BIS Department for Business Innovation & Skills

A STRATEGY FOR SUSTAINABLE GROWTH

Economic Annex

JULY 2010

We will work closely with the Devolved Administrations in Northern Ireland, Scotland and Wales, recognising their particular and varying responsibilities. While some of the policies in this paper are specific to England, the challenges are common across the four countries of the United Kingdom. Each will need to consider the most appropriate arrangements in those areas for which they have devolved responsibility, to address the issues in ways that meet their own circumstances and needs.

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Introduction

Laying the right foundations for growth is paramount as the economy recovers. Growth is needed to raise living standards, deliver high quality public services and meet the challenges of an ageing population and climate change.

The Emergency Budget set out a medium term plan to put public finances on a sustainable footing, build business confidence and provide a springboard for a private sector-led recovery. This is the first step in transforming our economy. Microeconomic policies will support the macroeconomic framework by focusing on the longer term and the supply side of our economy.

The challenge is to rethink growth policies under tight public finances. This involves having a clear understanding of aspects of our recent economic performance that were unsustainable, how to provide businesses with the right conditions to drive growth, and where investments get the highest returns. We have to realise the twin aims of securing deficit reduction and promoting sustainable growth. Our growth prospects will be undermined if we do not have a credible deficit reduction plan, but equally, deficit reduction over the medium term requires significant and sustained growth.

1. Recent UK economic performance

The headline performance of the UK economy in recent years may in some ways appear respectable. The UK economy grew, at an average rate of growth of 2.0 per cent per annum between 1990 and 2009. The UK also made significant progress in closing the productivity gap with Germany, and narrowing it with France, although the gap with the US has remained stubbornly large[1]. The UK also had a relatively low unemployment rate in the years before the recession, at an average of 5.2 per cent over 2000-2007. However, this growth model has proved unsustainable.

As the Emergency Budget set out, economic growth in the UK has been driven by the accumulation of unsustainable private sector debt and rising public sector debt:

The household saving ratio had, by 2008, fallen to the lowest level since the 1950s and household debt had risen to 100 per cent of GDP[2], as households borrowed heavily to purchase increasingly expensive property, which grew at an average of around 9 per cent a year[3]. Reflecting this, private consumption typically accounted for almost two-thirds of annual GDP growth over the period 2000-07.

Business investment has been particularly low. Business investment and investment in dwellings, each contributed on average, just a quarter of a percentage point to average annual GDP growth of 2¾ per cent over the same period. Since 2003 the share of business investment has been predominantly at the lower end of the historical 10-12 per cent of GDP range, dropping below 10 per cent of the economy in three out of the last six years. During the recession, business investment has been exceptionally hard-hit, falling in six successive quarters by a total of 25.7 per cent since the autumn 2008.

According to the OECD, by 2007, the UK had the largest structural budget deficit in the G7. Government spending[4] has been the second most significant driver of annual GDP over the period 2000-2007, contributing, on average, three quarters of a percentage point to average annual GDP growth over the period. During the recent recession, the budget deficit increased sharply, with a related increase in Government indebtedness. Public sector

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1 Between 1998 and 2008, the UK closed the productivity gap (measured as output per worker) with Germany, the gap with France was narrowed (from 14 per cent to 9 per cent) while the gap with the US widened slightly (to 33 per cent from 30 per cent), according to ONS International Comparisons of Productivity

2 HMT (2010), ‘Budget’, June

3 Nationwide House Price Index Survey (2010), June

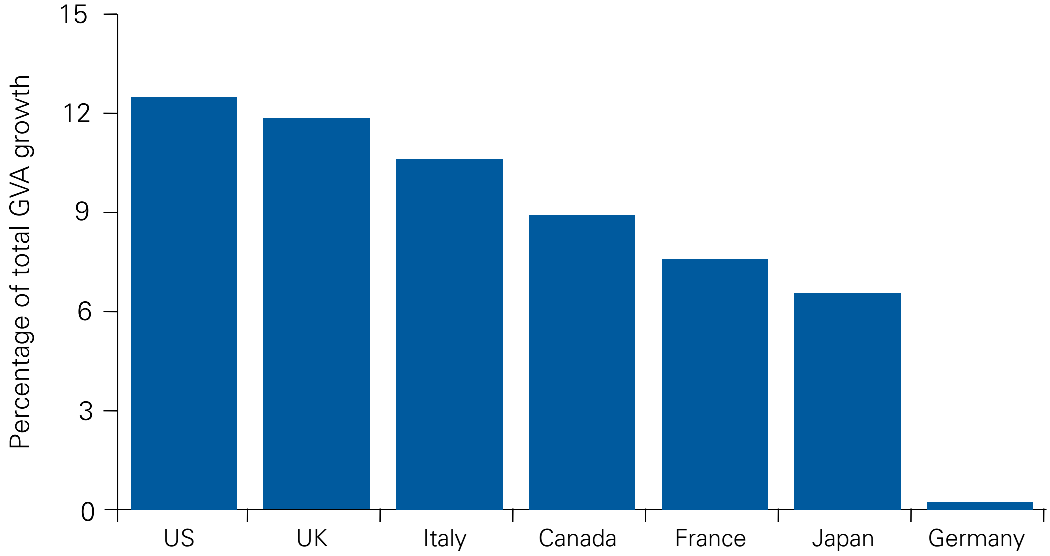
4 Government consumption and investment combined

net borrowing is forecast to peak at 11 per cent of GDP this year. The IMF forecast that the UK will have the highest borrowing rate in the G20 this year.

Net trade has dragged down GDP growth over 2000-2007, subtracting on average a quarter of a percentage point from average annual GDP growth over this period. Indeed, since 1996 net trade has made a positive contribution to the overall economy in volume terms in three years (2006, 2008 and 2009).

Sectoral growth has been unbalanced towards financial services. In recent years, financial intermediation in the UK grew faster than in any other G7 country, and much faster than growth in the UK economy as a whole[5]. Even when one adjusts for the faster growth of the whole UK economy over the period, it can be seen in Chart 1 below that amongst major industrial economies only the US saw financial services account for such a large proportion of overall growth in the economy between 1997 and 2007. UK bank balance sheets nearly tripled between 2002 and 2007[6].

Chart 1: Financial services contribution to GVA growth (1997-2007)



Source: BIS calculations from OECD STAN database

Although growth in large parts of the financial services sector have played an important role in creating jobs and raising incomes in the UK, it has

5 Between 1997 and 2007 the UK banking sector (retail and wholesale) expanded by 139 per cent; the UK financial intermediation sector (insurance, broking, fund management, banking) increased by 80 per cent (it increased by 60 per cent in the US and remained stable in Germany) (OECD STAN database for structural analysis). Financial corporations' total debt doubled between 2000 and 2008, rising from 126 per cent to 240 per cent of GDP. By 2008, UK financial corporations' indebtedness was the highest in the G7 (OECD National Accounts database)

6 Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 16 June 2010

been clear since the onset of the downturn that this growth has not in fact brought about a permanent increase in overall living standards in the UK. The Office for Budget Responsibility (OBR)[7] highlighted that: 'the adjustment of the financial sector may reduce its direct contribution to whole economy productivity. For example, a reduction in the financial sector's share of output from its pre-crisis level of around 8 per cent to 7 per cent could reduce the whole economy level of productivity of around ½ per cent. NIESR[8] also suggested that the adjustment of the financial sector may reduce the sustainable level of output by around 1 to 2 per cent based on the assumption that the financial sector share of output reverts to its share in 2000 of just over 5 per cent'.

Growth has been unevenly spread between regions. For the last forty years, London and its surrounding regions have grown faster than the rest of England. Since 1989, the gap averaged over ½ percentage point[9]. The recent recession has lead to further imbalances. As a result, workers and firms earn 46 per cent[10] more in London and the surrounding regions than the rest of England, with London workers earning more than twice the level seen in the North East. Moreover, output in some parts of the country has been too dependent upon public sector activity.

Employment in the public sector rose much faster than in the private sector. General Government employment rose by 690,000 (14 per cent) from 4.8 million in 1999 Q1 to 5.5 million in 2010 Q2. Private sector employment stood at 22.8 million in 2009, up by 911,000 (4 per cent) from 21.9 million in 1999.

