration as part of the devolved decision making framework, through:

- new responsibilities and greater flexibilities for the RDAs;
- a series of City Summits seeking views on how to strengthen cities' role further in driving economic growth and city-regional development plans developed as part of the Northern Way; and
- an economic fourth block for Local Area Agreements, Neighbourhood Renewal, New Deal for Communites, the Local Area Business Growth Incentives, the Local Economic Growth Initiative and Business Improvement Districts.

Cities and regional growth

3.11 The Government has been analysing the economic performance of its cities, alongside the work of the Core Cities and the State of the Cities Review, which is due to report in early 2006. In the north of England, for example, 90 per cent of economic activity is concentrated in eight main city-regions. In addition, cities play a pivotal role in providing the economic flexibilities and opportunities to respond to the challenges of globalisation. However, outside London, most city-regions under-perform relative to international competitors on several important productivity and employment indicators.

[1] See for example, *Devolving Decision Making: 2 – meeting the regional economic challenge: increasing regional and local flexibility*, HM Treasury, ODPM and DTI, March 2004.

3.12 Improving sub-national economic performance and regeneration requires action across local areas, cities and regions. To reflect the strong links between these levels, it is important to review interventions on economic development and regeneration in a coordinated way to assess their effectiveness. This will be done in preparation for the Comprehensive Spending Review to inform an assessment of progress against the Government's regional growth and regeneration targets.

Regional Development Agencies

3.13 Regional Economic Strategies (RES) set out the shared growth priorities for each region and local area. Six of the nine RDAs are currently reviewing their RES showing how regional partners will contribute to enhancing regional growth over the next ten years. This round of RES consultation has involved a stronger focus on the evidence base on regional economic performance, that has been built up in the five years since the RDAs were established, and on regional distinctiveness. The Government welcomes the publication, in June 2005, of the Northern Way business plan by the three northern RDAs and other regional partners as an important vehicle for driving action on economic performance in the north.[2] The Northern Way is developing a number of measures, described later in this chapter, as part of this plan to strengthen growth in the north, including new science research centres, skills pilots and transport interventions.

3.14 High quality regional data is important for underpinning these strategies. The Government committed in the 2004 Spending Review to implementing Christopher Allsopp's recommendations on improving statistics for regional economic policy.[3] Towards fulfilling this commitment, the RDAs have agreed to work in partnership with the ONS to deliver a full regional statistical presence by March 2007.

3.15 Building on their role as strategic leaders of growth in each region, and increasing regional input to national decisions, the RDAs have been asked to contribute to the development of Budget 2006 in three key areas: links between the national and regional frameworks on innovation; rationalising business support; and increasing private investment in economic regeneration.

COMPETITION

3.16 Competition stimulates improvements in efficiency and innovation by allowing the growth of successful firms. It also benefits consumers through lower prices and a greater variety of goods and services. Competitive UK firms operating effectively in global markets help drive higher growth and standards of living in the UK. The Government has radically reformed the UK competition framework through the Competition Act 1998 and the Enterprise Act 2002. These reforms created independent competition authorities with strong powers to combat anti-competitive activity and proactively investigate markets. The 2004 KPMG peer review of competition regimes ranked the UK regime third globally, and described the UK competition authorities as having all the necessary powers to develop a world-class competition regime.[4]

3.17 The Government supports a strong and proactive European competition policy, and welcomes the sector inquiries into energy and financial services launched by the European Commission in June 2005. The inquiries are examining areas where these key markets are not functioning on a competitive basis and will determine what action can be taken to remove the barriers identified.

[2] *Moving Forward: The Northern Way, Business Plan 2005-2008*, Northern Way Steering Group, June 2005.

[3] *Review of Statistics for Economic Policymaking*, Christopher Allsopp, March 2004.

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

Enhancing competition in markets

Competition authorities

3.18 The Office of Fair Trading (OFT) investigates markets that do not appear to be meeting the needs of consumers. Since the last Budget, the OFT has launched two new market studies looking at the effects of the Pharmaceutical Price Regulation Scheme (PPRS) and at the commercial use of public information. The OFT completed a market study into care homes in May 2005 and the Government has accepted that competition can be improved by providing better information for users.

3.19 The Competition Commission (CC) conducts more in-depth investigations into markets following referral from the OFT. Current CC investigations include store cards, where it is estimated that cardholders are paying excess prices for credit and insurance in the region of £80-£100 million a year, and the home credit market.

Energy

3.20 Secure supplies of energy, delivered through open, transparent and liberalised markets, are crucial for Europe's competitiveness. This is particularly important for the UK this winter. The independent energy regulator – the Office of Gas and Electricity Markets (Ofgem) – and the Government are taking a number of steps to ensure that the UK energy market is working as effectively as possible, and that reliable information is available on the level of supplies in the UK market.

3.21 On average, around 90 per cent of the United Kingdom's gas supply is sourced from the North Sea. The Government has worked closely with Ofgem to assess information about the reliability of this source and Ofgem has confirmed today that it is satisfied that all available supplies from the North Sea are currently flowing. The remainder of gas is imported, either through the gas interconnector between the UK and Belgium or through the liquefied natural gas (LNG) facility at the Isle of Grain. Concerns have arisen about the operation of the interconnector, in particular whether there is open access to gas supplies on the continent. Ofgem has asked the European Commission for an urgent investigation into the operation of the EU gas market, including whether there are any barriers to the free movement of gas that restrict supply to the interconnector. The Chancellor of the Exchequer and the Secretary of State for Trade and Industry have today written to the European Commission to ask for the investigation to be pursued urgently. There have also been concerns that the LNG facility is not being fully utilised by the market. Ofgem has confirmed today that it will, if necessary, use its powers to investigate and intervene including ensuring that LNG importers either "use or lose" their capacity at this facility, to ensure the UK market is operating effectively and the facility is fully utilised as needed during the winter.

Payment systems

3.22 Innovation, price inefficiency, access and governance are key issues in improving competition in payment systems. The Government therefore welcomes the Payment Systems Task Force agreement on faster electronic payments. The Government believes that access to all payment schemes should be fair, open and non-discriminatory and awaits the conclusions of the Task Force's work on access to the LINK scheme. The Government also expects the industry to improve transparency and to remove uncertainties and inconsistencies in current cheque clearing times, and is looking to the Task Force to examine the costs and benefits of moving to a faster clearing cycle.

3.23 The Government looks forward to the conclusions of the Task Force's work on governance across all payment schemes in the UK in March 2006 and believes that radical changes could ensure that current competition and efficiency problems do not arise again in future. The Government remains committed to legislating if there has not been a significant improvement in competition by the end of the Task Force's four-year lifespan.

Water **3.24** Since 1 August 2005 the Office of Water Services (Ofwat) has been inviting applications from prospective new licensees to supply water under the new water supply licensing regime. From 1 December non-household consumers who use large quantities of water have been able to choose whether to remain with their existing water company or be supplied by a new water supply licensee.

Spectrum use **3.25** Radio spectrum is a key resource for defence, aeronautical, maritime, and emergency services. In the 2004 Pre-Budget Report, Professor Martin Cave was asked to conduct a comprehensive audit of the spectrum currently held by the public sector. The audit, published alongside the Pre-Budget Report, recommends that market-based mechanisms should be extended to the public sector to provide ongoing incentives to maximise efficient use of spectrum. The Government welcomes the conclusions of the audit and agrees that spectrum being used inefficiently should be released to the market or shared with other users. This will create opportunities for the development of innovative new communications services. **The Government will work alongside the Office of Communications (Ofcom) to implement the audit's recommendations and the transition to the new approach.**

3.26 On the basis of the audit's band-by-band study, the Government is committed to making initial efficiency savings in approximately 2.5 per cent of public sector spectrum by 2007. The Government has also identified scope for further efficiency savings over the next five years in almost 65 per cent of public sector spectrum. Specific targets will be set for departments to achieve this. The value of the savings that will be realised will depend on the type of spectrum released and market conditions at the time of release.

3.27 In September 2005, the Government announced that the UK will switch to digital-only television between 2008 and 2012. The Government's established and declared policy is that future use of the spectrum released following digital switchover should be determined in a technology-neutral auction or auctions. Ofcom has recently launched a programme of work to assess how the cleared spectrum should best be made available for use.

Procurement **3.28** Good progress continues to be made on improving value for money through better public procurement. Following the Budget 2005 announcement of nearly £2 billion gains, the Office of Government Commerce (OGC) now reports further gains across central civil government of £2.3 billion. The implementation into UK law early in 2006 of two revised EU procurement directives, covering public sector and utilities purchasing, will make the procurement rules more helpful to today's purchasers and suppliers. These new laws will update and clarify the existing texts to reflect modern procurement methods and approaches. To accompany the Regulations, OGC will publish guidance notes on new areas covered, such as framework agreements and competitive dialogue. A training module on the new rules is available on the OGC website.

3.29 Small and medium enterprise (SME) involvement in public sector procurement improves competition and drives innovations, improving value for money in the delivery of public services. The 2004-05 Small Business Service (SBS) survey recorded over £1 billion of contract value awarded to SMEs, compared with £792 million for 2003-04, representing 22 per cent of the value of contracts. The Small Business Service (SBS) will today publish details of this survey.[5] OGC and DTI are contributing to this growing figure through the rollout of the National SME Procurement Programme, following successful pilots in the West Midlands and Haringey Initiatives that will enable SMEs to compete effectively for government business include:

- a national low value opportunities portal to be implemented in early 2006;
- a standard simplified pre-qualification questionaire introduced;
- training for SMEs (including those from the voluntary sector) and procurers is being delivered nationwide; and
- work with key suppliers to government to open up supply chains to promote a diverse sub-contractor base.

3.30 In Budget 2005 OGC and SBS were asked to investigate the public sector's use of third-party accreditation services. Research was completed in October 2005. Recommendations include more standardisation of accreditation models and greater clarity for contracting authorities on the most effective way to use accreditation services. A report outlining these findings will be released before the end of the calendar year.

Kelly Review

3.31 The Government is aiming to achieve greater value for money and increase competition and capacity in major government markets, implementing the recommendations of the Kelly report. A new Public Sector Construction Clients' Forum, chaired by Sir Christopher Kelly, has been established by OGC. As a single departmental forum, this will strengthen the leadership and co-operation of public sector construction activity. **With the award of the 2012 Olympics to London, an in-depth analysis of its impact on construction in the South East has been commissioned.** For the waste management market, a comprehensive survey of all local authorities has revealed significant issues with how waste procurements are being brought to the market. The results of this will be announced shortly.

