

# **Freeing Britain to Compete:** **Equipping the UK for Globalisation**

## Submission to the Shadow Cabinet

Economic Competitiveness Policy Group  
Chairmen, Rt Hon John Redwood MP and Simon Wolfson  
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## Foreword

By Rt Hon John Redwood MP

### Shifting Economic Power in a Global Economy

The winds of global competition are blowing strongly through the world's economies. We are living through a massive shift in economic power, as the Asian economies led by China and India emerge as global manufacturers, service providers and traders, with attractive offerings to the customers of the world.

These winds could carry us to greater success, or they could destroy businesses and jobs at home if our economy is not well secured and supported by a government that understands the needs of enterprise.

Some feel threatened by these new competitive forces. Chinese manufacturers have quickly gained a dominant position in the textiles, leather goods and computer hardware markets. They are moving into engineering, motors and chemicals. That is one reason why factories in the UK have closed over the last ten years, with the loss of a million manufacturing jobs. Indian service and call centres have taken on functions that British workers used to do nearer to the customers.

We should remember that with every new job India and China create to sell us goods and services, they create a better paid consumer who in turn needs goods and services which we can help provide. With every extra pound of Asian income comes money to spend and invest in the markets of the world. Globalisation is more opportunity than threat, if we create the right conditions at home to respond to the new challenges, and to offer the right goods and services to the new markets. We should not begrudge the Chinese and Indians their hard-earned, rising prosperity: we should seek to be partners and assistants in that success.

Sheer weight of numbers will propel China and India to the two top slots in the world league of economic output. China has already overtaken France, the UK and Germany, and will in due course overtake Japan and the USA. China is already one of the largest creditor nations, with massive foreign exchange reserves and big holdings of overseas bonds. With 1.3 billion people, China only has to deliver living standards around one third as high of those in the USA to be a larger economy than the USA. Like China, India, now growing quickly, will be another giant consuming large quantities of the world's supply of oil and other raw materials, and delivering an important part of world output.

#### **How is the UK placed to respond?**

The Government claims that the UK has done well over the last fifteen years, with steady growth and relatively low inflation. Compared to the 1930s or 1970s in the UK this is true. Compared to the rest of the world the performance is not so impressive.

The last ten years in particular have been good years for the world economy as a whole. They have been characterised by two massively favourable trends. The first is an era of easy money. The main central banks worldwide have opted for low interest rates, the ready creation of credit, and tolerance of innovative means of financing public and private sector activity through big increases in debt. It has been the era of public/private partnerships, specialised credit-based funds and funds of funds, collateralized debt obligations, collateralized loan obligations, credit default swaps, special purpose vehicles and many other similar ways of raising borrowing throughout the financial system.

The second has been the remorseless downward pressure on prices of both goods and internationally traded services from the migration of business to lower wage countries in the East using newer plant

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and equipment, and from the application of new web based technology that is revolutionising business models. As a result, the prices of manufactured goods from fridges to cars, from textiles to computers have been falling. Cheap holidays and better value insurance, online banking and web-based advertising have all assisted in creating this disinflationary environment.

The UK has not performed that well against this very favourable background. We have experienced higher interest rates than most of our main competitors, and have still ended up with higher inflation than the USA, Euroland or Japan. Our growth rate has been flattered by rapid inward migration, and conceals 5.4 million people of working age without jobs living on benefits. Productivity, output per head and living standards have, as a result, not risen as far and as fast as those of the better performing world economies. The UK has fallen down the league table of the most competitive economies, which has meant fewer jobs and lower incomes than if we had been more successful.

We should not rely on these two very favourable trends continuing to allow us an acceptable rate of growth. As we write, there is considerable uncertainty in world markets about how far the Federal Reserve Board, the European Central Bank and the Bank of England may go in raising rates to squeeze inflation out of the system. They must know there are huge pyramids of debt throughout the system, and inflation will not be killed unless the appetite for more debt is blunted. They also know that if they push interest rates too high for too long they could bring the debt structures crashing down, as we have seen with the sub-prime mortgage collapse in the USA, leading to falling asset prices, rising unemployment and even recession. We should proceed on the basis that money will be tighter in the years ahead than during the last decade.

We should also recognise that China and India will not continue to exert strong downward pressure on prices to the extent that they have in last ten years. Their workforces are now expecting better rewards. Raw material prices are being bid up by their large demands. The price of transport rises when capacity is stretched by their needs. These factors are leading to less intense price competition from these emerging giants. Whilst others in Asia can emerge as lowest price competitors, and whilst many millions more poor people can pour off the land in both India and China into the factories and call centres, the last couple of years have shown that this on its own is not enough for the UK and the USA to be able to ignore inflationary pressures brought about by easy money at home.

### **How prosperous is modern Britain?**

We recognise that the UK remains one of the richest countries in the world. Today's families take for granted the TVs, cars, fridges and carpets that were the prerogative of the rich sixty years ago, and they have access to the computers, iPods and mobile phones that had not been invented in our grandparents' day. Many of the people who have benefited from new jobs are recently arrived migrants, rather than people with poor skills who have been living here for longer.

Over the last decade the UK economy has experienced lop-sided growth. London has been the most successful part of the country, based on its openness to new people and new capital coming in from around the world. The South East has done reasonably well. The further north or east you travel, the more disappointing the results. Our growth rate has on average been lower than the USA or Ireland, and in some parts of the country it has been poor, leaving cities like Glasgow with low incomes and short life expectancy.

Labour's policy has been to target more benefit support, especially for families, to those on low incomes. This has sometimes impeded creating incentives to work, and has led to the need for an expensive bureaucracy to persuade people back to work. There are towns, parts of cities and rural areas where low incomes and low employment rates still pose substantial problems.



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## What can be done to make the UK more prosperous?

Our report is based on the strong evidence from around the world that countries which choose the lowest tax rates, and which have the least oppressive but effective regulatory regimes, are the ones that grow the fastest and become the richest. We believe that any Conservative Chancellor should set business free to compete, by creating a simpler and more competitive tax and regulatory framework for enterprises based in Britain.

Our proposals include a dramatically different approach to business regulation. Many businesses, especially small businesses, have told us that it is the sheer cumulative volume of regulation which makes their lives so difficult. People who need to concentrate on customers and products have instead to spend a great deal of time on complying with regulators. We propose an annual regulatory budget for the government, setting out how much cost government will impose on business in the following year, and ensuring that in each year of Conservative government the costs imposed will be reduced overall. We also set out some regulations that we suggest the incoming government repeals in its first year in a Deregulation Act, to begin the long process of cutting this unwelcome, back door taxation. In many cases regulations are not necessary to keep businesses honest and safe. Intense pensions regulation has coincided with the worst period for the health of pension funds in post-war Britain. Some regulations achieve the opposite of what they set out to do. We fear this could be true of Identity Cards, giving more people access to important identity information about others.

We also believe that government needs to provide leadership in tackling the large number of capacity problems and bottlenecks which have emerged in the UK's ageing infrastructure. The UK may be an island of coal set in a sea of oil and gas, but it came close to running out of energy in 2006. We may have been the first nation to build railways, and we still have an extensive pattern of railway routes, but we are short of train capacity for both goods and passengers. We have far less motorway per person and per square mile than our leading continental competitors, France and Germany, and some of the most congested roads on the planet. We have some great universities, but our output of science graduates is small compared to business needs. We spend a great deal on schools and vocational training, but we still have too many people who lack the basic skills needed for them to obtain worthwhile and better paid jobs. We did have the best pension provision of any Western country ten years ago, but today many final schemes are closed to new members or are in wind up, leaving more people worrying about the adequacy of their pension and savings in old age. Recent floods have revealed the inadequacy of our flood defences, whilst last summer's dry weather left us short of water.

Our report examines why we are short of capacity of all kinds in transport, water and water control, energy, and skills. It demonstrates that where we have trusted the market and competition more – as with telephones – the much needed extra capacity has been put in to tackle the problem. Where we have left monopoly public provision in place, we have shortages. We examine ways in which private capital and competition can be harnessed to ensure more plentiful supplies of transport network capacity, of energy, and of water. We look at how our universities can be freed to raise more endowment money for themselves, and to serve the wider global educational world. We propose changes to the organisation of training, so that individuals and companies have more say, and quangos less, in how the money is spent.

We also consider the way in which so much money has been absorbed by the public sector in the last few years, with so little expansion of output. We propose a new approach to public sector management, releasing the talents of public officials, and incentivizing them to achieve higher quality and more output for the money government will be spending.

We examine the difficulties people and businesses encounter with the planning system when trying to put through new investments. We make suggestions on how decision making could be speeded up and applicants given more certainty, without damaging local wishes to protect valuable open country or to

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protect important urban settings. We help identify land suitable for development, which will be necessary for future economic growth.

### **Helping the many to own and to prosper**

Whilst the UK is a rich country on average compared with many other countries around the world, that does not mean that a majority of families in the UK are rich. We want a new Conservative government to be the friend of enterprise, on the side of those who strive to be more successful. We want that government to follow policies which make it easier for people to buy a home of their own, to own shares in other people's businesses, to own a stake in their own business. The nineteenth century saw the long march of everyman to the vote. The twentieth century saw the long progress of the many to home ownership. We want the new century to see us take decisive steps to the many owning shares, having savings, participating in the success of their firm. We set out proposals to promote wider ownership and to make it easier for people to work for themselves.

### **Our vision**

Our vision is of a UK capable of competing with the best. We seek a more prosperous country, with more owners participating in the wealth of the nation. We want reliably low inflation, taking no risks by turning fiscal rules into flexible friends. We seek a country with better railways and roads and less congestion, a country with plentiful supplies of energy for its more energy-efficient uses, with great universities and training geared to the needs of the students. We want to rekindle the savings culture, and to offer ways for people to save enough when working to earn them a more comfortable old age. A more enterprising Britain will be a more caring Britain: as incomes rise, so tax revenues rise and charitable giving flourishes. A more enterprising Britain will be a greener Britain: our businesses will be able to pioneer new ways of keeping us warm, allowing us to travel, or delivering our goods that use less energy. A more enterprising Britain will be a freer Britain, with lower tax rates and fewer regulations.



Rt Hon John Redwood MP  
Co-chairman, Economic Competitiveness Policy Group



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## About The Economic Competitiveness Policy Group

### Steering Committee

#### **Co-Chairman - Rt Hon John Redwood MP**

John entered Parliament in 1987 and has held various posts across government, including time in the DTI and as Secretary of State for Wales. Before becoming an MP, he was Chairman of a stock market listed industrial group and head of the then Prime Minister's Policy Unit.

#### **Co-Chairman - Simon Wolfson**

At 38, Simon is the second youngest CEO of a FTSE100 company - the High Street and Mail Order clothes retailer Next plc. Simon joined Next in 1991, and has been CEO of the company since 2001.

#### **Adam Afriyie MP**

Adam is the Conservative MP for Windsor. An entrepreneur and businessman, Adam has started and run businesses in IT and News services. He is particularly interested in simplifying the tax and benefit system.

#### **Carol Bell**

Carol has over 20 years experience in the oil and gas sector. Most recently she was Managing Director of Chase Manhattan's Investment Bank, with responsibility for oil and gas; and prior to that she was Global Head of J.P. Morgan's Energy team in Equity Research. She is a Non-Executive Director of Hardy Oil and Gas plc, and was awarded a PhD in the archaeology of ancient trade in May 2005.

#### **Andrew Feldman**

Andrew is Managing Director of his family textile company. Previously, he practiced as a commercial barrister after graduating with a First in Law from Brasenose College, Oxford.

#### **Greg Hands MP**

Greg is the Conservative MP for Hammersmith and Fulham. Leaving Cambridge with a First in Modern History, Greg embarked on a banking career in the City, working in both London and New York City. Greg's main interests in national politics are in finance, foreign affairs, housing policy and the criminal justice system.

#### **Cllr Peter Jones**

After a career in stock broking and investment research, Peter is now Leader of East Sussex County Council, Chairman of Sussex Police Authority, Deputy Chairman of SEEDA and a Board Member of the Audit Commission. In recent years, he has been involved in beating cost out of local government.

#### **Professor Peter Sinclair**

Peter Sinclair is Professor of Economics at Birmingham University. His current research focus includes aspects of monetary theory and policy, and international economics.

#### **Michael Wade**

Michael Wade served on the Council of Lloyd's and on the Rowland Taskforce with McKinsey & Co. He has spent over 25 years in the London Insurance Market and is currently the chairman of Bowood Holdings Lloyd's brokers, a Director of Rostrum Group investment fund managers, and of Paterson Martin reinsurance analyst specialists.

#### **Michael Johnson, Policy Group Secretary**

Michael joined CCHQ in early 2006, after 21 years in investment banking, and two years as a Senior Consultant at an actuarial consultancy.

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## Technical Team

Bill Allen, Senior Economist, Brevan Howard  
Esther Baroudy, Equity Analyst, GE Asset Management  
Bruno Paulson, Senior Analyst, Sanford Bernstein

## Deregulation

Chairman: Adam Afriyie  
Julian Gregory, Barrister, Monckton Chambers  
Jonathan Herbst, Partner, Norton Rose  
Ruben Lee, Founder and MD, Oxford Finance Group  
Claire Bullen, Bristol-Myers Squibb Pharmaceuticals Ltd  
Tom Price, Counsel, Financial Services Group, Dechert LLP

## Pensions

Chairman: Carol Bell  
Ken Davy, Chairman, Simply Biz  
Andrew Dennis, Retired insurance and pensions executive  
Kevin Wesbroom, Partner, Hewitt Bacon & Woodrow  
Mark Younger, Former Partner, Accenture  
Howard Flight, Director and Joint Chairman of Investec Asset Management Group, and former Shadow Chief Secretary to the Treasury

## Transport

Richard Currie, Director, UPS  
Gurmaj Dhillon  
Jon Pritchard, Director of Policy, ICE  
Graham Smith, Planning Director, EWS  
Colin Sewell-Rutter, Former MD, UK Airports Ltd

## Public Sector Efficiency

Chairman: Cllr. Philippa Roe, James Committee member  
Iain Corby, James Committee member  
Cllr. Peter Jones, Leader of East Sussex Council  
David Sexton, Senior Executive, Cable & Wireless, Mercury and BT  
Patrick Smith, Partner, Atos Consulting  
Deborah Thomas, James Committee member  
Mark Younger, Former Partner, Accenture



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## Higher Education and Skills

Chairman: Greg Hands MP  
Philip Wright, Director, Science and Technology, ABPI  
Lee Hopley, Senior Economist, Engineering Employers Federation  
Duncan McBrid, Former Partner of Ernst & Young

## Energy

Chairman: Carol Bell  
Toby Allen, EDF Energy  
Michael Liebreich, Chairman and CEO, New Energy Finance  
Barry Neville, Centrica plc  
Christine Wheeler, Non-Executive Director, Encore Oil  
Bruno Prior, MD, Summerleaze Regeneration

We welcome the findings of the STEM Task Force, which will be published at a later stage of the Conservative Party Policy Review. We would like to thank them for their contribution to this report.

The main report is the product of 18 months of research by the Steering Committee. The Working Papers reflect the opinions of their authors, and do not necessarily reflect the views of the Economic Competitiveness Policy Group.

We would like to thank all those who gave us their time and expertise, from which we have greatly benefited.

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# 1. The Economic Background

## 1.1. Overview

### 1.1.1. From the Fast Lane to the Slow Lane

The UK is in transition. Its comparatively strong performance in the 1990s, which was based on relatively light regulation and taxation, is now being damaged by their increase to a more typically European level. The UK has fallen from 4<sup>th</sup> to 10<sup>th</sup> in the competitiveness league tables, and there must be a concern that it will decline further. Both economic and productivity growth are already well behind successful advanced countries such as the United States and Ireland.

In a global context, the shift of economic power to India and China clearly dominates, as does the out-performance of the USA relative to Europe. The EU economies accounted for 18% of world output in 2000, but this is forecast by the EU itself (and arguably optimistically) to fall to 10% by 2050. The UK must seek to improve upon its current performance, returning to a more lightly taxed and lightly regulated environment that will allow our economy to expand more quickly. This will benefit all of us, as the more sustainable tax revenues of healthy growth will mean better public services, more job opportunities, and higher incomes.

A comparison between the performance of the Irish and Scottish economies in recent years provides a striking example of the benefits of very low corporate tax rates. Between 1998 and Q3 2006, Irish GDP rose 76% in real terms; in contrast, the UK's rose 27% (including the growth of London's economy by 41%); and Scotland's only 16%. Given the similarity in the size, skills and international relationships of the populations of Ireland and Scotland, and their common membership of the EU, corporate taxation levels are the main differential. This has allowed Irish citizens to return home to a better range of job opportunities, while their Scottish peers have often had to move elsewhere; and is also reflected in unemployment rates being 4.1% and 6% respectively.

It has been argued that Ireland's performance is due merely to substantial transfer payments from the EU. This, however, is wrong. These payments predated the past fifteen years of Ireland's growth surge, and were anyway directed into its agricultural sector, which performed less well than the economy as a whole. Irish success has been powered by US and other foreign multinational companies taking advantage of a main corporation tax rate of 12.5%, and of a well-educated labour force. It is true that low Euro interest rates in the early years of the new currency boosted both growth and inflation.

Meanwhile, Scotland has been harmed by much higher UK tax rates, with industrial output falling 20% during a decade of Labour rule in both Westminster and Edinburgh. Government intervention and misguided spending programmes have led to a very high ratio of public spending to GDP, without encouraging any significant creation or growth of entrepreneurial businesses.

The UK is an economy of two halves. London and the South East are closer to the better performing Anglosphere economies, with a lower proportion of public spending to GDP, and entrepreneurial locals supplemented by a ready supply of new labour from overseas. The London economy has grown especially quickly, because London is a haven for entrepreneurs and investors, who have been attracted to its fast moving markets, its business opportunities, its favourable tax status for non-domiciled residents, and its cosmopolitan flavour. The rest of the UK (with some notable exceptions within regions) is characterised by a higher proportion of public spending to GDP, substantial interventions by government at several levels, and arguments over the size and use of substantial transfer payments received from the more prosperous London and the South East.

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### 1.1.2. Divergent Trends between Sectors

The manufacturing sector is now only a small percentage of the UK economy, but the survivors have made rapid strides in improving productivity, with typical gains of around 5% per annum. In part, this is the result of the investment and hard work of the companies concerned, as they strive to innovate in a very competitive world. But it is also the result of the closure, or transfer abroad, of less productive businesses, as often hostile government policies have helped to speed the loss of more than one million manufacturing jobs. The UK pharmaceutical and aerospace sectors still contain world class companies; but the lack of plentiful supplies of gas and electricity at competitive prices means that process industry, for example, is being forced abroad to find more and cheaper energy. Wage regulation hastened the collapse of low labour-cost manufacturing in sectors like textiles.

The City of London represents a huge strength of our economy, and this sector needs the UK to stay at the forefront of technological developments, with both good quality broadband provision, and access to the best computer specialists. Recent figures from the London Stock Exchange demonstrate our leadership in many areas of financial services, with forty Initial Public Offerings in the first six months of 2006, compared to only three each on the New York Exchange and Nasdaq. In 2006 as a whole, the main London market raised over £50 billion of new equity money, with another £14 billion raised on AIM.

The public sector, by contrast, has started to see productivity fall in recent years – although the Government has now suspended the relevant statistics, while it works upon a new method of taking account of (alleged) quality improvements. The Civil Service alone has expanded by 300,000 in the last decade, unnecessarily increasing administrative overheads. Meanwhile, the Home Office has been declared ‘not fit for purpose’ by government ministers; HMRC continues to make a mess of many people’s tax credit and benefit calculations; Defra proved unable to handle a new funding scheme for farmers, leaving many unpaid; the NHS has faced both difficulties with its new computer system, and chaos with its new recruitment system for junior doctors; and the MOD has sent troops into dangerous situations without the right equipment. It is difficult to avoid the conclusion that the public sector’s performance is getting more expensive but less effective, and that this is resulting in much unhappiness for many people.

Finally, the inadequacy of the public infrastructure has become much more acute in the last decade. It is very clear that our road and train capacity, water and energy supplies, education and training system, and much else, have failed to keep up either with the successful growth of many parts of the private sector, or with the 1.45 million people who have come here to work and live. If we are to create a more competitive country, we must put right this mismanagement, and expand capacity where needed. The Government’s regulatory system for the electricity generation industry has left us short of cheap supplies of power. The Water Regulator’s preoccupation with quality at the expense of quantity has left the South East and London short of water, whilst the Government and Gas Regulator have failed to preside over conditions of fair competition within the EU, leaving the UK exposed to shortages. These problems with the supply of basic requirements for an enterprise economy need to be addressed early.

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## 1.2. The Present Government's Main Economic Mistakes

In addition to these more general points, there have been other specific obstacles to greater competitive success. In particular, the Government has made ten errors, which have been of great cost to the UK economy:

1. Much investment in health and other public services was clearly needed. But, unfortunately, the very large increase in spending in the past ten years, which the Government has counted as one of its better achievements, has largely gone to waste. For example, there has been only a 2% increase in health activity. Meanwhile, too much money has gone on managers, inspectors and administrators: a symptom of the centralized interference that is stifling the NHS's productivity.
2. The £5 billion annual pensions tax has done very great damage to many company pension funds. At the time Labour came to power, the UK had the strongest position of any country, in terms of saving for retirement. Instead of fearing cutbacks in unsustainable public pensions schemes, as many other developed countries were, people in the UK were able to look forward to comfortable retirements based on their own savings. Today, however, many funds lie in ruins, either closed to new members, or closed entirely. This was a tax too far: one that starved funds of cash, and that took £100 billion off the value of the equity market, as the reduction in shareholder income was discounted in new and lower company valuations.
3. Persistent regulatory interference has harmed companies, and helped to make British manufacturing in particular less competitive. After two manufacturing recessions, our manufacturing industry now employs 25% fewer people than it did ten years ago; and is still losing 10,000 jobs per month.
4. The UK has moved from a healthy current account surplus to a huge balance of payments deficit under Labour. The continued decline of manufacturing has resulted in our imports greatly exceeding our exports, to the point of a record deficit on goods in 2006, of £34bn.
5. The Treasury has compromised foreign business investment in the UK by maintaining uncertainty over its attitude towards sterling and the Euro. Although few commentators believe the Government would win a referendum on joining the Euro, the Government has risked competitive disadvantage with its opaque stance. Most experts now agree that Euro membership would have been damaging to the UK economy, as the ERM was.
6. Gordon Brown sold 395 tonnes of our gold reserves at the bottom of the market, between July 1999 and March 2002. Hindsight is of course a wonderful thing; but if he had not gone against the advice of senior gold traders at the Bank of England and warnings from Opposition MPs, and had held onto the gold, it would now be worth £2 billion more than it was at the time of the sale.
7. A government auction of spectrum effectively turned into the imposition of a £22 billion tax on the telecoms industry, just when it needed all the cash it could generate in order to build new networks and compete in a global market. Such short-sightedness amplified a cyclical downturn; bankruptcies, job losses and cancelled investment programmes occurred as a direct result. This undoubtedly helped to set a leading UK sector back three years.
8. Railtrack was put into administration, although a few hundred million pounds more would have kept it and its large investment programme going. If the Government had insisted on a new Board, and a suspension of dividends while the company was sorted out, taxpayers would not have had to guarantee £20 billion. For this huge sum (which could grow further, and is already



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the most the railways have ever cost us), we have been left with slower running times, delayed trains, and cuts in investment.

9. The Government has failed to resolve the UK's transport issues with a plan suitable for a modern economy. A stated intention to move people and goods from road to rail has resulted merely in the cutting of our road capacity, while railways descend into an ever more unsatisfactory condition.
10. PFI and PPP contracts have become the cornerstone of Gordon Brown's Third Way financing, with only a note to the accounts to tell us how much the Government has to pay each year under these agreements. In a post-Enron world, it is hard to be comfortable about a potential liability that has already risen to above £100 billion; and the Treasury should have to inform us of the cost of these contracts going wrong.

### **1.2.1. The Declining Growth Rate of Productivity**

During the last forty years of the twentieth century, the UK average growth rate was a consistent 2.5% per annum; and the peaks and troughs of the cyclical pattern were fairly well set. Superficial data show that this has continued into the twenty-first century, *but* these aggregate growth figures disguise an important change: the big increase in inward migration. If we adjust recent growth rates for the substantial expansion of the working age population, the evidence suggests that the trend rate of growth of productivity, or output per head, has slowed down considerably.

Our economic study concludes that real national income per head may now only grow below 2% on average. If current levels of immigration are sustained, the overall output of the UK economy will rise by considerably more than this. But what in the end matters is output per head, as this reflects the living standards of all of us.

We believe that it is possible to get the UK economy back to its former 2.5% trend rate of growth, before adding in the extra product from migrants, if sensible decisions are taken to reduce regulation and taxation; and if necessary decisions are taken to allow the private sector to invest in more capacity for our principal networks and utilities. This report sets out in more detail how these issues could be tackled by a new government in a way which shares out responsibilities, creates more jobs, and ensures an innovative focus on our quality of life and surroundings. Centralized state planning results in poverty without hope, tyranny without effective rule, and an environment owned and cared for by no one. Free enterprise at its best can tackle injustice, offer people opportunity, solve environmental problems and buttress a free society.

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## 2. Managing the Economy: Macro Economic Policy and Public Finances

### 2.1. Making the Bank of England Independent

Gordon Brown's early decision to make the Bank of England the independent judge of interest rates, with the creation of the Monetary Policy Committee, was an idea whose time had come. It has been welcomed by all political parties and the business community, and has combined with the effects of globalization to continue the relatively benign interest rate and inflation environment we have enjoyed since 1993. However, it is important to understand the limitations that the Government placed on the Bank's independence; and we will recommend that, in contrast, a Conservative government takes action to strengthen the MPC still further. It is also important to understand that the first decade of a more independent MPC has coincided with a very favourable business and interest rate climate worldwide, and with easy money globally. It should be remembered that Gordon Brown also took substantial powers away from the Bank, transferring banking regulation to the FSA and removing the Bank's role in managing public debt.

Between 1999 and 2006, the UK enjoyed an average interest rate of 4.72%. This is historically low, but in the same period average interest rates were, in Japan, 0%; in the Euro zone, 2.91%; and in the USA, 3.43%. Throughout this time, therefore, individuals and businesses paid more to borrow sterling than our leading competitors paid to borrow dollars, yen or euros. Meanwhile, the UK's rate of inflation has been above Japan's for a decade; above the Euro zone's for the last three years; and just slightly below the USA's. In the first half of 2007, these were respectively 3%, 0.3%, 1.9% and 3.23% (using the CPI for a strict comparison). If the RPI is used, it is arguable that UK inflation is now above US inflation.

There are many complex structural causes of these trends, including savings rates, the structure of our lending institutions, and fee arrangements. And there is no doubt that the UK has benefited from a benign, disinflationary international environment. But there are two reasons for our performance still not rivalling the best of our international competitors, which relate to government actions; and these need to be considered if we are to create an optimal mix of inflation and interest rates in the future.

The first is the decision of Gordon Brown in 2003 to change the Bank of England's target rate of inflation. He replaced a 2.5% annual increase in prices as measured by the RPI with a 2% target as measured by the CPI (which typically rises by 1% per annum less). It is widely agreed that this led to a relaxation of anti-inflation policy at a crucial time. And its result can also be seen as further proof of the destabilization consequent upon attempts to bring fiscal policy in line with Europe's, which was earlier seen in the deleterious effect of the ERM policy.

The ERM was a policy recommended by the Bank of England and the Labour/Lib Dem opposition when it was adopted by the then Conservative government in 1990, which illustrated how too much attention to EU policy can be very damaging. First it created high inflation, and then recession, as interest rates were hiked in a vain effort to maintain the value of the pound. Trying to keep in line with the Deutschmark meant printing pounds and selling them to keep the value down, when markets wanted Sterling to rise. This created too much high-powered money in the banking system, leading to inflationary credit expansion. When the market wanted the pound lower, the reverse happened. The Bank had to buy pounds, withdrawing Sterling from the banking system, and creating recessionary conditions.