The economic downturn has impacted on the economy, leading to a decline in UK productivity. Labour productivity[11] has fallen on a year on year basis in six successive quarters, between 2008 Q3 and 2009 Q4. The latest data for 2010 Q1 show that productivity began to grow again, rising by 1.3 per cent on 2009 Q1, as a result of both a small increase in output and a fall in labour input. Since the beginning of the recession, there has been a rapid and sizeable increase in ILO unemployment rate from 5.2 per cent in 2008 Q1 to 8 per cent in 2010 Q1, although less than in past recessions. Greater wage moderation and shorter working hours, as well as the efficiency of UK labour markets, have all contributed to this. However, unemployment rates for the young and the low skilled have particularly increased.

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7 OBR (2010) 'Pre-Budget Forecast', June, p.76

8 NIESR (2009), 'Growth prospects and financial services', Economic Review Vol.207, January

9 ONS Regional Accounts

10 BIS calculations from ONS Regional Accounts
These differences in headline earnings do not reflect possible changes in regional prices which would impact on real incomes

11 Measured as output per worker

2. Achieving sustainable growth

We have to lay the foundations for a new type of growth in the UK, one that is sustainable. This means building a more competitive and productive economy, which crucially requires markets to function well.

The global context for growth

While growth in advanced economies, particularly in Europe, remained fragile in the first half of 2010, and well below pre-crisis rates, the broader world economy has continued to strengthen. World trade is forecast by the OBR[12] to rise by 6 per cent this year followed by 6¼ per cent in 2011, and around 7¼ per cent in 2012-14. Global growth is forecast to rise by 4 per cent this year. Emerging Asia is leading the recovery, with many countries growing at above trend rates. Global growth is forecast to rise by 4.2 per cent next year, then by 4.5 per cent in 2012-13 and 4.6 per cent in 2014-15. In line with the growing world economy, UK export markets are forecast by the OBR to grow by 4 per cent in 2010, 4¾ per cent in 2011 and by close to 6½ per cent thereafter. Whereas Europe and the US will continue to be important trading partners, improving the UK's openness to global trade, particularly in fast-developing economies, is key for our growth prospects. World growth will continue into the longer-term as incomes rise in both developed and developing economies and consumers and businesses look to take advantages of developments in new technologies, and respond to the need for a lower carbon economy and ageing populations in advanced economies. Growth therefore will be also based upon UK companies being successful in global markets.

Restoring the competitiveness of the UK as a location for economic activity is important. In the near term, the lower pound provides a boost to the UK's competitiveness. UK exporters are benefiting from the 25 per cent fall in the trade-weighted value of sterling since July 2007. While there are indications that many firms have used this as a breathing space to rebuild margins and balance sheets, as the recovery picks up, a lower level of sterling provides a real opportunity for firms to raise their export presence.

In the longer term, in a global economy where capital, goods and workers are increasingly mobile, other factors such as taxation rates directly affect cost or price differentials and therefore UK firms' profitability. The Emergency Budget announced a package of reforms to the corporate tax system, ensuring the UK continues to have the lowest corporation tax rate in the G7 and one of the lowest in the G20 when fully implemented. Key measures include reducing corporation tax from 28 to 24 per cent over the course of

12 Pre-Budget Report, June 2010,OBR, p.14

four years from April 2011; reducing the small firms rate of corporation tax to 20 percent from April 2011; and lowering the cost of national insurance contributions to make it cheaper for companies to employ people. Lower business taxation, combined with the depreciation of sterling, will allow UK businesses to enhance their export competitiveness.

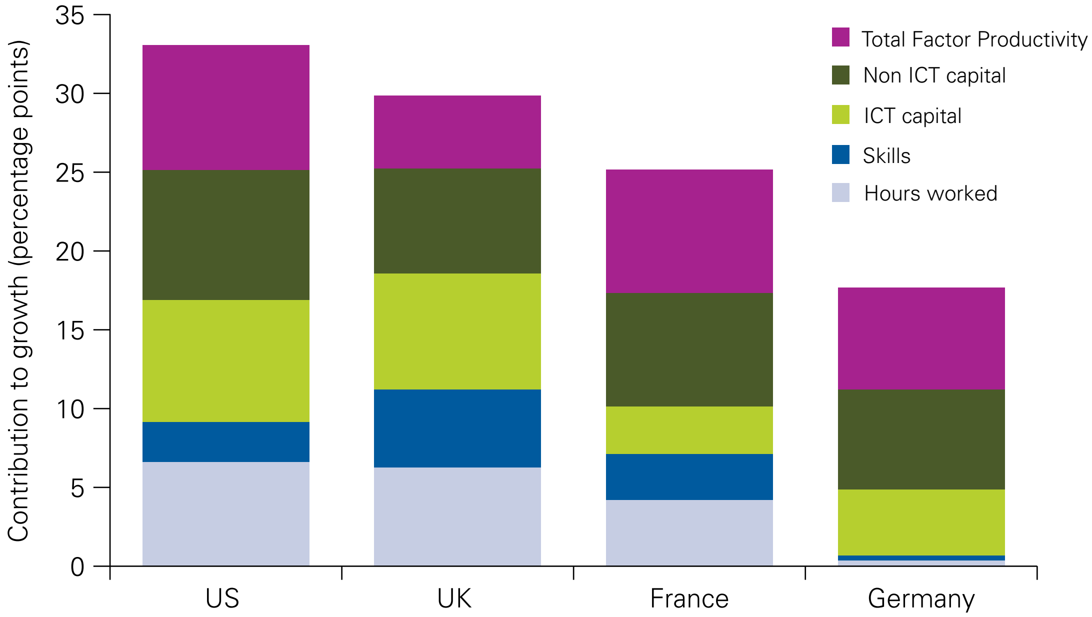
What drives growth?

A more competitive tax regime has an important role to play in creating the conditions for growth, but there is much more that government can do. Fiscal consolidation will underpin private confidence and reduce competition for funds for private sector investment, supporting job creation and growth over the medium term.

Over the longer term, growth will be dependent upon both the efficiency of markets and the effectiveness of investment made in our productive capacity, underpinned by strong entrepreneurialism.

Analysis from the internationally recognised Groningen Growth and Development Centre (chart 2) suggests that UK growth benefited prior to the recession from increased labour input and increasing skill levels, as well as strong investment in Information and Communication Technologies (ICT). But broader investment has been less strong by international comparisons, and the efficiency within which these inputs have been combined (so-called Total Factor Productivity) has been weak, suggesting that either the investments that business and government have chosen have not been optimal, or that we have not made the best use of those investments.

Chart 2: Composition of GVA growth (1997-2007)



Source: Groningen Centre for Growth and Development

International organisations such as the OECD[13] identify a role for government in both strengthening economic fundamentals and encouraging investment in growth capacities.

Such investment is particularly important in enabling UK firms and workers to compete successfully in global markets. In recent years low-wage economies have improved their skills levels and business sophistication, enabling them to compete in more markets. The UK needs to respond to this challenge by ensuring our skills and innovation capabilities are of world-class levels to enable us to develop and compete in new markets.

More balanced growth

Over the next couple of years the UK will undergo significant structural adjustments. The Office for Budget Responsibility[14] expects the economy to 'rebalance away from consumption towards investment and net exports', with most of this re-balancing expected to take place from 2011 onwards. The measures taken in the Emergency Budget on public spending and tax will play an important role in building the conditions to support more balanced growth.

But there is more that government can and must do. **We need to set out a strategy for a new growth model: one that delivers sustainable growth in an economy that is no longer over reliant on big government, debt or financial services and one which rebalances the economy so that firms and individuals have the opportunity to innovate and grow.** Sustainable growth involves balancing economic development, social development and environmental protection. There is no wide agreement on what the optimal balance between regions and sectors should be. The long run economic trends that have led to changes in the regional and sectoral composition of our economic activity are in part the result of global economic forces which government cannot and should not look to reverse. However, government has a key role to play in removing specific barriers to growth for all regions and sectors of the economy, building on the efficiency and flexibility of the UK labour markets.

All regions must be enabled to realise their full potential. It would be unrealistic to expect regions to all have the same level of income per head, and both structural and wider geographical and sociological forces will mean that different regions enjoy differing periods of growth over time. But the extent and persistence of present imbalances mean we are not maximising our overall potential. Furthermore, output in regions outside of London has been too dependent upon public sector activity and will have to be replaced by strong, private sector growth.