Wood Review

3.32 Progress has been made on all the 15 recommendations from the Wood Review, published in November 2004, which found that significant obstacles stood in the way of effective competition in EU public procurement markets. In particular, the UK has been working with the European Commission and EU Member States to promote best procurement practice across the EU.

3.33 The adoption of best procurement practice in e-procurement could lead to savings for governments of up to 5 per cent on expenditure and up to 50 80 per cent on transaction costs for both buyers and suppliers.[6] OGC is promoting take up of e-procurement across the public sector through the Government Procurement Card and e-Auctions. e-Auctions run so far could produce savings of £18 million.

[5] Available at www.sbs.gov.uk

[6] *European Commission Action Plan for e-procurement*, European Commission, December 2004.

ENTERPRISE

3.34 Enterprise is essential to a dynamic, modern and growing economy, helping to boost productivity, create employment and prosperity, and revitalise communities. As the third international Advancing Enterprise Conference on 2 December 2005 set out, a more entrepreneurial economy is vital to enable the UK to meet the challenges of an increasingly competitive and globalised market. Going forward, the Government will focus on further improving the UK business environment and tackling barriers to business growth to allow the UK to fulfil its potential as an entrepreneurial economy.

Leading regulatory reform

3.35 Effective and well-focused regulation can play a vital role in correcting market failures, promoting fairness and increasing competition. However, the Government believes that inefficient and over-burdensome regulation can impose a significant cost on business without improving regulatory outcomes. The importance of reducing regulatory burdens in a global economy where technology and the growth of emerging markets impact on businesses' decisions is highlighted in *Globalisation and the UK: strength and opportunity to meet the economic challenge.*[7] The Government has pursued a programme of reform to deliver better regulation, announcing extensive reforms in Budget 2005 to the ways in which regulations are made and enforced, which reinforce the Government's objectives to:

- ensure that regulation is used only where necessary, that it is only used to achieve policy outcomes for which there is a clear rationale, where the benefits outweigh the costs and where alternatives to regulation are not feasible;
- minimise the administrative burdens upon business of understanding regulations and complying with them, including the costs of paperwork, undergoing inspection and complying with enforcement activity; and
- because over half of all new regulations affecting UK businesses originate in the EU, pursue an agenda of regulatory reform in Europe.

Regulating only where necessary

3.36 The reforms announced in Budget 2005 build upon recent changes made to strengthen systems of regulatory scrutiny and accountability. Since it was established last year, the Prime Minister's Panel for Regulatory Accountability (PRA) has been holding departments to account for their regulatory performance by scrutinising all new regulatory proposals that impose a significant cost upon business. The existence of the PRA institutionalises in the policy-making process the Government's principles of better regulation, and it will remain at the heart of the further reforms being made by holding departments to account for their progress. The PRA continues to reject and delay a significant proportion of regulatory proposals, and is delivering significant benefits for business:

- in response to a target set by the PRA, the Department of Trade and Industry (DTI) has published a detailed plan to deliver annual savings of around £200 million a year for business over the next five years, by simplifying regulations for which they are responsible;

[7] *Globalisation and the UK: strength and opportunity to meet the economic challenge*, HM Treasury, December 2005.

- the Health and Safety Executive has agreed plans to extend risk-based inspection and enforcement practices across its operations, including a commitment to cut the burden of form-filling by 25 per cent; and
- the Department for Environment, Food and Rural Affairs (Defra) has published details of its simplification plan to reduce administrative burdens on business from their regulations. Its 65 initiatives will save business in excess of £86 million per year.

Removing unnecessary burdens

3.37 In response to recommendations made at Budget 2005 by the Better Regulation Task Force, chaired by Sir David Arculus, the Government has adopted a strengthened regime that forces departments to prioritise between new regulations, and to simplify and remove existing regulations.[8] Government departments are now committed to:

- always explore 'one-in, one-out' options for removing unnecessary and outdated regulations as part of the Regulatory Impact Assessment (RIA) process when new regulations are being proposed. The PRA will reject proposed regulations from departments unless the scope for off-setting simplifications has been addressed;
- always respond, in detail and within 90 working days, to suggestions made to government by businesses and business groups for regulatory simplifications. A new portal through which businesses can submit proposals to government has been established;[9] and
- produce and publish early next year, for each department, a rolling simplification plan for reducing regulatory burdens on business over time.

3.38 The Government is also committed to implementing EU regulations in the least burdensome way possible, and not 'goldplating' EU directives in UK law unless there is a strong and proven case for doing so in the interests of consumers, business and society. However the Government recognises that, prior to best-practice guidance for policy-makers published in Budget 2005 to ensure that all new EU requirements are not inappropriately goldplated when transposed into UK law,[10] the stock of existing laws that originate from Europe may not have been transposed in the least burdensome way possible. **The Government has therefore asked Neil Davidson QC, the former Solicitor General for Scotland, to work with the Better Regulation Executive to scrutinise departments' efforts to identify aspects of UK law that have gone beyond the regulations required by the EU, and selectively review areas of UK legislation where the EU-sourced rules are most prevalent.**

[8] *Less Is More: Reducing Burdens, Improving Outcomes*, Better Regulation Task Force, March 2005.

[9] Available at www.betterregulation.gov.uk

[10] *Transposition Guide: how to implement European directives effectively,* Cabinet Office, March 2005.

3.39 Although the process of implementing the reforms announced in Budget 2005 has only just begun, the Government has announced some early benefits for business. **The Government is abolishing the statutory requirement for quoted companies to produce an Operating and Financial Review (OFR), reducing the burden on business by an estimated £33 million every year. Instead of the more prescriptive reporting requirements of the OFR, which would have imposed greater burdens across all businesses, quoted companies will instead be required to produce a Business Review.** This reduces business costs by up to 80 per cent while maintaining all the key reporting requirements and performance indicators necessary for shareholders to monitor business performance and risks, including on environmental and social issues where these are material to the business. The Business Review represents a significant advance in reporting standards in line with the minimum requirements of the EU Accounts Modernisation Directive.[11]

3.40 The central requirements of the Business Review[12] are largely identical to those of the statutory OFR,[13] and companies must still disclose all material information. Like the OFR, the Business Review requires a balanced and comprehensive analysis of the development, performance and position of the business; a description of its principal risks and uncertainties; and analysis using appropriate financial and other key performance indicators.

3.41 The Business Review also requires the disclosure of any information that is material to understanding the development, performance and principal risks affecting the business, including on environmental matters, employees, social and community issues, and information about the company's policies and their implementation. But for businesses where this information is not material, there will be less pressure than with the OFR needlessly to incur the cost of providing it, and reduced legal and assurance-driven compliance costs.

3.42 By focusing reporting upon those issues that are material to the company and its stakeholders, the improved narrative reporting of the Business Review will help focus and improve corporate engagement with all stakeholders. Many, particularly larger, quoted companies already provide more information than the Business Review minimum requirements, and the OFR will be maintained as voluntary guidance. The Government remains committed to improving strategic forward-looking narrative reporting by companies.

Regulation of financial services

3.43 Following last year's review of the Financial Services and Markets Act, the Government is announcing a ten point action plan of reforms to wholesale and retail financial markets, which reflects the greatest concerns that businesses have raised with the Government about the burden of financial services regulation, as described in Box 3.2.

[11] Directive 2003/51/EC of 18 June 2003.

[12] The current requirements for the Business Review are set out in section 234ZZB of the Companies Act 1985.

[13] The current requirements for the OFR are set out in Schedule 7ZA of the Companies Act 1985.

Box 3.2: Reforming the regulation of financial services

This ten-point plan for further modernising the regulation of financial services over the next year or two has been drawn up alongside the Financial Services Authority's (FSA) own Better Regulation Action Plan to benefit both wholesale and retail financial markets.[a] Working with industry, consumers and the FSA, the Government will:

Modernise the scope of FSA regulation by:

1. reviewing all 135 articles of the Regulated Activities Order in light of market developments, to amend where possible the activities the FSA can regulate, with the aim of simplifying compliance and reducing costs for business;

2. reviewing all 83 articles of the Financial Promotion Order and the financial promotion restriction in Financial Services and Markets Act (FSMA), to reduce where possible the complexity and cost of marketing communications by financial firms;

3. reviewing the "controllers regime" in Part XII of FSMA, to reduce the need to tell the FSA about changes in control over regulated businesses, aiming to cut some reporting requirements by up to 15 per cent, with particular benefits for fund managers, nominees and custodians; and

4. broadening last year's exemptions from financial regulation for employers advising employees on work-related financial matters, including pensions, health, income and life insurance, share incentive schemes and share saver schemes.

Further enhance the FSA's risk-based regulation by:

5. introducing a Regulatory Reform Order so that the FSA may waive or modify more rules to cut compliance burdens, and may avoid burdening industry with consultation on up to 20 smaller measures per year; and

6. conducting a value for money review to examine the FSA's use of resources, to help the FSA operate efficiently, economically and effectively.

Improve the regulatory framework by:

7. improving consumer credit regulation through better joint working between the FSA and OFT, reducing the administrative burden on firms;

8. considering the scope for reducing regulatory restrictions in the longer term, by enhancing consumer education and understanding of financial services;

9. informed by the findings of the FSA's imminent review of mortgage and general insurance rules, considering with the OFT any adverse effects of financial regulation on competition in these sectors; and

10. introducing, in line with BRTF recommendations, simplification plans and quantified burden reduction targets to sharpen the deregulatory focus.

[a] *Better Regulation Action Plan,* Financial Services Authority, December 2005

Reducing the administrative burden of regulation

3.44 As well as pursuing better and more proportionate regulation overall, the Government believes that the costs to businesses of administering regulations should be as low as possible without jeopardising regulatory outcomes. Following the recommendation of Sir David Arculus and the Better Regulation Task Force to adopt an approach first used in the Netherlands, the Government is undertaking a project to measure the total administrative burden on business of complying with government regulations. The Government will next year set stretching but achievable targets for reducing this burden over time, and these targets will be met as departments implement the recommendations of the Hampton Review.[14] Following a parallel process in the tax system the first department to set such a target will be HMRC in Budget 2006. As outlined in Box 3.4, ahead of this target being set HMRC have announced plans to deliver around **£300 million of savings to business every year by extending the Hampton principles of regulatory enforcement into the tax system.**

Risk-based regulation

3.45 The Hampton Review of regulatory inspection and enforcement, recommended that the government adopt a system of risk-based regulatory enforcement. The Government has accepted the Review's recommendations and believes that by focusing regulatory resources on areas of greatest risk, the administrative burden of complying with regulation for the vast majority of compliant business can be reduced, while maintaining or improving the UK's record of excellent regulatory outcomes. The Government is implementing the Review's recommendations in full and is applying a risk-based approach to all aspects of regulatory enforcement, including when making data requests from businesses, when issuing forms, when applying penalty regimes and when undertaking inspections. The review estimated that by taking this approach the number of inspections could be cut by 1 million, and the burden of form-filling by 25 per cent. Box 3.3 outlines the progress already made in delivering the Hampton Review's recommendations.