The second reason is the deterioration in the public accounts from 2001 onwards. After two years of following Conservative spending plans, with sensible and tight controls on public spending, repayment of borrowings and fiscal prudence, Gordon Brown turned to a large increase in public spending. This

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resulted in substantial inflationary expenditure in the public sector, and large debt issuance. Money growth was strong, and the public finances worsened rapidly.

This has resulted in the Bank of England struggling to reduce inflation from a high of 4.8% on the RPI (3.1% on the CPI). It is being forced to tighten monetary policy, in an attempt to offset the impact of inflationary public spending, rapid money growth, and increases in public sector charges (in particular, postal prices and student fees).

In relation to this, we are also concerned about the appointment process for the MPC. The majority of its members are chosen by the Chancellor, who has at times failed to fill a vacancy promptly, and whose decision-making is opaque. We recommend that an incoming Conservative government should make this process a far more transparent one.

We are concerned about the division of responsibility between the FSA and the Bank over banking and market regulation. Fortunately, conditions in the last decade have been benign internationally, with no serious threats to banking liquidity. We think it would be safer if the Bank of England had responsibility for solvency regulation of UK-based banks, as well as having an overall duty to keep the system solvent. Otherwise, there could be dangerous delays if a banking crisis did hit, with information having to be exchanged between the two regulators; and there might be gaps in each regulator's view of the banking sector at a crucial time, when early regulatory action might have spared a worse problem.

## 2.2. Recommendations on Economic Management

1. The government should neither reintroduce exchange rate targeting into its monetary policy, nor enter the Euro: these are likely to prove destabilizing, and to reduce the UK's competitiveness.
2. An independent MPC should continue to be supported in its role of controlling inflation through the setting of interest rates.
3. There should be further debate about whether the CPI is fully reflecting important inflationary pressures, including the cost of housing, and whether the Bank of England's target needs reviewing, given the common use of the Retail Price Index in contracts.
4. The independence of the Bank from any external pressures should be buttressed further by introducing an open selection process, and formalizing the role of the Treasury Select Committee in scrutinizing appointments to the MPC.
5. Whenever possible, fiscal policy should support, rather than undermine, keeping both monetary supply and inflation under control.

## 2.3. The Fiscal Framework – and its Weakening Foundations

### 2.3.1. The State of the Public Finances

Under the Labour Government, there has been a rapid build up in debt, and official figures show the UK's public sector net debt at £497.7 billion (April 2007). However, recent work by MPs and the Public Accounts Committee has revealed that the true extent of the UK's public sector financial obligations is almost three times this stated amount. A report from the Centre of Policy Studies in 2006 itemised the following:

<b>Stated net debt</b>	£487 billion
Public unfunded pension liabilities	£720 billion <sup>1</sup>
Local government unfunded pension liabilities	£90 billion
PFI	£25 billion
Network Rail guaranteed borrowing	£18 billion
<b>TOTAL public sector obligations</b>	£1,340 billion

Even these figures could be increased, however, if allowance were made for the possible failure of some PFI projects, with the consequent need for the Government to spend more on them; for the current rapid growth of the public sector pay bill, and hence of pension liabilities; and for probable further borrowing by Network Rail.

PFI, in particular, are misleadingly valued in the public accounts. In July 2003, the capital value of PFI projects was included as £20 billion on the Government's balance sheet. And yet payments due under those contracts amount to £138 billion over the next twenty-five years (from 2005/6). It is also worth noting that there are many PFI contracts entered into by local government, which do not appear in these figures at all.

### **2.3.2. The Fiscal Rules – Flexible Friends?**

Two fiscal rules were established by Gordon Brown, to reassure those who remembered previous Labour Governments' economic mismanagement that this time things would be different. The Golden Rule required that the current budget should not be in deficit over the cycle as a whole; and the Sustainable Investment Rule required that public sector net debt should not exceed 40% of GDP.

In the early years, this framework worked well, as Gordon Brown effectively followed Conservative spending plans. The Government repaid debt and ran surpluses. However, this has all changed in recent years. Public spending has expanded rapidly, which has plunged the country into large annual deficits.

As a result, Gordon Brown has been able to remain within the Golden Rule only by changing the years of the cycle; and similarly, he has remained under the Sustainable Investment ceiling only by keeping many public sector borrowings, and unfunded liabilities, off the official balance sheet. This willingness to undermine his own rules, and to exercise such flexibility within apparently sensible and tight controls, has damaged both his credibility, and the Government's reputation for financial management.

This is a pity, since we agree with the principles that initially formed the basis of the former Chancellor's fiscal framework. We believe that governments should not as a rule borrow to pay for current spending; but instead should run healthy current account surpluses in the good years of an economic cycle, so that some latitude is possible in the weaker years. We also believe that there should be a limit on the total borrowings of the public sector as a percentage of national income, both to reduce any crowding out of private investment, and to preserve a good sovereign risk rating on world credit markets. The common theme here is that borrowing is simply deferred taxation, which ultimately will have to be repaid by taxpayers, with interest.

### **2.3.3. Public Capital Expenditure – Sustainable Investment Rule Proposals**

The distinction between current and capital spending is clear. Daily expenditure on wages and supplies, for example in the education and health services, is recorded as current spending in the public

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<sup>1</sup>The actuaries Watson Wyatt estimate central government pension liabilities at £960 billion; whilst Neil Record's IEA study puts them as high as £1,025 billion. We have used a lower £720 billion estimate, based on the return on indexed gilts.



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accounts. In contrast, the construction of a school or new hospital ward is recorded as capital spending or investment: items that will be available for a period of years, once the initial sum has been spent.

The contrast between public and private capital spending is, however, an added complication. In the private sector, a company invests to produce a future return; if that return is inadequate, the investment has to be written off. If the investment is sufficiently large and badly judged, it might, in extreme circumstances, even lead to that company's bankruptcy. As most private investment yields a return higher than the cost of borrowing, it is usually appropriate to borrow some, or even most, of the money to make that investment, increasing both risks and rewards for shareholders. So, for example, a car manufacturer might borrow to invest in a new factory, in the belief that he can then make and sell extra cars; this extra revenue will then bring in sufficient cash flow to pay both the extra cost of his new factory, and the interest on his loan.

Much public sector investment spending, however, does not generate such useful additional revenues, and hence there can be no automatic assumption that an investment can be afforded on these grounds. If a Local Education Authority spends capital on a new school, there will be extra costs in future years, but no extra revenues. Staff will have to be paid to maintain, clean and staff the school, but the service that it provides is of course free. The only possibility of extra revenue is if the school is due a government grant under the education funding formula, for example if it is to cater for extra pupils.

All of this requires careful management, as there is no market test for many of the capital projects that a government will want to carry out. We believe that a new government will need a revised framework for capital spending, to ensure a sensible balance between the need to control spending, and the need to make enough money available to upgrade and expand public facilities in core areas such as health and education.

We therefore propose that an incoming government should consider adjusting the Sustainable Investment Rule to:

1. Include guaranteed borrowings (such as those of Network Rail) in the calculation of public borrowings.
2. Include a more meaningful figure, to be settled by the NAO, for public sector liabilities under PFI and PPP contracts.
3. Adjust the limit on state borrowing to take these changes into account.
4. Continue to exclude public sector unfunded pensions liabilities from calculations of debt for the purposes of the Sustainable Investment Rule. Instead, they should be represented openly on a restated, and more accurate, government balance sheet.
5. Value government assets such as schools and hospitals on a 'replacement cost minus assessed depreciation' basis, in order to take into account their state of repair and fitness for purpose.

These adjustments should be made to reflect existing liabilities, and should not lead to any loosening of fiscal control. In addition, we need to make it easier to decide sensibly the priorities for the limited supply of public capital. We believe that the best way to mitigate this capital scarcity is to allow worthwhile and appropriate infrastructure projects to take place in the private sector, for which there will always be (in normal conditions) readily available capital. This approach, adopted for most capital investment in a free enterprise society, can be applied to the following types of investment, which, in the UK, have typically taken place in the public sector:

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1. **Transport.**

- a. Road improvements. The Government has demonstrated, with the new M6 toll way relief road to the north of Birmingham, that a new road can be completed successfully as a privately financed investment, with all the risks taken by private investors. We propose that this principle should be applied to the building and improvement of other road links, thereby taking their capital cost out of the government system.
- b. Railways. The railway industry has shown that substantial new investment in rolling stock and engines can be financed privately. We propose that new track projects should also be financed privately, with limited cash subsidy guarantees where necessary and appropriate.<sup>2</sup>

With these two measures, total capital expenditure on transport infrastructure could be increased from the £4.1 billion spent by the Department of Transport in 2006-7, while making a substantial reduction in the amount that the government has to fund itself.

2. **Leisure and cultural facilities.** There is scope for these to be financed through public-private initiatives. Those councils wishing to ensure access to such facilities by young, elderly or disabled people could guarantee payments to providers, which would cover their use by local communities.
3. **Affordable home ownership.** We propose that more substantial private sector mortgage money should be brought into the affordable housing arena. This would release public capital, where national and local government still own the freeholds of rented accommodation; as would the sale to tenants of a proportion of the Ministry of Defence's housing estate.

In addition, there will be some types of investment in services that are offered free at the point of use, which are best paid for by conventional government borrowing through the gilt market. The difficult cases, however, are those where a PFI or PPP contract is being considered.

This Government's practice has been to undertake most new school and hospital projects on a PFI or PPP basis, in order to keep within the Sustainable Investment Rule. Our proposed changes to that Rule are intended to move an incoming Conservative government away from this idea. We believe instead that there should be a genuine test to demonstrate whether, in any given case, a PFI or PPP solution is the best one. Quite simply, the test would establish which way of handling a particular investment would be most likely to produce the lowest cost for the taxpayer, over the life of the asset. Where the private sector, with its superior efficiencies in financing and managing that asset, can produce a lower lifetime cost than public borrowing and management, the PFI or PPP should go ahead. If, conversely, it cannot show this, then the investment should be paid for by the government.

This is an important reformulation of the approach adopted at the introduction of the PFI system, which was that its higher financing costs could be justified only where substantial risk was transferred to the private sector.

There will, of course, be decisions on cost-effectiveness that are finely balanced. But our proposal will at least ensure that the greatest care and diligence is practised by ministers when assessing the upside and downside risks of any investment. This should help to avoid some of the spectacular misjudgements surrounding capital projects in recent years.

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<sup>2</sup> cf. Proposals 34 and 35 of the Annex to Chapter 3: the Transport Working Group's report to the Economic Competitiveness Policy Group, 'Transport for the 21<sup>st</sup> Century'.

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### 2.3.4. Independent Charitable Trusts

Finally, we would note that UK universities have many of the characteristics of public sector bodies<sup>3</sup>, and yet they remain private sector institutions for financial purposes, with their own balance sheets, assets and borrowing capability. We believe that other public sector institutions could be modelled along these lines, establishing them as independent trusts. Their trust deeds would require them to continue offering their particular public service, in return for which they would be granted their assets, and given scope to borrow. If they wanted, on occasion, to do this without a government guarantee, there would be no need for such borrowing to be part of the controlled capital spending by the state.

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<sup>3</sup> Reliance on a substantial grant from the Treasury, and part-funding from other government sources; regular engagement with the government over budgets and funding; and substantial government assessment and regulation.

## 3. Transport: Getting Britain Moving Again

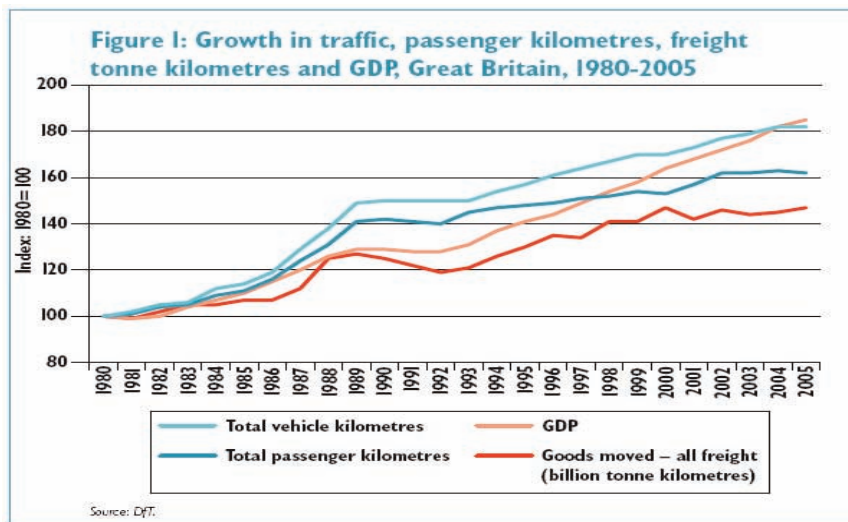
### 3.1. Overview

Transport has become the biggest challenge to the UK's economic competitiveness after taxation and regulation. It is an issue regularly raised in meetings by business, when discussing how the Government can support their international competitiveness. There are problems with public and private transport in every locality, all of which come down to one basic underlying fact – we simply do not have enough transport capacity to meet the demands of business, government and families. It is clear that the failings of our transport networks have to be addressed, if employment and prosperity are to grow further.

Although, throughout our work on transport, we have been conscious of environmental impacts, including impacts on carbon emissions, we have left it mainly to the Quality of Life Policy Group to come forward with specific proposals to reduce the quantity of emissions, and to increase the energy efficiency of our transport systems. We have focused on proposals designed to ensure that the transport system meets the economic needs of the country – recognising that new investment in transport will allow us to cut congestion and fuel inefficiency at the same time. Congestion is one of the prime causes of undesirable exhaust emissions including carbon dioxide, and is also a major impediment to business.

### 3.2. Transport Really Matters to the Economy

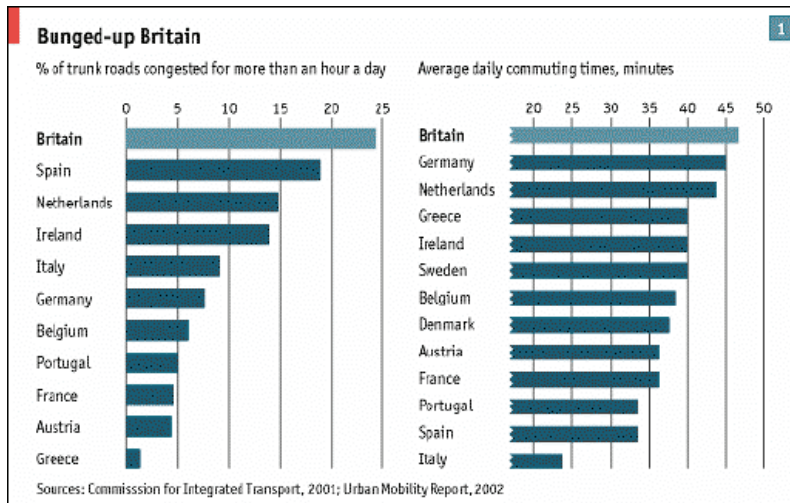
GDP growth and transportation are inextricably linked. As GDP and disposable incomes rise, so does the demand for transport. Constrain our ability to move people and freight, and GDP will suffer.



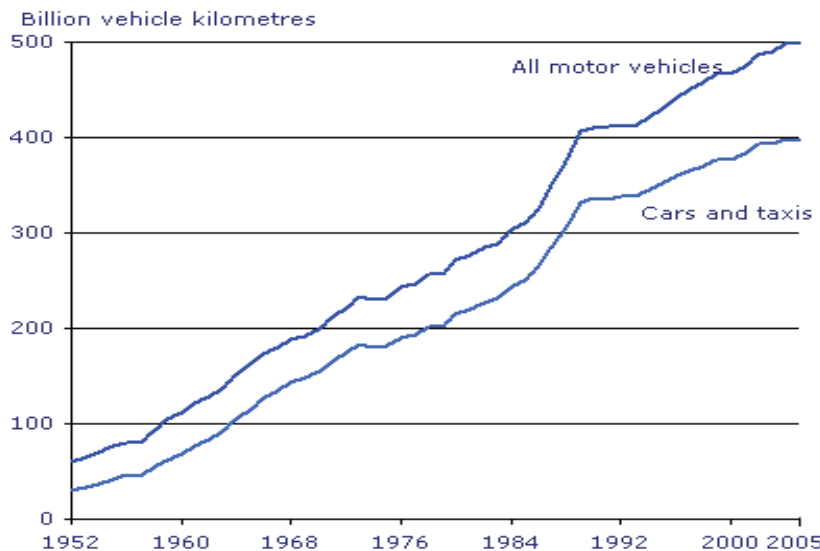


### 3.3. Congestion: Here Now, and Getting Worse

There is a serious congestion problem today. Our trains are overcrowded, airport approach paths are fully stacked and our roads are more congested than any of our European competitors’.



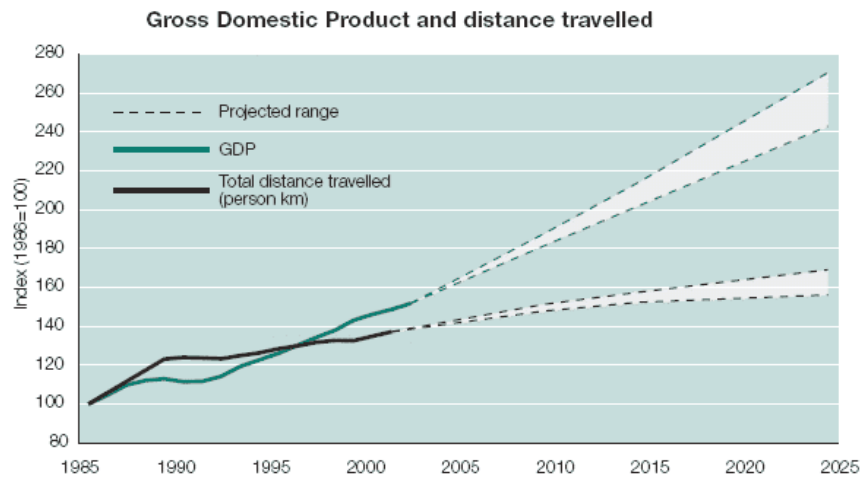
Congestion constrains the economy; it is expensive, both financially (Eddington estimated that congestion by 2025 will inflict economic damage of £22bn per annum) and in terms of quality of life, and it is seriously damaging our competitiveness. Road congestion is a case in point. Between 1950 and 1990, car usage grew at an average 6% per annum, and road traffic has increased eightfold since 1952<sup>4</sup>, fuelled by a combination of changes in demographics (growing population) and employment (particularly more women entering the workforce, necessitating two car families), and by rising real incomes. There are now 33 million vehicles in Britain, up by six million over the past decade.



Today, around a quarter of all trunk roads are congested for more than an hour a day. Average speeds on main roads have been falling in the past ten years, and while congestion charging in central London has produced marginal reductions in congestion (at the expense of pricing lower income people out of central London), the capital's outskirts, as well as cities like Sheffield and Nottingham, are snarled up.

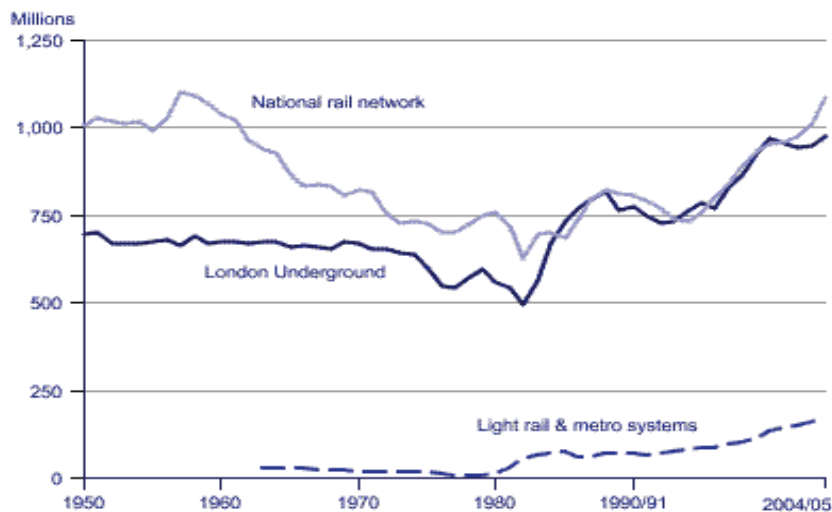
<sup>4</sup> Source: ONS

The DfT's forecasts for GDP growth and total distance travelled are as follows:



The DfT is forecasting between 9% and 18% growth in car usage between now and 2025, primarily due to growth in economic activity, population (c.8% to 2025) and car ownership. Given that building new roads in the UK is almost at a standstill, the implication for congestion in the future is clear. Eddington predicted a 25% increase in traffic congestion by 2015.

Since the early 1980s, passenger railway journeys have also increased significantly:



### 3.4. The Government's Track Record

In the last ten years, the Government has failed singularly either to expand our transport capacity through public funds, or to draw the private sector into increasing capacity, in spite of the clear signals of rapidly rising demand. There continues to be little evidence that the Government is going to achieve anything significant in respect of transport on present policies. Current statistics show that:

- more than 85% of passenger miles are by car;
- three quarters of passenger activities and two thirds of freight movements are by road;
- buses and trains account for only 6% and 5% of passenger miles respectively;
- trains carry only 8% of freight tonnage; and
- some 84% of personal journeys and 69% of business-related trips involve a distance of 15 miles or shorter. Yet, even when the destination is further away (200 miles or more), the car dominates in the UK.

Consequently, even if rail capacity were doubled, this would cater for less than three years' extra traffic from economic growth.

Successive governments have failed to address our transport problems because they have not accepted two essential principles for making transport systems work:

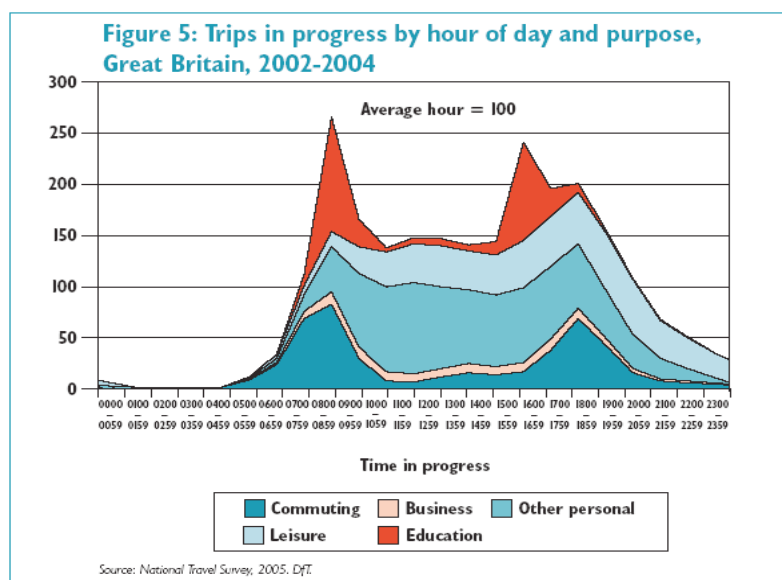
- (i) the public sector needs to plan using realistic forecasts of future demand; and
- (ii) the private sector, as well as the public sector, needs to pay.

### 3.5. Urban Public Transport

50% of all car journeys are less than two miles. Apart from adding to congestion, short jerky journeys are the most damaging to the environment, as carbon emissions are high and catalytic converters are only effective for journeys over three miles (and the first half mile produces 60% more fumes). There is clearly a substantial opportunity, in urban environments, to encourage people to travel short distances using public transport, as well as to rediscover the lost habit of walking or cycling (which would improve public health as well as the environment). As well as its environmental benefits, increased use of public transport and of non-motorized movement can significantly reduce the crowding on urban roads, which otherwise does so much to diminish the appeal of our major cities to investors and international businesses.

We do not, however, want to reduce car usage through direct regulatory intervention or diktat. We prefer individuals to change their behaviour voluntarily, rather than through regulation and control. Policies should therefore facilitate public transport that is more attractive in terms of cost and convenience than private car use, so that people willingly leave their cars at home. This requires more frequent train and bus services on busy routes, with car parking available at the interchanges.

The pattern of travel during the course of the day illustrates the public transport opportunity in respect of education-related transport, for example:



In major conurbations public transport is currently delivering mixed results. Rail use is increasing significantly, with overcrowding a major issue, but bus usage is generally declining. London is different, owing to the much higher population density over a much larger central urban area.

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Public transport requires policy makers, who are conscious both of economic competitiveness and of environmental concerns (including the need for energy efficiency and reducing carbon emissions), to consider a wide range of issues, including:

- (i) influencing how working patterns could change (e.g. more working from home, more flexible office hours, “hot desking”, and greater use of technology to reduce business travel);
- (ii) encouraging urban developments that integrate work places, homes, shops and schools into a compact area served by frequent public transport (18th and 19th century urban development often shows how to do this, designed before common access to personal transport);
- (iii) remembering that trains in the UK are heavy and often powered by old engines, so they are themselves an environmental hazard; and
- (iv) remembering that the South East of England is, after The Netherlands, the most densely settled part of Europe.

### 3.6. Roads – Private Money for Public Benefit

The strategic road network has never been completed, and is now strikingly inadequate for the traffic wishing to use it. Just 2% of the total road length in England carries one third of all road traffic, and two thirds of all road-based freight; and the motorways and main trunk roads groan under the weight of goods and people seeking to travel from city to city. In England, there are just six basic motorways, four of which radiate from London. Their limitations are clear when one considers that there is: no continuous motorway either through Devon and Cornwall, or across the south coast, or from London to the Scottish border; and no continuous motorway links to the ports of Felixstowe, Dover and Folkestone, nor from the Midlands to Southampton. (We do not consider in this paper the road networks of the devolved administrations, where the national government does not have control.)

In addition, there are the relief motorways, which have been built alongside the M1 to M6 routes. The most heavily used of these is the M25 London outer-orbital. This is a crucial link that allows traffic travelling up and down the country to avoid crossing London; and it has also become a very popular road for shorter journeys within outer London and the South East, a heavily congested and substantially built-up area that otherwise lacks an adequate road system.

Every forecast, whether independent or commissioned by the Department of Transport suggests that this motorway network is not only too small for current requirements, but will become chronically congested over the next two decades. The Government has taken some action in the most heavily clogged part of all (the western sections of the M25), but an enormous amount of work remains to be done throughout the country to provide additional capacity. This also applies to the trunk roads, whose situation is no better. Indeed, if there is one economic priority in transport policy, it is to expand the access that trunk roads provide to our principal ports, thereby improving our ability to import and export the raw materials, components and finished goods that British businesses need and produce.

In addition, the best thing that could be done to encourage more development and regeneration in the North East, and in southern Yorkshire, would be to make substantial improvements to both the number of lanes and junctions along the whole length of the A1M and A1, from London to the Scottish border. And finally, it must be recognised how inadequate the roads that service the towns and villages of the south coast, Devon and Cornwall are. It is to the benefit of neither residents nor drivers that pockets of unimproved highway result in huge quantities of traffic crawling through otherwise beautiful villages.

As for the lack of any proper southern highway, this means people are forced on round-about routes that cause more unnecessary vehicle miles, as well as further congestion.

Clearly, in some cases, patterns of development and local landscape may make expanding roads difficult or undesirable. Nevertheless, the Government's plans to improve and upgrade the network have been far too limited. Labour began their period in office with the belief that they could switch enough people and freight from the roads to the railways not to need any extra road capacity. New road schemes were cancelled, and encouraging speeches were made about the capacity of the railways to handle more traffic. Unfortunately, the mathematics did not work. 85% of passenger movement, and 86% of freight, is by road; 5% and 8% respectively is by rail. The Government put forward a ten year plan to increase railway capacity by 50%; but this would have been scarcely enough to keep up with the natural growth in traffic, as well as being totally inadequate for any extra demand from those they aimed to switch from road to rail. In practice, however, even these targets for rail capacity were never met. Shortly after the plan began, two tragic disasters on the railway led to a reduction in the capacity of the railway, as new speed restrictions and different safety requirements were imposed. Policy shifted again, in the last three years, as the Government belatedly recognised that demand for the movement of people and freight grows in line with the economy; and hence that it was necessary to make selective improvements to road capacity as well as to railways, if congestion on all modes of transport were not to worsen further.