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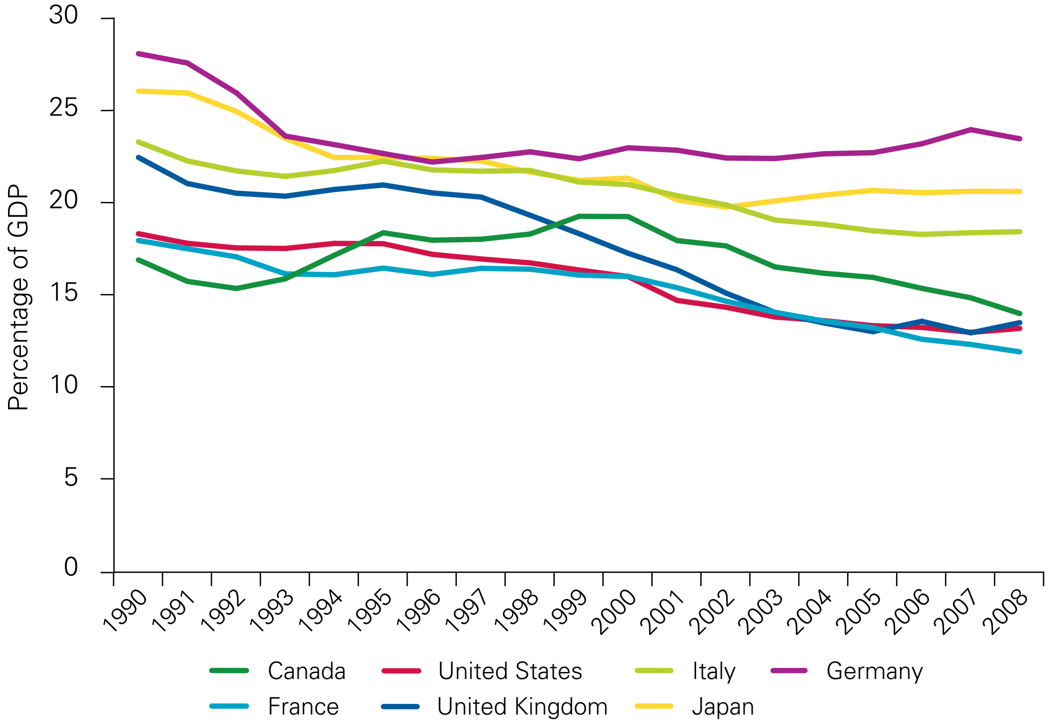
13 OECD (2001) 'The New Economy: Beyond the Hype', Growth Project Final report'

14 OBR (2010) 'Pre-Budget forecast', June

Growth must be diversified across a wide range of sectors to underpin a more resilient economy. The UK has seen a long-term shift towards services, with manufacturing as a share of overall GDP in the UK declining from 32 per cent in 1970 to its current level of around 12 per cent[15]. This broad shift in GVA and employment from manufacturing to services is a long-term trend and common to all G7 economies (chart 3). It results from both globalisation and difference in scope for productivity growth between sectors, feeding through to final prices, which have fallen for most manufactured goods relative to services.

Chart 3: Manufacturing as a share of GDP (1990-2008)



Source: UNCTAD Handbook of Statistics (2009)

Whilst on some measures of overall sectoral concentration, the UK does not look out of line with other major economies, the rapid shift we have seen towards financial services, means that we are increasingly at risk of becoming less diversified, and less resilient to the economic shocks this can bring. As McKinsey[16] and others have pointed out, achieving a broad based shift in the economy towards manufacturing would be challenging against the long-term global forces described.

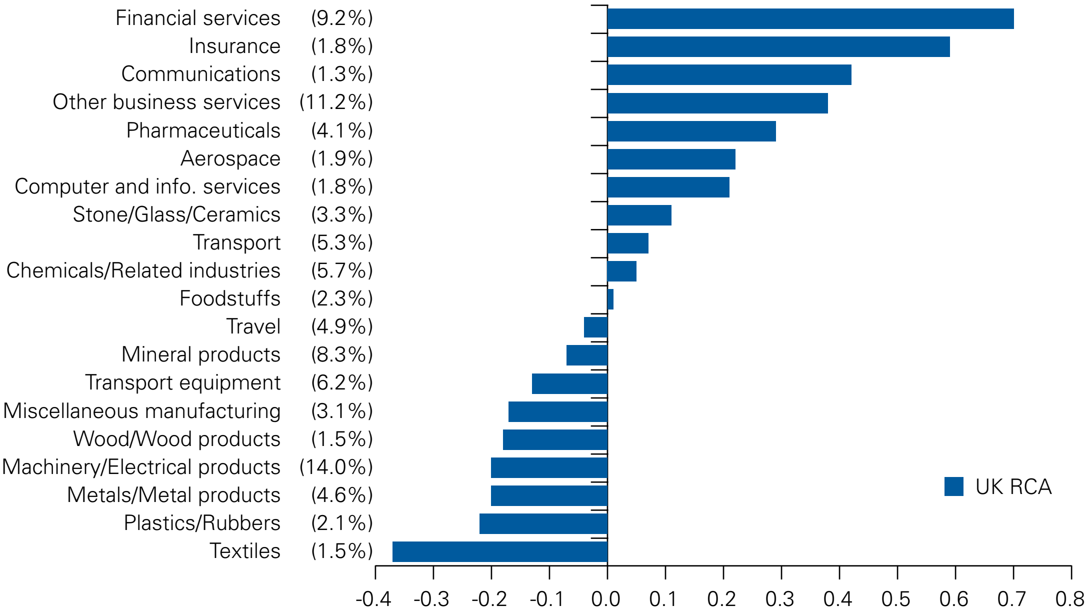
Chart 4 shows the UK's revealed comparative advantage, with a positive figure showing that UK exports are particularly focused on a given sector. The overall picture is of specialisation in areas such as aerospace and chemicals, as well as a range of business services where competition is

15 ONS (2009) 'Blue Book'

16 McKinsey Global Institute (2010) 'How to Compete and Grow: A sector guide to Policy', March

primarily on the basis of high skills and technology rather than low wages. There is also evidence of strong performance in a range of niche markets, for example, machinery and technical textiles[17]. We need to build on and expand our strengths in these areas, as well as look for new areas in which we can build internationally competitive firms.

Chart 4: Revealed comparative advantage in selective sectors



Source: IMF and UN COMTRADE

Lastly, **environmental quality and renewable resources must be maintained.** We need to make sure our economy responds to the need to draw on the natural environment more sustainably, with carbon emissions falling to meet internationally agreed targets. But the low carbon industry also provides a particular opportunity for balanced economic growth, both geographically and sectorally; extending high-value, high-tech manufacturing in different areas of the country whether it be the Midlands and the North East for low emission vehicles, or the North West for the manufacture of components for the growing nuclear energy market. Support for innovation and infrastructure in these areas can build on geographical and industrial strengths.

17 Intra-industry trade, including the process whereby components are imported, placed in a product and then re-exported, means that we should be cautious in interpreting export data.

3. The Way Forward

Our strategy is therefore to promote the efficient operation of markets and encourage investment in our productive capacity, underpinned by strong entrepreneurialism.

A. Promoting the efficient operation of markets to support growth

Markets drive investment and growth, through encouraging productivity improvements, through both efficiency improvements within firms and the entry of more competitive firms. But markets can fail to deliver desirable outcomes for a range of factors, relating to externalities and tendencies for markets to move toward non-competitive structures. Government has a key role in setting how markets operate to ensure that the financial sector supports investment in the economy, competition is fair, markets are open to trade, and regulatory burdens on businesses are reduced.

Domestic competition frameworks

The benefits of competition on our growth potential are wide ranging. Competitive markets provide strong incentives for firms to increase their efficiency, driving down costs, and encouraging innovation in products and processes. Market discipline also ensures that the more efficient firms prosper, and leads to the economy becoming more productive overall.

The potential gains from the increased allocative efficiency in the economy which may arise from limiting the abuse of market power have been shown to be substantial, and estimated to be in the order of 0.5–1 per cent of GDP across the economy as a whole. The dynamic benefits of competition substantially exceed the more easily estimated static benefits. There is, for example, strong evidence of competition driving firm-level productivity, through its effects on managerial incentives[18], through inter-firm effects such as 'natural selection' of firm entry and exit, and through incentives to innovate[19].