[14] *Reducing Administrative Burdens*, Philip Hampton, March 2005. Available at www.hm-treasury.gov.uk

Box 3.3: Implementing the Better Regulation Action Plan

In May 2005, the Government published an Action Plan which set out the timetable for implementing the wide-ranging reforms to the UK's regulatory framework that were announced in Budget 2005. The Government has met the milestones set out in that plan, and remains on track to deliver these fundamental reforms in full by 2009. Already the Government has:

- **prepared the Regulatory Reform Bill for introduction to Parliament, which will reinforce the principles of risk-based regulatory enforcement as the heart of regulatory practice. It will make the removal of complex or outdated regulation, and the reform of regulatory structures, simpler and quicker;**
- **made progress merging regulatory bodies, with the Adventure Activities Licensing Authority likely to be the first body to merge into the Health and Safety Executive in 2006. By April 2009 31 existing national regulators will be consolidated into just seven bodies, to streamline enforcement and reduce complexity for business;**
- **established the Local Authority Better Regulation Group to drive through joined-up enforcement and consistent inspection practices at the local authority level. It will be reporting progress this month, including a new Regulatory Compliance Code, incorporating the Hampton principles of risk-based enforcement;**
- **begun a Better Regulation Executive-led review of regulatory penalty regimes, under Professor Richard Macrory. It aims to make penalty systems more consistent across regulatory bodies, ensuring that they reflect the impact of the offence, with tougher penalties for businesses that persistently break the rules; and**
- **started to reduce the burden of form filling ahead of new principles to be published next year on shortening forms and greater data sharing between regulators, for instance by abolishing a requirement for 400,000 small businesses to reapply for small business rate relief every year; and by introducing a single comprehensive application form for planning applications and associated consents.**

3.46 A key concern for business identified by the Hampton Review was lack of consistency and coordination in local authority regulatory services. To address this concern, building on the work of the Local Authority Better Regulation Group and initial proposals for a Consumer and Trading Standards Agency (CTSA), **the Government instead will establish a new body – the Local Better Regulation Office (LBRO).** The LBRO will not be a new regulator. It will have a clear central mission to minimise burdens on business and work in partnership with local authorities and the national regulators to deliver a risk-based approach to business inspection and enforcement, driving up performance standards within the wider local government performance framework. The LBRO, working with the national regulators, will ensure a single coordinated set of priorities for local authority regulatory services covering trading standards and environmental health. It will secure improved consistency and coordination for all businesses, particularly those that operate across local authority boundaries, building on the Home Authority principle. **The OFT will take on the other roles envisaged for the CTSA building by Hampton**, and will work with LBRO and other national regulators to drive through the Hampton principles.

Strengthened regulatory scrutiny

3.47 To deliver this programme of regulatory reform the Government has built stronger and more independent structures of regulatory accountability at the centre of Government. A new Better Regulation Executive (BRE) has been established in the Cabinet Office to drive delivery across Whitehall, and support the PRA in holding departments and regulators to account. William Sargent, from the media company Framestore CFC, has been appointed as the private sector chairman of the BRE.

3.48 The Government has also set out plans to transform the Better Regulation Task Force (BRTF) into a new Better Regulation Commission (BRC) to sit alongside the BRE and provide independent business-focused advice to the Government about its overall regulatory performance. Rick Haythornthwaite, former Chief Executive Officer of Invensys plc has been appointed to chair the new commission.

Regulatory reform in Europe

Regulating only where necessary in the EU

3.49 The Government has placed regulatory reform at the heart of its presidency of the EU. In December 2004 the UK launched the "6 Presidency Initiative on Advancing Regulatory Reform in Europe" with the support of the five other Member States holding the EU Presidency from 2004 until the end of 2006. Since the summer, the UK Presidency has worked closely with the Commission and the other 24 member states to promote progress on this agenda including:

- revised impact assessment guidelines with an enhanced competitiveness test published by the Commission in June 2005;
- the withdrawal of 68 items of pending EU legislation announced in September;
- a three-year programme of simplification tackling 1400 rules and regulations which businesses have indicated are the most burdensome ; and
- in November 2005 EU Finance Ministers endorsed a European methodology for the measurement of administrative burdens and called for the Commission to bring forward proposals to establish measurable targets for reducing burdens on business.

3.50 In November, Finance Ministers, led by the UK Presidency, called on the Commission to present proposals to ensure that SMEs, in particular, are protected from disproportionate burdens imposed by new EU regulatory proposals. At 6 December meeting of Ecofin, **the UK Presidency intends to propose, with the incoming Austrian and Finnish Presidencies, a further programme of regulatory reform for 2006 and beyond.** This will call for further progress toward risk-based regulatory enforcement, greater regulatory convergence between the EU and other major economic regions and increased business engagement in Europe's regulatory reform agenda.

Modernising and simplifying tax administration

Simplifying tax administration for small business

3.51 As set out in Chapter 5, the Government is committed to delivering a fair and efficient tax system for business. HMRC's vision for delivering improvements to the customer experience of smaller business was set out in a Budget 2005 consultation paper.[15] Building on the views expressed by business, *Making the new relationship a reality,* published on 28 November, sets out progress to date and summarises the continuing programme of further improvements.

Box 3.4: Making tax easier for small business

The consultation paper *Working Towards a New Relationship* asked for views from business on a new vision for the administration of tax in which businesses will provide information only once, spend less time dealing with inspections, benefit from a range of flexible payment options, enjoy a single point of contact with HMRC and benefit from clear and targeted support, education and guidance at the time they need it most.

During its first seven months, HMRC has:

- **delivered the short tax return, down from 16 to 4 pages for the smallest businesses, saving them a total of around £5 million in compliance costs;**
- **begun the withdrawal of payment via employers for tax credits, reducing employers' costs by an estimated £110 million;**
- **modified the reporting requirements for employment-related securities so that at least 90 per cent of new companies will not have to complete 'Form 42'. This will save an estimated 300,000 businesses up to £200 per form; and**
- **brought forward a package of measures for employers that will help them with payrolls, leading to a £10 million reduction in the burden of dealing with employees' queries over their tax affairs.**

Following the associated review of links with medium-sized businesses, significant improvements will be made to HMRC's enquiry process. The review published today sets out what medium-sized business as a sector told HMRC were its main concerns and outlines what actions HMRC will take to address them.[a]

HMRC and Companies House have issued a consultation on aligning filing dates as an essential first step towards a single filing system, which would remove duplication from both organisations' requirements, and at the same time reduce the burden to companies, particularly small and medium-sized ones. This responds to one of the initial recommendations emerging from Lord Carter's review of HMRC's online services and will lead to progressive compliance cost savings for business that are estimated to reach £100 million per annum after five years.

Together, it is estimated that these measures will save businesses up to £300 million a year of administrative burdens once fully implemented.

[a] *Better Working with Business*, HMRC, December 2005, available at www.hmrc.gov.uk

[15] *Working Towards a New Relationship*, HMRC, March 2005.

Deregulating tax administration

3.52 The Government is keen to work with both small and larger businesses to identify opportunities to simplify other tax regimes. HMRC are currently working on reforms to the alcohol duty regime and have identified around 30 regulations that will be repealed or simplified. HMRC will discuss these further with the industry and introduce these deregulatory changes in or before Finance Bill 2006. The Government will look at the scope for further deregulatory initiatives in the oils, tobacco, holding and movement, and environment tax regimes. It will also be reforming the excise duty deferment guarantee system, which will yield substantial savings for businesses in the alcohol, oil and tobacco sectors.

3.53 One example of deregulation in practice is stamp duty land tax. HMRC has improved and simplified the service provided to customers by offering an e-channel for delivery of the land transaction return, which provides for direct submission of a correctly completed return. The Government is committed to further deregulation of stamp duty land tax where appropriate and will continue to engage with stakeholders to identify and implement further improvements. In particular HMRC will explore with practitioners ways in which the stamp duty land tax treatment of more complex transactions such as dealings in commercial leases and partnership interests might be simplified, for consideration in Budget 2006.

Post-implementation reviews

3.54 Government departments complete Regulatory Impact Assessments (RIAs) for new regulatory proposals. The Government is committed to reviewing regulations after they are implemented to ensure that they are having the intended effect. **HMRC is today publishing a report on its methodology for reviewing the compliance cost assessments in published RIAs including the first case study used to test it, and two completed post-implementation reviews of compliance costs.** These reviews have demonstrated that the process was reasonable in each case given the circumstances at the time but they highlight improvements which can be made to processes and data collection. This is the first stage of a rolling programme looking at an area which has been a key area of concern for businesses. Carrying out these reviews will help the Government to improve its understanding of compliance costs and provide assurance that the figures used in RIAs are reasonable, as well as helping to inform and improve the quality of future RIAs. HMRC expects that these reviews will be published, in line with the proposed methodology.

Employee share ownership

3.55 The Government remains committed to supporting employee share ownership, which benefits companies, employees and the economy. A number of the administrative simplification measures being taken forward by HMRC will make it easier for companies to administer employee share awards. The Government also encourages employee share ownership through four tax-advantaged share schemes. Following the introduction of Enterprise Management Incentives and Share Incentive Plans in 2000, over 4 million employees are now estimated to be participating in one of the schemes. To further encourage businesses to offer shares to their employers under these schemes, HMRC intends to improve further the process for administration of employee share schemes that offer tax advantages, in discussion with shareholders.