Congestion does not only impose costs on businesses and makes Britain less competitive, although the remit of this report is to tackle just that issue. It also obviously makes transport systems less safe. If too many people wish to use the railways, they are forced to stand, which is not only uncomfortable but can exacerbate the dangers in cases of sudden braking or derailment. Crowded roads increase the chances of collisions between vehicles, and add to the frustration of motorists, making mistakes and misjudgements more likely. Road space is so inadequate that it takes only one crash on a main junction or route to lead to long hours of tailbacks; and indeed it seems that almost every day we hear reports of one or more of the main motorways experiencing serious delays, after an accident has led to lane closures. In other words, the British traffic system is imposing unacceptable congestion not only on the economy, but also on society.

There have, nonetheless, been some improvements made, such as to the capacity of the western section of the M25; and the Government has a number of limited schemes for improvements elsewhere. The following table provides details of the motorway and trunk roads scheduled for widening in the next five years, subject to the satisfactory completion of statutory processes, and to the availability of funding:

<b>Project name</b>	<b>Start of works</b>	<b>Length of scheme (miles)</b>
A3 Hindhead improvement	January 2007	4.04
M1 J31-J32 widening	January 2007	1.24
A595 Parton-Lillyhall improvement	January 2007	3.23
A1 Bramham-Wetherby (including Wetherby bypass)	Spring 2007	6.21
M1 J21-30 widening (Phase 1)	Summer 2007	14.60
A14 Haughley New St.-Stowmarket improvement	Summer 2007	2.49
M25 J1b-3 widening	Summer 2007	2.67
A1 Dishforth to Barton	Spring 2008	24.67
M27 J11-J12 climbing lanes	Spring 2008	1.99
M27 J3-J4 widening	Spring 2008	2.55
A421 Bedford to M1 J13	Autumn 2008	8.02
M1 J10-13 widening	Winter 2008	14.17
M62 J25-J27 widening	Winter 2008	7.21
M25 J16-23 widening	Winter 2009	22.12
A453 widening (M1 J24 to A52 Nottingham)	Winter 2009	7.15
M1 J39 -J42 widening	Spring 2009	6.59



M62 J27-J28 widening	Summer 2009	3.29
A14 Ellington improvement	Spring 2010	22.56
M1 J21-30 widening (Phase 2)	Spring 2010	37.84
A21 Tonbridge to Pembury	Spring 2010	2.55
M25 J27-30 widening	Summer 2010	14.04
M1 J34-J37 widening	Winter 2011	10.00
A47 Blofield to North Burlingham dualling	Spring 2011	2.49
A23 Handcross to Warninglid widening	Spring 2011	2.36
M1 J32-J34 widening	Spring 2011	7.39
M1 J30-J31 widening	Summer 2011	5.90

We recommend that an incoming Conservative government should tackle as quickly as possible the obvious shortfalls in terms of congestion, safety and capacity on the most stressed major routes. This will involve both improving management of the existing network, and expanding the current programme to increase capacity on the main motorways and trunk roads.<sup>5</sup>

It would not be possible, however, to carry out all the works necessary simply by using taxpayer funds, or by borrowing money on the government's account, as part of the Highways Agency's road programme. We do not believe that the country can wait another ten years while the government ponders such projects, and spaces them out in an affordable way. We need to accelerate the programme, and to have access to additional money from outside the public accounts.

Two very successful precedents for this are the former Conservative Government's Dartford river-crossing (to complete a higher-capacity M25 to the east of London); and this Government's completion of the M6 toll route (to provide a bypass to the heavily congested M6 to the north of Birmingham). In both cases, bipartisan support enabled the private sector to design, build, finance and operate the bridge and road; and to do so by levying a toll (or charge) on the users. In the latter case, a completely new alternative has been provided for those who were fed up with the congestion on the existing M6, which meanwhile remains free at the point of use. In the former case, anyone wishing to use the M25 to cross the Thames can take advantage of the new bridge's extra capacity, and hence a reduced journey time.

We propose, therefore, that selected route corridors should be put out to tender for private sector improvement. The valuable land would remain the freehold of the public sector. On offer would be, together with the right to collect a toll on the added capacity, the duty to provide extra capacity and an improved management of traffic flows. Other motoring taxes should be reduced proportionately to avoid double taxation.

The franchise period needs to be long enough for private contractors to be able to make substantial new investment while charging a realistic toll rate. The Labour Government established thirty years as the franchise period for its partial privatisation of the London Underground network; and, while we are critical of that scheme for a variety of other reasons, we believe a similar period would make sense in the case of private sector road improvement schemes.

Of course, there do need to be safeguards, for the government *and* taxpayers. First, there should be laid down a regulated maximum tariff (with an index-linked maximum permitted rate of increase) for different categories of vehicle user. This is a wise precaution as a monopoly over a route is being offered; and it will not prevent a private contractor from being free to vary charges, both by time and day, in a way that will encourage the maximum spread of use, and thereby help to avoid congestion.

<sup>5</sup> For example, adding one or more lanes to the M25, M1, A34, A12, A14, and M6, where congestion, and hence accidents, are most common; developing the A1M into (at least) a dual carriageway from London to Scotland; converting the A303 into a dual carriageway, with a by-pass or underpass to Stonehenge.

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Second, in the case of a franchisee failing to carry out any specified work programme on which their bid was based, the government must have the right both to cancel the contract, and to replace the franchisee. Suitable clauses should cover both the transfer of what has been achieved, and any compensation due to the original franchisee from the new, incoming franchise holder.

Third, we recommend that the government should have the right to change the management of a road at any point during a franchisee's contract, in the unlikely event that it is not being operated in the best interests of the users. To avoid creating private sector uncertainty, and therefore unwillingness to get involved in road franchises, there should be a review with the franchisee to see how management can be improved, once a certain volume of complaints has occurred. This would be followed by a further review a year later: if there has been insufficient improvement by that point, and there remains a high volume of complaints, then the government would have the right to advertise for someone to take over the daily management of the franchise (whilst ensuring that all revenues were returned to the principal franchisee, minus the managers' costs). It is, however, very likely that the interests of the franchisees and road users will coincide, as the franchisees have every incentive to maximise toll revenue, and will be able to do so only if they work out the best way of allowing the road users to enjoy a congestion-free journey on the tolled sections of road.

### **3.6.1. Local Roads – Busting Congestion**

Most of the roads in the UK are under the control of county or unitary council highways authorities. We are not proposing a change to these local democratic arrangements, but many of the A, and some of the B, roads under local authority control have an economic significance that runs over county and unitary boundaries. We therefore recommend that an incoming Conservative government should change the guidance to local councils, in order to encourage both a short and medium term response to the congestion crisis, and to make clear the priority it attaches to transport policy. Busting congestion is not only the best way of improving road safety, but is essential for the further economic progress of the country.

Short term guidance would focus on relatively inexpensive actions, such as re-phasing traffic lights, inserting traffic sensors at junctions, reducing conflicts between parking and traffic flows, and ensuring better (and fewer) signs. The medium term plan would concentrate on improving junction capacity by widening roads, and, wherever possible, on making available a segregated right-hand turning lane. Selected improvements to the carriageways of those roads overburdened by traffic would also be implemented.

We also note that the capacity of the existing road network, especially in urban areas, has been reduced by traffic management schemes over the last decade, as a result of the Government's focus on reducing speed to the exclusion of all else. We recommend a reassessment of improvements that have been made in the name of safety, since the measures taken have often been ineffective or even unintentionally dangerous (as in the case of artificial chicanes), and have sometimes ignored the evidence that speed is not a factor in over 90% of road accidents.

These steps should help to reduce the frustration most people experience at busy times of the morning and evening, as they try to take the children to school, get to the local shops, or travel to work, and which has been predominantly the result of the inadequacies of local road networks.

Of course, such schemes will require additional public funds. We recommend £10 billion being made available by the government over a period, raised from our proposed increased charges on foreign-operated lorries (see Section 3.9). Those local authorities able to identify the worst problems of unsafe junctions, bad traffic management schemes, and congestion would be invited to bid for this money; and to produce suitable schemes for junction improvement and road widening, which could be implemented within a reasonable time frame.

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We hope that local highways authorities would propose to:

1. Re-phase traffic lights. This would include abolishing all red sequences, giving priority to main roads, and using traffic sensors for traffic from side roads.
2. Allow left turns on a red light, effectively treating it as a 'Stop' sign.
3. Reconsider the effectiveness of chicanes.
4. Place bicycle lanes on pavements, where this will not inconvenience pedestrians.
5. Allow taxis, motorcycles and electrically powered vehicles into bus lanes, and remove bus lane restrictions at non-peak times.
6. Widen junctions, to separate traffic going in different directions, with large companies encouraged to sponsor such works as will benefit them.
7. Widen lanes around large roundabouts, creating two lanes where possible.
8. Provide safer crossings for pedestrians, whether footbridges or underpasses.
9. Build elevated carriageways or underpasses at main busy city junctions, to improve flows at peak times.
10. Review speed limits, using modern technology to alter them as appropriate (for example, 20mph limits outside schools only at the start and the end of their day).

### 3.7. Lorry Charging – Allowing UK and Foreign Lorries to Compete Fairly

Of the £31 billion that the Government raises annually in motoring taxation (even without taking account of corporation tax on car manufacturers and retailers), only £7 billion is spent on roads; and, as already stated, expenditure on new roads in particular has been very low in the last decade. The OECD has concluded that: 'The UK ranks poorly in international comparisons regarding the quality of transport infrastructure and congestion. The case for raising expenditure on strategic roads should be considered'. This becomes clear when one considers that there are 12,000 registered cars for every mile of British motorway, compared to 6,000 in Germany, and even fewer in France and Spain. In other words, if we were to harmonise our road provision with Germany's or that of France we would need to double our motorway network.

Meanwhile, the UK road freight industry has been increasing its efficiency, with fuel consumption reduced by 16% since 1993. And although 25% of lorries still run empty, this is a 25% reduction in twenty years. But their international competitiveness has been reduced by an inequitable taxation system, and hence the highest cost base in Europe. UK hauliers not only pay twice as much in diesel tax as their continental peers (who take on as much diesel as they can buy when leaving the French or Belgian channel ports for the UK); but they are also alone in having to pay heavy annual vehicle excise duties, simply to have the right to travel on British roads. This has resulted in a substantial loss of market share over the last ten years, with 75% of all lorries leaving the UK to travel on the Continent now foreign-owned.

The British haulage industry has made strong representations to Ministers, but to no avail. We therefore recommend that an incoming Conservative government should implement a system of charging all lorries for their mileage on British roads. At the same time, either the duty on diesel, or the rates of truck excise duty, would be reduced for UK hauliers, so that their overall level of taxation

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would not rise. This would have several advantages: British truck owners could compete more fairly, without breaking any EU rules; the Treasury would benefit from extra revenues as foreign trucks started to pay user charges; and there would be more money to pay for much needed road improvements.

### 3.8. Railways – More Trains, Not Faster Trains, is the Priority

The railway industry saw a long decline after 1960, which was reversed only by its privatization in the early 1990s. Passenger numbers have since expanded substantially, and freight volumes have risen 50%. Initially, the Government professed itself willing and able to work within this inherited structure, but those who always preferred the idea of a nationalized railway system have prevented this from being a straightforward consensus for Labour. It is certainly arguable that two tragic crashes on the network allowed those who wanted to resume national ownership to put Railtrack into administration. This could have been avoided if the cost of safety works had not been inflated, and if the Government had not then declined to negotiate over a suitable grant to complement the private sector payments.

In place of Railtrack, the Government created Network Rail, a company with monopoly control over the provision of railway track within the UK. Theoretically a similar private sector body, it is different from Railtrack in one crucial area: it was given Treasury guarantees for very substantial borrowings, and access to Consolidated Fund revenues. Effectively, this has removed any real private sector financial discipline, and has transformed the costs of the railway completely. There has been a huge surge in extra administrative, consultancy and renewal costs, which have thereby come to dominate the transport budget. In 2000/1, the government accounts showed £1.3 billion of expenditure on the railway, but by 2006/7 this had leapt to £5.5 billion (and this figure does not include the very substantial sums being borrowed by Network Rail, with a government guarantee). Despite this enormous increase in expenditure, however, there has been no noticeable shift upwards in either railway capacity or growth compared to the late 1990s, when expenditure was under much better control.

Against such a background we believe that significant action needs to be taken, since it is clear that more railway capacity is extremely important to the future transport wellbeing of Britain. For example, there are many companies that would like to have a competitive rail freight offering, so that they have the opportunity to move their goods by train rather than by lorry; but in too many cases, the railway industry effectively turns freight away. Instead, the industry prefers to concentrate on providing a competitive package only for those businesses which require whole train loads every day, thereby avoiding the complexities of single wagon marshalling. Another group not being served well enough are those commuters into our big cities, especially into London, who have to rely on the trains. The railways should have a relative advantage in morning and evening peaks into and out of these leading conurbations, but the reality today is that of considerable problems with insufficient capacity, very high fares, and an unreliable service. For example, Ministers set a far from challenging punctuality target of 85% of all trains to be on time, and this has now been achieved. But it still means that three trains in every twenty are late; and closer analysis shows that, even worse, seven long distance trains in every twenty are late.

The industry has invested in new rolling stock, as a result of which the average age of trains has declined from twenty to thirteen years. However, this still means that there are many old locomotives, which are failing to hit modern standards for fuel efficiency and emissions control. It is too readily assumed that the railway is the green option: the fact is that, for it to be so, it has to use modern locomotives with high fuel efficiencies, low emissions, and a large number of passengers per train. The passengers also need to be able to get to and from stations without undue emissions from doing so.

After several reorganisations, the industry's current structure consists of a Department of Transport policy team, whose central control operates through its influence and funding of Network Rail. The

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Office of Rail Regulation (ORR) is responsible for all regulatory matters, from health and safety to supervision of the franchises and private sector contracts. We recommend keeping this framework, but with one exception: the status and position of Network Rail.

We recommend that an incoming Conservative government should decentralise Network Rail to allow for greater benchmarking in the industry, and to open up the potential for track and train services to be run together. We also recommend that the provision and use of track should be contestable: if someone wishes to build a new track, they should be able to do so, subject to planning permission. Clearly, they should also be able to interconnect this new track with the existing system; and, if charging and timetable arrangements for such an interconnection cannot be agreed upon voluntarily, arbitration would be compulsory. Most of the money for track improvement and maintenance should come from the private sector.

This is important, because any monopoly is undesirable, whether within the public or the private sector. A monopoly usually charges too much, fails to squeeze out inefficiencies or adopt the best technology, and sees customers or the government as a ready source of money to sustain all corporate overheads. And most people looking at the state of the railways would surely conclude that this is the case here. The track monopoly was handled very badly as a nationalised industry, and so far has not done much better under the different types of monopolistic private sector control that have been tried since privatisation.

In the nationalised era, for example, hardly any investments were made in extending and improving the track network, in order to reflect modern patterns of demand. Even as Heathrow grew to be the world's biggest international airport, at no point was it thought worthwhile to link it to the Great Western railway system, even though only 1.5 miles of track were required. Only when private capital was permitted, did the Heathrow spurline come to fruition. As for safety, although Labour has claimed that Railtrack was bound to be less safe than either its nationalised predecessor or Network Rail (a private company with a Treasury guarantee), the figures in fact show not only that this contention is inaccurate, but that none of these bodies can take much comfort from their records.

### **3.8.1. Priority for Commuters and Freight?**

In short, the UK's railway system attempts to do too much on too little, with four principal activities all jostling for space and investment over the same track.

First, there is the freight railway, which transports huge quantities of coal and other bulky commodities around the country, as well as large volumes of container traffic to and from the ports. Such traffic puts enormous weight stress on the track bed, proceeds quite slowly, but doesn't need to make many stops on the way.

Second, there are the commuter railways that run into (and out of) the principal cities, especially London. These require a very large number of trains at peak times of the morning and evening, and rather fewer during the remainder of the day. The trains are slow-moving ones, which need to stop at very frequent intervals along the track.

Third, there is the high speed inter-city train service, which is in conflict with all the others. This moves a limited number of passengers, for high fares, and at a relatively high speed. Combining these express trains with slower freight, commuter and regional trains is very difficult; and they also place a particular stress on the track, which rises geometrically with increased speed.

Finally, there are the regional and rural railways, which provide slower, cross-country links.



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We believe that, of these, the commuter and freight railways should be the priority, because in a country the size of Britain they are the most economically advantageous, and because the environmental benefits are also the greatest in these two areas of rail transport, reducing both road congestion at peak times, and the carbon emissions of fuel-hungry heavy lorries. It is impossible to accommodate anticipated freight growth on the roads without huge increases in congestion and significant increases in emissions. It is also quite impossible that all the commuters who need to get in and out of our big cities for work could do so by car, given our limited road space (even if we were willing to tolerate the environmental effects): such travel demand can only be met by a large number of efficient trains.

Looking first at freight, the railway is much better placed to keep it moving than queues of lorries on our motorway network. Rail freight in the UK operates on a strictly commercial basis with only limited support from government, in respect of environmental benefits and cross-channel operations. Rail freight moves over 100 million tonnes of goods a year, and has grown by 70% since it was set free by privatisation. Freight operating companies face several challenges to continuing this growth, notably:

- (i) It is difficult to forecast demand. Potential customers are not considering rail as an alternative because they do not believe that the infrastructure expansion that is needed to accommodate them will occur.
- (ii) Network Rail does not view freight trains as attractive customers because “they only pay the marginal cost of using the network (£1,000 per train)”.
- (iii) The capacity demands of freight services are different from those of high-speed rail. Consequently they are often delayed and redirected to keep them away from high congestion areas.
- (iv) Increasing pressure on network capacity from plans to increase the frequency of passenger services. Examples include Crossrail, the proliferation of services on the East Coast Main Line and the London Mayor’s proposals for a metro style frequency on London’s orbital routes.

The rail freight industry has proposed that the rail industry should adopt the concept of the “Big Freight Railway”. The underlying premise is that whilst it is possible to buy locomotives and wagons and to employ staff, the key asset for rail operation is the path or slot, which is limited by the constraints of the infrastructure. Therefore, to grow rail business in general and freight in particular, we need to pack as much into a path as possible. This means running freight trains that are longer, heavier, higher and wider – replicating the efficiencies obtained by the North American railways. In respect of freight, the minimum 50% growth that is forecast by 2014 will not be achieved on an incremental basis: adding a wagon here and there will only scratch the surface of capacity need.

A number of schemes have been identified to encourage rail freight growth that focuses on international gateways and key inter-urban routes, reflecting the priorities identified by Eddington. Port traffic is expanding year on year, leading to local congestion problems. There are currently planning applications for a new port at Shellhaven to the east of London, and at Bathside Bay at Harwich. Felixstowe is also seeking planning permission to expand. The success of the ports in attracting freight will cause local and trunk route congestion, if investment is not made in the rail handling capacity and capability. There are a number of key freight arteries across the UK that link key terminals and carry significant volumes. Enhancement of these routes would allow freight to make greater use of the routes, and remove congestion from other routes.

The express train system is more problematic, mainly because the UK’s geography (unlike Japan’s, for example) does not favour the long runs of track through unpopulated areas that can be used by high speed trains. Despite endless efforts, it has also not yet proved possible to increase speeds to above 125 mph; and it required huge investment to achieve even this on the West Coast Main Line (and this is

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without considering the difficult timetabling problems it produced). It is also difficult for railways to compete successfully on total journey times against internal flights, much of which is down to relative surface transport links to stations and airports. Many of us have much better access to roads and car parks when going to an airport, than we do when trying to get to very busy, constrained London rail terminals. Trains tend to have a relative advantage (both from a time and an environmental point of view) only for those who live in major city centres.

The Government's plans for the railway have, for many years, included three important engineering projects. The West Coast Main Line has seen some progress, but the Thameslink is still only on the drawing board, as is the scheme to construct a tunnel from west to east London, allowing trains to go on from Paddington to the City and beyond. There is a very simple reason that these have not gone ahead: money. This is despite the trebling of the railway budget within the main government accounts; and despite the decision to allow Network Rail to borrow an additional £20 billion with a Treasury guarantee. Although the Government has said that it favours private capital for these schemes, the truth is that, without its guarantees and subsidies, such large projects are often not economically attractive (especially given the expense of railway technology, and the complexity of drilling new tunnels under London).

### **3.8.2. Proposals**

So how might an incoming Conservative government square the circle? How can the capacity of the railway be increased within the budget constraints that will still undoubtedly apply? The answer cannot simply be that the private sector will put capital into large projects at its own risk, in the same way that it would pay for new toll roads if given permission by a future government.

Instead, we suggest that- in addition to any large scale projects that can be afforded- substantial progress can be made rapidly by focusing on smaller projects that can have a considerable positive impact on both the environment and those travelling to work by train.

First, we propose expanding the freight railway, primarily by allowing and encouraging a large number of short links from the existing railways into the industrial estates and ports. In the last thirty years, these industrial parks have been built near motorway junctions, in order to give them good road access; but as many are still within range of train lines, it would make great sense to link them up, so that more freight can take to the railways.

Second, we need to look to best practice abroad, in order to improve the technology for the commuter railway. Currently, the industry reckons it is only safe to run twenty-four trains per hour on a typical commuter track, because of the lack of grip that running steel wheels on steel tracks provides. In other words, both braking and accelerating quickly and efficiently (which commuter trains do much of, given they stop at many stations) are very difficult, particularly in bad weather conditions; and this has led to the delays and cancellations with which we are all so familiar.<sup>6</sup> The railway companies do attempt to overcome this problem by placing sandboxes on the trains, which put grit between the wheel and track – a primitive system that has proven ineffective particularly in autumn and winter. However, the Paris Metro has overcome this very problem by introducing rubber wheels that give trains extra grip, enabling them to accelerate more smoothly and brake more quickly. The Montreal metro runs on rubber tyres, with the same advantages; and some metro vehicles can also be driven onto roads. It has been suggested that, if we introduced these to British commuter trains, the railway could run a much more effective service of forty trains per hour, an increase in capacity of about 65%. Rubber could be introduced either in the form of additional wheels on a special running strip, or on the

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<sup>6</sup>The railway companies have attempted to overcome this, with measures such as sandboxes, but they have not worked well.

steel wheels. Whilst there would be costs in adapting the trains, these would be quite modest compared to the costs of the alternative solutions on offer.

The current view of the railway industry is that it needs to improve the signalling, by which it means to cut the safety margin by reducing the length of the red phase for any given train; and to lengthen the platform so that an individual train could have, say, twelve carriages instead of eight. Neither of these methods would be nearly as effective at raising capacity as improving the traction on the trains. Lengthening trains does not improve service frequency: running more trains does, which makes trains more attractive to busy people.

Network Rail itself now accepts that there is a capacity problem caused by the technology, and is looking at much lighter-weight trains, which would accelerate and brake more quickly, allowing more to run per hour on the same track. They would also be more fuel efficient. This is the most imaginative approach they have adopted to date, and it would help produce more capacity and more reliability of service. One way or another, we want to make a big leap forward in track utilisation on the existing network.

Finally, we have looked at high speed train options for the UK, and have concluded that an incoming Conservative government should explore the feasibility and costs of implementing the new Maglev technology, which offers the opportunity of far faster inter-city travel, and hence a more effective challenge to the aeroplane. This should surely be preferred to spending further large sums of money on attempts to create a limited number of express facilities on our already congested and overburdened track at the expense of other rail services.

### 3.9. Airport Policy

Aviation has seen huge growth in Britain in the last thirty years. The 32 million passengers in 1970 became 228 million passengers in 2005. A form of travel reserved for the rich and for the business traveller only a few decades ago is now available to almost all of us, with an expansion in choice brought about by low cost airlines. There are competing airlines, competing airports, and a privatized national air traffic services company.

	1995	2006
Passenger traffic (millions)		
London area airports*	82.8	136.9
Regional airports	46.6	100.6
Total all UK airports	129.4	237.5
Air Freight (millions tonnes)		
London area airports*	1.36	1.85**
Regional airports	0.34	0.60**
Total all UK airports	1.70	2.45**

\*BAA airports: Heathrow, Gatwick, Stansted plus London City and Luton

\*\* Provisional

Source: CAA Air Transport Statistics

As the table shows, air cargo has also grown rapidly, yet over the years has been treated as something of a poor relation to air passenger demand. Yet 25% by value of UK freight is shipped by air. The desired yield on many air routes is achieved primarily by freight rather than passengers, even though popular perception may be otherwise.

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The 2003 White Paper *The Future of Air Transport* set out a strategic framework for the development of airport capacity in the United Kingdom over the next thirty years, against the wider context of the air transport sector. Passenger traffic is projected to grow to double or triple current levels by 2030, as a result of increased affordability opening up the possibilities of foreign travel for more people, as well as providing efficient services to support business. At the same time, however, it is recognised that these benefits have to be balanced against the environmental impacts of air travel.

The 2006 Eddington report adds little if anything to this assessment. It reiterates the White Paper in identifying key international gateways as a strategic economic priority for the future, and the vital role of aviation in supporting the international competitiveness of the UK's high-tech manufacturing and financial services sectors.

The Government has stated in the White Paper that it believes that simply building more and more capacity to meet demand is not a sustainable way forward, but that a 'balanced approach' is required, an expression first used by the International Civil Aviation Organisation (ICAO) in relation to aircraft noise.

The primary issue for UK air transport is the lack of airport capacity to meet the relentless demand, and to a lesser extent the lack of airspace capacity. It is now widely accepted that aviation demand should be met within the region in which it originates or is destined for. Most significantly, this means that demand related to the South East region should be met by the London Area airports, and that the particular economic importance of Heathrow should be recognised. This should be enshrined as policy for all UK regions. The alternative of forced diversion is not feasible.

The South East region generates significantly more demand than elsewhere in the UK, and this needs to be accommodated at the London Area airports<sup>7</sup>. These airports remain the busiest in the world for the handling of international air traffic, including significant transfer traffic. At Heathrow, about one-third of passengers are changing planes and, understandably, this business is integral to the London Area airports business model. It is transfer traffic that enables Heathrow to sustain the biggest international route network and the highest frequencies of operation in the world. Such pre-eminence has much to do with London's position as the world's leading financial centre.

It is important to ensure that London does not lose its position and reputation, thereby prejudicing the UK's economic competitiveness. However, the South East's airports face a number of different challenges, including fully subscribed runway slots (especially at Heathrow), and passenger terminal capacity shortages. These constraints are not replicated at London's principal competitor airports at Amsterdam, Frankfurt and Paris where each has more (but not unlimited) scope to expand capacity to meet forecast demand.

There are several initiatives to consider, with the priority being to place even greater emphasis on maximising the use of existing airport capacity. Given the finite nature of runway capacity, it is essential to optimise what there is, in the interests of UK economic competitiveness. This is particularly the case at Heathrow, which alone accounts for 30% of the UK's air passenger traffic. At Heathrow, capacity can be eased both through operational changes and through better use of existing slots. This will require the cooperation of airlines that have "grandfather rights" to domestic runway slots and investment in surface modes (road, rail) to cope with the diverted domestic demand. Beyond these measures to maximise existing resources, the question arises of further runway capacity in the South East region and more specifically at the London Area airports.

The government's role is that of overall regulator. We recognise that the Conservative Party is considering green taxes aimed at addressing the environmental effects of rapid growth in carbon-

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<sup>7</sup> Heathrow, Gatwick, Stansted, Luton and London City

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inefficient forms of aviation. However, this needs to be balanced against the fact that Britain needs to have and retain world-class facilities and capacities, and strategically important aviation links that will be important to our future economic success. To achieve this, the present Government is recommending the early construction of a new runway at Stansted, as well as a shorter third runway at Heathrow. It has also drawn attention to the need to improve access to all of the major airports, especially Heathrow. We recommend that an incoming Conservative government's priority should be the strengthening of London's, and Britain's, main air transport hub at Heathrow, including through the Heathrow East proposal and the proposed redevelopment of Terminals 1 and 2. We believe that priority should be given to intercontinental traffic at Heathrow, while maximum use should be made of smaller airports by corporate aviation.

### 3.10. Shipping

There has been an increase in the UK shipping fleet in the last six years, from 4 million dead weight tonnes a decade ago to 12 million today. We welcome the option of the tonnage tax for shipping companies, and would recommend that a future Conservative government should improve the taxation position further, by allowing more companies to set up here, and more ships to be registered under the British flag.