Consumer confidence in markets is also essential to their proper functioning. Consumers need to be confident that goods on offer are correctly described and their rights can be enforced; lack of confidence in this area can reduce demand. Hence the consumer framework has an important place in the creation of competitive markets. Similarly, the pressure to attract and retain

18 Bloom and Van Reenen (2007) 'Measuring and Explaining Management Practices Across Firms and Countries'

19 Ahn (2002) 'Competition, innovation and productivity growth: A review of theory and evidence', OECD Economics Department Working Papers, No. 317

customers provides a strong incentive for businesses to act responsibly and improve their products and services. Confident consumers, who are adept at exercising choice, can therefore exert significant pressure on business practices without the need for burdensome regulation. There is growing evidence to show that empowered consumers act as a spur to drive competition and as a driver for firm-level innovation[20].

The UK domestic competition regime is ranked among the best in the world. The Global Competition Review gives the Competition Commission its highest rating, at five stars, putting it on par with the US Department of Justice and the Federal Trade Commission. The Office of Fair Trading receives a 4.5 star rating, equal to that accorded to the EC, Australia, France, Germany and South Korea[21].

Going forward, the challenge will be to get the balance right between a thorough and rigorous competition regime on the one hand, and simple regulation and fast process on the other hand; and to ensure that effective competition underpins and supports a range of future policy proposals, such as on banking reform.

Need for banking reforms

If the economy is to be encouraged to evolve in a sustainable way, it is critical that the ability of the financial sector to support investment is not limited by past regulatory failures. Financial institutions, especially banks play a key role in financial intermediation, pooling funds from savers, and lending on to businesses and consumers. But the financial crisis and resulting recession showed the impact that systemic problems in the banking sector can have on the wider economy, reducing the availability of finance for business.

Steps have been taken to address these problems, to improve financial stability and strengthen the role of the financial sector in financial intermediation. Changes will be made to banking regulation, both in terms of institutional reform to UK regulatory system, and the implementation of the global agenda on financial sector reform in areas such as strengthening capital and liquidity requirements. The G20 Toronto summit declaration makes clear that these new standards will be introduced over a timeframe that is consistent with sustained recovery.

The Independent Commission on Banking has also been established to formulate policy recommendations to reduce systemic risk in the banking sector, mitigate moral hazard, reduce the likelihood and impact of firm failure, and promote competition in both retail and investment banking.

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20 Waterson, M. (2004) 'Research to analyse the links between consumer empowerment, competition and productivity and to scope further work which could be undertaken to quantify these effects', University of Warwick

21 Global Competition Review (2010), Enforcement Ratings survey

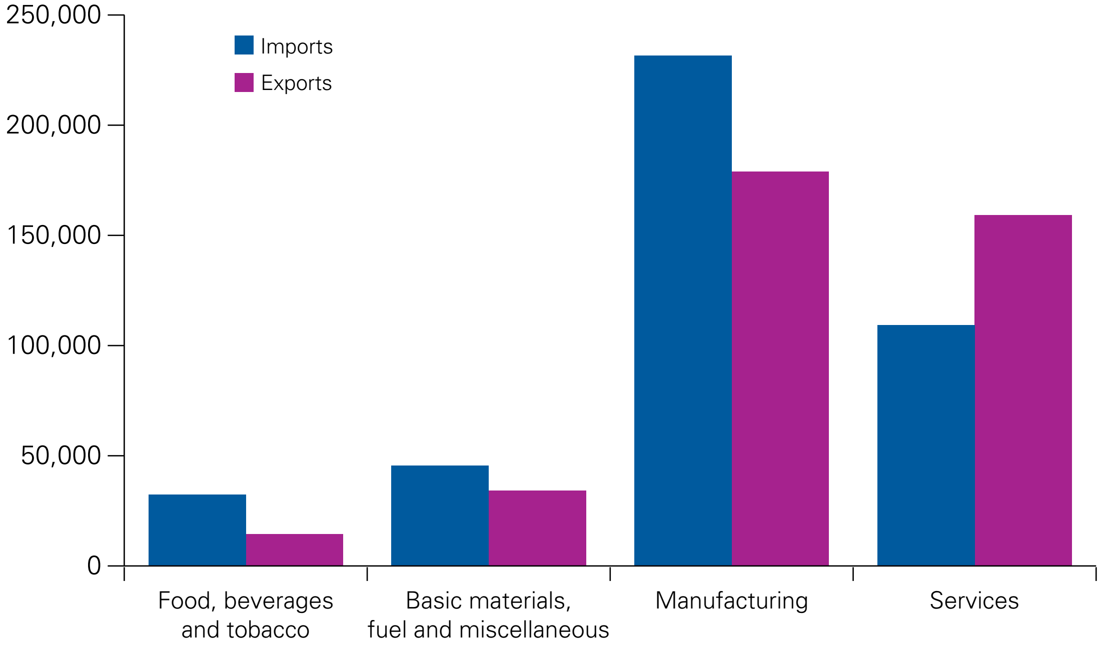
International frameworks and openness to trade

Trade can contribute to growth. There is a close correlation between trade and growth, although trade is more volatile[22].The benefits of exporting are well established and cover access to bigger markets, increased revenue, increased probability of firm survival and more innovation, research, and development. Imports also provide hugely important benefits that include cheaper inputs, more choice, and access to the benefits of innovation from around the world.

UK firms that import services have better performance characteristics in terms of productivity and employment than firms which do not trade services. Analysis[23] suggests that UK firms which import services account for 2.8 per cent of all firms but 7.9 per cent of employment and 11.2 per cent of output. Firms which both export and import services perform even better accounting for 4.4 per cent of firms but 11.3 per cent of employment and 16 per cent of output.

The UK is the world's 6th largest exporter and importer of goods and services. It is the 2nd largest exporter and 3rd largest importer of services, with manufacturing still accounting for the largest share of UK imports and exports (see chart 5).

Chart 5: Imports and exports, value by sector 2009 (£m)



Source: ONS

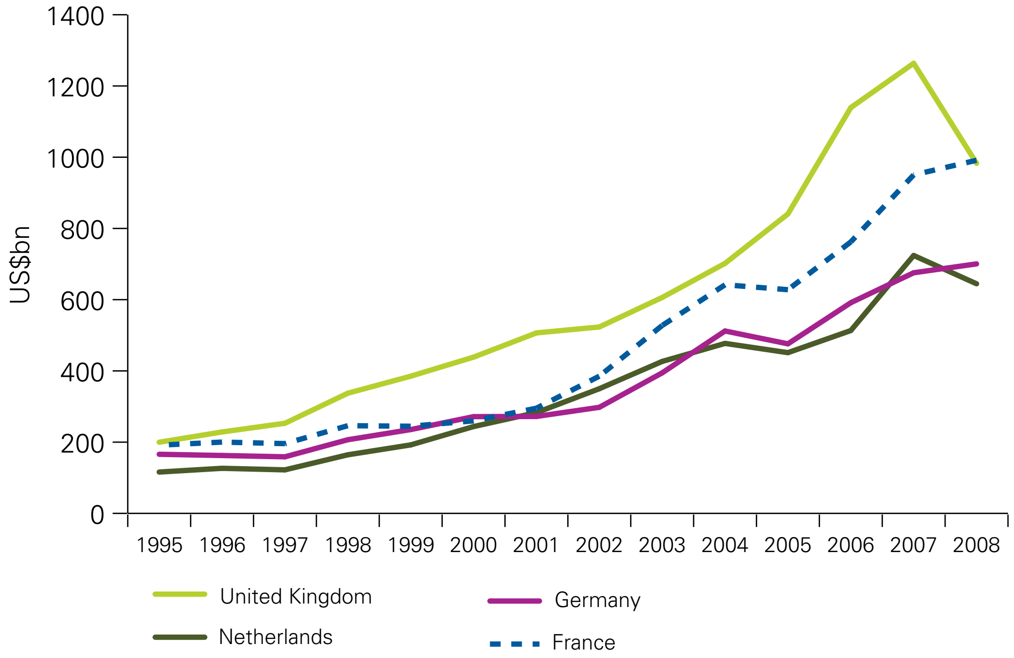
22 Trade declined much more sharply than GDP in the crisis (-12 per cent compared to -0.6 per cent); it is expected to bounce back more rapidly this year (growing by 9.5 per cent compared to 4.2 per cent) according to WTO and IMF forecasts

23 Breinlich and Cricuolo (2009) 'International Trade in Services: A Portrait of Importers and Exporters', CEPR Discussion Paper 7837

Net trade (export less imports) is expected by the OBR to boost GDP growth by around ¾ of a percentage point in 2011 and 2012 and to continue to contribute positively to growth.