Supporting small businesses

Flexible payment options

3.56 To help small businesses with cashflow difficulties and reduce administrative burdens, the **turnover threshold up to which businesses will be able to take advantage of the Annual Accounting Scheme will be increased from the current level of £660,000 to £1,350,000 from April 2006.** The Government has also written to the European Commission for derogation to **increase the turnover threshold for the Cash Accounting Scheme from £660,000 to £1,350,000.** These measures will benefit both small companies and sole traders, with up to 1 million small businesses able to benefit from a range of more flexible payment options to suit their business needs.

VAT Bad Debt Relief

3.57 The Government is committed to relieving the burden of debt on business and is looking at providing more help through the VAT Bad Debt Relief scheme to those businesses affected by customer insolvencies. In the coming months, **HMRC will be engaging with business representatives to assess options for providing more help, with a view to announcing the outcome at Budget 2006.**

Tax-motivated incorporation

3.58 Chapter 5 sets out the further action the Government is taking in response to continuing tax-motivated incorporation. The Government will replace the non-corporate distribution and zero per cent rates with a single banding set at the current small companies' rate of 19 per cent. This will simplify the corporation tax calculations for most small companies, refocus incentives, and leave the small companies' rate at its lowest since its introduction in 1973.

First-year capital allowances

3.59 To support this, and in the light of representations received from a number of small businesses and their representatives, **first-year capital allowances will, in the year from April 2006, be increased to 50 per cent for small businesses investing in plant and machinery.** This will reward up to 4.2 million small businesses, irrespective of their legal form, who choose to invest their profits for growth.

Access to finance

3.60 In the Budget 2004 the Government announced a temporary doubling of the rate of income tax relief for investments in Venture Capital Trusts (VCTs) to 40 per cent. This provided a stimulus to investment in VCTs, with fundraising increasing to a record £520 million in 2004. The Government remains committed to ensuring the long-term sustainability and success of the VCT market, and will announce the future level of VCT reliefs at Budget 2006. The intervening period will allow further analysis of trends in the VCT market and continued dialogue with key stakeholders.

3.61 For new and innovative businesses to succeed, they need to be able to raise finance to invest and grow. The Government is committed to addressing market failures in the supply of risk capital and improving access to finance for small business. The newly enhanced Small Firms Loan Guarantee scheme (SFLG) was launched on 1 December to provide better help to individuals seeking debt finance to start new businesses and to help small businesses aiming to expand. The changes follow the Graham Review of the Small Firms Loan Guarantee, published in October 2004, and provide additional targeted support to help start-ups and young SMEs with growth ambitions, but who continue to find a lack of collateral a barrier to accessing debt finance. All such businesses, including start-ups, which meet the banks' commercial criteria, will now be able to borrow up to £250,000. The bureaucracy around the scheme has also been removed, to allow banks and other approved lenders to integrate the scheme with their existing lending products.

3.62 The Government invited, in July 2005, commercial bids from experienced venture capital investors to run the pathfinder round of Enterprise Capital Funds (ECFs). 45 bids have been received to run the first ECFs, which will be commercially-managed entities investing a mixture of public and private capital in potentially high-growth small businesses affected by the equity gap. The Government has established a panel, chaired by David Quysner, Chairman of Abingworth Management Ltd, to provide expert advice on assessing the bids. The first ECFs will be established during 2006.

High growth business coaching

3.63 Well-designed and targeted business support can enhance the survival and growth prospects of both new and existing businesses, with the potential for high growth. In accordance with the priorities in their regional economic strategies, the Regional Development Agencies are working with Government on implementation plans and a framework for evaluation to ensure businesses have access to high quality, focused coaching. All nine regions have now agreed a model, centred around a dedicated, experienced coach to be rolled out across the regions on a phased basis from spring 2006. This includes the following:

- a structured programme of support including elements on investment readiness, innovation, market understanding, workforce skills, and leadership and strategic management;
- understanding how to finance growth, including how and when to access venture capital and other forms of finance, and managing cash flow in a growing business; and
- links to universities and research establishments.

Promoting creativity

3.64 The UK has a world-leading creative sector, directly contributing 8 per cent to UK GDP. By increasing the distinctiveness of their products, creativity allows large and small firms to compete in global markets on the basis of their unique appeal to consumers. Notwithstanding the success of the UK's creative industries, there is evidence that UK businesses are not realising the full potential of applying creativity more widely. In Budget 2005, Sir George Cox, chair of the Design Council, was asked to consider how best to ensure that businesses – SMEs and modern manufacturers in particular – apply creativity to improve their productivity and performance, enabling them to compete more effectively. The Cox Review of *Creativity in Business: building on the UK's strengths,* as outlined in Box 3.5, was published last week.

Box 3.5: The Cox Review of Creativity in Business

Sir George Cox's review of creativity in business urges the business community to harness creativity as a driver of performance, applying creative and design skills to their products and services. The Government supports this message. The report also identifies a number of steps that can be taken by government, businesses, broadcasters and educational institutions working together to enhance the UK environment for creativity, including:

- **creativity and innovation centres around the UK to raise the profile of the UK's world-class creative capabilities, including a central hub in London;**
- **nationwide rollout of the Design Council's Design for Business programme;**
- **improving the effectiveness of government support and incentive schemes, including recommendations to the review of R&D tax credits;**
- **building the capacity for creative entrepreneurship through the higher education system; and**
- **taking further steps to harness the power of public procurement to encourage more imaginative solutions from suppliers.**

In parallel with the Cox review, the DTI has published an economic study of the relationship between creativity and design in business performance,[a] highlighting that effective use of creative inputs is vital to improving firms' competitiveness.

[a] *Creativity, Design and Business Performance*, Economics Paper No. 15, Department of Trade and Industry, December 2005.

3.65 The Cox review points to the challenges both for government and for businesses in exploiting the UK's world-class capabilities to improve the distinctiveness of products and services and to help UK businesses to compete successfully in global markets. The Government supports Sir George Cox's call for a dialogue within the business community to ensure that the performance benefits for businesses which arise from the successful application of creative skills are more widely understood and taken up.

3.66 The Government welcomes the Cox review and will be taking forward the recommendations it makes for the public sector. In particular the Design for Business programme will be made available across the country by the RDAs, and the Higher Education Funding Council for England will lead the piloting of centres of excellence combining capabilities in business, engineering, technology and creativity as part of its Centres for Excellence in Teaching and Learning. The Government has considered the recommendations that Sir George Cox has made to the review of R&D tax credits and will be taking a number of them forward. Further, Sir George Cox will work with industry leaders from design, the arts and business and in partnership with the London Development Agency and other RDAs to develop a new network of creativity and innovation centres across the country, including a national hub of international stature in London.[16]

[16] *Supporting growth in innovation: next steps for the R&D tax credit*, HM Treasury and HMRC, December 2005.

3.67 Following the Chancellor's announcement in Budget 2005 to provide £12 million to promote excellence in management and leadership within the cultural sector, the Arts Council will launch the Cultural Leadership Programme early in 2006. The programme will aim to promote business and leadership skills among high flyers in the sector, will encourage the talents of leading ethnic minority figures in the arts, and will create new opportunities for business-arts collaboration.

Creating an enterprise culture

3.68 Promoting and strengthening UK enterprise culture must begin with helping young people to develop entrepreneurial skills and aspirations. The UK's second Enterprise Week in November 2005 delivered over 1,000 events, encouraging young people to consider entrepreneurship as a career option. Building on this, the Government is introducing a series of programmes to ensure that young people in the UK are given the confidence and skills to apply their creativity and entrepreneurial drive to the world of work, including:

- the roll out of £60 million a year for the three academic years from September 2005 to deliver at least five days, enterprise education to every pupil at Key Stage Four;
- **from next summer, 11 pilot business-led Enterprise Summer School Pathfinders,** to investigate how to best deliver an extra-curricular enterprise experience to young people and inform a national roll-out in summer 2007; and
- **the National Council for Graduate Entrepreneurship will begin discussion with the Kauffman Foundation, US universities and businesses to create a US Enterprise Scholarship programme for UK students, and extend the New Entrepreneur Transatlantic Scholarship programme for young people from the most deprived areas of the UK.**

3.69 The Chancellor launched Enterprising Britain in June 2004 to reward those places that were creating environments where an enterprising culture can thrive. Enterprising Britain is a national award to find the town, city or place in the UK that is best improving economic prospects and encouraging enterprise. This year's winner was the Sherwood Energy Village.

3.70 The Chancellor hosted the third international Advancing Enterprise Conference on 2 December 2005. This event brought together leading international businesses leaders, entrepreneurs and Government representatives to discuss how this partnership can further build on the UK's key enterprise advantages in free trade, stability, free-thinking science, belief in education and openness to the world.

Women and enterprise

3.71 Budget 2005 welcomed the action plan to increase women's business ownership in the UK. From spring 2006 the Task Force on Women's Enterprise will work with Government and the RDAs, over three years, to increase levels of female entrepreneurship by accelerating the implementation of this action plan. To take the UK further towards US levels of entrepreneurship, the Task Force will:

- ensure that every regional economic strategy includes a plan to increase women's enterprise rates, and that all RDAs have a strategy for incorporating women-friendly business support into mainstream provision;
- robustly evaluate the regional Women's Enterprise Unit pilots, working with all nine RDAs to ensure that lessons from the pilots are reflected in delivery;

- work with all publicly-funded business finance and support sources to collect data on the number of women-owned businesses to monitor progress on access levels for finance, advice and coaching; and
- propose and drive the implementation of measures to improve awareness and access to formal sources of finance for women entrepreneurs.

Enterprise in disadvantaged areas

3.72 The Local Enterprise Growth Initiative (LEGI) announced in Budget 2005 will provide flexible, devolved investment in some of the most deprived areas to support locally developed and owned proposals that pursue new or proven ways of stimulating economic activity and productivity through enterprise development. The aim is to effect a transformation in deprived local communities that will remain for generations to come, using economic development as the primary mechanism for change. LEGI will be worth £50 million per year from 2006-07, rising to £150 million per year by 2008-09 (subject to confirmation in the 2007 Comprehensive Spending Review).

3.73 Following the LEGI consultation, the Government published in July 2005 *Enterprise and economic opportunity in deprived areas: Local Enterprise Growth Initiative – Next Steps,* which outlined the steps needed during implementation of the first phase of LEGI to ensure it is a success for the long-term.