Most important, if we are to encourage further growth in shipping, as an environmentally and economically sound method of transporting goods, we need to expand our port capacity. 95% of our international trade by volume, and 75% by value, is transported by sea; but there is still scope for this to rise further, given the impact on climate change of growing air freight. We agree with the Government's decision to permit increases in capacity at Felixstowe and near Harwich, two of the UK's largest container ports; and we also welcome in principle the Government's consideration of an important new development at London Gateway, on the Thames Estuary. A proposed expansion of the seaport terminal at Liverpool is also being investigated. 27% of freight volume by tonnage is moved from one UK port to another. With suitable measures to improve port capacity, the proportion of port-to-port domestic freight movement could be increased for certain types of freight, helping to take some cargo volume off our crowded roads, thereby helping also to reduce emissions, and to solve other environmental problems. The use of coastal domestic shipping should be encouraged where economically viable.

There is no public expenditure on UK ports as each port operator is responsible for all capital expenditure, including dredging of channels, building quay walls and expanding facilities.

In considering proposals for ports, it is necessary to have in mind the very different model of port operations elsewhere within Europe.

The continental model tends to involve the state or state entities owning the port land, retaining responsibility for dredging channels and building quays. The authorities grant leases or concessions to operators for activities in the ports, for example container terminals and oil storage facilities. In some cases, the port authority employs some or all of the labour that operates these terminals, such as the container crane operators in Le Havre. There is no transparency over the return, if any, that the port operator achieves on the infrastructure it provides.

The EU has been keen to legislate in the area of port services in Europe, but has failed twice in the last three years, primarily due to opposition from organised labour. In essence, the draft Directives have tried to mandate the regular re-tendering of contracts for facilities and services at ports, such as stevedoring. This approach could probably work in public sector landlord ports, but would be burdensome and potentially very damaging in UK ports.



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For example, Bristol has an integrated and very flexible workforce which may be unloading coal one day and cutting the grass and painting the next – coal ships don't come in every day. Forcing Bristol to create dedicated contracts for stevedoring and putting them out to tender might mean making their existing workforce redundant, and would both reduce labour efficiencies significantly and add to costs materially, for no advantage.

The EU continues to examine the area and the industry anticipates another draft directive followed by another round of trying to persuade the Commission, Parliament and the Council that the UK does not need a regulatory regime in what is already a very competitive market, because of the geographical spread of ports and the disciplines of private sector ownership.

The UK has developed a successful privatised model of port ownership. Over 85% of the 575 million tonnes of trade that goes through UK ports is handled through privatised operations. These ports are geographically widely spread, and the ownership models are equally diverse, with quoted companies (e.g. Forth Ports), private joint ventures (e.g. Mersey, Medway, Manchester Ship Canal and Clydeport now owned by Peel Holdings and Deutsche Bank), buy-outs (e.g. ABP, which was brought off the stock exchange by a Goldman Sachs vehicle) and private companies (e.g. Bristol). Port performance should be benchmarked against global best practice in throughput and costs, in order to ensure that the UK economy benefits from high levels of operational and financial efficiency.

Examples of trust ports include Dover and Milford Haven, and the Port of London Authority. The trust ports operate under an Act of Parliament. Their strengths are that they have to be self-financing, they are transparent, and the Secretary of State can sack at least part of the Board if he is not satisfied that the enterprise is being conducted effectively.

With trust ports there may be a perceived lack of accountability, as they are counted as public corporations and their debt is within the DfT's accounts. But the Ports Act 1991 does give the Secretary of State for Transport the right to privatise trust ports if their annual turnover exceeds £5 million. Ipswich is a former trust port that was acquired by ABP and is now run on a commercial basis. Since the acquisition, ABP has invested more in Ipswich than the cost of the acquisition and tonnage turnover has increased by 300% in eight years.

As well as continuing this policy of expanding container port capacity, we recommend the further privatisation of trust ports with a turnover above £5 million, recognising that the Conservative Party currently has no plans in this regard. It is notable that Felixstowe has been a stunning success, because its managers have energetically pursued every growth opportunity over the last twenty years. We would also like to see new entrants into the ports business encouraged; and the facilitation of private sector plans (or of public/private partnerships) to improve surface transport access to the main ports.

Road infrastructure is not the port developer's responsibility but too often a planning application demands that the applicant invests in the local road structure if the development is to receive permission. Such investment is often also necessary commercially if the port investment is to produce the desired efficiencies, growth and investment return. Improved road and rail infrastructure is required to support the growth of UK ports against competing EU ports, and to reduce the cost of imports into and exports out of the UK. However, the Government and the private sector developers of ports are equally unwilling to meet this cost.

This apparent gridlock can be broken, once potential investors (private sector or state) become convinced that a virtuous circle could be created by simultaneous investment in hinterland infrastructure and ports. Improvements to both would generate additional revenues for both, although the two businesses could remain separate, albeit that their success would be closely linked. The private sector should be able to enhance (or build new) roads and rail paths into and out of ports, and to recoup their costs through pay-as-you-use pricing, operated under long term franchises.



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### 3.11. Green Transport – Travelling with a Smaller Carbon Footprint

We recognise the announced commitment of the Conservative Party to adjust incentives, to ensure that the average carbon emissions of all new cars in Britain fall from 170g/km today to 100g/km by 2022; and that the average carbon emissions of all cars in Britain fall to the same level of 100g/km by 2030. It is, of course, the remit of the Quality of Life Policy Group rather than of the Economic Competitiveness Policy Group to consider detailed measures to achieve these reductions in the carbon footprint of cars, and more widely of our transport system. But it is important to note that improved road links – as well as reducing congestion and its economic impact – should reduce emissions, by minimizing traffic queues and inefficient vehicle use. Vehicle emissions vary greatly depending on the drive cycle. They are much higher in stop-start traffic congestion. Our proposals for improved rail freight capacity, greater port capacity, and increased seaborne container traffic are designed not only to relieve further the roads of congestion, but also to make freight transport more fuel efficient. We support the road haulage industry's progress in reducing the number of lorries running empty (i.e. without return loads); and we believe that railway companies should have a similar objective. Finally, the aim of any reform in air travel would be to reduce the overall growth in its emissions (with any tax incentives linked closely to carbon content and fuel efficiency), even as we recognise its continuing contribution to the UK's economy.

### 3.12. Government's Own Transport: Taking the Lead on Reducing Transport Demand

We would also like to see an incoming Conservative government review urgently its own use of transport facilities. We propose that:

1. Government and its agencies, as well as the wider public sector, should introduce car-free schemes for staff travel, wherever possible.
2. Long distance travel should be replaced by video conferencing, wherever possible; and the number of overseas conferences, and fact-finding trips, undertaken by both ministers and civil servants should be reviewed and reduced.
3. Ministers and civil servants should group together meetings that involve significant periods of travel within and outside London to reduce the number of journeys.
4. Staggered and flexible working hours should be introduced throughout the London office estate, in order to reduce the burden that civil service travel currently places on the public transport network at peak hours.

### 3.13. The Organisation of the Department of Transport: Slimmer is Fitter

90% of the Department of Transport's staff is employed by eight principal agencies: the Highways Agency; the Maritime and Coastguard Agency; the Government Car and Dispatch Agency; and the Driver Vehicle and Operator Group, which includes the Driving Standards Agency, the Driver and Vehicle Licensing Agency, the Vehicle Certification Agency, and the Vehicle Operators Services Agency. The myriad complexity apparent from just their names suggests that action needs to be taken; and indeed the Government's Gershon programme has attempted to produce efficiency savings, both by reducing the numbers employed, and by moving some jobs from London to less expensive parts of the country.

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However, we suggest that further measures are required to produce a more efficient and streamlined department:

1. The amalgamation of the DSA, DVLA and VOSA into one agency, which would save both central management and back office costs.
2. The transfer of the Vehicle Certification Agency to the private sector. Currently, it breaks even, and has a substantial number of overseas clients, which provide it with commercial revenue. Within regulatory control, it could perhaps be allowed to set its own fee levels, provided that they are never higher than 90% of the equivalent fees charged in Germany or Japan (our two main competitors, excluding the USA, in vehicle manufacture), whichever is lower. This would prevent both the exercise of monopoly rights in order to charge unrealistic fees, and over-regulation.
3. The transfer of the Government Car and Dispatch Agency (which organises private transport, ministerial cars, and postal services within government) to the private sector, with the employees of the agency receiving shares in the new company, and competition introduced progressively into contracts.
4. The closure of the Commission for Integrated Transport, which is an advisory non-departmental body. We believe that, instead of relying on a single source of transport advice, the government should turn to a wide range of think-tanks, universities and private industrial sources. These should provide ready (and free) access to the innovative advice of all those pursuing a serious interest in public transport policy matters.
5. A review of the Ports Act 1991, with a view to returning more trust ports, currently sponsored by the Government (with all the powers and administration that this entails), to private ownership and control, recognising that the Conservative Party, whilst not ruling out the possibility of one day privatising one or more trust ports, does not currently have plans to do so.

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## 4. Skills, Training, Science and Engineering

### 4.1. Vocational Skills

The UK desperately needs more, and better, vocational skills training if it is to have any chance of sustaining its competitiveness in the global market. The current supply-led system of training provision has proven to be entirely out of step with both employer and trainee needs, with productivity and prosperity being damaged as a result. The vocational path from training to employment has become almost impossible to navigate, as was highlighted by Lord Leitch's 'Review of Skills' interim report in 2006. Too many courses leave trainees uncertain of their prospects, and without the level and combination of relevant skills demanded by employers. At the other end, employers are faced with a confusing array of qualifications whose relative value is difficult to assess. This has also been the conclusion of the Vocational Skills Working Group, in their report to the Policy Group.<sup>8</sup>

The key problem is that employers are being denied the opportunity to tailor vocational training programmes to any meaningful degree, and thereby make them relevant. Instead, training provision is corseted by an overly bureaucratic, complex and wasteful funding framework, whose services remain unresponsive to market needs, and bewildering to its users. Substantial government funds are channelled through the national, regional and local offices of the Learning and Skills Council (LSC)<sup>9</sup>, alongside myriad other agencies (with further changes in funding patterns now coming from the Government, as a result of the separation of the DfES into two departments). The labyrinthine complexity of such regional funding will never be able to meet the needs of different industry sectors efficiently. In fact, the only beneficiaries of this convoluted funding and decision-making are the current training providers, who remain immune to market forces, and therefore to the needs of employers. Employers and trainees, in contrast, are entirely disadvantaged by the lack, or inaccessibility, of appropriate training.

It is clear that the chasm between the UK's needs and vocational training can only be redressed by a demand-led system, served by a radically simpler funding architecture. The requirements of trainees and employers must be paramount, with the government limiting itself to facilitating the supply of state-funded skills training, without subjecting it to central planning. As trainees will then have purchasing power, providers will finally be exposed to market forces, and have to respond to industry sectors' needs.

None of this will mean a reduction in current government funding of skills training, but the money will be spent much more effectively. Where there are conflicting claims on necessarily finite state funds, there must be both an appreciation of the future skills requirements of UK industry, and a prioritization of the most motivated and qualified candidates. Such a funding system will allow UK plc to remain globally competitive, and to attract foreign investment.

#### 4.1.1. A Way Forward for Vocational Training: Closing the Gap

Apprenticeships should constitute an effective way of tallying the needs of employers and trainees. And they should develop skills that can add value to both the organisation and the individual. But the UK's current enrolment levels lag well behind its European competitors, such as Germany and Austria, while completion rates remain poor.<sup>10</sup> As already indicated, a major reason for this is that firms have much more limited scope to signal what key skills they need from their apprentices than do their continental peers. In Britain, only about 20% of the training providers to whom the LSC allocates

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<sup>8</sup> Vocational Skills Working Group report (hereafter referred to as VSWG Annex) 2.3- 2.5

<sup>9</sup> VSWG Annex 2.6 & 2.7

<sup>10</sup> VSWG Annex 3.1.1

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its apprentices are actually employers. Too few trainees, therefore, are provided with invaluable workplace experience and mentoring; and this limits their opportunities to attain skills relevant to potential employers.

All this clearly suggests that apprenticeships desperately need to be made professional once again. We believe that they must be under the genuine control of employers, who should complement government subsidy with a substantial commitment of their own financial and organisational resources.<sup>11</sup>

Instead of there being confusing multiplicity of qualification-awarding bodies, the Sector Skills Councils should act as the apprenticeship scheme's sole licensing body. This would not only be a much simpler system, but a more appropriate one, given the Councils' status as employer-led organisations.<sup>12</sup>

The apprenticeship qualifications themselves need to be overhauled radically, so that they meet both the basic and the intermediate skill requirements of employers. NVQs should test genuine vocational knowledge; and a general education component in apprenticeships should be a condition of state subsidy (albeit with greater flexibility over its nature and content).

And finally, any increase in employer involvement must include SMEs. We would like to see the piloting of relaunched Group Training Associations (GTAs), which would enable small and medium-sized businesses to take on apprentices. They should be led by employers who already run successful apprenticeship schemes; and who would receive extra funds to expand them beyond their own employment needs. In this way, group training could be provided for SMEs which would otherwise struggle to deliver full apprenticeships.

#### **4.1.2. The Proposed Framework**

##### *Funding*

We propose a single, integrated funding architecture for all state-funded vocational skills training, which channels money in accordance with market needs. Funds will be allocated directly to the individual trainee, be they unemployed, self-employed, a school leaver or a company-sponsored employee.

This funding will be administered by local authorities and county councils, which are already geared up to do this as part of both education and regeneration. This will replace the existing architecture of LSCs, SSDAs, RDAs and LLSCs, whose involvement with vocational skills training will cease. As a result, training providers will be exposed to market forces, and be forced to drive up the quality of their provision so as to meet trainees' requirements.<sup>13</sup>

##### *Sourcing Advice*

We propose the transformation of a significant part of the current Connexions service into a fully fledged Careers Advisory Service (CAS)<sup>14</sup>, which would be highly visible on every high street, on the internet, and within schools. Not only would it provide communication between trainee, market and employer; but it would also be responsible for matching the best candidates to the training most relevant to industry's indicated needs:

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<sup>11</sup> VSWG Annex 3.3

<sup>12</sup> VSWG Annex 3.3 refers to both this, and the remainder of this sub-section.

<sup>13</sup> VSWG Annex 4.1

<sup>14</sup> VSWG Annex 4.2

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1. The CAS Advice Desk would offer training advice, tailored to the needs of individuals and businesses. Over time, we anticipate that the myriad of state-funded skills training advice services would be merged, or have their capabilities folded into the CAS.
  2. The CAS Funding Desk would advise on applicants' eligibility for state funding, applying a set of basic criteria.

We further recommend that the CAS framework should be piloted before being rolled out across the UK.

### *Empowering the Sector Skills Councils*

The CAS would be supported by substantially empowered Sector Skills Councils (who will need, in some cases, to strengthen also their own governance). These should be given resources that allow them to provide the CAS with research both on skills shortages, and on labour market signals. This will ensure that state spending on vocational skills training is always guided by market needs, on a sector by sector basis.<sup>15</sup>

The SSCs should:

1. Support businesses in the design of training programmes, together with training providers and other industry bodies.
2. Work with accreditation bodies, to shape qualifications that reflect the changing needs of industry. They should also continue to keep training providers aware of those changes.
3. Promote British business in the global market, and attract foreign investment.

### *Allocation of the Finite Skills Budget*

The SSCs' market information should inform the allocation of the DIUS budget. We propose that the Department introduce a simple set of criteria that will match funding to skill requirements in an effective manner. SSCs should bid for funding on behalf of their respective industries, replacing the current top-down system of funds allocation. State funding should be available annually to those who meet the criteria set for funding by the DIUS; and once the DIUS budget has been exhausted, applicants should be deferred to a waiting list either for the following year, or until a course becomes available.<sup>16</sup>

We do not propose a precise framework of funding criteria here, but what we do recommend is that it be kept simple, and that it includes:

1. Three categories of skills training (A, B and C), to reflect the SSCs' analysis of the requirements of UK industry. Funding would be awarded according to their relative weighting.
2. Greater flexibility in funding. Courses may be co-funded by individuals, the state and/or employers. The rigidity of the current funding arrangements has contributed to the loss of more than one million adult learners since 2005. Co-funding adult and continuing education would enable provision to respond more effectively to demand.

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<sup>15</sup> VSWG Annex 4.3

<sup>16</sup> VSWG Annex 4.5

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3. Funding related to an income threshold for those individuals who are not employer-sponsored. Those below the threshold would receive more funding than those above it.
  4. A link between funding and basic achievement levels. For example, an applicant with a number of GCSEs would obtain funding ahead of an applicant with none.<sup>17</sup>

Those trainees who are partly self-funded should be able to access loans, contingent on income, just as university students are. We would also like to see traditionally inaccessible sources of personal savings opened up to them.<sup>18</sup>

## 4.2. Higher Education

### 4.2.1. Science and Engineering – Stimulating the Knowledge Economy

Industry projections suggest that 2.4 million additional people will be needed in science and engineering between 2004 and 2014. The CBI has expressed grave concerns about the likelihood of these requirements being met, either in quality or quantity. This is clearly a significant problem, as comments from companies such as GlaxoSmithKline (GSK) show:

“The availability of a high quality workforce, properly trained scientists and clinicians, coupled with a thriving commercial environment for innovative medicines, are prerequisites for the continued success of the UK in attracting pharmaceutical investment.”

The scale and urgency of the task has prompted successive waves of public policy responses, as well as a host of private initiatives. Unfortunately, while this policy energy springs from genuine concern, it has now become part of the problem. A review by the DIUS in 2004 revealed that, in combination with the DTI and external agencies, it was running 470 different science and engineering initiatives. The consequent establishment of a committee by the DIUS to address this lack of focus, and to streamline the multiplicity of schemes, is a welcome but insufficiently radical gesture.

### 4.2.2. The Global Context

In order to stay competitive, the UK not only has to catch up with other countries in terms of STEM (Science, Technology, Engineering, Maths) higher education, but must hold onto its current successes in the face of growing global competition. University league tables are an important indicator of the UK's relative position; and at present, we can take comfort from having three universities in the top ten world rankings (the other seven are all in the USA). However, there is no room for complacency at a time when China and India's universities are racing up the rankings. China, for example, now has nine universities in the top two hundred, including two in the top thirty.

As for STEM higher education in particular, it is clearly problematic that only 26% of new degrees awarded in the UK in 2003 were in science and engineering subjects, compared to 38 % in Korea, 32% in Germany and 29% in France

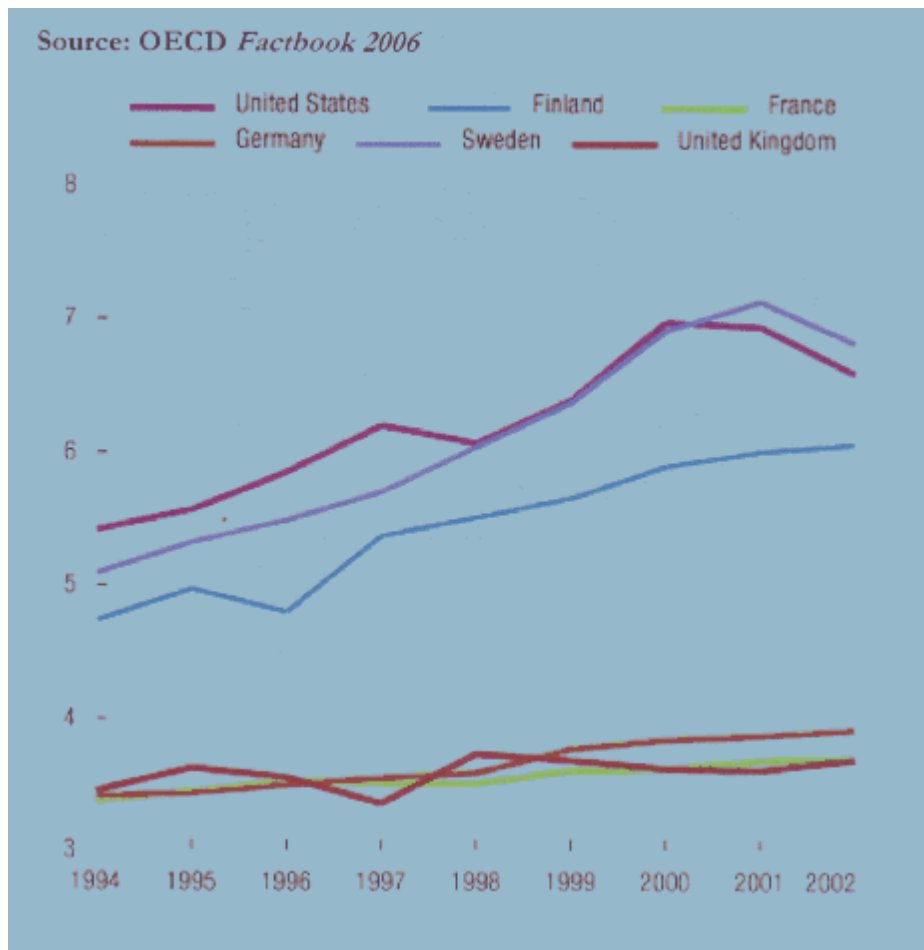
Investment in Knowledge for Selected Countries as a Percentage of GDP

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<sup>17</sup> VSWG Annex 4.4 & 4.5

<sup>18</sup> See Chapter 5 on Pensions





This graph shows how the UK lags behind many of its competitors when it comes to investment in knowledge. Another key indicator of STEM performance, Research and Development (R&D) spending, also shows our unsatisfactory position. We currently spend a mere 1.88% of GDP on R&D, which is not only far less than Japan (3.15%) and the USA (2.68%), but also less than many other EU countries, including Austria, France, Germany and Sweden.

#### 4.2.3. Influencing the Place of STEM in Society

The evidence received by our STEM Task Force suggests that there are three major inter-related areas that currently influence the place of science and engineering in society: public perception, public engagement, and the skills pipeline.

##### (i) Public Perception of STEM

People do recognise the impact of science and engineering on their quality of life; and there is certainly public trust in scientists, especially those working in universities. But these generally positive views<sup>19</sup> are tempered by the findings of the British Association survey, which identified that just 14% of the public trusted those scientists based in businesses. It must also be of concern that a higher percentage of young people distrust scientists. A survey for the Nestlé Trust showed that only 50% of those aged between 11 and 21 trust scientists to make responsible judgements.

This does not so much suggest that there is an anti-science culture, but that a lack of understanding can polarize opinion between blind faith and no faith. Many scientists and engineers also believe that the media frequently gives them a negative image, and that the importance of STEM to Britain's prosperity is even less well recognised as a result.

<sup>19</sup> DT/MORI, 2005 Study.

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**(ii) Public engagement with STEM**

The Government and external agencies agree that public engagement with science and engineering is a major lever to changing the standing of science in society. Unfortunately, although (according to one survey) 74% of scientists participated in at least one public engagement activity in 2005, it is still not seen as an important element of science and engineering careers. It is recognised neither in career development, nor in research assessment exercises; and best practice is not defined.

Nevertheless, an enormous amount of work is now being undertaken in order to improve perception and understanding. Some of this is directed at stemming the decline in the study of science at university (see below), and some is directed at changing the more negative perceptions of science.

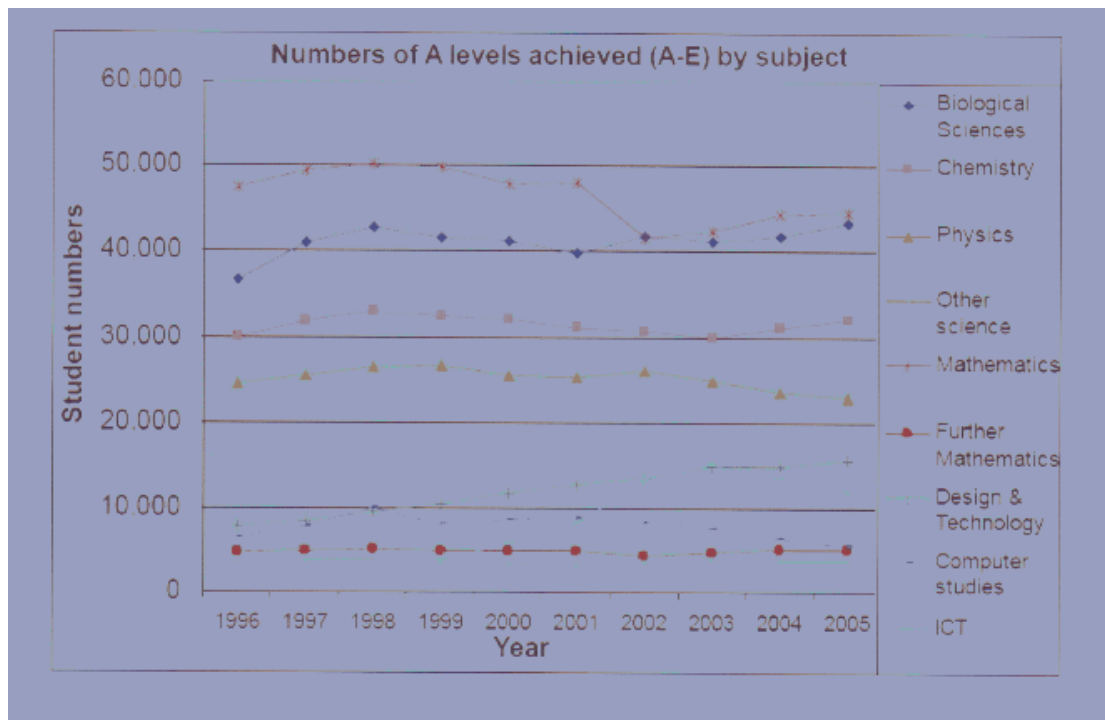
There are too many examples of good practice to list here, but significant work is being done by the Royal Society; by the Research Council's UK Science in Society Unit; and by the British Association for the Advancement of Science. The Arkwright Scholarships, a voluntary sector scheme to provide bursaries to science and engineering 'A'-Level students, is also an excellent example of the kind of initiatives currently underway. What now has to be asked, however, is whether some of these outstanding efforts involve an unnecessary duplication of resources, and how they can be coordinated more effectively.

**(iii) The STEM skills pipeline**

First, it should be noted that the facts and figures we highlight below come from a wide range of professionals, academics and organisations. We have preferred these to the perhaps more optimistic, even complacent, figures quoted recently by the Government.

**School Students – Fewer Science and Engineering Pupils**

Since 1984, the number of students taking physics and chemistry 'A'-Level has declined by 57% and 28% respectively. Since 2002, the number of students taking STEM 'A'-Levels has declined still further, especially in maths, physics and computer sciences. And at GCSE level, although the uptake of science and maths increased between 2002 and 2005, that of IT and design decreased, so that there was no overall improvement. These trends show no credible sign of reversing, and can be seen in the following chart:



The decline in students choosing some science and engineering subjects can be attributed to a shortage of qualified teachers; the ‘nerdish’ image of science and scientists; the fact that science is perceived as a ‘harder’ and less ultimately rewarding subject; and inadequate careers advice.

Since publication of the Rogers and Smith reports on Science and on Maths Education (2002 and 2004 respectively), the Government has launched teaching and careers advice initiatives. Recruitment of specialist teachers is improving, but their shortage is still a huge problem. For example, a study by the National Foundation for Education Research in 2006 found that 25% of secondary schools do not have a specialist physics teacher. This is likely only to get worse, because of the ageing profile of the science and engineering workforce in schools: one in three physics teachers will retire over the next decade.

As already stated, the (then) DfES identified 470 different initiatives aimed at increasing the supply of science and engineering professionals, and at promoting science and engineering literacy. Not only do many of these initiatives have similar objectives, but it seems (unsurprisingly) that STEM teachers either do not know about them, or are simply overwhelmed by their number.

More progress is also needed in providing continuous professional development for existing teachers. The Science Learning Centres, funded by the Government and the Wellcome Trust, are admirable but under utilized (head teachers are reluctant to allow key staff to attend, as supply teachers are expensive). And careers advisors clearly need more training, with 90% of them not confident about advising on careers in science and engineering.