Trade and investment are linked. Inward investment also generates knowledge and productivity spillover benefits. The UK is one of the most attractive destinations for inward investment in Europe. According to UNCTAD[24], the UK has historically attracted more FDI stock than its main competitors (chart 6).

Chart 6: Stock of inward Foreign Direct Investment



Source: UNCTAD

However competition with the UK has intensified. According to Ernst and Young[25], annual project numbers have fallen substantially in Europe in 2009.

The international framework of regulation which enables trade is incomplete. Working closely with the EU to make progress on multilateral and bilateral trade agreements and implementing existing agreements to reap their full benefits is the most effective way to lead to an improvement of the UK export performance, for instance through helping UK businesses tackling barriers to entry.

The UK's export dynamism is for a large part dependent on the situation in the EU, which accounts for around 50 per cent of UK trade in goods and services. UK export growth will be made much more difficult if the rest of the EU stagnates. To protect and ensure Europe's economic recovery, Single

24 UNCTAD (2009) 'World Investment Report'

25 Ernst and Young (2009) 'European Investment Monitor'

Market integration and simplification of the administrative burden have the potential to drive a substantial increase in European countries' growth rates by several percentage points[26].

Better regulation

Appropriate use of regulation can help improve a country's economic performance. A key aim of regulation is to redress market failures and ensure a more efficient allocation of resources. Other motives for regulation can involve the pursuit of social goals to maximise the society's overall welfare.

Recent estimates in the UK and US suggest that the benefits of regulation outweigh costs[27]. In the UK, government regulation is expected to deliver at least £1.85 in yearly benefits to society for every £1 of cost. A number of recent international surveys, such as The World Bank's Doing Business series, have established links between macroeconomic variables (e.g. GDP) and regulatory quality. For instance, a recent internal study estimated the overall benefits in the UK of cartel regulation to be £250 million per year, a net benefit of £230 million[28]; measurement standards regulation have been estimated to contribute about 0.8 per cent of GDP[29] to the UK's economic growth.

However, as economies become more complex, and more regulations are introduced, the cumulative burden can restrict growth by raising the costs of operating a business in placing both financial and time demands on it, and by creating overly complex incentive structures. The implementation of the regulation is as important as its legal design. According to business surveys, the areas that impose the highest administrative costs are health and safety law, employment law, taxation law, sector specific legislation and environmental law[30].

The indirect impacts of regulation are also important as these can add additional burdens and affect incentives, having a direct bearing on the UK's competitiveness. For example, effective use of land is essential for business growth. Land use regulation is necessary to overcome market

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26 Ilzkovitz, F., Dierx A., Kovacs V., and Sousa N (2007) 'Steps towards a deeper economic integration: the Internal Market in the 21st century. A contribution to the Single Market Review', Ecofin Economic Paper No 271

27 HMG (2009) 'The Total Benefit/Cost Ratio of New Regulations 2008-2009'; US Office for Management and Budget, (2008) 'Report to Congress on the Benefits and Costs of Federal regulations'

28 DTI (2006) 'The impact of regulation: a pilot study of the incremental costs and benefits of consumer and competition regulations'

29 PA Consulting Group (1999) 'Review of the Rationale for and Economic Benefit of UK National Measurement System'

30 BIS (2008) 'The Annual Small Business Survey 2007/08'

failures, which would otherwise prevent the efficient allocation of land to different uses. However, by specifying which land can be developed and how, regulations affect the price of land. Recent research suggests that planning regulations increase the cost of office space in London much more than other European cities[31]. Moreover, businesses are significantly less likely to feel informed about Planning Law than other areas of regulation[32]. And, whilst planning permission is the major risk for developers, the cost, time and unpredictability of the process required to obtain non-planning consents exacerbates the challenges a developer faces in dealing with planning issues.[33]

Overall, the UK ranks relatively well in some international surveys of regulatory burdens but less so in others (chart 7). There are signs that, while UK regulatory barriers may not be increasing, other countries may be catching up with and, in some cases, overtaking the UK's efforts at reducing regulatory burdens.

Chart 7: UK International Ranking of Government and regulatory burdens

Rank	WEF Global Competitiveness 2009/10	World Bank 2010	OECD Barriers to Entrepreneurship indicator 2008
1	Switzerland	Singapore	**United Kingdom**
2	United States	New Zealand	Netherlands
3	Singapore	Hong Kong	Sweden
4	Sweden	United States	Italy
5	Denmark	**United Kingdom**	Korea
13	**United Kingdom**		

Sources: WEF; World Bank; OECD

It is important that the UK economy is underpinned by the right regulatory framework that supports business creation and growth, and avoids imposing unnecessary burdens which would undermine UK competitiveness. New regulations must address market failures or be clear about the objectives they intend to deliver. It is equally imperative to look at the stock of regulation, to ensure regulations remain fit for purpose given changing market circumstances, and responsive to business needs.

31 Cheshire and Hilber (2007) 'Office space supply restrictions in Britain: The political economy of market revenge'

32 NAO (2010) 'Business Perceptions Survey'

33 BIS (2010) 'Penfold Review of non-Planning Consents', Interim Report, March

B. Encouraging investment in our productive capacity to drive growth

Evidence shows the crucial importance of investment in capital (buildings, equipment and infrastructure), skills, science and innovation in driving growth. Public investment is complementary to private investment. Government can encourage investment by minimising uncertainties and correcting sources of market failures, both in capital markets and in areas that would otherwise be under-invested because the benefits to the economy are over and above those borne by workers or businesses.

Access to finance

Growth requires access to appropriate finance. Businesses have a number of options to finance investment and growth, some will use cash generated in the business while others will seek external finance. External finance can include a combination of bank credit such as loans and overdrafts, non-bank lending such as public or private bonds, or equity investment.

The financial crisis of 2008 led to an immediate reduction in the supply of credit from the banking sector to business (Chart 8), causing significant difficulty for firms utilising external finance. Since the crisis, many borrowers have experienced higher spreads over the Bank of England base rate. Businesses have improved their resilience by cutting costs, delaying investment and building up cash reserves, thus reducing the demand for bank finance. Therefore bank lending activity is very weak across most developed countries with the UK, US and Euro area all having witnessed contractions in the net flow of bank credit over the last twelve months.

Chart 8: Lending to UK businesses

Source: Bank of England Trends in Lending (June 2010)

Now, as the economy grows and business confidence returns, many businesses will increase investment again and grow. The challenge is for the supply of finance in general, and the banking sector in particular, to support rather than constrain the recovery. This concern is particularly marked with respect to small and medium sized businesses, given their historic reliance on bank lending. As banks seek to reduce their leverage and extend the maturity of their funding[34], combined with the potential impact of the regulatory changes, there is a risk that the availability of bank finance will again restrict the supply of finance to creditworthy firms.

Large businesses, as well as some mid-sized companies, have been able to access the capital markets as an alternative to bank debt. There was record issuance of debt and equity in 2009 enabling a more diversified finance portfolio.

Alongside the changes to the finance environment experienced through the recession there are some long-term structural market failures that may prevent some companies from getting the finance that they require.

Imperfect information makes it difficult for both investors and businesses to make optimal investment decisions. The high cost of obtaining information on the viability of SMEs relative to the size of funding they are seeking leads to potentially viable businesses not being able to raise finance. This is an issue for bank lending and equity.

The Green Paper on Business Access to Finance, to be published before the summer recess, will explore some of these issues in more detail.

Infrastructure

Good infrastructure networks support economic activity and growth and conversely, economic growth increases the demand on infrastructure. The UK's infrastructure networks enable people, goods, energy, information and water to move efficiently. In this way, the capacity and quality of infrastructure directly affects labour and product markets and competition within these. Infrastructure also facilitates innovation by lowering the cost and increasing the speed of communications.

Recent empirical work by the OECD[35] found that over the period 1970-2005 investment in UK roads, rail and electricity had a stronger positive effect on the level of GDP per capita, and short term growth, than would have been the case for other types of capital investment, demonstrating the strong contribution that infrastructure has made on growth.