3.74 The Government recently published an application pack containing criteria and an application form template for use by local authorities in developing and submitting their proposals. Not all eligible local areas will necessarily receive financial support from LEGI. Local areas will be selected on the basis of the quality of the proposals submitted and the ability to deliver positive and tangible outcomes for the local community, working in close partnership with the business community and the Regional Development Agencies. **Local proposals developed by these partners will be submitted to the Government Offices in the regions by 9 December 2005, and successful applicants will be announced in early 2006.**

3.75 The under-served markets project has demonstrated that clear commercial opportunities exist in England's most deprived wards. The Government has therefore extended this project by a further year, continuing to focus on encouraging retailers and other businesses to invest in deprived areas, building on the practical experience of the business-led regeneration of Harlem, New York. In close co-operation with the private sector, the Government has identified 12 priority areas for investment and will finalise in the coming year a series of demonstration pilots, to replicate the Harlem model.

SCIENCE AND INNOVATION

3.76 Science and innovation have a pivotal role in advancing the UK's long-term competitiveness in an increasingly knowledge-driven global economy. The nations that can thrive in a highly competitive global economy will be those that can compete on high technology and intellectual strength as set out in *Globalisation and the UK: strength and opportunity to meet the economic challenge.*

3.77 In July 2004, the Government published a ten-year *Science and Innovation Investment Framework,* which set out a long-term vision for UK science and innovation, together with the ambition that public and private investment in research and development (R&D) should reach 2.5 per cent of GDP by 2014. The Government also made a commitment to review progress against the measures set out in the ten-year framework on an annual basis and the first Annual Report was published in July 2005.[17] The report found that good progress had been made on key indicators for implementing the framework, with the UK maintaining its position as second only to the US in global scientific excellence and continuing strong growth in the level of knowledge transfer activity in UK universities. However, the report also identified some key challenges, notably on further increasing levels of business investment in R&D, and making more rapid progress on improving science, engineering, technology and mathematics skills. The Government will continue to work with business and other stakeholders to build on the progress achieved so far, and will publish a more comprehensive assessment in summer 2006.

BUSINESS R&D

UK Science Forum

3.78 The Government is committed to working with industry to ensure that the UK provides the right environment for business to locate R&D. The UK Science Forum is a high-level forum between Government, business leaders and academics to support these goals. The group, chaired by Sir Tom McKillop, met in July 2005 and discussed a number of key issues, including science, technology, engineering and mathematics (STEM) skills, the role of public procurement, joint programmes and projects between industry and government and public attitudes to science. A working group has been established to take forward this agenda jointly with HM Treasury, the Department of Trade and Industry and the Department for Education and Skills. The UK Science Forum will present its findings on these issues to the Government in spring 2006.

R&D tax credits

3.79 A discussion document on the future development of R&D tax credits was published in July.[18] The Government's response to these discussions was published on 2 December.[19] The Government welcomes the strong level of support shown by business for the R&D tax credit and has noted areas to further improve their delivery. **The Government has announced a package of major improvements to the administration of the scheme, including the creation of dedicated R&D units in HMRC to develop specialist R&D expertise and handle all SME R&D tax credit claims.** These measures will ensure that all businesses get the full value from the R&D tax credit.

3.80 The first stage of the Government's evaluation of the R&D tax credit was also published on the 2 December. It continues to show the positive impact of the credit since its introduction in 2000. Evidence from the DTI Scoreboard of the top 1,000 global and the top 750 UK R&D companies has also shown further strong growth in the number of smaller R&D intensive companies in the UK.[20] The Government wishes to support the sustained growth of these smaller innovators through the R&D tax credit. Over the coming months the Government will continue to review whether there is a case for further enhancements to the existing structure of the SME R&D tax credit. Any conclusions will be announced at Budget 2006.

[17] Available at www.ost.gov.uk/policy/sif.htm

[18] *Supporting growth in innovation: enhancing the R&D tax credit,* HM Treasury, DTI and HM Revenue and Customs, July 2005.

[19] Available at www.hm-treasury.gov.uk

[20] Available at www.innovation.gov.uk/finance

Intellectual Property

3.81 The UK's Intellectual Property (IP) framework is a critical component of the UK's present and future success in the global knowledge economy. While the Government believes the present system strikes broadly the right balance between consumers and rights-holders, there are a number of practical challenges that business and government face relating to the present operation of the system. **The Government is announcing an independent review to examine the UK IP framework, led by Andrew Gowers, reporting to the Government in autumn 2006.** Where appropriate, the review will make targeted and practical recommendations to improve policy.

3.82 The review will provide an analysis of the performance of the UK IP system, to include, among other things:

- the way in which Government administers the award of IP and its support to consumers and business;
- how well businesses are able to negotiate the complexity and expense of the copyright and patent system, including licensing arrangements, litigation and enforcement; and
- whether the current technical and legal IP infringement framework reflects the digital environment, and whether provisions for 'fair use' by citizens are reasonable.

3.83 The Government has previously committed to examining whether the current term of copyright protection on sound recordings and performers' rights is appropriate. This will also be conducted within the review.

Medical research in the UK

A new agreement with industry

3.84 Medical research, development and innovation – focused on the needs of patients and the wider public – can significantly contribute to both improving the nation's health (through the discovery and development of new medical treatments), and increasing the nation's wealth (through scientific advancement and economic innovation).

3.85 Central to groundbreaking medical research is the biomedical industry, widely recognised as one of the UK's major industrial success stories. The industry – including the pharmaceutical, biotechnology and medical devices sectors – also employs some 73,000 people, 29,000 of which are employed in R&D-related activities, with a further 25,000 jobs in the wider supply chain. Moreover, the industry contributes around £3.3 billion per year in R&D expenditure, representing 70 per cent of all medical-related R&D in the UK.

3.86 The Government is therefore committed to building upon the foundations laid in the *Pharmaceutical Industry Competitiveness Task Force* in 2001, the *Bioscience Innovation and Growth Team* chaired by Sir David Cooksey in 2003, and the recent Department of Health consultation *Best research for best health* to move this agenda to the next level. Therefore, as the next stage in the ten year Science and Innovation Framework, building on the clearly recognised indigenous strengths of the UK – the historically strong record of the medical research; a strong and growing science base; and the National Health Service – **the Government will take forward a series of important reforms that will make the UK a truly world-class environment for health research, development and innovation, as set out in Box 3.6**.

Box 3.6: Building a world-class environment for medical research and development

As a result of the consultation which closed on 21 October 2005 – with over 500 responses – the Department of Health will improve and modify their strategy *Best Research for Best Health* to proactively manage their R&D budget. This framework includes:

- the establishment of a National Institute for Health Research (NIHR) to join up existing institutions and efforts within the broader NHS to create a clear strategy and ensure coherence for quality publicly-funded health research;
- strengthening research programmes with new NHS funding schemes to make public research funding more responsive and innovative;
- the establishment of around ten major Centre Grants, by competitively selecting half from premier research hospitals with strengths across a range of clinical areas, and half from hospitals specialising in specific clinical areas, to lead scientific translation and innovation;
- a clear funding stream to support key technology platforms for patient research in the NHS;
- a single, IT-based data portal to streamline regulatory and approval procedures so that researchers only encounter regulatory procedures and input data once; and
- supporting clinical academic careers, creating around 250 Academic Clinical Fellowships and 100 Clinical Lectureship training opportunities per year.

Further measures will also be developed within the strategy to reinforce the environment for health research, including:

- ensuring the capability will exist within the NHS IT System to facilitate, strictly within the bounds of patient confidentiality, the recruitment of patients to clinical trials and the gathering of data to support work on the health of the population and the effectiveness of health interventions;
- building on the existing clinical research networks to ensure capability exists to create a Clinical Trial Clearing House function to act as a "one-stop shop" for industry to make informed decisions about the feasibility and suitability of a trial site, raise the public profile of clinical research and the health benefits of participating, and act as a matching service between willing volunteers and clinical trials in appropriate circumstances;
- further efforts to streamline regulatory and governance processes for clinical trials – rationalising NHS Trust R&D regulatory approvals and permissions through introduction of a standard R&D application form and a single "Lead" Trust R&D sign-off for multi-site trials; together with a national roll-out of the National Costings Initiative to make clinical trials costs more transparent; and national roll-out and use of the model Clinical Trials Agreement by Trusts and companies for UKCRN multi-centre trials; and
- the publication of performance data for NHS Trusts relating to patient numbers, speed and quality, to provide a source of information on reliability on which to base judgements about the location of clinical trials.

Further details will be announced by the Secretary of State for Health early in 2006 when the Department of Health's new R&D strategy is published.

3.87 In addition, the Government is also committed to take firm action to deal with campaigns of violence and intimidation by animal rights extremists, and has made significant progress to this end over the last year. The Government will continue to work with the industry to maintain this progress in future.

3.88 Members of the UK Clinical Research Collaboration (UKCRC) Industry Reference Group – chaired by Sir David Cooksey – believe this action by the Government is vital to reverse the decline in clinical research and clinical trials activity that has occurred in the UK over the last few years. Therefore, if the Government is successful in implementing this agenda to improve NHS clinical research activity, bringing on stream the R&D component of the NHS IT system and substantially curtailing the activities of animal rights extremists, members of the UKCRC Industry Reference Group believe that the right conditions will have been set in place to allow them to grow their investment in medical R&D in the UK very significantly. In aggregate they believe private sector investment in R&D involving the NHS should start to rise again. **They believe it would be likely to rise by as much as £500 million a year in the short to medium term and around £1 billion a year in the medium to long term**.

3.89 This marks the start of a new partnership between the Government and the biomedical industry that recognises the mutually advantageous relationship that exists, and the Government will continue to work together with the industry to invest in science and innovation for the future. This will greatly enhance patient care at the same time as strengthening the biomedical industry.

UK Stem Cell Initiative

3.90 Budget 2005 established the UK Stem Cell Initiative (UKSCI) to develop a ten-year vision for UK stem cell research, which seeks to make the UK the most scientifically and commercially productive location for this activity over the coming decade, and which commands the support of public and private research funders, practitioners and commercial partners. The Chancellor invited Sir John Pattison to chair the Initiative, drawing together panel members with a wealth of experience in biomedical research. The report of the UKSCI[21] makes a range of recommendations which will enable the UK to maintain a leading role in stem cell research and enhance the links with clinical practice. **The Government accepts the recommendations of UKSCI and will take them forward,** working together with the private sector. Box 3.7 provides a detailed response to the recommendations made.