Finally, pupils must be made aware that those who successfully study STEM ‘A’-Levels are increasingly likely to be considered by leading universities, which are keen to promote these subjects. This growing opportunity is in contrast to the chances of those studying the more popular ‘non-core’ subjects (such as leisure studies and performing arts). For example, Cambridge University has recently published a list of about twenty subjects it regards as undesirable for potential entrants.

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## Undergraduates – A Decade of Closing Physics and Chemistry Departments

Since 1984, the number of students obtaining first degrees in science subjects has risen by 66%, against a background of an increasing uptake of higher education. Nevertheless, the number of physics and engineering degrees fell by 7% and 11% respectively.

The growth of first degrees in science between 1994-5 and 2004-5 at first sight also appears good (up from 31% to 37%). However, the Royal Society study of 2006 showed that this is in fact due to changes in the way statistics are compiled. In this context, ‘science’ has come to include psychology, sports science, and forensic science; and these subjects’ popularity has hidden the absolute drop in those graduating in physics, chemistry, engineering and mathematics.<sup>20</sup>

This is creating a vicious circle, whereby 31 and 26 fewer universities offer physics and chemistry degrees respectively than was the case in 1994. Five maths departments have also closed since 1999. These closures reflected a range of factors, including the fact that the cost of teaching sciences is higher than for other courses, and exceeds the funding provided by the HEFCE (even after a recent increase).

The combined impact of all this is of serious concern. In evidence to our STEM task force, GSK expressed views echoed by others:

*“We are concerned about the downward trends in the number of students entering certain degree courses, and are troubled by the decrease in the number of high quality graduates emerging from UK universities with appropriate expertise, practical skills and depth of knowledge in relevant scientific disciplines. This is particularly the case in relation to the decline in the availability of graduates who have developed in vivo skills in pharmacology, physiology and so forth; and there is also a longer term reduction in those studying chemistry and the other physical sciences.”*

## Career Scientists and Engineers

Between 75,000 and 100,000 chartered engineers will retire in the next ten to fifteen years, while only half that number will begin their career. It is encouraging that professional bodies are addressing the continuing development needs of their members; but there also has to be more government and industry focus on wider access to more relevant apprenticeships and other vocational training schemes in scientific and engineering fields. Only 28% of Britons are qualified to apprentice, skilled craft and technician levels, compared to 51% in France and 65% in Germany. Projections suggest that up to 75% of jobs in 2012 are likely to require at least Level 3 skills; but only 50% of the current workforce has obtained this level.

## Postgraduates and University Teachers

Some 39% of postgraduate STEM students in British universities are from outside the UK. While this recognition of the excellence of our universities is very welcome, there must be concerns about the economic and social impact of so many of those training in the UK not then remaining in the country. Our competitiveness is not helped by Western-trained scientists returning to work in China, for example, to lead the high number of science graduates emerging from universities there.

Meanwhile, the Association of British Pharmaceutical Industries’ report *Sustaining the Skills Pipeline* highlights the shortages of adults with key skills in science and engineering subjects, right across the

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<sup>20</sup> The Council for Industry and Higher Education has said that the absence of agreement over what constitutes ‘science’ is confusing for both policy makers and the public; and the STEM task force certainly noted in evidence given to them a disagreement about whether psychology, for example, is a science subject or not.

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pharmaceutical and biopharmaceutical industries. In sector after sector, the report identifies shortages of staff with PhDs and post-doctoral qualifications. This is particularly significant, because other evidence to our inquiry suggested that this is resulting in pharmaceutical manufacturers beginning to contain the size of their UK operations, and to locate new investment overseas, despite our world-renowned pharmaceutical base. Another problem often cited is that UK universities are pricing themselves out of long term research work, through inflexible application of the full economic costing of contracts.

Much effort will be needed in the future, if we are to ensure that the UK has the science and skills base needed in a competitive world. And of course the solutions to other major challenges for the UK, such as those of energy diversity and climate change, will be dependent upon the ingenuity of our scientists and engineers.

### 4.3. General Issues in Higher Education – Quality Not Quantity should now be the Aim

It has been government policy in the last ten years to increase the proportion of school leavers who go to university. In this they have been successful: only 6% of pupils went on to higher education in the early 1960's, but by 2006 this had reached 42%, close to their target of 50% by 2010.

This increase has been paid for not only by government, but by student funding. Students now have to take out loans to cover their living costs; and more recently have started to contribute to the cost of their university place through student fees. At the time of the last General Election, the Conservative Party both opposed the idea of introducing student fees, and favoured a revision of government targets with respect to student enrolments. This was driven by the concern that the quality and expense of a university education were going in opposing, and unintended, directions.

We do not recommend that the Conservative Party reverses the move to student fees, as they will have bedded down as part of student finance by the time of the next General Election. However, we do recommend – as and when affordable – the expansion of access funds. It is vital that more talented pupils from poorer backgrounds are able to benefit from a good university education; but it is apparent that many are reluctant to take on the large debts involved in paying for three years of a university course and maintenance. More grant support – if and when affordable – should obviate this problem, and ensure that universities do not become increasingly the preserve of those whose parents can both afford to contribute to their university fees, and are willing to do so.

Another issue is that, although our headline 42% university participation rate is high by world standards, it is combined with a 14% drop out rate, and masks the key statistic that only 36% of young people will both go to university and complete their course successfully. Unlike the Government, however, we do not believe that the way to create more opportunities for young people, and a better educated and trained workforce, is to target figures for participation in higher education regardless of either abilities or demand.

Rather, we recommend that a future Conservative government should make student finance available for all those who reach the required standard, to be determined every few years in conjunction with the universities (and subject to them wishing to offer the places; and to the students being willing to take up the courses, and to take on the consequent financial obligations). This standard would approximate to the minimum standard that those wishing to qualify for a full maintenance grant under the old regime had to attain (two grade Es at 'A'-level). This system would have the advantage of being blind to background and income, and of making it simpler for universities to get on with their main task of providing a good academic education.

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### 4.3.1. Higher Education and Financial Resources

In 2007-08, the Government is making available £9 billion to the university sector, of which £6.9 billion will come from the Higher Education Funding Council for England. Most of this money will pay for student places, with just over £1 billion will be available for research grants, and £700 million for capital expenditure to improve university buildings and estates. The remainder will be used both for writing off any losses on the student loans portfolio, and for the grants that are still available.

We believe that this is an appropriate level of public funding, but that universities should be allowed to access other forms of funding to complement this. A strong and independent university sector is to everyone's advantage; and we would like to see our universities build on their current revenue-generating activities.

These are various. First, universities can attract overseas students, who have to pay the full economic price of their courses. Second, they can attract business funding for research and projects. Some have been most successful at this: Warwick University's School of Manufacturing now has an annual external income of about £100 million a year. Third, universities can enter into partnership agreements with business, in which they provide mid-career training or education for executives, in return for financial assistance or the funding of particular university posts or facilities. And finally, they can attract substantial gifts from those businesses and rich individuals who want to give something back to the community, and who like to be associated with a university.

There is some controversy within the Government about such growing financial independence, and particularly about the leading universities which have made substantial strides in creating and enhancing endowment assets of their own. This has led to suggestions that such universities should see a commensurate reduction in their public funding. We believe that this is a very short-sighted approach to the state of our universities and their finances. The truth is that Oxford and Cambridge are not sufficiently endowed to be fully competitive with the likes of Harvard, with the current endowment of Harvard four times the level of theirs. Harvard has been more successful at raising money from ex-alumni and business sources than either Oxford or Cambridge, and considerably more successful at investing it. In recent years, Harvard investments have been growing at twice the rate of Oxford or Cambridge investments simply from superior investment performance.

Both of our distinguished universities are aware of the need to raise their game on investment management. Both are taking action to introduce more professionalism into their investment activities, and to diversify their portfolios in order to try and benefit from a varied and innovative range of assets, which may both increase returns and reduce volatility.

The United Kingdom is blessed to have five great institutions in the world's top twenty. Alongside Oxford and Cambridge rank Imperial, UCL and LSE, a formidable array of three leading London institutions which represent excellence in science, arts and the social sciences respectively. We need to understand that they need encouragement and a healthy climate, so that they can keep up with the pace of improvement of the biggest and best American universities. If we wish to attract the best faculty members today, we need to offer very competitive rates of pay, which look very high by traditional UK academic standards. If we wish to attract the best students from around the world, we need to have generous grant funds to pay for those who do not come from rich backgrounds or from prosperous countries. If we wish to have the best facilities, particularly on the science side, we need to make substantial investments.



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### **4.3.2. Higher Education and Fundraising**

We therefore recommend that an incoming Conservative government should make it easier for all British universities to raise more money, whether from alumni, wealthy individuals or businesses. For our proposals, we draw on the work of the Thomas Report, and its specific recommendations on how to amend the British tax system in a way that will encourage more philanthropy.

First, those making large donations to universities should be able to claim full income tax relief through self-assessment. Gift Aid would remain for charities that prefer it as a way of receiving tax relief.

Second, we would like to see tax relief extended to new classes of assets, such as unquoted shares and personal property, when they are given to a university.

And third, we would ask the Treasury to design a planned-giving vehicle of the type which has been so successful in US higher education fundraising. To leverage this effectively, universities would have to become more active in raising money from alumni and businesses; and to continue the work of improving their investment management performance. We would also recommend allowing companies to offset the costs of contributing revenue to a university against Corporation Tax.

### **4.3.3. Office of Fair Access**

The universities do not see the need for the Office of Fair Access. We have every confidence that British universities wish to seek out the most talented and diligent students. We do not believe that our leading universities seek to exclude people from poor backgrounds. Indeed, we notice just how much work leading universities do to contact pupils in less privileged areas and tell them that they would be very welcome if they can make the grade.

### **4.3.4. Higher Education and Links with Businesses**

Links with business are another important source of funding for STEM education and research. There has been some very impressive work done by universities such as Warwick, both in building strong links with industry, and in transferring ideas from campus to companies. Magdalen College, Oxford has set up an industrial park, which provides both a useful rental income for the college, and much-needed facilities for small start-up businesses to develop ideas pioneered in the university. The University of Cambridge has also had great success in establishing high-tech industries, and in encouraging communication between business and the relevant faculties. The University of Surrey has an important company campus attached to its own academic campus, which has led to some very successful ventures.

There is scope for further development, however. The most dynamic and successful US universities have forged links with private equity and venture capital, to great mutual benefit. Financial executives regularly listen to the pitches of faculty members and students on their business enterprise ideas; and are available to give advice on all aspects of developing and growing a company. We propose that British university contracts become flexible enough for faculty members and students to create and foster similarly strong relationships with such financial institutions.

### **4.3.5. Government Funding of Research**

There is no guaranteed method of ensuring the right distribution of public funding, when it comes to fundamental research in science. All research grants are taking risks on whether the researcher will find something of value, and some money will therefore always be wasted. We do not believe this is sufficient reason to alter the current RAE system. It is important that a future Conservative

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government allocates the substantial amounts of money available to the best universities, and to the most worthwhile and inspiring projects.

#### 4.4. Conclusions and Recommendations

1. British universities can and should be encouraged to raise substantial extra money from the private sector.
2. Tax changes should be made so that there is a decent tax incentive for people to give money, when living and on death, to leading university institutions.
3. Universities should be required to allow their faculty members contractual terms which permit time off and time out to develop enterprising activities based on their research, where the university retains a financial interest in a successful outcome.
4. Other universities should be encouraged to follow the Warwick example: raising substantial amounts of money by tie-ups and links with business; and developing a symbiotic relationship whereby the university benefits from the projects, challenges and cash offered by the business, and the business benefits from the research testing and problem solving provided by the university.

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## 5. Pensions and Competitiveness

### 5.1. Overview

In 1997, our private pensions system was the envy of Europe, even of the world. We had more money invested collectively in pension schemes than the rest of Europe put together. The funds were solvent, and Trustees were meeting to discuss whether to increase benefits or to reduce contributions as funding levels were so good. The incoming Labour Government acknowledged this, especially in the words of Frank Field, the first Labour Welfare Minister in the new Government. Some 5.8 million private sector workers were covered by employer schemes, whilst most of the public sector also enjoyed good pension promises, some based on funded schemes, others relying on future taxpayers and politicians to honour the pledges.

Since 1997, over 60,000 occupational pension schemes have been wound up, or have begun the process of winding up. There has been a serious decline in the number of funds open to new members with at least two-thirds now closed, and a decline in the number of funds continuing to offer savings facilities for existing members. Many funds are in deficit, with employers having to increase contributions to meet existing entitlements. We need to understand why this happened, if we are to create conditions in which private savings for retirement can be revived for more people.

The Government claims there are two reasons for the plunge into deficits. The first is the fact that many funds either stopped making contributions, or reduced the level of contributions, in the good days in the 1990s. The second is that people are living longer, increasing the cost of meeting their pension needs.

It is true that many funds were able to reduce their contributions. Indeed, they had to, under the regulatory system in place from the Treasury. Savings through pension funds are tax privileged, and the Treasury under governments of both parties prevents a company putting more money into a fund than is judged necessary by an independent actuary to meet the pension costs. Pension funds were so successful in the mid-1990s that they had to reduce the contributions. This did no damage to the funds, which remained solvent.

It is also true that in recent years actuaries have changed their minds on how long people are likely to live. This has imposed additional cost on funds, and does require some increase in contributions. Also, the actuaries – who value the liabilities on the basis of the inverse of the interest rate, have been putting in much larger figures for the liabilities, because current interest rate assumptions mean that it will cost more to buy bonds to guarantee payment of the pensions.

The other main contributory factor to the deficits was Gordon Brown's decision to remove the dividend tax credit from pension equity investments. UK funds typically held between one half and two thirds of their investments in UK equities. When a dividend was paid to a fund, the fund also received a tax credit based on the standard rate of income tax, as part of the imputation tax system of corporate taxation. The removal of these credits has cost the funds an estimated £100 billion. The loss can be calculated either by taking 10 years of tax credit foregone, £50 billion, plus the reinvestment gains that would have been made on that money; or by recognising that the UK equity market fell by £100 billion more than other leading world markets (adjusted for capitalisation), reflecting the fact that the market valued companies at 20 times earnings, and that they had just lost £5bn of earnings.

The £100 billion lost through the tax change exceeds the current aggregate deficit of private sector funds. The damage to pension funds has been reinforced by regulatory action. The introduction of FRS17 required companies to place the latest version of the deficit of their fund onto their balance sheets, thereby introducing great volatility into balance sheets as the pension liabilities rise every time

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the interest rate falls. The regulator has required some discretionary benefits to become mandatory, increasing costs, and has led a drive to persuade Trustees to invest more in government bonds at a time when bond yields are very low. This has meant companies have been required to put even more cash into their schemes, to compensate for the poor value available in bonds.

## 5.2. Why Does This Matter to a Review of Competitiveness?

The need to put more into company pension schemes to tackle low bond yields, rising regulatory requirements, the absence of the dividend tax credit, and longer mortality has meant UK companies have had to spend a great deal of their free cash flow on this issue. This has diverted money from much needed investment in plant and equipment, new products and services, and research and development. UK business investment has fallen from 12% of GDP to 9% of GDP this century, at a time when profits have been rising. Between 1996 and 2000 companies invested under £20 billion per annum in their funds. In 2003 they put £31 billion in, in 2004 £36 billion, and by the first quarter of 2006, investment through pension funds had reached an annualised £50 billion.

This is a huge extra burden to carry at a time when world markets are demanding lower costs and lower prices, and when competitors in Asia do not pay pensions to their staff in this fashion. It is also a time of great change, when large sums are needed to automate manufacturing, to invest in high quality web based technology in all sectors, and when world brands require large sums of R& D, marketing and promotion to create and sustain them. UK business has a £50 billion a year ball and chain on, as it attempts to run in the world competitive race.

## 5.3. Can We Revive the Final Salary Pension Scheme?

Final salary schemes are popular with employees, and are common still in the public sector. They are dying out in the private sector, as the lethal cocktail of tax changes, higher regulatory requirements, low bond yields, and regulatory interference with investment policy persuade company after company to abandon such schemes. Their replacements, defined contribution schemes, put the investment and funding risk onto the employee, and often enable both employer and employee to cut their contribution rates, at the price of having a lower pension in retirement.

We do think there should be changes to try to save more final salary schemes, and to encourage employers to set up new ones, as final salary schemes both offer a better deal to employees and cut the need for means tested benefits for people in old age.

We recommend the following proposals to assist in maintaining the schemes we still have, in opening new ones, and in helping those choosing to save through defined contribution schemes:

1. There should be no compulsion to buy an annuity with the invested money in any pension fund on retirement.
2. There should be no maximum age to start drawing down a pension.
3. Future pension contracts could specify a range of benefits that are guaranteed, to be agreed between employer and employee.
4. A future government should seek to persuade the Accounting Standards Board that FRS17 and IAS19 have introduced too much volatility into company balance sheets, and need to be changed.

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5. The discount rate applied when valuing the funds' assets and liabilities should not necessarily be based on the bond rate. When bonds are expensive this can distort the valuation. The government should consider legislation to allow fund-specific discount rates, which reflect the asset and liability pattern of the fund.

These changes would shift employer perception of risk in a way which might encourage more to keep their current funds open, and some to set up new funds. It would also relieve the immediate pressure to put so much cash flow into pension fund investment, based on present low bond yields and deep regulatory pessimism about future returns – pressure from the very same sources who told funds ten years ago that they should not put more money in because they were super-solvent.

## 5.4. Savings for Life

The savings ratio in the UK has collapsed in recent years. It has remained under 4% this century, compared with a longer term average of 8%. In part this reflects the anti-savings changes made to tax policy, removing dividend tax credits for pensions savings, and abolishing Tessas and Peps, replacing them with less advantageous ISAs. In part it reflects the growth of property purchases on large mortgages, as the savings ratio is a net figure including debt.

A higher savings ratio in the personal sector would be a good thing, providing more capital for business investment and offering people opportunities to buy property, training and decent pensions in retirement. We favour the idea of the lifetime savings account, partly modelled on the US 401K plans. We would recommend that people are allowed to establish their own lifetime savings plan, which would:

1. Allow investment in the fund with full income tax relief on contributions.
2. Be free of Capital Gains Tax on investments sold within the fund.
3. Allow tax free withdrawal to buy a pension annuity or to make pension payments.
4. Allow a borrowing facility to permit property purchase or a training course, where the money has to be put back into the fund over an agreed period.
5. Allow commercial borrowing against the security of the fund for other purposes.

These schemes would give people more flexibility in planning their lifetime needs, and would encourage further saving. Whilst accumulating enough money to allow a comfortable retirement is the main aim, people also need help with buying their first home and with gaining the skills they need to get a better job. The fund could also be collateral for a business loan, if they wished to set up their own business.

We need a new approach to savings. Tax raids and over-regulation have left all too many people without a decent second pension to look forward to. Too many struggle to find the deposit for their home, or to raise the money to get started in business. Our proposal is designed to show them that government can be on their side, with judicious use of tax incentives to encourage them.

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## 6. The Growing Burden of Regulation

People and businesses are fed up with being bossed around so much by government. There are too many layers of government – EU, UK, regional, county, district and parish. There are too many agencies and departments, each with their own requirements and charges. There are too many laws. On top of Statute law come Statutory Instruments, regulatory rules, licensing and by-laws.

We would be better off without unelected regional government in England, and with much greater clarity over what Brussels does and what we do at home to avoid duplication.

The British Chambers of Commerce calculate that this government has added a massive £56 billion of extra regulatory cost to British business so far. Each year brings thousands of new requirements which businesses have to know about and obey.

The impact of all this is to make the UK less competitive. That means fewer jobs, higher prices, and less good products and services. Over-regulation is part of the reason we have sunk from 4<sup>th</sup> to 10<sup>th</sup> in the world competitive league tables. More importantly, it is part of the reason 5.3 million adults of working age do not have a job.

The EU in particular is in regulatory overdrive. There are now 170,000 pages of live legislation on the EU's books. As Open Europe has explained, the amount of current EU legislation would stretch for 31.7 miles in printed form, taking someone more than four hours to run its length.<sup>21</sup> Commissioner Verheugen reckons the cost at 5.5% of EU GDP, a huge €600 billion (£400 billion) of cost on business. It means that EU based businesses have to race against China, India and the USA sandbagged by forty-five stones (285 kg) of lawcode.

### 6.1. Do We Need All This Regulation?

Government claims that this regulation is all necessary. They seem to believe that without it banks could steal our money, bakers would put nails in our bread, drinks manufacturers would water the beer, pie makers might poison us, and builders would construct houses that fell down when the wind blew. This shows ignorance of how a competitive market works.

Most people running businesses take a pride in their brand and their product. They go to great lengths to make a better pie or to produce a tastier brew. They don't need regulators to tell them to do so. They do so because they want to, and because it makes business sense.

Competition is the customers' main ally. It is competition which keeps the bank honest and the pie free of nails. A competitive marketplace soon spreads the news that a brewer has watered the beer. Our competitive market is allied to a vigilant press and consumer groups, who would highlight such tricks should any wish to try them.

The civil law provides the third bulwark against malpractice. It is against the law to fail to make a product to the recipe and standard set out in the contract or on the label.

People have criminal redress if a business does deliberately try to harm its customers. Actions which cause people harm, or which represent fraud or theft, are against the criminal law. Customers have the support of the police and criminal courts in preventing them.

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<sup>21</sup> Open Europe



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We should be very sceptical of why we need a fifth layer of “protection” in the form of regulation, on top of business common sense, competition, the civil law and the criminal law. Much of this additional regulation impedes progress, and acts against the customer interest.

## 6.2. The Failings of Regulation

Regulation adds extra cost to a product or service. The business facing extra regulation has to pay more in taxes to pay for the government’s involvement. It may need to pay fees and charges to a special regulator, and it will need to spend more on people on its own payroll to comply with the details of the regulation.

The intrusion of regulation limits innovation. Sometimes regulations are so proscriptive, a new way of doing something would be against the law. Sometimes the delay and hassle of getting approval for a new way of doing things puts the business off the idea of trying. Many in the City say openly that they launch their best new financial products offshore, because it is just too slow and expensive to get approval for them at home.

Sometimes the regulations achieve the opposite of what they are setting out to achieve. Current pensions regulation is said to be in the interests of future pensioners, the members and prospective members of pension schemes. Instead, the combination of current regulation with the former Chancellor’s tax policy has closed most schemes to new members, and closed many schemes altogether. It has led many businesses to conclude that the only safe thing to do is to wind the schemes up or to stop any more liability accruing. The advisers and regulators have required pension funds to put more and more of their assets into government bonds, instead of equities and property. Over the last three years this has been a disastrous investment policy, with UK equities and overseas equities producing returns three times the level of gilt securities, and property a return more than four times as large. With “help” like that, no wonder many funds do not have sufficient money to pay the pensions.

The many regulations that seek to protect the interests of employees are well intentioned. It would be a wonderful world if we could legislate for us all to have Beckham’s wages or a teacher’s holiday entitlement, but the reality is that we need to accept terms and conditions that make it worthwhile for the employer as well as the employee. There needs to be balance. The evidence from around the world is clear – the more so-called employee protection you have in law, the fewer jobs there will be for the people looking for work. The so-called social model may be better for some of those in jobs, but is far worse for those seeking jobs, and has led to much higher unemployment on the Continent.

Sometimes regulations achieve something that would happen anyway. You do not need a regulation to stop chimney sweeps sending small boys up chimneys. The invention of the flexible brush and the vacuum cleaner has made that as unnecessary as it is undesirable. Social attitudes have moved on, and everyone thinks young boys should go to school. The very complex money laundering regulations are designed to make financial institutions report suspicious money being deposited in their accounts. But it is likely that UK mainstreet banks would all ask intelligent questions if someone walked in off the street as a new customer, with £100,000 in cash to deposit; and that they would report it to the authorities if there were not good answers to the origins of the cash.

Sometimes the regulators decide they want to become proxy directors of the businesses they are regulating, without technically becoming shadow directors. The regulators of the main UK utilities want to settle detailed rates of return on the business, and become embroiled in complicated arguments about how much capital investment is desirable, and how much efficiency can be improved. They do this instead of promoting more competition in these markets, when they should know that competition would answer all those questions for them, and give the public a much better deal.

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### 6.3. Past Deregulation

To date, the argument in the UK has been about whether the rate of new regulation can be reduced, and whether it is possible to revisit all past regulation to reduce and simplify it. Most people in the debate accept the fundamental propositions that regulation is necessary, and that you can weigh up the costs versus the benefits to come to sensible decisions about it.

We appreciate that people want some business regulation, in addition to the civil and criminal law where it can do good. It may be 100 degrees in the business bedroom, but people still want a comfort blanket to keep them company. It is time, however, to present a more radical challenge to government's desire to set out ever more things in legislation; and to become involved in ever more detail that properly should be managed by suppliers and customers. Too much regulation just overcooks, harming or putting off the businesses that need to deliver the goods and services.

The old approach that regulation should be given a smart new haircut has led to many disappointments. The most recent publication of the British Chambers of Commerce's *Deregulation or Déjà Vu* shows well how there has been almost continuous pressure for less regulation over the last twenty years. It shows that three successive Prime Ministers and their chosen senior colleagues have firmly stated they want less regulation, but that the government machine as a whole has failed to deliver.

Big business has lobbied for less, but has rarely come up with ideas for the repeal of much specific regulation. By definition, the big businesses that lobby on these issues are usually suspicious of new proposals because they may rock the status quo which suits them as the survivors. They may be relatively relaxed about the inherited volume of regulation, both because they are able to handle it, and because it acts as a barrier to entry to smaller and more energetic competitors. The casualties of over-regulation have more things on their mind than trying to influence government, whilst many small businesses do not have the time to spend explaining to government just how foolish or impossible much regulation can be.

Employment regulation is one of the causes of the continuing flight of manufacturing beyond these shores. We do not disagree with the aim – more, better paid jobs – but believe that we need to be careful, lest we think regulation is the way to create them. The way to create more, better paid jobs is to make the UK a better place for people to set up and expand a business; and a better place for people to learn and train, so they have skills that make business succeed.<sup>22</sup> We are aiming to strike a better balance between the interests of those in work and those out of work in our proposals on employment regulation.

### 6.4. Ways of Curbing and Reducing Regulation

We have looked at a number of models for reducing the flow of new regulations and the stock of existing regulations. All of them require political will to come from the combined pressure of Prime Minister and Chancellor. We need to make it more difficult for ministers to regulate, and we need to give the critics of regulation more opportunity to make their case against specific new proposals.

### 6.5. More Debate of Regulatory Statutory Instruments

Most regulations in the UK are implemented by writing a Statutory Instrument (SI) and passing it through Parliament. Large and important SIs are debated for ninety minutes in Committee, or occasionally on the floor of the House. The rest go through Parliament with no debate, under the

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<sup>22</sup> The Deregulation Working Group (DWG), reporting to the Economic Competitiveness Policy Group, in its Annex (Proposals 34-44) addresses in detail how to achieve cultural reform in the civil service, business and media.

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negative resolution procedure. Only if a group of MPs insists on a debate, do such SIs have their hour and a half in the sun. Parliament cannot amend the text. If the government makes a mistake with the text, it has to withdraw the whole SI and return at a later date with a revised one. If the Opposition wish to improve the SI by amendment, it is too late once the full draft is submitted for approval.

We propose that the Committee on Statutory Instruments should mark all regulatory SIs that impose burdens on business and people nationwide for debate. The more important SIs should have three hours of debate permitted, and within that time the Speaker or Chairman of the Committee should accept an amendment, if MPs wish to table changes to the proposal.<sup>23</sup>

If the government wished to move an amendment it should be free to do so, but the time needed to discuss the government amendment should be added to the time available. If there were a dispute about the time government amendments might need, then the Chair could allow up to ninety minutes for each substantive amendment, but expect the Committee to put minor corrections through without extra time.

If the Opposition or any other group of MPs wished to move more than one amendment, the Chair should grant an additional one and half hours for each amendment supported by the signatures of 150 MPs.

If the government wished to impose an emergency regulation in a hurry, it should be free to do so – indeed if its own supporters want it, the government cannot be stopped from doing so. However, there should be a convention that if a government should do this, the regulation should contain a six month sunset clause, thereby bringing it to an end unless the government had brought it properly to the House for detailed scrutiny and approval during that time period.

## 6.6. Regulatory Budgets

The most important way of translating Prime Ministerial wishes to deregulate into reality is to create regulatory budgets for each department.