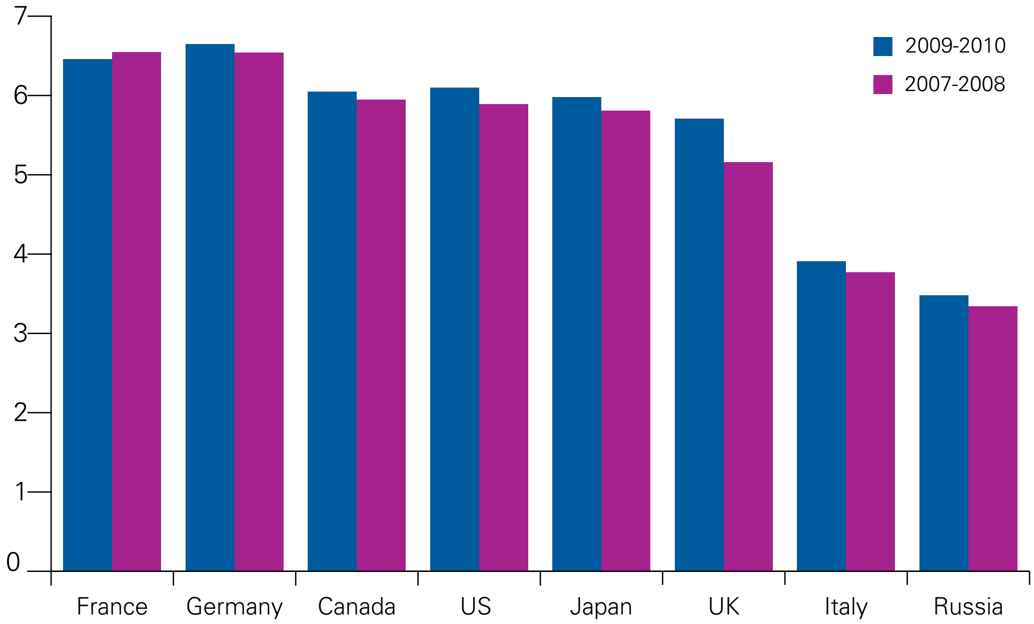
34 Bank of England (2010) 'Financial Stability Report', June

35 Egert, B., Kozluk, T. and Sutherland, D. (2009) 'Infrastructure Investment: Links to Growth and the Role of Public Policies' OECD Economics Department Working Papers, No. 686

Both private and public investments contribute to infrastructure. Government has a major role in supporting infrastructure development; ensuring private investment exists alongside fair prices where there are natural monopolies e.g. in utility networks and rail; ensuring land is available through the planning system; and as a provider where the market alone is unlikely to deliver optimal levels of infrastructure e.g. in roads.

The performance of our existing infrastructure varies by mode but the World Economic Forum's 2009/10 Global Competitiveness Index placed the UK only 33rd out of 133 economies, behind many other G8 countries (chart 9).

Chart 9: Global Competitiveness Index – Infrastructure quality in G8 countries



Source: World Economic Forum

Demand for UK infrastructure investment up to 2030 and beyond is forecast to be significantly higher than historic levels. Approximately £150 billion was invested in UK economic infrastructure between 2005-2010, predominantly by the private sector. There are substantial challenges to meeting potential future demand for infrastructure of around £40-50 billion per annum until 2030[36]. Investment in infrastructure by both the private and public sector is necessary to allow growth and to meet new demands such as population growth, the needs of the energy sector and the development of low-carbon technologies.

As with other forms of financing during the credit crunch, the cost of PFI financing has increased. This is due to the combination of a lack of liquidity in the bank market and an inability to access the capital markets for PFI assets. This resulted in increased pricing and stricter terms and conditions

36 HMT (2010) 'Strategy for National Infrastructure'

from funders. Despite this, PFI projects provide value for money and continue to cut across a wide range of asset classes.

However, the market remains uncertain about making long-term investment commitments and new regulations which require banks to allocate more capital to long-term lending could result in a further decline in capacity. Alternative sources of investment from capital markets and institutional investors would provide a wider funding base and would help to reduce reliance on bank finance. However, at present the risk profile of PFI projects with construction risk is unable to achieve the necessary rating to attract these sources of finance.

Higher education and skills

Investment in higher education and skills is essential to provide individuals with the competencies that will enable them to find employment in the knowledge economy and to contribute to social mobility and fairness.

Greater levels of skills lead individuals to work more effectively, adapt to changes better and carry out more complex tasks. Graduates in particular complement innovation and facilitate the introduction of new ideas and technologies. Higher levels of management capability are associated with a higher ability of firms to make the most effective use of skills in their overall business strategy. Evidence that attempts to estimate the benefits of qualifications to individuals in terms of wage enhancements in the labour markets[37] shows that acquiring qualifications leads to considerable and increasing returns on investment. It also indicates that for vocational qualifications there are greater benefits when acquired through the workplace[38].

The demand for highly-skilled workers and an increasingly mobile workforce also explains net inward migration to the UK over the last decade. The majority of work permits issued to non–EEA nationals have been

37 McIntosh (2009) 'The Economic Value of Intermediate Education and Qualifications', UKCES Evidence Report

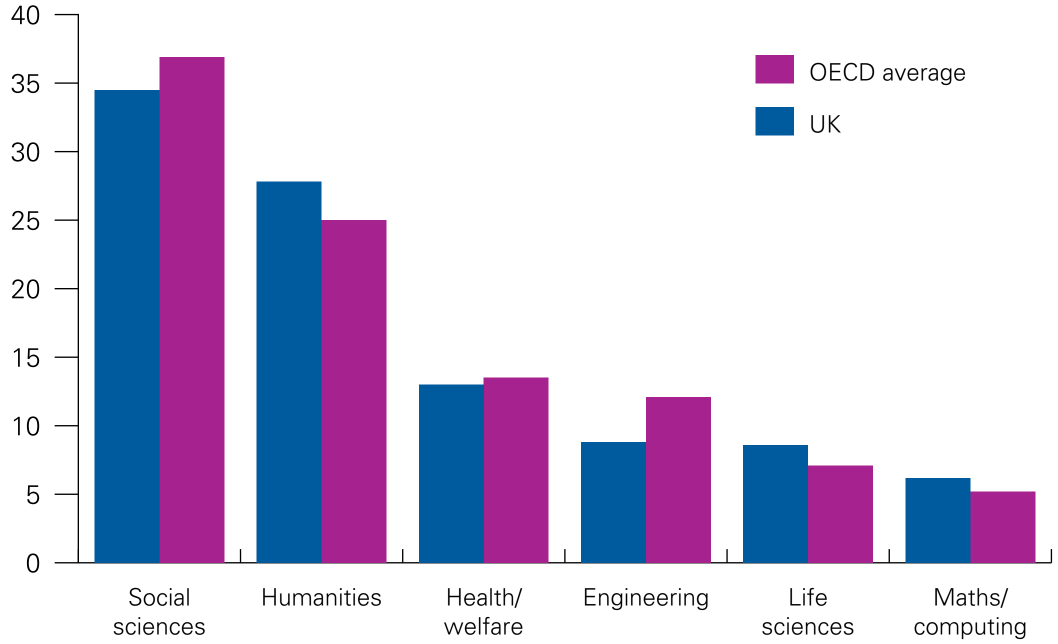
38 Jenkins, Greenwood and Vignoles (2007) 'The returns to qualifications in England: updating the evidence base on level 2 and level 3 vocational qualifications'

predominantly in the most skilled occupations[39]. Research suggests that immigration made a positive contribution to growth in the UK[40].

Information failures, both amongst learners and firms, may lead to sub-optimal levels of investment in training. Problems with access to finance may deter some individuals, particularly those from lower socio-economic backgrounds, from being able to invest in training or education. The potential for firms other than those making the investment to benefit from spillover effects may also limit the amount of skills investment undertaken.

Since 2000 there has been an increase in UK educational attainment. Yet persistent gaps remain in management quality[41] and in some STEM subjects such as engineering (see chart 10).