[21] *UK Stem Cell Initiative: Report and Recommendations*, UKSCI, November 2005. Available at www.advisorybodies.doh.gov.uk/uksci/

Box 3.7: UK Stem Cell Initiative

The UK Stem Cell Initiative report presents a ten-year plan to ensure the UK remains one of the global leaders in stem cell research. The Government accepts the recommendations and key next steps are outlined below.

In order to build on the existing science base, Research Councils will allocate £8 million to redevelop and maintain the UK Stem Cell Bank. Together their support for Centres of Excellence and basic research in stem cells will be at least £24 million by 2007-08. In addition, the Medical Research Council and the Stem Cell Foundation are currently considering a clinical proposal for joint funding worth £2 million and it is the Government's intention to meet eligible service support costs of clinical stem cell research within the NHS. To expedite the development of stem cell therapies for regenerative medicine, the Government will consult with the private sector to determine the feasibility of establishing a public-private consortium to develop predictive toxicology tools for stem cell lines.

The Government will continue to ensure regulation of stem cell research is flexible and appropriate and makes use of proven expertise such as the Gene Therapy Advisory Committee to review novel stem cell clinical trials.

The Government will build on the close links established under the UK Stem Cell Initiative to provide effective forums to improve collaboration around research funding, cross-fertilisation between scientists, technical experts and industry. A sustained and coordinated programme of public dialogue on stem cell research will be developed, taken forward by the Research Councils and the Office of Science and Technology's *Sciencewise* programme.

As a result of taking forward these recommendations, total public sector funding for stem cell research over the two year period 2006-07 and 2007-08 will be up to £100 million, representing additional investment of around £50 million.

Investment in Science and Innovation

Science cities

3.91 Boosting regional centres of world-class scientific excellence and creating closer regional links between industry and the public research base are key to the Government's long-term ambitions for science and innovation. In the 2004 Pre-Budget Report and in Budget 2005, the Government supported plans by the Regional Development Agencies to develop six "science cities" in Manchester, Newcastle, York, Birmingham, Nottingham, and Bristol. The first national Science Cities workshop, held in York in September 2005, brought together the six science cities to present their initial plans and formulate a vision for the future development of science cities. These plans will be developed in more detail over the coming months, and a further national meeting will be held in Manchester in the spring. The Government will continue work with the science cities to explore how local, regional, and national policies can best support the development of science cities, in areas such as business-university collaboration, support for enterprise, infrastructure development, skills and public engagement with science.

3.92 To further support regional centres of scientific excellence, the three northern RDAs will be seeking proposals for a small number of new Research Centres under the Northern Way growth strategy. These centres will be developed in key areas where research strengths combine with industry demand, and will help to catalyse the development of new products and services which will enhance the competitiveness of northern businesses. This initiative will be complementary to the northern RDAs' science city activities, and will be delivered with the significant involvement of the "N8" partnership of the eight most research-intensive universities in the North of England. The Government strongly welcomes this initiative.

Research Councils' income from the EU

3.93 **The Government is reforming the budgeting arrangements for income received by Government departments and public bodies from the European Commission**. These changes will benefit UK Research Councils by allowing them to offset all research income from the EU against their budgets, providing stronger incentives for Research Councils to compete for European funding for research.

SKILLS

3.94 Skills drive productivity by equipping workers with the ability to manage complexity and adapt to change. These qualities become ever more valuable as the global move towards international competition and technological change increase the demand for higher level skills as highlighted in *Globalisation and the UK – strength and opportunity to meet the economic challenge*. However, despite substantial improvements over the last few years, the UK still has a large stock of workers with low or no skills, including poor basic literacy and numeracy.

3.95 *In Skills in the global economy,* published alongside the 2004 Pre-Budget Report, the Government commissioned an independent review of the UK's long-term skills needs to be led by Lord Leitch, a former chief executive of Zurich Financial Services and chairman of the National Employment Panel.[22] **The interim report of the Leitch Review, *Skills in the UK: the long-term challenge,* is published alongside this Pre-Budget Report** and its key findings are set out in Box 3.8.

[22] Available at www.hm-treasury.gov.uk

Box 3.8: Leitch Review of Skills

The global economy is undergoing fundamental change and the UK must respond in order to secure its prosperity over the longer term. *Skills in the UK: the long-term challenge* sets out the interim analysis of the Leitch Review of Skills and shows that while the UK has a strong economy and world-leading employment levels, its productivity trails many key comparator nations.[a] Poor skills are a key contributor to this problem as well as having wider impacts on social welfare.

Over the last decade, the skills profile of the UK has improved. For example, the proportion of adults with a degree has increased from one fifth to over one quarter of the population. Despite these improvements, the UK still does not have a world-class skills base:

- **over one third of adults in the UK do not have a basic school-leaving qualification – double the proportion of Canada and Germany;**
- **5 million people have no qualifications at all; and**
- **one in six adults do not have the literacy skills expected of an 11 year old and half do not have these levels of functional numeracy.**

Future global, demographic and technological change will place an even greater premium on the UK's skills profile. New analysis conducted by the Review shows that meeting the Government's targets for improvement in skills would bring significant improvements by 2020. The most marked improvements would occur at both ends of the skills spectrum: a decrease in the proportion of the working age population with no qualifications and an increase in those qualified to at least degree level. These changes would have significant benefits to the economy – contributing 0.2 percentage points to average annual productivity growth and generating a net benefit to the economy of £3 billion a year, equivalent to 0.3 per cent of GDP.

However, even meeting current ambitious targets will leave considerable problems in 2020: at least 4 million adults will still not have the literacy skills expected of an 11 year old and 12 million would not have numeracy skills at this level. The Leitch Review believes that the UK must urgently raise its game still further and set itself a greater ambition to have a world-class skills base by 2020. The next phase of the Leitch Review will build on this analysis and address three key issues:

- **the skills profile that the UK should aim to achieve in 2020 to support the needs of the economy and society over the longer-term;**
- **the appropriate balance of responsibility between Government, employers and individuals for the action required to meet this level of change; and**
- **the policy framework required to support this.**

The Review will report its conclusions and recommendations to the Government in 2006.

[a] *Skills in the UK: the long-term challenge*, The Leitch Review, 5 December 2005.

Developing the skills of young people

3.96 The participation of young people in education or training up to the age of 19 is key to contributing to a modern, competitive and more productive economy. The Department for Education and Skills recently announced that it had met the target for at least 28 per cent of young people to have started an apprenticeship by 2004. However, despite this and other progress in recent years, the UK ranks among the lower performing OECD countries in terms of post-16 participation. The reforms set out in the White Paper, *14-19 Education and Skills*, published in February this year will tackle this problem. An implementation plan putting into effect White Paper reforms will be published shortly.

3.97 As announced in Budget 2005, the Government has allocated £80 million over two years to pilot new Learning Agreements. These will be aimed at 16 and 17 year olds who are in work but not receiving accredited training, to improve training options. Building on the existing statutory right to paid time off to train or study for this group, the pilots will test the effectiveness of formal learning agreements, financial incentives and wage compensation in encouraging greater involvement in training by young people and their employers. **The pilots will be implemented from April 2006 and will be located in eight Learning and Skills Council areas: Greater Manchester, West Yorkshire, East London, Cornwall & Devon, Lancashire, South Yorkshire, Black Country and Southend & Thurrock.**

National Employer Training Programme

3.98 Since September 2002 Employer Training Pilots (ETPs) have been testing the effectiveness of a new policy aimed at stimulating the demand for work-based training for low-skilled employees where market failures that reduce investment in skills are most acute. So far ETPs have benefited over 26,000 employers and 213,000 employees. Evaluation has shown that ETPs appear to offer a platform for progression to higher levels of learning, and increase employers' interest in training their low skilled staff. **The National Employer Training Programme, Train to Gain, will be rolled out in 2006 and will build on the success and lessons learned from the pilots.** The programme will be delivered through an impartial and independent skills brokerage service as described in the Skills White Paper, *Skills: Getting on in business, getting on at work.*[23] The skills brokerage service will be integrated with business support services managed by Regional Development Agencies and will be particularly focused on employers who would not usually train their low-skilled staff or engage with government training programmes. The budget for the programme will be fully contestable, allowing employers to choose the public or private sector training provider best able to meet their needs. This will also help develop the provider market and ensure supply continues to keep up with the demand for training. Small firms face higher costs associated with training their low skilled employees. **To help businesses with fewer than 50 employees, wage compensation, paid to employers for the time low-skilled employees take off to train, will continue to be made available in 2006–07 and 2007–08 at a cost of £38 million a year.** The Government will continue testing its impact.

3.99 Skills can play a key role in helping to meet the challenges of globalisation and enabling individuals to take advantage of its opportunities. The New Deal for Skills is testing a package of measures to help people move from welfare into sustainable, productive work and help adults in employment get the information and guidance they need to progress from low to higher-skilled work. From April 2006 a new Union Academy will work with employers, colleges, universities and other training providers to help them deliver learning opportunities that working people want and need to progress, in ways that suit their individual circumstances.

[23] *Skills: Getting on in business, getting on at work*, DfES, March 2005.

Further education: the Foster Review

3.100 Sir Andrew Foster's Review looking at the key challenges and opportunities facing Further Education (FE) colleges has now concluded.[24] The report recommends a number of ways forward to improve colleges' standing. The Government will respond in full to Sir Andrew Foster's report in spring 2006. In Budget 2005 the Government committed an additional £350 million capital investment in the FE sector over 2008-09 to 2009-10. The Government will also set out how it intends to use that investment to drive change in the sector to meet the challenges ahead.

Boosting higher education exports

3.101 Globalisation has considerable implications for higher education. Traditional barriers are falling as international collaboration increases, learning can more easily be delivered across borders and there are now over 2 million international students. There are real benefits to these changes, allowing researchers better access to global networks and providing institutions with additional revenue. The UK is at the forefront of developments – only the US has a larger share of the international market for overseas students. This is worth over £3 billion to the economy each year. But competition is increasing as existing providers raise their game and new entrants join the market. To help the UK sector meet these challenges the Government will take the actions set out in Box 3.9.