Each year, considerable effort goes into the public spending round, with a Cabinet Minister (the Chief Secretary to the Treasury) backed by the Chancellor, having detailed discussions with Cabinet colleagues and their departments over how much they may spend in both the following year, and the following three years. This system allows the Cabinet to express an overall view of how much the country can afford, and then permits detailed decisions to be made by accountable politicians on how to split up that total between the competing causes. The system does not guarantee good spending discipline, as we have seen in recent years, but it does mean that the spending totals are the ones that the elected politicians wish to see. The big and inefficient spending splurge of the present Government was willed by its senior members, and they are proud of the amount of money they have wasted, because they genuinely believed that throwing money at problems would solve them. The spending round is a good device for control, and can be used by politicians who have a better understanding of how you obtain value for money, to flush out waste and to limit expenditure to what is really needed.

We need similar discipline in regulation. All regulations put through in recent years should have attached to them a so-called Regulatory Impact Assessment, or a cost benefit analysis. Those dreaming up new ways to make our lives a misery should impose on themselves the obligation to tell us how much it would cost us to comply with the new regulation, and to try to give us a figure for the benefits that will come our way.

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<sup>23</sup> DWG Annex, Proposal 13 has also proposed that the Select Committee should vote on every regulatory SI, before it is debated, and publish the outcome and any consequent reports.

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An incoming Conservative government should appoint a senior Cabinet Minister in the Cabinet Office – perhaps the Chancellor of the Duchy of Lancaster – as Deregulation Secretary. He or she should draw up regulatory budgets for all departments, bringing together the administrative and compliance costs that their principal regulations impose. Some of the inherited RIAs would doubtless need revising and improving, as some of them have been hazy and incomplete. No department would be allowed to put a new regulation through before it had an approved regulatory budget base figure, so they would all have an incentive to get on with producing figures that the Cabinet Office Deregulation Secretary of State would accept.

Each year the Deregulation Secretary would enter bilateral discussions with each departmental Cabinet Minister over how much they can reduce their budget by in the following year. Any new regulation which a department wanted would have to be accommodated by striking out regulations of equivalent cost, as well as by meeting the target for an overall reduction. The Cabinet as a whole would decide on the reduction for the year, but the aim should be to achieve a reduction of 20% over a five year Parliament, or 3.7% a year. If an individual department made out a good case for an overall increase in regulation, then that should be allowed only if offsets could be found in other departments. If we estimate total regulatory costs at £70 billion per annum in the UK (based on the EU estimate of 5.5% of GDP), this would amount to a reduction of £14 billion per annum by the end of the five year period of the programme of improvements, split between savings for the government and regulators, and savings for business. The savings to government could help with a Conservative government's wish to reduce taxes.

This method has been tried with some good effect in Holland. There they concentrate on the administrative cost. We would wish to include the compliance cost incurred by business as well. They have found cutting the cost by one quarter feasible, and this is part of the background to Holland becoming a more attractive place for the location of major companies in Europe.

## 6.7. Independent Verification of New Regulatory Impact Assessments

Each department wishing to bring in a new regulation has to produce an assessment of cost and benefits. We recommend that the National Audit Office be given the task of approving RIAs that meet the necessary standard.<sup>24</sup> No regulation could be brought to Parliament for approval without NAO endorsement of the figures in the Impact Assessment. If the government wished to proceed with a regulation where they could not agree figures with the NAO, then they could do so under the emergency procedure, but would have to bring it back within six months with an agreed set of numbers for Parliamentary approval.<sup>25</sup>

## 6.8. Sunset Clauses

More regulations should be introduced with a sunset clause included, giving government and Parliament time to assess its performance against the stated costs and benefits since the time it was first passed.<sup>26</sup> Regulatory bodies too should have a stated design lifetime, with the aim of replacing themselves with a proper competitive framework.<sup>27</sup>

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<sup>24</sup> DWG Annex, Proposal 14

<sup>25</sup> DWG Annex, Proposals 5-9, 20, and 23-27 recommend other RIA procedures.

<sup>26</sup> DWG, Annex, Proposal 18 recommends that sunset clauses should be standard in cases where civil liberties are significantly restricted, where the regulation is in response to a crisis or to public media outcry, or where there is little certainty over calculated costs and benefits.

<sup>27</sup> Cf. DWG Annex, Proposal 19

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## 6.9. Removing Regulators

The present Government has seen the advantage of abolishing some of the industry-specific regulators, who were set up to control former nationalised monopolies when they passed into the private sector. However, it has usually created super-regulators, who subsume the activities of the former industry regulators, and sometimes add to its complexity.

A better approach would be to phase in competition wherever possible, so that all such industry-specific regulation could be removed as sufficient competition was established in the market. Residual elements of monopoly should be handled by the Competition Authorities.

A competitive market has largely been established in telecommunications, although the regulator still has to achieve a fully competitive fixed link into each home. The markets in gas and electricity are now much more competitive, with real choice of supplier and the ability to switch. The water market is still based on regional monopolies, which should be broken up by legislating to allow full competition at all levels of water use. So far, only the large users have the benefit of a competitive offering. Finally, a competitive market is being created in post. We consider these industries in more detail in our chapter on competition, and government's direct involvement in business.

The aim should be to remove the remaining barriers to competition in all these markets, and then to abolish the special regulators.

## 6.10. A Deregulation Bill

We propose that, each year, a government pursuing reductions in regulation through regulatory budgets would need a deregulation bill. The contents of each Bill would emerge through the inter-departmental process, led by the Prime Minister and the Deregulation Secretary.<sup>28</sup>

Below are examples of regulations we believe need repeal, consolidation or significant amendment. An urgent review would help identify others, with the objective being to repeal or reform a significant number of regulations by the end of the first year of the Bill.

1. **Working Time Regulations.** These regulations make up almost one third of the additional cost imposed on British business, on the British Chamber of Commerce's (BCC) Cumulative Burdens Barometer from 1997-2006. The regulations restrict people's access to overtime, and reduce businesses' flexibility to respond to their employees' wishes, as well as their ability to manage their workload sensibly. They should be repealed.
2. **Data Protection.** We recommend the repeal of this expensive bureaucracy, which fails to protect people's data. The ever growing power of the internet and computers means we all end up on ever more lists, whether we want to or not. Proper handling of the data given to public bodies and private sector companies would be governed by the general law of privacy, and by established codes of conduct. This measure amounts to 12% of the BCC's extra burden, on its burdens barometer. The repeal of Items 1 and 2 would remove 44% of Labour's extra costs to business, without harming the protection offered to most people.
3. **Money laundering.** The money laundering regulations could be amended to say that no financial institution which accepts payment from a customer in the form of a cheque drawn on a UK regulated high street bank or building society need take any further action to satisfy itself about the origins of the money. Although a high street bank or building society has a duty to

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<sup>28</sup> DWG Annex, Proposal 31 recommends a Statute of Repeals, introduced every year to help departments hit their targets for reducing their regulatory burden.



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satisfy itself of the origins of the money when setting up a new account, there need be no legal requirement to carry out checks of identity or residence when customers are paying in cheques or small cash sums, although they may wish to do so for business reasons.

4. **Home Information Packs.** A new government should remove the need for a vendor of a residential property to buy an HIP, when putting the property on the market.
5. **Mortgage Regulation.** We see no need to continue to regulate the provision of mortgage finance, as it is the lending institutions rather than the client taking the risk.
6. **Financial Service regulation.** The Government argues that the complex and expensive regulation of financial services providers and products is necessary for customer protection. We agree that institutions which take clients money and place it on their own balance sheet, or mix it with other funds, should have to meet capital adequacy requirements, and strict reporting requirements. Institutions taking client money to place in unit funds, and similar separately identified savings pots, should also have to meet high standards of reporting and independent trusteeship. However, there is not necessarily a good reason why a regulator should have to be involved in product design and marketing for rich and sophisticated investors. We recommend that such investors should be able to sign a piece of paper, which allows them to go ahead and buy unregulated products at their own risk. The paper would have an agreed form of words, which made it crystal clear that by buying such a product the customer could expect no regulatory protection or compensation, and that they could afford to lose the money they were venturing. All businesses, and some experienced investors, could then take themselves outside the regulated product net if they wished, and would have to rely on the civil and criminal law and their own abilities. We would then be able to see how much experienced investors do value and want regulation.
7. **Gaming licences for charities.** A Conservative government should remove the need for licences for small charity events holding raffles or offering bingo games.
8. We recommend the abolition of mandatory horse passports.
9. We recommend lightening the regulatory requirements on traditional herbal medicines.
10. We propose simplifying care home regulations, to allow more places to come forward.
11. We suggest restoring food supplements to the shelves, by opting out of the EU Directive.
12. We advise restoring the statutory dismissal procedures to the pre 2000 position.
13. We advise restoring the Social Chapter opt out, and producing UK rules on: Works Councils, part time and fixed term working, sex discrimination, information, and consultation. These should balance the interests of existing employees with the need for a flexible labour market to create more jobs.
14. We recommend removing the compulsion from metrification, allowing businesses to work in units that they and their customers like.
15. **Single disclosure to the Revenue and Companies House.** We recommend giving companies the option of filling in one form for the Revenue, which will also serve as notification of year end figures to Companies House.
16. We suggest the levelling upwards of small business threshold rules for exemption.



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17. We propose the introduction of a streamlined approach to National Insurance exemptions, for people with more than one job.
  18. We recommend increasing the maximum permitted limit for Premium Bonds, and for tax exempt National Savings certificates.
  19. We propose scrapping the IR35 tax on providers of personal services.
  20. We recommend deregulating venture capital fund raising, and investment for professional investors.
  21. We suggest scrapping the Best Value regime for local government. This would save money for councils, and allow better market access for companies in council areas wishing to use private services.
  22. We suggest abolishing the Comprehensive Performance Assessment for local government.
  23. We advise scrapping regional Housing Boards, and the system of regional targets.
  24. We recommend introducing more Simplified Planning Zones in run down areas, allowing businesses and individuals an easier way to gain a planning permission.
  25. We propose to abolish sellers packs in the housing market, leaving it to agents and vendors to decide what information to make available before an offer is made.
  26. We advise simplifying regulation on Housing Associations.
  27. We propose the repeal of the **Legislative and Regulatory Reform Act**, as deregulatory measures will be placed directly in the annual Deregulation Bill.
  28. We suggest that the Equipment and Protective Systems Intended for Use in Potentially Explosive Atmospheres Regulations 2002 should be reviewed, to see if a more proportionate approach would be better.
  29. We recommend that the **Waste Incineration Regulations 2002** are amended to allow and encourage more recycling.
  30. **Health and Social care Act 2003**. We recommend that the Healthcare Commission and the Commission for Social Care Inspection set up under this Act are merged, and the regulatory structure streamlined.
  31. We propose increasing the small business exemptions from the **Welfare Reform and Pensions Act 1999** requirement to offer Stakeholder pensions.
  32. We suggest reforming the **Package Travel Regulations 1992**, to reflect modern methods of selling and buying holidays.
  33. We advise improving the risk assessment regime in the **Health and Safety at Work Act 1974**, to make responses more proportionate.

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## 6.11. European Union Legislation

Over half of the regulations applying to business in the UK come from Brussels. Much of this legislation is never scrutinised. 57% of the new measures brought in in 2006 were passed in Brussels following a single reading in the European Parliament, under the accelerated procedure allowed for by the Amsterdam Treaty ( 1 May 1999). This in turn is translated into UK law in a way which either are never debated, or have a perfunctory ninety minutes of discussion before the Government uses its majority to push them through. The UK Parliament is told it does not matter what it thinks of them, as the UK has to pass the measures to meet its Treaty obligations.

## 6.12. Gold Plating

Some people think the main problem is gold plating in the UK. The UK is well known for its diligence in translating EU Directives into domestic law. Often the UK version is considerably longer and more detailed than the Directive which brought it about. All governments claim to be against gold plating, but most businesses think it is still endemic in Britain.

There are several reasons why Ministers in the UK do not prevent gold plating. Some ministers in the present Government see the transposition of a Brussels measure as a welcome opportunity to flex their own legislative pen, without the same scrutiny that could occur with UK primary legislation. Other current ministers are unaware that the UK version is over the top, because they have not read the original Directive carefully enough, nor understood how much scope there is to minimise its impact.

Even ministers who do wish to keep the burden under control find it difficult to avoid gold plating. The UK civil service takes a very cautious approach to transposing Brussels regulation. They regard infraction proceedings in the European Court for a failure to transpose in full as a serious matter. The easiest way to avoid such proceedings is to overdo the implementation. The ECJ drives a ratchet for more regulation. It rarely complains if you overdo it, but regularly complains if you underdo it. A minister who wishes to sail closer to the wind will sometimes be prevented by strong legal advice from within government from doing so, for fear of Court action.

We repeat the mantra that a Conservative government should oppose gold plating,<sup>29</sup> but we are realistic in knowing that this cannot tackle most of the problems of over-regulation from Brussels.

## 6.13. Double Regulation

Because governments of all persuasions have battled to some degree to keep British jurisdiction in areas where the EU claims power, the UK is especially afflicted by double regulation. The present Government has decided to opt the UK into European social and employment regulation, an area where previous Conservative Governments kept an opt out. Instead of then reducing or removing UK employment regulation as Brussels rules come in, they have followed a double legislative programme, implementing the EU material, and running a separate UK programme.

We recommend that where the EU has the power to regulate we should rely on EU regulation, and not put in place additional UK regulation. This would have the advantage of reducing complexity, removing legislative efforts for UK officials either at home or in the EU; and it would make it clear to people where the governing power lies in those cases.<sup>30</sup>

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<sup>29</sup> DWG Annex, Proposals 48 and 55, recommend that the problem can at least be reduced by the introduction of an Extended Impact Assessment (EIA). This would ensure that all EU regulation would be subject to some scrutiny, and this should prevent the worst excesses of gold plating.

<sup>30</sup> DWG Annex, Proposal 54 also suggests tailoring domestic legislation to ease the transition of companies for whom the corresponding European legislation suddenly becomes applicable upon crossing a defined size threshold.

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## 6.14. The Main Problem – Over-regulation by the EU

The main issue is that the EU simply regulates too much. There are four things the UK can do about this:

1. Seek to persuade other member states that the legislative activities of the EU need to be curbed. We are told that many in the EU are now in deregulatory mode, although there is no evidence of this in what is happening, as more and more Directives emerge from the law factory. We also have to be realistic: as so many issues are now the subject of qualified majority voting, the UK can only prevent a new law being passed if it has the support of several other countries.<sup>31</sup>
2. Let the EU regulate, but remove all domestic regulations in that area, save those needed to implement the EU's wishes.
3. Gain opt outs for the UK from further areas of EU regulation, and keep or put in place a more lightly regulated domestic alternative. This is the approach which the UK has traditionally followed, opting out of the Social Chapter under the Conservatives, declining to accept some of the Euro regulation as part of the decision to opt out from the currency, and opting out of the common borders regulation under previous Governments.
4. As a last resort, legislate at home by means of an amendment to the 1972 European Communities Act, to allow the UK to disapply EU regulation unilaterally where we think it is against our national interest to apply it.

An incoming Conservative government should go to Brussels with proposals to deregulate the whole EU in a way which promotes more jobs and greater prosperity. We should negotiate hard to achieve progress for all.<sup>32</sup>

If our partners could not be persuaded, we should seek opt outs from the areas of regulation that we think are most damaging, or where we could improve the job creation and lifestyles of UK people by replacing the EU rules with our own. This would include all employment and social regulation. We should legislate in the UK, if our partners do not grant us reasonable opt outs from the regulations we find are most damaging. The precedent is available in the William Cash amendment to the Legislative and Regulatory Reform Bill, which was supported by Conservative MPs on a party whip in favour.

### 6.14.1. The Case for Small Business – Oaks from Acorns

Small businesses are crucial to the life and growth of an enterprise economy. They are the large companies of tomorrow. They innovate, and help create the market flexibility which serves the customer well. They are an important source of new jobs.

Small business groups have three main areas of complaint. They feel badly over-regulated, which our deregulation proposals address. They feel over-taxed, which we believe a Conservative government should tackle as circumstances permit. They also feel that they do not always have access to the capital they require to grow quickly.<sup>33</sup>

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<sup>31</sup> DWG Annex, Proposal 47

<sup>32</sup> DWG Annex, Proposal 46. Proposal 57 also talks of encouraging employer organisations to be more effective at a Pan-European level.

<sup>33</sup> Our general deregulation proposals address the first issue to an extent, but we also have specific recommendations for SMEs within the DWG Annex, Proposals 58-61.

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The main tax complaints usually relate to the complexity of VAT. We recommend lifting the threshold, to take more small businesses out of the requirement to keep records and pay VAT, during the crucial early months when they need to grow rapidly with the full attention of the entrepreneur/manager.

The income and profits tax regime for small business is not bad. Small businesses are allowed CGT relief on sale. We recommend a similar relief on special dividend payments up to a threshold, so that people do not have to sell their business to release some cash for other purposes on a tax advantageous basis.

There are a number of sources of funds for small business. Many are financed by family money, or by money from an entrepreneur's previous business activities. Some are set up by people who have another main job, to bring in an income during the early months or years of the new venture.

Many rely on bank finance, mortgaging their homes or the property of their business. Some produce business plans and capital requirements large enough to warrant private equity or venture capital funding. Some take out loans guaranteed under the Government's Loan Guarantee Scheme.

Some obtain money from business angels, or other investors taking advantage of the tax relief under the Enterprise Investment Scheme.

We do think the banking sector could improve its range of offerings to small business. We are attracted to the success of micro-credit banks in developing countries, and would like to see experiments with micro-credit for a new sector of small owner/manager businesses, especially in the poorer urban areas of the UK. We are also attracted to the success of venture banking, through institutions like the Silicon Valley Bank. A Conservative government should relax banking regulation, allowing a new breed of venture/micro-credit institutions, should people wish to establish them here in the UK to meet this gap in the market.

## 6.15. Competition Policy

Monopoly and abuse of market power remain substantial problems in limited parts of the British economy. Monopoly has traditionally been created by statute, and sustained by government intervention. Government has often done this in the false belief that preventing competition allows sane planning, eliminates duplication, and cuts out the so-called unnecessary costs of competition, such as advertising, marketing and different company structures. In practice, evidence abounds that wherever public sector monopolies are broken, and new competitive providers emerge in the marketplace, the costs to the customer are cut, and the quality of the good or service improves. This was very manifest when the telephone monopoly was broken in the United Kingdom. A wide range of new competitors emerged, offering new technologies, new services and much lower prices. Similarly, the advent of competition in electricity and gas ushered in an era of price reductions, before international energy prices rose substantially and became a more dominant influence.

A Conservative government has no need to overhaul or change the competition institutions or legislation. The present Government has done that often enough. The requirement is to use the institutions and legislation to tackle remaining monopoly areas, where the introduction of competition would be in the customer's interest. Conservative ministers should ensure that the following areas are referred to the Competition Authorities, and should to set out a strengthened competition policy in the following areas:

1. **Water.** The previous Conservative Government introduced limited competition to the water industry, allowing the largest users access to alternative supplies and providers. Smaller businesses and domestic customers still have to take their water from a monopoly provider in most cases. The result

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has been a sharp increase in prices permitted by the regulator, in the name of raising water quality; and a shortage of supply given the failure of the regulated monopoly to make sufficient provision for rising water demand and for dry periods in the climate cycle.

The introduction of competition in water would both solve the shortage problem, and provide downward pressure on prices. Water is not a natural monopoly as some argue. Water is a natural resource, like oil, gas, coal and many others that are exploited by competitive businesses and sent to customers through pipes or by other means. The government as environment regulator does have an interest in the system and would naturally wish to prevent both the over-extraction from rivers and streams that leads to environmental damage, and to regulate drawdown from boreholes.

The current pipe network is antiquated and full of leaks. Around a quarter of the water collected by the industry is lost on the way to customers in certain regions. If the industry had to move onto a competitive footing, the regulator could act as referee, arbitrating in the event of disputes over access to the common carrier pipeline by new competitor businesses. Something similar was used to open up telephones to competition, to deal with the problem of BT (the former monopolist) having most of the telephone lines in the country. Over the years ahead, it is quite likely that the new businesses would wish to invest in new and better pipe networks, as part of their contribution to developing the industry; but in the short term they need to be given the right of access to existing pipe systems. Water is not a finite resource like oil or coal. Its use does not damage the environment. There is a water cycle. The water that people use, they are only borrowing from the system, and they return it once they have used it. The water industry is there to collect and clean the water, which is mainly carried by the winds, rivers and seas, on its ceaseless motion around the globe. A competitive industry would solve the quantity problem and would result in lower prices, whilst still guaranteeing that all the investment would be in the private sector. There are substantial untapped water resources, where competition is currently held up by a shortage of permits. The Environment Agency should be asked not to curtail extraction rights for new players, unless clear environmental damage would result. The Agency should have to set out what this damage would be, so it can be properly scrutinised and be subject to judicial review.

2. **The BBC.** The BBC has certain monopoly rights, given to it by statute. It has the right to levy a poll tax on all people who own a television, whether they are watching BBC or not, as well as having monopoly rights to advertise on its own channels. In an age of digital media competition, with an explosion of new choices and channels, it is important that the BBC should not use its licence fee and monopoly rights to cross-subsidise, and to compete unfairly in parallel markets to its primary television channel marketplace. There are worries that the BBC's entry into magazine publishing, webpage design, international news and other such services is only possible because of the cross-subsidy from its principal tax-financed activity. We would propose considering splitting off the commercial activities of the BBC from its public sector broadcasting duties and responsibilities more clearly than at present, and wish to ensure that the financing of such activities is entirely within the private sector, with no recourse to licence payers' money in the event of mistakes being made. The BBC should not be allowed to advertise its commercial services on public service channels that do not take adverts from other commercial concerns.

3. **Airports.** Common ownership of Gatwick, Stanstead and Heathrow by a single operator has not been good for the development of London airport activity. The system is short of capacity, although this also reflects the difficult planning background, and political reluctance to tackle the shortage in recent years. Worse still, there has been a number of incidents involving interruptions to services and delays and inconveniences to passengers, which might not have happened had there been more competition within the London airport system. The competition authorities are currently investigating whether common ownership of the three London airports amounts to a complex monopoly, and whether changes need to be made to inject more competition. We are of the preliminary view that

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there are serious competition difficulties, which can only be resolved by splitting the ownership of the three airports.



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## 7. Energy Policy

### 7.1. Background – We Need More Energy with Less Carbon

The Government's policy on energy has been set out in two White Papers and various DTI departmental documents. The overall aim is "to ensure that competitive energy markets deliver secure, sustainable and affordable energy supplies, through delivery of the department's contribution to the full goals of UK energy, reducing carbon emissions, maintaining reliable energy supplies, promoting competitive markets, and making energy affordable for the poorest households in the UK". Between 1997 and 2006, UK energy consumption increased by 2% compared with a 21% increase in GDP. As a result of this, and the dramatic changes in power station fuelling and efficiency brought about by electricity privatisation in the 1990s, the UK is on track to meet its Kyoto commitments for CO<sub>2</sub> to be 12.5% below 1990s levels by 2008-2012.

However, the Government is getting complacent about progress in reducing carbon emissions<sup>34</sup>. It is meeting its Kyoto commitment only because of privatisation of the electricity industry, and the big shift that occurred from coal to combined cycle gas as a result; and because this Government has created an atmosphere hostile to high energy-using industries, which are now basing more of their activities outside the UK. It is widely accepted that the Government will not hit its Kyoto-plus target of a 20% reduction in CO<sub>2</sub>, showing the futility of introducing targets for political reasons without the ability to put in place a policy which enables the target to be hit; and it is unlikely to meet its target of generating 10% of energy from renewables, despite the subsidy and encouragement of onshore wind power. Currently, the Government is also not meeting its requirement to make energy affordable for the poorest households in the UK. It is unsure what to do about the fundamental dilemma in its policy, wishing both to have cheap energy available for people to use and to increase the cost of energy to reduce the usage for emissions reasons. The Government is in danger of ending up with the worst of both worlds, with an energy price that is too high for those on the lowest incomes but not high enough to achieve its target on carbon emissions; and with a price that is quite high enough to drive companies offshore, but not high enough to get individual households to cut back on their energy usage, where their use is higher than the average.

In practice, the UK is still very dependent on a mixture of coal, gas and nuclear fuel for its electricity, and more generally on gas from the North Sea and further afield. In the winter of 2005-2006, the country ran perilously short of gas. Although the interconnector is now in place, the failure to take timely decisions to allow markets to respond to demand left the UK surprisingly vulnerable. This took some doing, given that the UK is an island of coal set in a sea of oil and gas, with plenty of wind, wave and tidal power around as well. An incoming Conservative government needs to do more to secure energy supplies by making the necessary decisions to which the private sector can respond, guaranteeing a plentiful supply of energy at affordable prices for both poor consumers and for business. The tax and emissions trading systems can take care of providing incentives to both individuals and business for more efficient use of much greener energy, but this should not be used as an excuse for a failure to grapple with the real problems of sustainable energy supply and sensible prices, which are needed for any acceptable level of economic activity.

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<sup>34</sup> The Energy Working Group report Group (hereafter referred to as EWG Annex). cf. Section 10 on Kyoto; Section 11 on Renewables; Section 12 on Carbon Emissions.

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## 7.2. Oil and Gas from the North Sea – Lower Tax Rates Will Bring More Oil and Gas and More Tax Revenue<sup>35</sup>

Gordon Brown in recent years has been increasing the tax take from North Sea activity. With effect from the 1<sup>st</sup> January 2006, he increased the supplementary charge to 20%, and has brought forward the timing of payments in order to boost revenues in recent years. This has proved to be a dangerous game, as the North Sea is now a mature and high cost oil province compared with many more exciting exploration and development opportunities around the world. It is important to keep the North Sea tax competitive, so that oil companies have incentives to exploit what is already well known or effective, and to continue to search for additional reserves which can be brought ashore. It is therefore proposed that a Conservative Chancellor should negotiate with the industry agreements that will prolong field-life, and should consider not levying Petroleum Revenue tax on oil or gas produced from new fields not currently in production<sup>36</sup>.

The government needs to discuss with the oil industry how enhanced recovery can be developed and whether there is scope to inject carbon dioxide into mature reservoirs, both as a carbon sink and as a means of increasing reservoir pressure and thereby recovery. The government should explore with the industry what kind of tax incentives may be appropriate to foster the more rapid development of carbon capture and storage technology in the North Sea.

## 7.3. Gas Facilities – Plan to Keep Warm, Not to Force Energy Using Industry Out<sup>37</sup>

The crisis of the winter of 2005-06 did persuade the Government to take action together with the industry, to try and ensure more plentiful supplies in future years. In April 2005, the UK and Norway signed a cooperation treaty and approved the new pipeline, the Langeled South to the UK. The private sector is pressing on with the BBL interconnector, which could supply up to 10% of UK peak day demand, and has upgraded the oil interconnector. Two major natural gas import terminals are being constructed, as are potential major new gas storage facilities.

The Government has pressed European partners to make a more competitive market on the Continent, but so far without progress. One of the reasons the UK market was left undersupplied in 2005/2006 was the unwillingness of continental operators to pass gas onto the UK through the available pipeline despite the very strong price signals from the UK. We support plans to increase gas import facilities, and recommend a faster track process to ensure that planning applications are decided more promptly, in order to allow the private sector to carry out this crucial work.

## 7.4. Coal – Clean Coal could be the Long Term Future<sup>38</sup>

The UK coal industry is a shadow of its former self. It is the casualty of too many years as a nationalised industry, where poor management and endless political rows helped to ensure its rapid decline. The UK still has huge coal reserves underfoot and under the sea, but has only seven surviving larger deep mines, supplemented by considerable open cast output. Coal output fell to 20 million tonnes in 2005, split roughly fifty-fifty between open cast and deep line production. Open cast production is unpopular with the local communities, and it is difficult to get planning permission to expand the activity.