Chart 10: Percentage of tertiary graduates by field of education



Source: OECD

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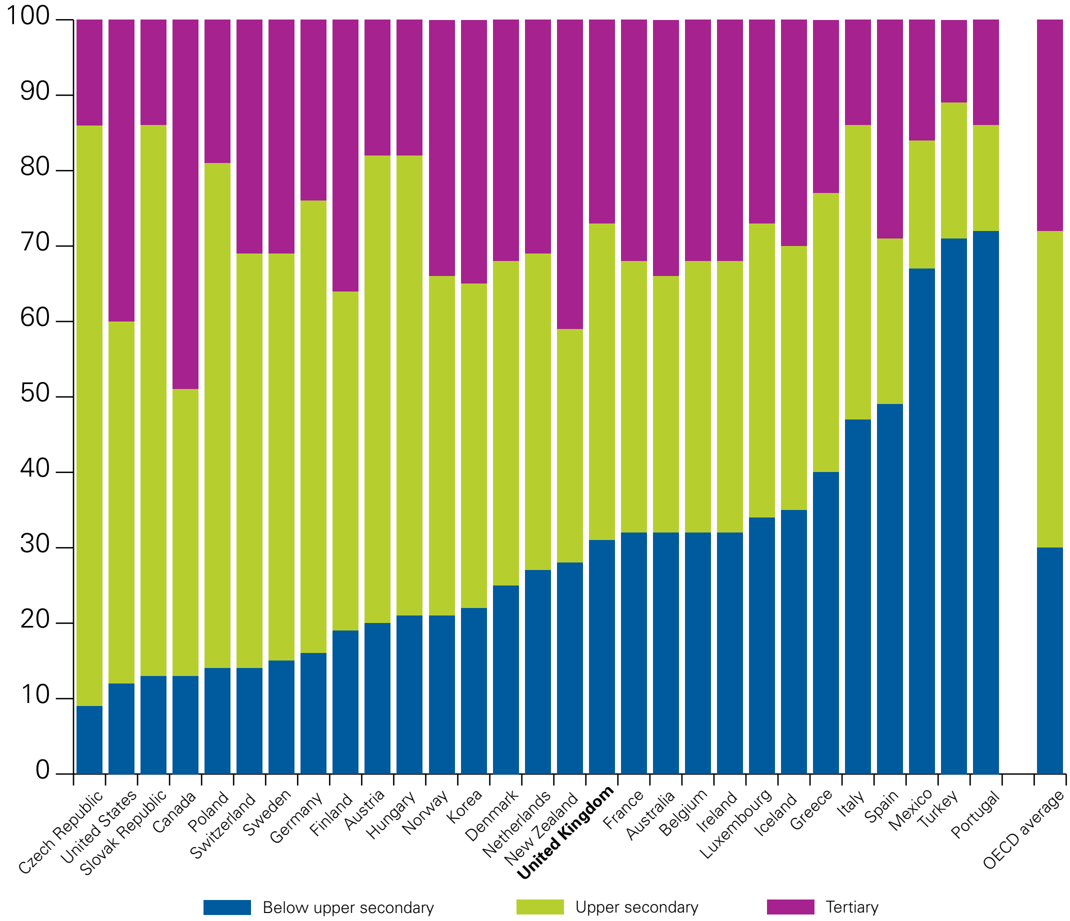
39 Salt (2008) 'International migration and the United Kingdom: Report of the United Kingdom SOPEMI Correspondent to the OECD', Migration Research Unit

40 Research undertaken by the National Institute for Economic and Social Research estimated that immigration accounted for 17 per cent of economic growth in 2004 and 2005. HMT estimate that between the third quarter of 2001 and mid 2006 immigration increased the working age population by 0.5 per cent per annum. This accounted for between 15 and 20 per cent of output growth between 2001 and 2006, adding around £6bn per annum to the UK economy. However, as noted by the House of Lords, the impact of immigration on the overall size of the economy (GDP) is not a useful measure of living standards and that the focus should be on GDP per head, or even GDP per head of the resident population.

41 CEP/McKinsey & Company (2007) 'Management practice & productivity: Why they matter?'

Overall, the UK remains a middle-ranking country in terms of qualifications (see chart 12). In particular, the UK continues to have a long tail of people with low skills. In terms of those holding at least upper secondary qualifications (level 2 and 3), the UK ranked only 18th across OECD countries. The position for higher education is more positive with the UK placed 11th and UK universities have an excellent reputation worldwide.

Chart 11: Highest qualification obtained as a percentage of population aged 25-64



Source: OECD

International comparisons[42] also show that both public and private expenditure on higher education in the UK is below OECD average, and that the increase in the share of the working population with tertiary education over the last decade has been similar to the OECD average. Up-skilling our workforce is a major challenge we have to tackle. In doing so, we need to consider the balance of funding between the state, the individual and private businesses/institutions, placing funding responsibility with those who benefit most.

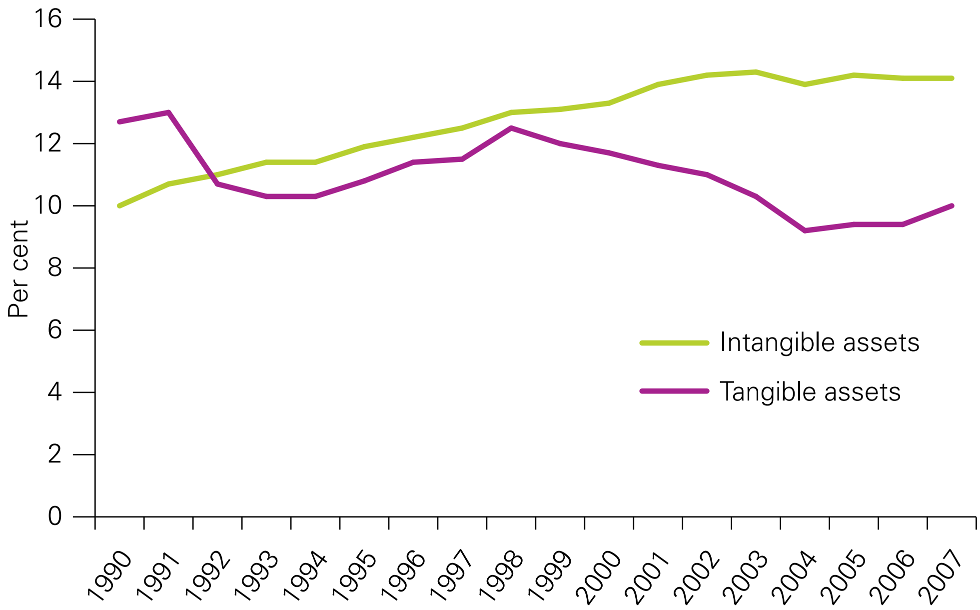
42 OECD (2009) 'Education at a glance'

Science, research and innovation

Innovation is the introduction and diffusion of new products, services and processes and one of the major sources of long-term productivity growth. This occurs both through investment and because innovation is one of the explanations for increases in efficiency. The provisional results from NESTA's Innovation Index suggest that in combination these could account for two thirds of UK productivity growth over the period 2000-2007[43]. For developed economies close to the technology frontier, innovative firms are an important source of net employment creation and increased investments in innovative processes and products are paramount for growth.

Business investment in innovation comprises investment in intangible assets such as computer hardware and software, and advanced machinery, design, training, market research or external R&D. Chart 12 below shows the growing importance of nominal intangible investment in the economy. Computerised investment has made a significant contribution to this increase.

Chart 12: Intangible Investment as a share of output



Source: NESTA

Although there are limitations in the relevant data, comparative analysis suggests that UK business investment in intangible assets compares favourably with other advanced economies.