Box 3.9: Responding to the globalisation of higher education

Ensuring the UK remains one of the most attractive places for students to study abroad requires concerted action from both the sector and government. The main component of the strategy must be ensuring the UK maintains and builds on its reputation as a provider of high quality education. This is the main driver of student demand and the primary source of the UK's comparative advantage. In addition there is the need to ensure effective promotion of the UK as an attractive place to study, to improve the experience of those studying here, to enhance the employment prospects of students completing their study, and to ensure the visa system is as efficient as possible while maintaining the integrity of UK borders. To help the sector seize the benefits of globalisation the Government will:

- **work with British Universities International Liaison Association and the Council for International Education to encourage best practice in meeting the needs of international students;**
- **increase by 50 per cent government support for marketing and promotion of UK higher education to non-EU students, with matched funding from the sector;**
- **establish a new UK-China University Partnership Scheme to support scholarships and encourage academic exchanges and collaboration between centres of excellence in science and technology;**
- **allow all international students on completion of a post-graduate degree, or an undergraduate degree in a shortage sector, to work in the UK for up to 12 months, benefiting up to 50,000 students;**
- **under the new points-based system for managed migration, award bonus points in Tier 1 (highly skilled migrants) and Tier 2 (skilled migrants with a job offer) to people who have previously studied in the UK; and**
- **improve the efficiency of the visa process.**

Migration

3.102 These new measures aimed at higher education institutions build on the Government's consultation document *Selective admission: making migration work for Britain* launched in July this year.[25] The document set out proposals for a new single points-based system for managed migration, designed better to target highly skilled individuals, and to be simpler and more transparent so that employers and migrants find it easier to use. The Government will report in the New Year with more detail on the proposals.

[24] *Realising the Potential, a review of the future role of further education colleges*, Sir Andrew Foster, November 2005.

[25] Available at www.homeoffice.gov.uk

INVESTMENT

3.103 The accumulation of physical capital through investment is an important determinant of an economy's productivity performance. Total investment in fixed capital in the UK economy, incorporating investment by businesses and government, and investment in housing, has been low relative to comparable economies over long periods of the UK's post-war history. This has had significant impacts on the productivity of the business sector, on the nature of the UK's housing stock and housing market, and on the quality of public services. Ensuring that policy provides the right environment for business, housing and public investment has therefore been and continues to be a crucial government priority. Creating this environment becomes all the more important in the context of increasingly internationally mobile capital flows. As identified in *Globalisation and the UK: strength and opportunity to meet the economic challenge*, particular challenges here are ensuring that the planning system responds to economic needs and that the UK's transport infrastructure supports business flexibility.

Investment in housing and property

3.104 A stable and responsive housing market is essential for the UK's future economic and social success. Greater economic stability, delivered by the Government's macroeconomic framework, has resulted in the lowest volatility and levels of unemployment for three decades, household incomes growing by over 20 per cent in real terms since 1997, and inflation and interest rates at historically low and stable levels. As a result of this economic stability and rising prosperity, over 1 million more people have had the confidence to become homeowners since 1997, taking the proportion of households that own their home to over 70 per cent.

3.105 Even so, nine out of ten households would prefer to own their own home if they could.[26] If the opportunities of home ownership are to be extended to a new generation, the Government must address the long-term challenge posed by the UK's low and unresponsive housing supply in the face of rising demands. The population of England is currently projected to grow by 5.7 million over the next twenty years, with an average household formation rate of at least 190,000 per year up until 2021.[27] Yet despite recent increases, annual new housing supply in England is currently running at 150,000 net dwellings.

3.106 Kate Barker's independent review of housing supply, commissioned jointly by the Chancellor and Deputy Prime Minister in April 2003, identified how long-term structural weaknesses in UK housing supply placed this hard-won stability and prosperity under threat. Her review set out clearly how constrained housing supply leads to increasingly unaffordable housing, frustrating the home ownership aspirations of many individuals and families. It also leads to wealth redistribution from those outside the housing market to those inside it, and reduces labour mobility – damaging the flexibility and performance of the UK economy and key public services – and translating into wider macroeconomic instability.

[26] *British Social Attitudes Survey*, National Centre for Social Research, 2001-02.

[27] ODPM Interim 2002-based household projections, based on 2002-based population projections.

Response to Barker Review

3.107 The Government's response to the Barker Review, published today,[28] sets out how achieving the Government's aim to improve affordability for future generations of homebuyers will require housing supply to become much more responsive to demand. Current projections suggest that **to meet the Government's aim to improve affordability, new housing supply in England will need to increase over the next decade to 200,000 net additions per year.** The speed at which this increase can be achieved, and affordability benefits realised, will be determined by progress in delivering the necessary investments and reforms.

3.108 The Government is therefore today setting out proposals to help deliver investment in the infrastructure necessary to support housing growth, and to reform the mechanisms, particularly planning, by which new housing and infrastructure are delivered. Successfully delivering these proposals will enable the Government to set out as part of the 2007 Comprehensive Spending Review its detailed plans for achieving its ambitions for a step-change in housing supply by 2016, helping extend home ownership to another million people in the next five years and taking the UK towards the Government's aspiration of 75 per cent home ownership.

Affordable housing

3.109 The Government's proposal to increase housing supply better to meet demand applies to social, as well as market, housing. Many households cannot afford to rent or buy a home of their own, and for these families that would otherwise struggle, Councils and Housing Associations play a valuable role in providing decent, affordable accommodation.

3.110 In her Review, Kate Barker identified a long-term shortfall in social housing provision, manifested through overcrowding and the growing use of unsuitable temporary accommodation for vulnerable households. The review set out the need for a substantial increase in the supply of social housing in order to keep up with demographic trends and to tackle the backlog of unmet housing need.

3.111 The Government has already made significant progress in meeting this long-term challenge, providing funding through the 2004 Spending Review to help deliver an additional 10,000 new social homes a year by 2007-08 compared with 2004-05 – a 50 per cent increase – and by reducing demand through investment in new approaches for preventing homelessness. **The Government intends to go further to respond to the challenges set out by the Barker Review, and will set out its ambitious plans for increasing social housing supply, with new investment alongside further efficiencies and innovation in provision, as part of the 2007 Comprehensive Spending Review.**

3.112 The Government is also working with builders, lenders and housing associations to bring forward shared equity products that will directly assist over 100,000 households into home ownership over the next five years. In addition, the Government is in discussions with industry to determine what further scope there is for the housing finance market to offer shared equity loans direct to first time buyers.

Social housing sinking funds

3.113 Sinking funds are an efficient way for those in rented accommodation, including those in social housing, to save money for major repairs. Sinking funds are trusts and at present income arising, for example bank interest, is liable to income tax at the rate applicable to trusts of 40 per cent. **The Government will bring forward legislation in the Finance Bill 2006 to provide relief from the 40 per cent rate for service charges and sinking funds for tenants of registered social landlords.**

[28] *The Government's Response to Kate Barker's Review of Housing Supply*, HM Treasury & ODPM, December 2005.

Infrastructure

3.114 Flourishing communities are not created by new housing alone. The Government is committed to ensuring that its ambitious plans for a step-change in housing supply are supported by the necessary investment in social, transport and environmental infrastructure at the local, regional and national level.

3.115 To ensure that appropriate infrastructure will be provided to support housing and population growth, **the Government is today announcing, to inform the 2007 Comprehensive Spending Review, a cross-cutting review into supporting housing growth** to:

- determine the social, transport and environmental infrastructure implications of housing growth in different spatial forms and locations;
- establish a framework for sustainable and cost-effective patterns of growth, including by examining the use of targeted investment through the Community Infrastructure Fund and Growth Areas funding to support the fastest-growing areas; and
- ensure that departmental resources across government are targeted appropriately for providing the national, regional and local infrastructure necessary to support future housing and population growth.

Planning-gain Supplement

3.116 In order to help finance the infrastructure needed to stimulate and service proposed housing growth, and ensure that local communities better share in the benefits that growth brings, **the Government is today consulting on its response to Kate Barker's recommendation for a Planning-gain Supplement (PGS).**[29]

3.117 Kate Barker's Review argued that the Government should actively consider measures to capture a portion of the gains accruing to landowners as a result of the granting of planning permission, so that increases in land values can benefit the community more widely. It argued that these gains could play a useful role in providing a funding stream for the local and strategic infrastructure necessary to support growth.

3.118 The PGS consultation paper restates the case for capturing a modest portion of the land value uplift for the benefit of the wider community and describes how a workable and effective PGS might operate. The consultation sets out options for allocating PGS revenues, informed by the following overarching principles:

- as an essentially local measure, a significant majority of PGS revenues will be recycled to the local level for local priorities. This will help local communities to share better the benefits of growth and manage its impacts, and will ensure that local government overall will receive more funding through PGS than was raised through the planning obligations system ('s106 agreements');
- PGS revenues will be dedicated to financing additional investment in the local and strategic infrastructure necessary to support growth. The Government anticipates that an overwhelming majority of PGS funds will be recycled within the region from which they derived; and
- PGS revenues will also be recycled to deliver strategic regional as well as local infrastructure to ensure growth is supported by infrastructure in a timely and predictable way. Local and regional stakeholders, including business, will play an important part in determining strategic infrastructure priorities to help unlock development land.

[29] *Planning-gain Supplement: a consultation*, HM Treasury, HMRC and ODPM, December 2005.

3.119 **The introduction of PGS would be accompanied by a scaling back of planning obligations, as recommended by Kate Barker, to make the planning obligations system more efficient and transparent.** Reforms to the planning obligations system, which could reduce its scope to matters affecting the environment of the development site itself and the provision of affordable housing, are also set out for consultation. PGS revenues and other alternative sources would help cover the provision of infrastructure previously secured through planning obligations before scaling back.

3.120 Through consultation, the Government now seeks to engage the development industry, business, local government, the voluntary sector, professional associations and the wider public in creating a fair, workable and effective system for capturing land value uplift for community benefit, ensuring new housing growth is delivered in a sustainable way.

Local incentives

3.121 The Barker Review also recommended that government should consider ways of incentivising local authorities to meet housing growth targets. In addition to its proposal that the majority of PGS revenues be retained at the local level, the Government proposes to consult on further measures to enable local areas to invest to support housing growth and to share in the benefits it brings.

3.122 **The Government accepts the case for an incentive scheme to encourage local authorities to deliver housing growth.** As a first step Government proposes to reform the Planning Delivery Grant (PDG) to ensure it better supports areas which are delivering high numbers of new homes. **The Government will consult on these allocations in 2006, as part of a wider consultation on local planning and housing incentives, including PDG, for the next Spending Review period.**

Planning reform

3.123 Delivering the Government's housing ambitions also requires planning reform and **the Government can today announce further reforms to the planning system with the publication of a new draft Planning Policy Statement for Housing (PPS3).**[30] This new planning guidance will ensure that local and regional plans take better account of housing markets and are more responsive to changing demands. It will ensure that local and regional plans prepare and release more land, in the appropriate places, and at the appropriate time, to meet the UK's future housing requirements. It also encourages local authorities to use design codes to accelerate the delivery of high quality development.