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<sup>35</sup> EWG Annex, Section 7.2

<sup>36</sup> EWG Annex, Section 2.2

<sup>37</sup> EWG Annex, Section 7.3

<sup>38</sup> EWG Annex, Section 8

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There is considerable discussion about the opportunities to develop clean coal technology. Whilst progress has been made in cleaning up the output of gases from coal fired power stations, more needs to be done to make this an attractive option in a world which is increasingly concerned about CO2 emissions from power generation. Linking coal fire generators to district heating schemes in CHP developments would help. Developing carbon capture technology is also an important part of the process of cleaning coal.

A Conservative government should back more intensive research and development in the clean coal area as the long term future of Britain's energy requirements will have to entail a shift from reliance on North Sea oil and gas to domestic coal, if we wish to be sure of our supplies.

## 7.5. Electricity Generation - We Need to Plan New Capacity Now To Keep the Lights On<sup>39</sup>

The main argument within political circles is over how future electricity should be generated. There is general agreement that it would be good to generate more from renewable sources, and general enthusiasm for local energy schemes. The more that people can put into energy conserving measures in their homes, offices and factories, the better<sup>40</sup>. The more that people can generate a bit of power for themselves by adding solar panels or a small wind turbine to their property, the better. The more that local communities can generate some of the power they need by harnessing combined heat and power as well as local sources like streams, rivers and wind, the better.

However, looking at the figures it seems quite clear that, in the short term, we are unlikely to derive a majority of our power from such sources. The Government will struggle to reach its target of ten percent of power generated from renewable sources by 2010. In the meantime, the country faces the bigger question about what to do about the ageing nuclear power stations, currently accounting for 20% of all electricity generated in the country.

In our discussions with the nuclear industry, the main protagonists have said repeatedly they do not seek a public subsidy; but they are seeking some kind of assurance on how the UK will be pricing carbon as the economics of nuclear power depend very much upon its carbon-free status. It will be difficult for an incoming Conservative government to give the nuclear industry any guarantees on carbon pricing. Whilst we need to see a more effective carbon pricing scheme than is provided by the ETS at present, it is most important that it is a market driven one, and that it operates globally.<sup>41</sup> If we introduce too quickly too high a carbon price in Britain or in the EU, in an effort to cut CO2 emissions more rapidly, we will price business out of the UK or the EU into competing jurisdictions where the price of carbon, and hence the price of energy, is lower. That would be bad for the environment, as well as bad for British business and British jobs. In the context of needing the gradual development of global emissions trading system that delivers a world price, it would be difficult for the British Government to offer firm long term guarantees on the price of carbon, in order to take the risk out of a nuclear investment programme.

However, it is likely to be difficult to deliver the desired combination of secure electricity supply and downward pressure on emissions without replacing the existing nuclear stations with new nuclear. It is therefore recommended that an incoming Conservative government should offer the following framework:

1. Expedition of planning permission for new replacement nuclear stations in the existing locations of such nuclear plants.

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<sup>39</sup> EWG Annex, Section 9

<sup>40</sup> EWG Annex, Section 4

<sup>41</sup> EWG Annex, Section 2.3

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2. The expedited granting of safety certificates to the three or four best technologies currently available in the world for new civil nuclear facilities.
  3. The setting out of standards of waste treatment and decommissioning that the government will expect from anyone undertaking the investment in a nuclear facility; and a requirement that provision be made over the life of the asset by the owners.
  4. The invitation to the private sector to bid, and to place a cash value on any guarantees or requirements for any type of carbon-reducing technology. During this process, it will also be possible to seek bids from local generation, renewable and clean coal schemes by way of comparison.

It will only be when the government has met these requirements in full, and knows exactly what the requirements of the nuclear industry are to establish specified projects, that it will be able to come up with a judgement about whether nuclear is a necessary technology at a realistic price, capable of sustaining and driving forwards the UK's wish to lower its carbon emissions, whilst also guaranteeing reasonable supplies of energy. It will also offer a good opportunity for the advocates of differing renewable technologies and of local power schemes to show how they could replace nuclear at an acceptable cost.

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## 8. Public Sector Efficiency

### 8.1. The Government's Burgeoning Waste Line

The charge against the Government of incompetence is easy to make. With growing regularity, Ministers have had to come to the House of Commons to apologise for botched projects, wasteful expenditure, and delayed implementation. In the decade that Labour has been in power, the cost of government has gone up by over 50%, and the number of civil servants by more than 300,000. Much more welcome has been the increase in the numbers of nurses, teachers, doctors, and police officers; unfortunately, however, they account for only a proportion of the public sector expansion since 1997, from five to six million workers. There are now 3,259 press officers across Whitehall and the public quangos; and the number of NHS managers has grown at almost triple the rate of NHS nurses.

Other examples of waste abound. The DBE presides over more than 2,500 small business schemes for England alone, dividing their budget up into penny packets that make it extremely difficult for businesses to understand their entitlements, and how to claim them. Not only did the Dome project greatly overrun its budget, but it then lay idle and purposeless once the Millennium celebrations were over. The Scottish Parliament, originally projected to cost between £10 million and £40 million, ended up costing £431 million. The Department of Work and Pensions wrote off £141 million on a new computer system. In 2006, the same department lost £2.6 billion of taxpayers' money to benefit fraud and error, including £574 million paid in pensions and benefits to dead people. Meanwhile, there have been nine major reorganisations of the NHS in nine years, estimated to have cost a total of £3 billion. The Ministry of Defence lost 200,000 sets of body armour, which were much needed by our troops in Iraq. The Home Office spent £6.5 million on an unsuccessful attempt to persuade the police force of the merits of a reorganisation. The Department of Environment and Local Government has been renamed on four separate occasions, each time requiring substantial expenditure on new signs, headed notepaper and more. DEFRA was unable to make farm payments under an EU scheme which other countries handled quite easily; and the Child Support Agency has been through countless troubles, causing misery to thousands of families. The Government had to delay the introduction of its Home Information Packs, as it had not managed to handle the detail of how they would work in practice. The Government also gave way in its negotiations with the EU over the British contribution and rebate, entailing substantial payment increases for the United Kingdom for no good reason.

### 8.2. Previous Whitehall Reform

These are problems that we have faced before. In 1976, when the Labour Government of the day was forced to go to the IMF to borrow money, the UK civil service employed 750,000 people. By 1979, this had fallen slightly, to 735,000. But it was during the first Conservative Parliament that a significant reduction was made, of 100,000. Over the remaining fourteen years of Conservative Government, further reductions of 185,000 were made. The present Government therefore inherited a civil service of 450,000, which should have continued to be more than adequate for its needs.

During the period from 1979 to 1997, the civil service was not just reduced, but reformed. 75% of its staff were transferred to 143 Agencies, under the 'Next Steps' programme. These administrative units were under the direction of Chief Executives, who were set the task of raising their productivity; they included the Benefits Agency, the Prisons Service, and the Civil Service College.

This Agency structure has continued, as the present Government has sought to reinforce the distinction between policy and delivery, and to strengthen the responsibility of the civil service for the latter. It has, however, moved away from accountable Chief Executives charged with increasing efficiency.

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The experience of the 1980s demonstrates that it would be entirely feasible to return to a more streamlined and effective civil service in the first term of a Conservative government, cutting administrative costs in the process.

### 8.3. Changing Whitehall Practice; Improving Public Service

An incoming Conservative government would need to change the way Whitehall does business, and to concentrate on its identified priorities. We propose:

1. Ending the Identity Cards scheme. The plan to register everybody's identity on a central computer will cost billions of pounds, and add needlessly to myriad existing forms of identification such as passports, driving licences, NHS cards, and other benefit entitlement cards.
2. Abolishing unelected regional government in England. Neither democracy nor accountability is served by adding another layer to our system of district, county, national and European government.
3. Reducing the number of quangos. Their powers should return to elected Councils or Ministers, where they cannot be restored to individuals and families directly.
4. Reducing the number of civil servants, but without any redundancies. This could be effected very simply, by not replacing those who retire.
5. Reviewing the role of external consultants. Before any consultancy work is outsourced, it should be standard practice to ask whether the capacity exists for it to be done 'in house'.
6. Changing the culture of public sector management. It is vital that a Conservative Prime Minister and Chancellor maintain a close interest in public sector effectiveness, so that Permanent Secretaries understand they are being held consistently to the highest standards
7. Clarifying accountability. The Government's penchant for political and special advisers has drained away responsibilities from executives, while constant evaluation has taken up their time with form-filling. Even units that were set up to coordinate and liaise have only added to the confusion. We recommend that there are much clearer definitions of which executives are responsible for which decisions. We suggest several measures that would encourage managers to be accountable to their bosses: severely curtailing the number of political and other advisors; reducing the number of coordinating or liaising units, which blur responsibilities; and stopping the Treasury second-guessing the operations of departments, as opposed to monitoring and controlling the money. We would also recommend reducing much of the form filling and evaluation activities that are currently undertaken, and dramatically reduce the use of consultants. We would expect Permanent Secretaries to tackle the problem of absenteeism more manfully, to introduce performance management, and to introduce a much higher element of performance-based reward into the remuneration of senior management.

Permanent Secretaries would have the power to make payments from a bonus pot, offering a meaningful percentage of the year-on-year cost reductions achieved within their department, subject to quality being maintained. More specific training would be provided, when it delivers the aim of providing more for less.



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## 8.4. More Trials and Fewer Errors

We have previously cited some of the Government's failures in implementing large scale change in both administrative systems and computer projects. We recommend that, in the future, every such project be piloted and assessed rigorously, before any national roll-out is embarked upon.

## 8.5. Replace Monopolies with Innovation, Building on the Best Recent Reforms

Because the public sector has been a monopoly, and hence averse to risk, it has been poor at innovating. We therefore recommend that public sector monopolies should be challenged wherever possible, and opened up to choice and innovation. A variety of public, private and voluntary providers in the marketplace will ensure delivery of the best public services; and where there are large specific problems to solve, competition should help to identify solutions. We support the Government's initiatives in introducing more private sector provision into the National Health Service, and would hope to see more diversified provision of schools under Conservative education policy. Our proposed approach is therefore evolutionary rather than revolutionary. We recognise that public sector efficiency will be enhanced if a Conservative government maintains and improves upon the best reforms of the past decade: foundation hospitals, academies, trust schools, the Decent Homes initiative, and the purchaser-provider split in the prison system. Local authorities too should be given more power to innovate: to pioneer new forms of service delivery that ultimately might be adopted as best practice across the country. A small team, sponsored perhaps by the Cabinet Secretary, should be established to identify successful public sector innovations in other countries, and to promote these ideas within the UK.

## 8.6. Rewarding Best Practice

We believe that there are many talented people within the public sector, strongly motivated by a sense of public service. This sense of vocation should not preclude those who work hardest and deliver the best from being offered greater financial rewards. Under this Government, there has been a sharp upward movement in real and relative pay rates for public officials, compared with their private sector comparatives. We would strengthen this trend, but make sure it was payment for results. We would want to work with a smaller top civil service, with much more highly motivated people, who are rewarded for success and who are encouraged to innovate within the civil service. Numbers would be reduced through natural wastage, which would enable us to offer accelerated promotion to those talented people within the public service, who currently feel frustrated by the lack of energy shown in pursuing innovation and better performance, and by the slowness of many promotion routes within the administrative cadres of our public sector.

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## 9. Wider Ownership and Planning

### 9.1. Wider Ownership

In the nineteenth and twentieth centuries, the UK made the long march to full political rights for all, bringing votes for women and for younger people. In a parallel movement, the twentieth century has seen significant progress towards full economic participation for all. In 1900, only one in ten owned their own home, and few people owned shares in the industry and commerce of the country. As the century drew to a close, seven out of ten adults owned their own home, and many millions had become direct shareholders. Millions more came to own shares through their retirement savings.

Much of the political debate centred on income redistribution, and the balance of rights between workers and owners. The twenty-first century would benefit from a more creative and less divisive debate. Most now realise there are limits to how far the state can go in offering protection and transferring income, before business turns elsewhere in a fast globalising economy. Supporters of free enterprise have, in the main, accepted the role of the state in guaranteeing rights and offering income to the needy. Today, the debate needs to be more about how the long march of everyone to own wealth and participate fully in economic life can be accelerated.

In the twentieth century, the dream of home ownership for many was brought about by government encouragement and tax breaks, offering people tax relief on mortgage interest. Towards the end of the century, as tax relief was reduced and finally abolished by the Labour Government, conditions remained benign for the expansion of ownership, as a result of increased competition in the mortgage market, and an international financial climate that allowed substantial advances to be made at low interest rates. Worldwide rates were very low, thanks to zero rates in Japan, rates around 1% in the USA, and 2% on the Continent. As a result, UK rates were attractive to those taking out mortgages, despite being above the main global rates, as a result of poor fiscal management.

In the twenty-first century we need to encourage more people to come to have a stake in the wealth generating assets of the country, as well as a stake in the residential estate. If people participate in the ownership of trade and commerce, it breaks down the Them and Us barriers, creates attitudes friendly to enterprise, and expands the amount of capital available to invest in new ideas and good businesses, thereby offering us a wider range of competitive services.

We believe that the right solution for future decades, starting at the next Election, is to promote shares for all – shares in the economic and commercial life of Britain, shares in our prosperity, and shares in the governance of our companies.

One hundred years ago, the ruling class thought the rest would be unable to rise to the responsibilities of owning property. They envisaged a continuing nation of tenants, with themselves as the landlords. The socialists who gained political power in the 1920s and 1930s came largely from similar backgrounds. They shared the prejudice, but decided to make the state the landlord rather than private individuals and families. The state proved no better a landlord than those who had gone before, restricting choice, designing ugly places, and preventing people showing that spark of individualism and that enthusiasm for ownership, which became so obvious as the home ownership movement took off.

Today we should offer the same prospect to people to own the factories and offices of Britain as we offered them to own the homes of Britain in the last century. Just as that movement spawned many newer and better houses, as the habit of ownership caught on, so, as the spirit of enterprise catches on more widely, we will spawn many more businesses that can offer us all better service and a wider range of choices.

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The task of spreading ownership will not be carried out by confiscation, or by attack upon the current owners of capital. We are not Marxist socialists who judge the current owners to be too rich or the wrong sort of people. Indeed, ownership is already diverse through the mass ownership of the larger companies by pension and insurance funds. Our aim is to involve the current owners more, not less; to allow them to enjoy the fruits of ownership more, not steal them from them; and to create a climate where many more set up businesses of their own, or come to buy and own stakes in the bigger businesses run by others.

First, as outlined in Section 5.4. of this report, we want a Conservative government to encourage new Lifetime Savings Plans, where long term savings can be invested in growing assets with good returns such as property and equities. These would be flexible, so that people could draw on their savings at important stages in their lives, such as buying a house, paying for children's university fees, and finally retirement.

Over the years ahead, more and more people should come to own shares in the commercial life of the nation through these lifetime savings accounts. Whether they use a professional money manager, or invest in shares and properties of their choice, they should have the right to attend the shareholder meetings of the companies they are invested in, and to cast their votes.

Second, we believe that far too many of those who have a business idea are put off doing anything about it, both by the complications of getting the support of their bank, and by the huge volume of paperwork required to comply with all the demands of government regulation.

We want to change this situation, to help more people realise their ambitions, and turn their business ideas into practice. To achieve this, we propose:

1. Offering the best enterprise and business management courses more widely in schools and colleges.
2. Allowing people to draw down cash, tax-free, from their Lifetime Savings Plans, to invest in their own businesses.
3. Exempting small businesses from the burdensome regulation that prevents them from doing their best for their customers.
4. Raising the VAT threshold.

Just as previous Conservative Governments succeeded in creating a nation of home owners, we hope to create a new nation of owners of business. We believe that the quality of life for millions of people can be improved by building up both homes and businesses; and that a bigger population of entrepreneurs will enrich all our lives through the variety of their skills, and their effect on the productivity of the nation.

## 9.2. Planning

These proposals for wider business ownership, however, will work only if home ownership can increase in a way that neither immobilises excessive amounts of capital, nor creates financial fear. We need to come up with a solution to the restricted supply of homes, and the lack of more affordable housing that it has resulted in. This is vital if we are to prevent the young avoiding riskier business paths, in the fear that a deposit for even the smallest property will take them years to save; and if we are to encourage older people to pursue a business idea, instead of being locked into a career by a burdensome mortgage on even the most modest house.

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The dramatic escalation of the cost of housing creates a number of serious problems for the economy and society in general:

1. To the extent that interest rates are maintained at a higher level than would otherwise be necessary in order to contain house price inflation, this can place a significant burden on other sectors of the economy.
2. The labour market has become less flexible.
3. People's quality of life has fallen, as either they cannot afford to buy houses in the communities in which they grew up; or they are forced to take on uncomfortable levels of debt.
4. The quality of life in towns and cities has worsened, as government policy continues to grab gardens for housing in metropolitan areas.

### **9.2.1. Urban Myth**

The whole premise of our planning system is based on the fallacy that land is a resource that requires draconian rationing. The reality is that 92% of our country is non-urban; and that a fraction of this land could satisfy our housing needs for many years to come. But the myth is sustained by cramming our population ever more densely into urban areas including gardens, thereby increasing our perception of limited space.

### **9.2.2. The Economic Opportunity**

Pent-up housing demand is an enormous economic opportunity, as house-building is one of the few manufacturing industries that cannot be exported. The difference in the value of agricultural land at £3,000 per acre, and development land at £1,500,000 per acre, illustrates the potential wealth that is wasted by what is in our view an over-restrictive planning regime.

### **9.2.3. The Green Agenda**

Planning can be harnessed to create greener, safer, more spacious and more beautiful communities, which will be an architectural heritage for the generations to come. The opportunity to build these is surely being squandered by an increasing 'grab' of green spaces in our cities that runs counter to what most people want from their environment.

### **9.2.4. Planning Philosophy – Planned Economies Don't Deliver**

The concept of a planned economy is one that has lost all credibility. In almost every area of economic endeavour we have embraced the free market, and have left it to determine sensible levels of investment. The market not only tends to allocate resources more efficiently, but is also better placed to deliver the product that people really want. It is only in the market for housing that the Government still believes in planning every detail, to our detriment.

### **9.2.5. The Correct Role for Planning**

Instead of the government planning the number or type of houses that are needed, we believe it should regulate the amount of land released for development. The aim should be to control house price inflation, just as the Bank of England regulates the money supply to control cost price inflation. The government's role should then be to determine where development takes place; to require that it

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enhances the environment; and to harness some of the planning gains, in order to ensure adequate provision of community and transport infrastructure.

### 9.3 Planning Proposals

1. **Reverse the burden of proof for brownfield development.** The way planning permission is granted is particularly inappropriate for brownfield sites, as it is fundamentally antipathetic to development. We propose instead that:
  - The presumption in brownfield sites (defined to *exclude* gardens) should be in favour of planning permission being granted; with the burden on the planning authority to submit good and timely reasons for development not to proceed.
  - The government should abandon all requirements on councils to achieve any particular density or mix of properties.
2. **Replace building regulations.** These are often wholly inappropriate in their restrictiveness, and should be replaced by building standards, which would allow the specification of homes to be tailored sensibly to the requirements of the building environment. This should reduce the cost of housing.
3. **Community Land Trust Initiative.** If the government is to deliver the houses we need, it has to identify the means of working with local people and local councils to create affordable new housing outside urban areas, particularly in suitable rural locations, and within easy reach of areas with very high house prices, where the market is telling us that housing is in too short supply. Planners often fall into the trap of housing people where they think they ought to live, rather than where people actually want to live.

Community Trusts are established by local councils in conjunction with local people, to provide housing for locally employed people. We believe that Community Land Trusts represent an opportunity to be innovative, and to improve the environment with the highest of eco-friendly building standards, meeting the need for affordable housing for locally employed people, through shared equity for new housing on land that would not otherwise be given planning permission.

4. **New Communities Initiative.** It will not be possible to find sites for all the extra housing needed by relying on existing practice allied to agreement with local authorities over limited expansions to the urban or village envelope under the Community Land Trust Initiative. Even after allowing for a lower rate of net inward migration, government will need to help identify sites for further housing development. This will require new communities to be formed in sparsely populated areas, preferably with a high proportion of brownfield land suitable for redevelopment. We recommend immediate progress on a larger new city initiative in the Thames corridor area, using existing sites, other brownfield sites, low grade agricultural land and reclaimed land from the estuary. We propose that other locations be identified and included in the next Conservative Party Manifesto, following proper local consultation. Such communities could be best advanced by using Development Corporations for their early development, modelled on the successful London Docklands Corporation and on the New Town Corporations used for Milton Keynes and others. The aim would be to use the necessary powers for land assembly and planning to speed development and encourage eco-friendly styles, but for the new communities to pass to elected local government once the scheme was well advanced.
5. **Proper compensation.** Hand in hand with a more positive attitude to brownfield and new Community Land Trust development, there must be better compensation for those who lose out as a result of development. In particular, people should receive significantly more than market

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value for properties lost through CPOs, thereby reflecting the great distress involved in being forced out of not just a house, but a home.

6. **Streamlined procedures.** The time wasted in planning decisions is a huge drain on business, and we therefore propose that all simple planning applications should be responded to within three months, with proper reasons given where planning is denied.
7. **Town centre regeneration.** Too many of our town and city centres are in long term decline, as a result of congested roads, expensive and limited parking, and retail and commercial properties that are outdated and small. Many planners have responded in a protectionist manner, by preventing development out of town instead of improving central facilities. This approach has been universally unsuccessful, and the government must instead encourage local authorities to revive town centres by redeveloping their commercial property stock and transport facilities. This is an issue being considered by Michael Heseltine's Task Force on Urban Regeneration.



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## 10. Taxation

High taxation is one of the biggest destroyers of enterprise that a government can design. Those countries which benefit from low taxes on profits and employment tend to grow much faster than those which do not. Hong Kong is an obvious example of a very successful enterprise economy that was built on low taxes; Singapore, Ireland and the USA have all pursued a similar path. Those governments of the developing world that have introduced flat tax systems have done so in the hope of replicating such advantages for their citizens.

By contrast, UK tax is currently high, relative both to history and to our international peers; and the trend is going in the wrong direction. In 1997, the UK tax burden was close to the OECD average of around 39% of GDP; but in 2007 (with almost 3.5 million more people paying income tax) it is forecast to hit 42.6%, while the OECD average is set to fall to below 38%. As a result of this growing lack of tax competitiveness, an increasing number of companies are contemplating either the relocation of their headquarters out of Britain, or basing their investments elsewhere. The OECD itself has concluded that higher taxes are damaging to enterprise and growth, calculating that there has been an increase in the average tax rate<sup>42</sup> of about 10% of GDP over the last thirty-five years, which may have reduced average annual growth rates by around 0.5% per annum. This seems a very large price to pay. If the UK tax burden had remained at its 1996 level, the average household would be paying £1,600 less per year than it does now; if aggregate UK tax had remained constant in real terms, that figure would be £5,140.

There is much evidence and analysis that has helped us to draw our conclusions on taxation, of which Michael Forsyth's report is an important part. This highlights the expensive (and growing) problem of legislative complication, which is reflected in the £5.1 billion per annum cost of administering UK tax regulation, a sum that is in addition to the taxes themselves.<sup>43</sup> Similarly, a review in the US Congress suggested that it could cost between 20 and 60 cents to raise an extra dollar of tax revenue.

Meanwhile, the American Office of Tax Analysis, which was set up to examine the impact of lower tax rates, in terms of increasing economic activity and revenues, has analysed the effect of the three years of tax cuts between 2001 and 2003. They found that, by the end of 2004, the US economy had created 3 million extra jobs; and that its GDP was 3.5% to 4% higher than would have been the case without such tax cuts. They also found that the most productive tax cuts were those in dividends and capital gains tax rates, followed by reductions in the four higher income tax rates. As the '2005 Tax Competitiveness Report'<sup>44</sup> concluded:

*“Tax competitiveness is related to the size of the tax burden: the more resources used by Governments to fund public services, the more taxes impinge on the private sector's desire to work, save and take risks. While wise public spending can improve economic growth, taxes – especially poorly structured ones – will undermine growth and job creation.”*

Income tax is, of course, an extremely progressive tax. The top 1% of taxpayers pays 21% of total income tax; the top 5% pays 40%; the top 10% pays just over 50%; and, conversely, the bottom 50% pays only 11%. However, Gordon Brown has so greatly complicated the tax and benefits system, that the UK now imposes some of the highest rates of tax and benefit withdrawal upon those who move into employment. For example, if someone moves from part-time to full-time work, on the average UK wage, their marginal effective tax rate can be as high as 80%, which is higher than in any other OECD country. For a married couple on a single income, and with two children, the marginal effective tax rate can be 90%, which is the third highest of any country in the OECD.

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<sup>42</sup> For OECD countries

<sup>43</sup> Estimate from APMG

<sup>44</sup> A study by the C D Howe Institute, a Canadian economic research institute.

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As for corporation tax, the growing challenge of the most competitive tax regimes is manifest, with companies such as Google, Microsoft and Intel setting up significant operations in Ireland to take advantage of rates of 12.5%, for example. Meanwhile, the Netherlands is reducing its corporate tax rate to 25.5%, as well as simplifying its tax system, in order to recruit more businesses to Holland. Unsurprisingly, a number of major firms in the UK are currently considering whether they too should be reducing the amount of tax they pay, by moving some of their activities overseas.

## 10.1. Background

It is an unfortunate fact that, for many years, the Government has encouraged an attitudinal rigor mortis about taxation levels. This happened even as other countries gradually lowered their marginal tax rates, and eroded the competitive advantages that Britain gained during the 1980s from its dramatic supply-side policies. These may have been controversial for other reasons, but the UK's boldness over taxes then is being emulated by our competitors now, to their relative benefit. In such a context, it was surely misguided of Labour to ignore for so long any argument that lower tax rates provide faster growth, and increase future tax revenues; and to ignore any suggestion that waste should be reduced, so that money could be returned to taxpayers. These were the moderate views of those who continue to want only the best for public services; and they sit in contrast to Labour's apparent dislike of any questioning of the party's moral and economic authority.

### 10.1.1. Waste in Spending

Fortunately, in the last three years there has been some movement in this hitherto unsatisfactory debate. It has become undeniable that not every pound spent in the public sector has been a pound spent either well, or in a way which has met with the approval of the majority of voters. It has also become a matter of clear consensus that any government would wish to increase spending on public services, on teachers, nurses, doctors, and police officers. Indeed, the amount that is spent on all frontline workers in the crucial public services represents only 25% of total public spending.

The Government itself admitted as much by appointing a Review Committee under Sir Peter Gershon, to examine how wasteful and unnecessary expenditure could be removed from the public spending totals. Its report before the 2005 Election concluded that there was £22 billion of annual expenditure which could be cut without damaging important frontline services. A similar Conservative review exercise concluded that not all of the savings suggested by the Review Committee were easily achievable; but it did identify other savings, which could perhaps add up to a figure in excess even of that highlighted in Gershon's report.

The growth of such a consensus across all the main political parties – that there is scope for improving the efficiency and value for money of public service provision – is very welcome. In addition, there are a number of contentious policies currently being pursued, which an incoming Conservative government should cancel. For example, as noted in Section 8 of this report, the Government's Identity Card scheme is a vain extravagance: a substantial expansion of state power that is unlikely to help in the assault upon crime or terrorism. There is no need, either, for unelected regional assemblies and many of the other regional quangos surrounding them, upon whose multitudinous layers the Government has spent a great deal.

## 10.2. Economic Stability Comes First

The Conservative Party, under David Cameron, has emphasised that it will take no risks with economic stability. It is right that this should be stressed, since no one would want tax reductions if the financial markets took such fright that interest rates then rose. Families obviously want to feel better

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off, and are never going to be grateful for a tax cut that is more than offset by an increase in their mortgages. We have therefore taken it as axiomatic in carrying out this review that no policy would be recommended or implemented if there were a serious body of expert opinion that it could in any way endanger economic stability, and thereby lead to an increase in interest rates.

### 10.3. Sharing the Proceeds of Growth

David Cameron and George Osborne have also stated that they would share the proceeds of growth between tax reductions and increased public spending. This formula commits the Conservatives to increasing the total of public spending by more than the rate of inflation, but not by as much as the overall increase in the UK's economic output across the economic cycle. This not only explicitly rules out spending cuts, but will mean a substantial increase in the amount that can be concentrated on those public services which are most valuable and important to all of us; and it will also mean a redoubling of efforts to improve productivity and efficiency throughout the public service, so that each pound spent goes further.