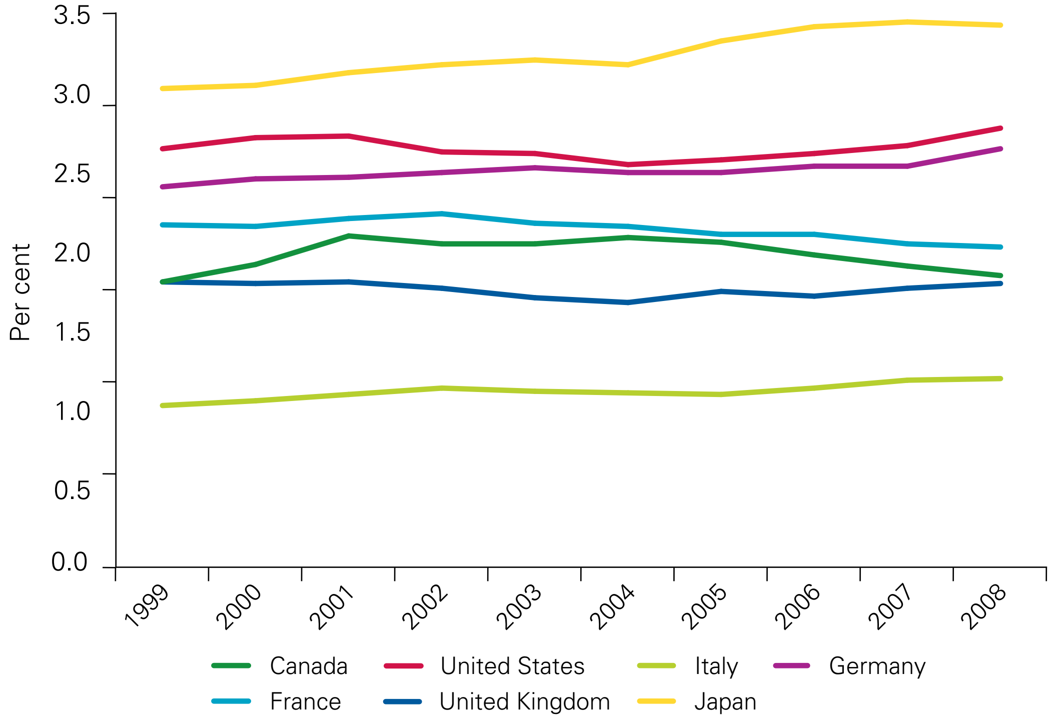
All advanced economies use public policy to create the conditions for successful innovation and address specific market failures that would otherwise restrict specific forms of investment in innovation. They also commit public funding to support their research base. Knowledge has many

43 NESTA (2009) 'Innovation Index Report'

public good characteristics. R&D spillovers and the risks and uncertainties associated with research explain why private funders can be reluctant to invest in research where there is little clear prospect of a benefit that can be protected. A number of academic studies also show that investment in the research base is also necessary to generate the ability to exploit knowledge generated by external sources or other economies[44].

Higher levels of R&D are associated with higher productivity[45]. UK expenditure on R&D is relatively low as a share of GDP (see chart 13). This is mainly because of lower business R&D but this is turn can be explained by the UK's relative specialisation in industries where formal R&D is not a major investment as mentioned earlier.

Chart 13: Gross expenditure R&D as percentage of GDP (1999-2008)



Source: OECD

The UK public research base compares very favourably with other countries. Across the range of disciplines, UK researchers in universities and research institutes stand second only to the US in terms of volumes of high quality (most cited) research and the UK is first in the G8 in terms of research productivity[46]. This publicly accessible knowledge base produces highly

44 The most common reference sources are Cohen and Levinthal (1989) and Griffiths, Redding and Van Reenen (2004)

45 OECD (2004) 'From R&D to productivity growth: do the institutional settings and the source of funds of R&D matter?'

46 Evidence Ltd (2009) 'International Comparative Performance of the UK Research Base Report'

trained researchers that constitute a problem-solving capability for all sectors of the economy. Surveys also suggest that the quality of the UK's public research base is also one of the most important factors attracting internationally mobile business R&D to the UK.

The publicly-funded research base is part of the broader knowledge infrastructure that enables businesses to innovate. Other important elements include frameworks for intellectual property rights, measurement, design and standardisation.

C. Encouraging entrepreneurialism

Central to encouraging business and individual engagement to drive growth is ensuring there is strong entrepreneurial behaviour across the economy, with the dynamism of the economy not held back by a business environment which dulls entrepreneurial incentives. Sustainable growth depends on there being incentives to drive the creation and growth of businesses.[47]. New and small businesses underpin growth by stimulating innovation and making a disproportionate contribution to job creation[48].

Nearly 70 per cent of SMEs employers aim to grow their business over the next 2 to 3 years, but only 20 per cent experience growth[49]. Several studies have found that encouraging and enabling businesses to access external advice and guidance results in business improvements that have a significant impact on business growth and associated business outcomes such as the propensity to export, train and innovate[50].

Boosting economic growth also requires that there is a much larger group of individuals who are actively thinking about starting a business, and have the attributes and skills to achieve their ambitions. Evidence[51] suggests that many people in the UK, while being supportive of enterprise tend to favour employment as a career option based on poor information which can lead to a lack of understanding about the benefits, risks and necessary skills associated with setting up a business.

Variations in growth and income between regions are also reflected in differences in business start-up rates and the density of the business stock. For example, the Northern regions have the lowest levels of entrepreneurial

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47 Robinson et al (2006) 'Business start-up, closures and economic churn'

48 Wright et al (2010) 'Job creation, job destruction and the role of small firms'

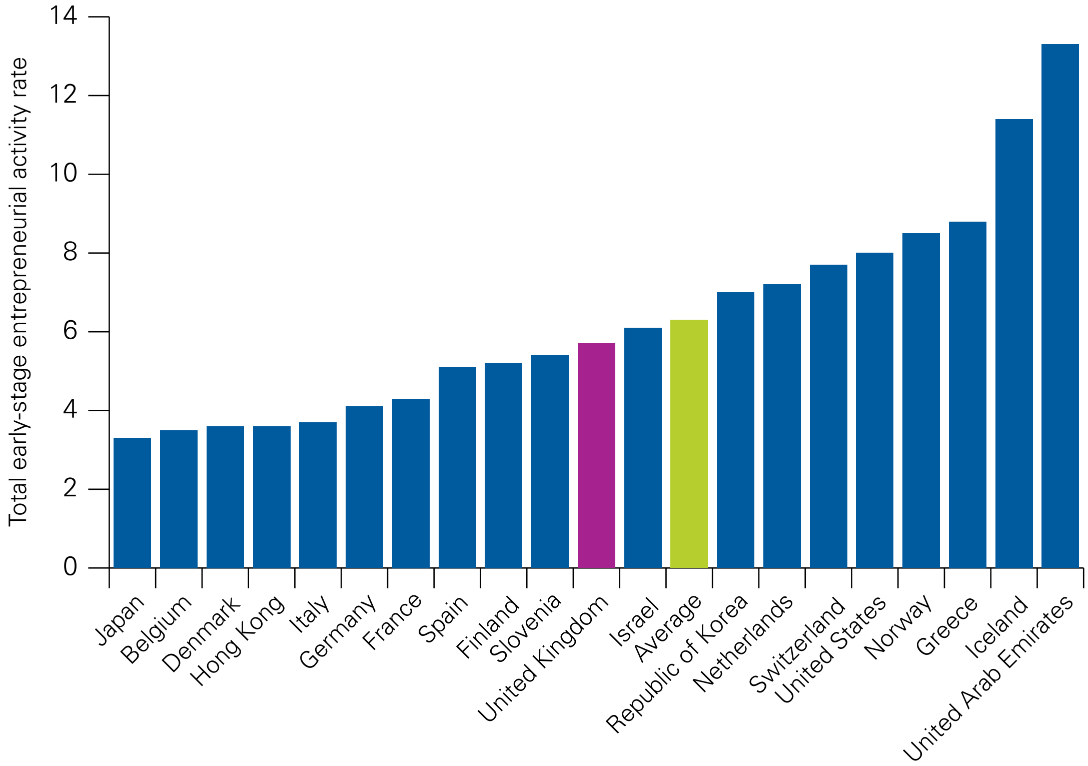
49 BIS (2008) 'Analysis of Annual Small Business Survey 2007-08'

50 Hart et al (2007) 'Economic Impact Study of Business Link Local Service', Annual Small Business Survey 2007/08

51 GEM (2009) 'Global report'

activity and London and the South East the highest[52]. A stronger enterprise culture, with larger numbers of people actively thinking about starting a business and given the opportunity to develop the skills to do so, can also help address those differences in business start-up rates between regions and individuals.

Chart 14: Proportion of the working age population involved in starting o growing a new business



Source: Global Entrepreneurship Monitor

According to the Global Entrepreneurship Monitor (see chart 14) the UK outperforms several G7 countries, including Germany and France, on measures of entrepreneurial activity and culture. But, we still trail the US and other competitors and there are significant differences between UK regions, indicating there is scope for improvement.

52 ONS (2008) 'Business Demography'

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