3.124 The Government also accepts Kate Barker's proposal that the planning system should reflect long-term objectives for affordability, set out at both the national and regional level. **The Government will bring forward detailed proposals as part of the Comprehensive Spending Review process in 2007.**

3.125 Kate Barker also proposed that the functions of Regional Housing Boards (RHBs) and Regional Planning Bodies (RPBs) be merged to create single bodies responsible for managing regional housing markets, and that these new bodies be supported by strong and independent Regional Planning Executives to provide expert analytical advice on improving housing market affordability. Following consultation, **the Government accepts the case for merging the functions of RHBs and RPBs, and expects the new arrangements to be in place by September 2006. The Government also proposes to establish a new and independent National Advice Unit, by autumn 2006,** to strengthen the evidence and analysis available to Regional Planning Bodies through the regional planning process.

[30] *Planning Policy Statement 3: Housing (PPS3)*, ODPM, December 2005.

3.126 The Government has enacted a number of wider reforms in recent years aimed at securing the Government's objective of a transparent, flexible, predictable, efficient and effective planning system. These include the reform of local and regional plan-making through the Planning and Compulsory Purchase Act in order to increase the transparency and flexibility of the system, the introduction of extra funding linked to delivery targets to increase capacity within the system and speed up the decision making process, and increased take-up of e-planning to improve customer service.

3.127 These reforms have already begun to deliver, with 55 per cent of local authorities now meeting their target for determining major applications within 13 weeks, up from around 20 per cent in 2003 and with progress being made towards the development of the new flexible Local Development Frameworks and Regional Spatial Strategies. There is also evidence of the planning system effectively balancing its economic, social and environmental objectives in terms of business needs, for example, over 150,000 applications are processed each year of which over 80 per cent are approved.

3.128 In the context of the increased competitive climate caused by globalisation the Government is committed to further reform, to ensure that planning delivers the development the UK needs. **The Chancellor and the Deputy Prime Minister have therefore asked Kate Barker to conduct a review to consider how, in the context of globalisation, planning policy and procedures can better deliver economic growth and prosperity alongside other sustainable development goals.** It will build on the reforms to the planning system that have already been put in place in England, the focus of which has been on housing supply and delivery.

3.129 In particular the Review will assess:

- ways of further improving the efficiency and speed of the system;
- ways of increasing the flexibility, transparency and predictability that enterprise requires;
- the relationship between planning and productivity, and how the outcomes of the planning system can better deliver its sustainable economic objectives; and
- the relationship between economic and other sustainable development goals in the delivery of sustainable communities.

Real Estate Investment Trusts

3.130 Alongside Budget 2005, the Government published a discussion paper on the creation of Real Estate Investment Trusts in the UK, (UK-REITs) to improve the efficiency of both the commercial and residential property investment markets by providing liquid and publicly available investment vehicles for all investors to access. As recommended by Kate Barker, this reform will encourage increased institutional and professional investment to support the growth of new housing, as well as the Government's wider objectives for raising productivity.

3.131 **The Government will bring forward draft legislation for inclusion in the 2006 Finance Bill.** Details of the tax proposals will be published before the end of 2005 and will include the following key features:

- the regime will be open to property companies resident in the UK, that are publicly listed on a Recognised Stock Exchange as defined for tax purposes;
- companies or groups that meet the UK-REIT eligibility criteria as set out in legislation will not pay corporation tax on qualifying property rental income or chargeable gains; and
- a requirement to distribute at least 95 per cent of net taxable profits on rental income to investors, who will then pay tax at their marginal rate.

3.132 The Government is committed to taking a flexible approach in developing a UK-REIT while ensuring a fair and appropriate regime for all taxpayers, and believes this model strikes the right balance. The Government remains committed to ensuring that the introduction of a UK-REIT results in no overall loss of revenue for the Exchequer and will continue to keep this under review. The rate and mechanism for the conversion charge applying to companies joining the regime will therefore be announced at Budget 2006. The Government continues to consider in parallel the taxation position for authorised investment funds investing in property.

Environmental sustainability

3.133 Extending opportunities for people to have a home that meets their aspirations must go hand in hand with measures to protect and enhance the environment. The Government is committed to using land as efficiently as possible. The target to build 60 per cent of all development on brownfield sites has been exceeded, with 70 per cent of all development in England being on brownfield in 2004, compared with 56 per cent in 1997. In addition, the Government has increased the average density of developments from 25 dwellings per hectare in 1997 to 39 dwellings per hectare in 2004.

3.134 The Deputy Prime Minister is today announcing further measures to maximise the environmental sustainability of new housing, including the announcement of a **new Code for Sustainable Homes, alongside proposals to minimise flood risk, achieve water efficiency savings and protect the green belt.** More detail is set out in Chapter 7.

Contaminated Land Tax Credit

3.135 The Barker Review also recommended that the Contaminated Land Tax Credit (CLTC) should be extended to long term derelict land, as long as it would encourage genuine new investment. To ensure the effectiveness of its support for regeneration of brownfield sites the Government has commissioned research to evaluate the effectiveness of CLTC which is scheduled to be completed early in 2006. The Government has therefore decided to delay its decision on whether to extend the credit until Budget 2006.

3.136 Following consultation, legislation was included in the Finance Act 2005 to introduce a Business Premises Renovation Allowance scheme. The Government remains committed to introducing it as soon as state aids approval is given.

Public investment and infrastructure

3.137 The public sector is itself a major investor in the UK economy. It invests both to provide the capital that is a crucial input to public services, for instance school buildings and hospital equipment, and to provide the infrastructure that underpins both private sector activity and public services, for example large parts of the transport network. Chapter 6 sets out the Government's approach to public investment in more detail. The public sector also plays a less direct role in infrastructure investment in its capacity as regulator of private sector activity, for instance with respect to the privatised utilities and crucial parts of the transport network such as airports.

3.138 Recognising the need to bring together investment and the right framework for prioritising and delivering new infrastructure, Budget 2005 announced that the Secretary of State for Transport and the Chancellor had asked Sir Rod Eddington, former Chief Executive of British Airways plc, to work with the Department for Transport and HM Treasury to advise on the long-term impact of transport decisions on the UK's productivity, stability and growth.

Eddington study

3.139 The Eddington study, which will report to Ministers in spring 2006, has focused on developing a comprehensive analysis of the links between the transport system and economic growth, within the context of the Government's objectives for sustainable development. Whilst the study is at an early stage, it is already clear that transport supports the efficient functioning of the economy, playing a significant role in the operation of labour and product markets, and that it is likely to play an important role in equipping the UK economy to respond to the challenges and opportunities of globalisation.

3.140 The contribution of transport to growth can be examined through a series of micro-economic drivers, including:

- a reduction in business costs and productivity growth through improved journey times for both freight and passengers;
- boosting productivity by supporting agglomerations and clusters;
- improving labour market performance by bringing individuals closer to jobs and better matching people to skills; and
- increasing competition by opening up markets and increasing economies of scale.

3.141 In addition, transport can play a critical role in supporting international trade, and may play a key role in attracting foreign direct investment (FDI) to the UK. The study is currently exploring the nature of these links with expert academics and stakeholders.

3.142 An efficient planning system is important in maintaining the flexibility of the UK economy, particularly in response to globalisation. In this context, it has been suggested that the Eddington study should look at streamlining the process for approving major transport schemes, while delivering effective sustainable development outcomes. In doing so, the study will work closely with ongoing work.

Airport capacity

3.143 In an increasingly competitive global marketplace, the UK economy is increasingly dependent on air travel. The Government's Air Transport White Paper predicted that by 2030, demand for air travel would be between two and three times its present level. Additional airport capacity to meet this rising demand will generate benefits for the wider UK economy.

3.144 Heathrow, the UK's major hub airport, plays a unique role in supporting economic growth across the country. The Government has been undertaking extensive modelling work to understand the nature and extent of the air quality issues that affect further development at Heathrow. This work is aimed at identifying solutions that would allow construction of a third runway to take place within relevant air quality limits. As part of the White Paper Progress Review in 2006, the Government will announce whether the challenges set out in the White Paper for the expansion of Heathrow can be met.

3.145 The Government is committed to meeting the demand for additional runway capacity in the South East which will arise before expansion of Heathrow is likely to be completed. A second runway at Stansted should be delivered as soon as possible. The airport operator is expected to submit a planning application for a second runway during 2007. The Government will set out plans for the surface access requirements to support this application, and will work with the airport operator to agree an appropriate package of improvements.

Box 3.10: Product and capital market flexibility – report on progress

Flexible product and capital markets promote stability and wider economic success. Product market flexibility is key in intensifying competition and promoting enterprise and research, enabling firms to remain competitive in the face of economic change. Capital market flexibility allows for a more efficient allocation of capital, provides business with good access to finance and helps share risk across the economy, reducing the UK's overall vulnerability to shocks. More flexible capital markets also provide financial instruments that help consumers and firms to smooth their consumption paths. Key new measures introduced by the Government since Budget 2005 to promote capital and product market flexibility include:

Modernising the business tax system: the new integrated tax department, HM Revenue and Customs, has set out proposals for further simplification of tax administration for business.

Regulatory reforms to ease the burden on business: continued implementation of the Hampton Review's risk-based approach to reducing the burdens on business, including the merger of regulatory bodies, announcement of a new Local Better Regulation Office and new legislation to streamline the deregulatory process.

Promoting competition: through market studies and investigations undertaken by the independent competition authorities including care homes and store cards, and putting in place a new framework for water competition.

Planning reform: including the Planning and Compulsory Purchase Act 2004 which introduces a simplified planning structure, updating national planning guidance on housing in response to the Barker Review, and increased resources for the planning system together with incentives to drive efficiency through the Planning Delivery Grant.

Improving access to finance for SMEs and individuals: launch of the newly enhanced Small Firms Loan Guarantee scheme to provide additional targeted support to help start-ups and young SMEs with growth ambitions, for whom a lack of collateral is a barrier to accessing debt finance.

Capital market integration: together with the FSA and the Bank of England, the Government has set out a strategic approach to developing the Single Market in financial services following the EU Financial Services Action Plan. The Government has taken action to identify under-performing links in the investment chain and implement solutions.