The impact of such a refreshing approach should be significant, as an incoming Conservative government would be able to maintain and improve the quality and funding of public services, and to reduce tax rates. To make this possible, a Conservative government should reform the public sector, and emulate the success of the private sector by delivering more efficient service each year, although with the added benefit of more money, which the private sector (such as the UK's manufacturing industry) often has to do without. We should ask the public sector to deliver more with more. The manufacturing sector has to deliver more with less each year.

### 10.4. Tax Competitiveness

The UK has slipped down the global league tables of tax competitiveness, as other countries have reduced both corporate and income tax. This is despite the fact that, in 1997, Labour inherited an extremely competitive economy, with considerably lower taxes than other major European countries. Gordon Brown finally acknowledged as much in his 2007 Budget statement. His surprise decision to cut the standard rate of income tax (from 22 pence in the pound to 20 pence in the pound, from 2008), and to lower the corporation tax rate (from 30 pence in the pound to 28 pence in the pound), was a belated recognition of the dangers of allowing UK tax rates to remain at levels that are no longer competitive (although even these announcements were counter-balanced by raising the rate of income tax on low earnings, and by increasing tax rates on small business).

The evidence in favour of lower marginal rates of tax on income and profits is overwhelming, with the (already noted) rapid growth of Ireland, the USA, and the flat-tax countries of Eastern Europe. Countries with very low corporation tax rates have seen businesses grow especially quickly, with many new enterprises relocating, in order to take advantage of a more benign corporate climate. Far from sacrificing revenue, a substantial marginal tax rate cut can, as a result of business and economic growth, lead to an increase in overall revenue after a year or so. The tax cuts implemented by President Reagan led to a surge of US revenues in the 1980s; and this was repeated successfully in 2000-2003 (as stated above), with a concomitant sharp reduction in the deficit, despite big spending increases. The Irish move to a very low corporation tax has generated very significant revenue growth, considerably in excess of Britain's, where a slower economy has been combined with a number of stealth taxes.

### 10.5. The Forsyth Report

The Economic Competitiveness Policy Group believes that the Forsyth Report remains the most authoritative and wide-ranging treatment of the issue of tax reform written in recent years in this

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country, and we broadly welcome its findings. The Forsyth Committee established that lower tax rates can lead to a dynamic effect that partially recovers revenue. It has also documented the decline in tax competitiveness in the UK, and has made a series of proposals for lightening the burden on individuals and businesses.

## 10.6. Proposals

We believe it would be wrong to set out detailed, costed programmes even for the first five years of a Conservative government, years in advance of a first budget. For wise and responsible decisions to be made, an incoming Conservative Chancellor will obviously need a clear idea of the state of the nation's finances at the start of his period in office; and the current Government cannot possibly tell us with any exactitude what the state of the public revenues and expenditure plans will be after 2010. Instead, we set out in this report the proposed general direction of travel.

We divide our proposals on the treatment of taxation into three areas: corporate profits, the ownership of assets, and individual and family income.

Generally, we believe that it is better to tax expenditure, rather than to tax earning and saving. The less tax that people pay when they earn and save, the more they will be encouraged to do both. Both are manifestly benign activities, leading to a richer and more balanced society, with more money available for public services, charitable activities, and individual and family enjoyment. We also believe that taxation should give industry and individuals every incentive to reduce our energy dependence, and to cut carbon emissions. As such, we warmly welcome the Shadow Chancellor's proposition that it is preferable to tax people as they burn, rather than as they earn. Such a switch of emphasis reflects the strong environmental policies that a Conservative government should develop, with revenue collected from the patterns of spending that are most environmentally damaging. This would then allow more scope to reduce taxes on earnings and savings, and for tax revenue to be less entirely dependent on the rate of economic growth, and so more beneficial for all of us.

### 10.6.1. Taxes on Company Profits

We endorse the Forsyth recommendation that the ambition should be to get corporation tax down from 30 pence in the pound to 25 pence in the pound. It is likely that a Conservative government will inherit a lower rate than the current 30 pence, as Gordon Brown has recommended 28 pence in the pound from 2008. Some of this can be paid for by continuing to reduce the allowances against corporation tax; but we do not believe that there should be a further increase in small business profits tax as envisaged in the 2007 Budget. We recommend 20 pence in the pound for small business, in line with standard income tax.

### 10.6.2. Taxes on Asset Ownership and Management

1. Inheritance tax is not a popular tax. This has become even more true as the swift rise of house prices in much of the country has resulted in many people, who could not in any sense be described as rich, suddenly finding that their family will be liable to pay quite substantial amounts upon their estate. We recommend the abolition of inheritance tax.
2. Capital Gains Tax. The present Government's introduction of taper relief was a complicated but welcome way of reducing the impact of this tax on enterprise and business formation. We would adapt this system to reduce the adverse impact of capital taxation on saving. We agree with the Forsyth Report that capital gains tax should not apply to any asset held for more than ten years, and agree that taper relief should apply to all chargeable assets. An asset held for nine years would attract 10% of the charge; and one held for five years, 50% of the charge. A person's home would remain exempt.

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In addition, we agree that estates on death should also pay this new capital gains tax, taking all assets held for more than ten years before death, and the primary residence, out of tax.

3. The Government has not only kept in place stamp duty on the trading of shares, but has also increased it greatly on property transactions. The latter has become another barrier to young people trying to buy a house; but, as Gordon Brown has made property stamp duty an increasingly significant source of revenue during the last decade, unfortunately its abolition will not be easily affordable during the early years of a Conservative government. We do, however, recommend that – subject to the maintenance of sound finances – early action be taken to abolish or reduce the stamp duty on shares. The London stock market has risen despite this uncompetitive penalty, only because banks have been very imaginative in designing and trading other instruments that do not attract the duty. Thereafter, the Chancellor should turn his attention to cutting stamp duty on property.

### **10.6.3. Income Tax**

An incoming Conservative government is likely to inherit a standard rate of income tax of 20 pence in the pound. This is not an uncompetitive rate relative to other major advanced economies, although it does compare unfavourably with the faster growing flat-tax countries. Nevertheless, it is worth considering that tax thresholds in the UK are low by international comparisons; and that, due to a failure to raise income tax thresholds, around 1 million more people now pay the top rate of tax than in 1997. Too many people are paying the 41% rate, and the threshold should be raised. We are also concerned that the 41% rate is becoming less competitive, as other countries cut rates, and recommend it be reviewed when circumstances allow.

A high tax economy makes no one better off, because it taxes heavily the poor as well as the rich. Such an economy grows more slowly, reducing employment opportunities, and making improvements to public services less affordable. The state has to spend more money on helping those without a job, or on low incomes; meanwhile, individuals are discouraged both from saving, and from investing in jobs. Ultimately, society becomes divided between the majority who pay the taxes and the minority who are the recipients from the tax system, to the benefit of neither group. We recommend the work of the Social Justice Policy Group, to remove some of the obvious disincentives to work currently in the complicated tax/tax credit/benefit nexus. Review of the disincentives to work is a necessary task to get more into jobs.

In contrast, a lower tax economy has many advantages. It attracts enterprising and innovative people and businesses, whose skills, risk-taking and wealth create more jobs and prosperity for the rest of us to share. And the greater the number of successful businesses, the bigger the tax base becomes, which then provides higher revenues over time for public services. The faster economic growth that comes from such hard work makes all sorts of investment and improvements in a country's facilities and services possible; and people are encouraged to save more, thus providing for themselves and their families.



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## 11. Conclusions

There have been exaggerated claims about how well the UK economy has performed in the last ten years. We welcome the fact that since the UK came out of the ERM we have enjoyed 15 years of growth, with lower inflation and interest rates than in the 1970s or 1980s. Much of this has been owing to the favourable world backdrop over the last decade, with low global interest and inflation rates, and a surge in cheap products from Asia keeping prices down. Some stems from the decision of both recent and present Governments to keep the UK out of European monetary arrangements, and to set interest rates that make sense for the UK through the advice of the MPC of the Bank of England.

This Government's own distinctive contribution has fallen into two different periods. In the first, from 1997 to 2000, the Government followed a cautious approach to public spending, inherited from the outgoing Government. This led to surpluses, debt repayment, and a strengthening economy. In the second phase, from 2000 to 2005, the Government unleashed a large increase in public spending, without thinking through how to obtain value for all the money, or how to direct it into the things that most needed extra spending. This has helped to undermine UK competitiveness, producing a slower rate of productivity growth, higher taxes and higher inflation. The UK, despite having an independent Monetary Policy Committee, has faced higher interest rates than her leading competitor economies, and, more recently, higher inflation.

The Government has compounded the errors on macro economic policy by failing to expand the facilities needed for a successful enterprise economy, and failing to bring about sufficient efficiency in the public services. We do not have an energy system capable of delivering a combination of energy security, competitive pricing and reducing carbon emissions. We are short of transport capacity of all kinds; short of competitively priced energy, and of water in the right places; short of science and maths graduates; and short of people with good vocational skills in numerous areas.

We have made numerous proposals to tackle each of these problems and shortages. In cases like transport, water and energy the task is to change the regulatory framework in a way which allows the private sector to apply more capital to solve the problems. In the administration of public services, what is required is a fundamental change of culture. To lift our output of people with the skills that modern business requires, we need reform of the vocational training system, and a new regime to allow the best universities to attract more private money and corporate revenues.

The UK economy has apparently sustained its growth rate in recent years by allowing in a large number of new people, either prepared to take the less glamorous jobs, or already equipped with the craft skills that we lack at home. Meanwhile, 5.4 million people of working age remain without a job, and the growth figure conceals a significant slowdown in the trend growth in output per head, and therefore in income per head.

We believe the UK can do better. The success of London and the financial services sector shows it is possible to be world class from a UK base. The continuing achievement of aerospace and pharmaceuticals shows that the UK can still be a centre for knowledge-based manufacturing, just as we continue to offer a home to some of the best vehicle assemblers of the world, and to many of the winning teams who participate in the Grand Prix.

If the UK had a government which obtained better value for every pound it spent, that reduced business taxes and regulation, sorted out the educational and training problems, and dealt with inadequate infrastructure, the UK could grow that much more quickly. Faster growth would put many of the unemployed back into work, and would raise living standards, and allow people to save more for life's needs. Above all, we would like to see a UK where more people felt they could have a stake in



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the wealth and income generation of the nation, by owning homes and shares, and by building businesses of their own.

# Working Paper 1

## The Economy Today

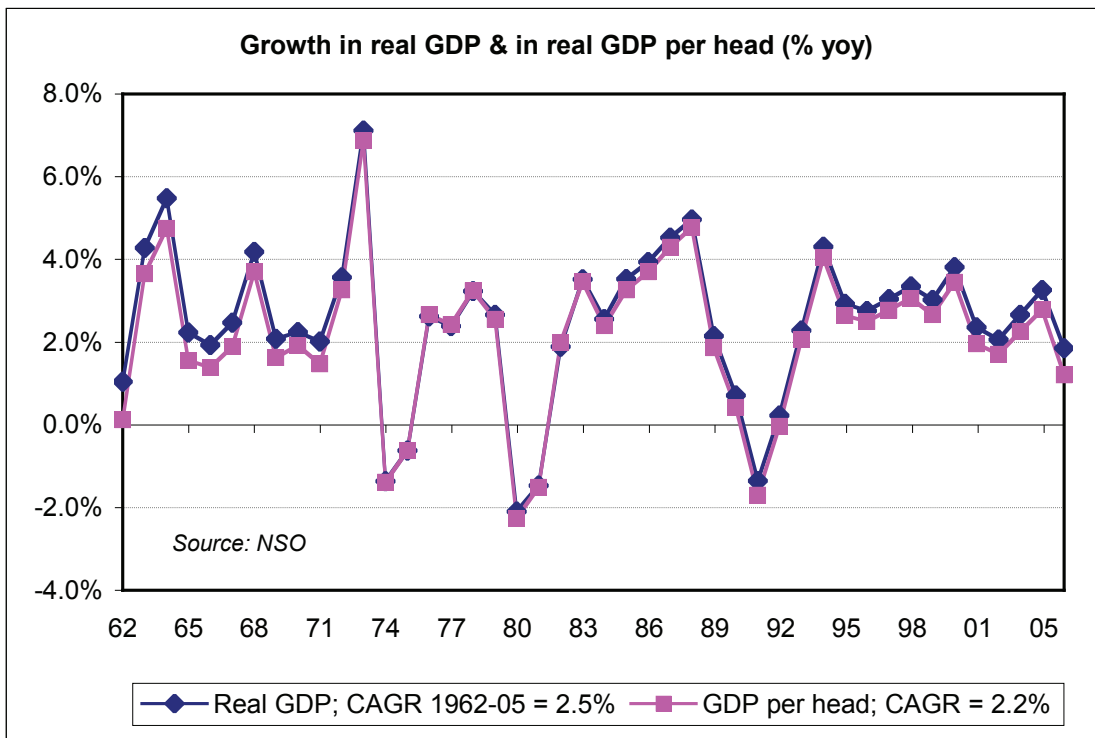
### 1. Growth Matters

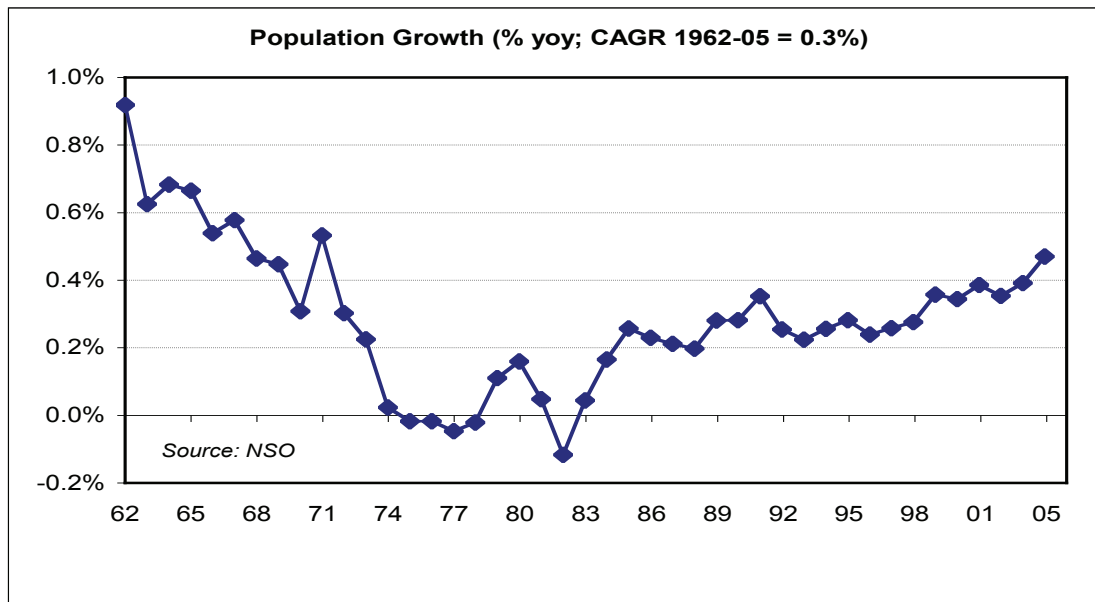
Growth rates matter. Even small changes in annual growth, compounded over many years, cumulate into large changes in levels of prosperity. Growth at 2.3% per year makes income rise nearly tenfold over a century. Raising the trend to 2.7% per year makes income after 100 years almost half as large again. Faster growth creates room for more tax cuts and extra health, education and social spending. Faster growth can contribute to the costs of protecting the environment, alleviating poverty, and preserving peace. The problem is that growth is likelier to be falling in future on a per head basis.

#### 1.1. The Historical Trend

To look forward, first one must look back. What were the key features of Britain's growth record in the last half of the last century? Two stand out. One is the remarkable degree of long run constancy in the trend. The second consists of varying short term undulations.

Britain's real Gross Domestic Product, on the latest chained volume estimates from the Office for National Statistics, published in 2006, displays an upward annual trend of 2.5% from 1962 to 2004. Exactly the same annual average growth rate is recorded for the sub-periods 1962-1980, 1980-2000, and 2000-2004; and, at 2.6%, the annual trend from 1962 back to 1948 is hardly any different, although the growth of GDP per head has been faltering recently. For the decade from 1973, the UK data betray a suggestion of deceleration, later arrested.





This contrasts quite sharply with the growth experience of some other countries. In the United States, growth was also quite steady, but slowed down a little more in the 1970s, and rebounded a little more strongly – and later – thereafter. Germany, Italy and Japan, when compared to the UK, all witnessed much faster – though declining – growth rates until the mid-1970s, and slower growth than the UK for most of the past twelve years. A similar, if less pronounced, timing pattern is evident for France. Ill-advised protectionism locked Spain and Portugal out of the early post-war boom, but let them grow all the faster when they started trading more freely later on.

These trends for aggregate real GDP at factor cost<sup>45</sup> ignore the fact that Britain’s population was growing each year, and with it, its potential labour force. So a better indicator of living standards is obtained from the ratio of (real) GDP (or GNP) to population. These trend upwards over the period, too, although the annual average growth figures over our sub-periods are not quite as rigid as the aggregate data: 2.1% from 1948 to 1962, then 2.2% for 1962-80, peaking at 2.3% in 1980-2000. In 2000-2004 they slip back slightly to 2.1%, but this figure is based on official guesses about net immigration that understates it. On some assumptions about migration, the annual growth rate for GDP per head over the two years up to the first quarter of 2006 is as low as 1.2%. It is the decline in output per head this century compared to last that concerns us, and reflects the competitiveness problem we identify. We believe this trend can be changed if the Government takes action soon to deal with the many issues that are impeding growth in output per head.

## 1.2. Britain’s Cycle

Britain’s growth trend may have been falling. Year on year, however, growth rates undulated. Until 1973 the cycles were regular, mild, and highly symmetric. Intervals between peaks in the waves were steady at four and a half years; nearly every year saw growth hover between 0.5% and 5%. Then the cycle became more violent, slower and lop-sided. Three brief phases of sharply negative growth, of which the last occurred at the start of the 1990s, have been followed by ever lengthening spells of growth, either just above or close to trend, with hints of the odd hiccup somewhere in the middle<sup>46</sup>. So annual average growth rates can vary with the choice of opening and closing dates – especially if measured over shorter intervals.

<sup>45</sup> They strip out the effects of inflation, and taxes and subsidies on goods; and they omit net asset income from abroad (the insertion of which would convert “domestic” into “national”).

<sup>46</sup> Separating cycle from trend is unavoidably arbitrary. Indeed D. Comin and M. Gertler (“Medium Term Business Cycles”, *American Economic Review*, 96, 2006, 523-51) argue that contemporary statistical techniques have misled economists into ignoring important longer term cycle phenomena.

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Britain's real national income advanced in every quarter since sterling's eviction from the European Exchange Rate Mechanism on September 16, 1992. By contrast, 70% of the 144 countries with reasonably complete data reported by the IMF have seen their real GDP fall from one year to the next on at least one occasion since 1992. Ten of the eleven countries in the Euro area (excluding Luxembourg for which IMF data are silent) are, for example, members of this large group. Austria is the sole exception. On the other hand, of the pioneer countries that, like Britain, adopted Inflation Targeting (with free floating exchange rates) a decade or more ago, all but one (Chile) are to be found in the minority of countries where real output has consistently risen year by year over that period. So too, among others, are several oil producers, various countries in Southern and Eastern Africa and in the Indochina peninsula, as well as the three giants, China, India, and the United States.

Inflation Targeting provides an economy with some built-in stabilisers. Monetary policy decisions restrain it if signs of overheating are suspected, and strengthen it in opposite conditions<sup>47</sup>. Such actions are suited to the economy's own particular needs, rather than those of some larger area of which the economy may form part. So exchange rates float.

History may cite the new financial regime introduced by Norman Lamont in late 1992, and extended by Gordon Brown in May 1997, as a major reason for the benign combination of steadier growth and lower inflation that the UK subsequently enjoyed. Yet other countries have displayed quite a similar combination, too; non-inflation targeters and euro-adopters among them. (Individual Euroland countries' dips into negative growth have primarily reflected their disappointingly low overall average growth rate, and the tight, non-cyclically-corrected budget deficit ceilings that tended to aggravate downswings, and less the fact that financial policy decisions in Frankfurt could sometimes be out of line with their particular needs).

The world as a whole has witnessed a retreat from the use of fiscal demand stimuli by government, reflecting several developments: a recognition that governments have no special skill in spotting future shocks, the realisation that gyrating tax rates tend to do damage, awareness of the complex lags, and conceptually, a growing understanding of previously under-appreciated supply side influences on the time-path of national income.

### 1.3. Some General Empirical Observations

Comparisons over time and space have generated a number of general findings, none of which is a universal law, but more of a general tendency with some exceptions. Among the most noteworthy of these are:

1. **Catch up:** all else equal, the lower your GDP per head starts, the faster it tends to rise.
2. **Asymptotic approach:** "medium term" deviations in a country's growth rate from a long run trend tend to close gradually, and at a diminishing speed.
3. **Wars:** while they last, wars can turn growth sharply negative, and the shadow they leave affects growth long afterwards, first negatively, then positively but with declining effect.
4. **Size:** countries with smaller populations have some tendency to grow faster, although we obviously recognise the current situation in China and India as exceptions to this.
5. **Openness:** all else equal, more trade is usually correlated with faster growth.

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<sup>47</sup> Responding to demand shocks is quite straightforward, but, in the case of supply shocks, which push growth and inflation in opposite directions, inflation targeting would generally give priority to stability in inflation.

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6. **Education:** literacy and coverage and duration of schooling are positively correlated with growth.

7. **Corporation Tax:** countries with lower Corporation Tax usually grow faster.

In a sense, (b) is a corollary of (a). There is ample evidence of (c) for Germany, Italy and Japan, as noted earlier, although the external war-growth relationship turns out weak in some other studies<sup>48</sup>. Recent European experience testifies strongly to (d), as the Appendix on small countries explains (although this link can vanish completely in other work). The smaller EU-25 economies have massively outperformed the big ones in the past decade. We think that one reason for is that little economies have been able to conduct tax reforms and other liberalisation measures which attract foreign capital, gaining more because the bigger ones have kept their tax rates up, not cut them to match.

## 1.4. Britain's Historic Growth Policies

Britain's governments have often fretted about its growth rate, which for many years was worryingly slower than those in Continental Europe and Japan, and is now dwarfed by the much faster expansion rates seen in Continental Asia. Various panaceas have been sought over the years.

In the 1960s, two main focal points were productivity and investment incentives. A form of indicative planning was first tried<sup>49</sup>, then abandoned<sup>50</sup>. The early 1970s saw big stimuli to aggregate demand and an untied exchange rate; but all this led to was massive jumps in inflation. From the 1980s on, governments have tried to roll back the State's control and ownership of assets. Council houses were sold. Most nationalised enterprises were privatised. Failing firms were not subsidised by the State. These actions were contested at the time. But, with very few exceptions, they were not reversed later on, and their general benefits came to be widely acknowledged. Indeed the Labour Government since 1997 has continued to use the private sector more, introducing it for the London Underground, National Air Traffic Services, and for work in both healthcare and education.

Despite these changing priorities and perceptions about what policy changes could best favour growth, every decade has seen emphasis on education and training as a route to higher productivity. This route is in fact rather uncertain. Education and training for adults imply at least some time off work. Less is earned now; but more later. The question is whether, after the gains are discounted to reflect interest, the investment represents a decent prospect of a positive net social present value. If the subject matter learnt has little discernible link with the work skills required later on, this becomes doubtful. If education is only a signal, a credential its recipient brandishes in the hope of jumping rivals in the job queue, the social return must be far below the private return. But there might be too little training in a market economy: some employers may free ride (or be thought to free ride) on the training investment by others; would-be trainees may be deterred if they cannot borrow; and, for the disadvantaged, education and training (including early years care) can offer a prospect of escape from poverty that is far more satisfying, and socially just, than redistributive transfers. In theory, education and training can be absolutely crucial in elevating productivity and pay, and propelling the growth process forward. In practice we see an undeniably positive link between higher education and growth. But all this link may tell us is that growth increases the demand for higher education<sup>51</sup>. Causation may run both ways. The case for an enlarged subsidy for higher education from the public purse may

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<sup>48</sup> Such as X. Sala-i-Martin, G. Doppelhoffer and R. Miller, "Determinants of Long-Term Growth: A Bayesian Averaging of Classical Estimates (BACE) Approach", *American Economic Review*, 2004, 813-35.

<sup>49</sup> With the establishment of the National Economic Development Office in 1962, and the Department of Economic Affairs in 1964 (which issued the National Plan in 1965).

<sup>50</sup> The National Plan's funeral obsequies are generally dated to July 20, 1966.

<sup>51</sup> A. Wolf, "Does Education Matter?: Myths About Education and Economic Growth", Penguin, 2002.

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be argued on non-economic grounds, but the economic case is as yet far from proved<sup>52</sup>. (It is wrong to think that raising the proportion of school-leavers that go to university, whatever they study there, must *automatically* raise the economic growth rate). In the case of specialist training, and even more so school-age education, however, the case is stronger – and so are the statistical links.

Aggregate demand can respond quite quickly to monetary or budgetary stimuli from the authorities, with maximum impact on aggregate output in perhaps a year or so. But supply-side measures can operate far more slowly. Many changes in the relation between taxed unemployment benefit and taxed wages in work, and in the legal rights and liabilities of unions, were enacted in the 1980s for example; but they appear to have borne most fruit, in the form of secular reductions in unemployment, during the 1990s, some ten years on.

## 1.5. Looking Forward: Some Key Observations

Any prediction of Britain's aggregate real GDP growth in future years must recognise the fact of a constant historical annual trend of 2.5%. That must be the starting point for any growth forecast. What arguments are there for departing from this number for the next fifteen years?

On the *positive* side, labour force growth could accelerate with any further rises in participation by the retired. Pension worries might also lengthen hours at work among younger workers. Further gains could arise from raising Britain's ITC (information technology and communication) capital per worker towards the higher figure it has attained in the United States, renewed progress towards freer international trade, and relief of the serious bottlenecks now apparent in transport and real estate that are impeding economic growth. Furthermore, Continental Europe's three largest economies, which absorb nearly a fifth of Britain's exports, are more than overdue for a spell of faster expansion, and the fact that their unemployment is, since the 1950s, at historic highs suggests that they could sustain it for a while. All these are possibilities.

There are also *downside* risks to growth over coming years. Although they display substantial slack at the moment, it may well become harder, in the longer run, to keep outpacing our major trading partners, the larger countries in western Europe, where trend growth rates now appear to be about 1.5% per year. Britain's rising tax share of national income, coupled with budget deficits that imply this trend could well continue, may deter risk-taking, effort at work and direct investment from both domestic and foreign sources, thus exerting negative impact on growth.

At the international level, the recent acceleration in world economic growth has much to do with the rapid expansion, and rising shares in world output, of India and China. This reflects their release from anti-growth policies fifteen to twenty years ago. They are now climbing rapidly, towards what will ultimately, in perhaps four generations, approach something close to advanced-economy status. But their growth rates are likely to fluctuate around a *declining trend* during this climb<sup>53</sup>. China's and India's expansion, while in progress, does not add to growth everywhere (especially not in countries with similar trade patterns), but its overall impact for growth on an "average" country, and on the UK, should on balance be favourable<sup>54</sup>. As Sino-Indian imports mature and expand more slowly, the repercussions these countries have on British growth will probably become increasingly unfavourable.

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<sup>52</sup> For an excellent recent analysis of some of these issues in the US context, see "Admission, Tuition and Financial Aid Policies in the Market for Higher Education", by D. Epple, R. Romano and H. Siegi, *Econometrica*, 74, 2006, 885-928.

<sup>53</sup> The farther a country below the world's peak in GDP per head, the faster – all else equal – it should grow towards it. This "asymptoticity" property is implied by models of intertemporal choice (such as N. Stokey and R. E. Lucas with E. Prescott, *Recursive Methods in Economic Dynamics*, Harvard University Press, 1989) and evidence of catch-up (R. J. Barro and X. Sala-i-Martin, "Convergence" *Journal of Political Economy*, 100, 1992, 223-51).

<sup>54</sup> See, for example, arguments presented in S. A. Heffernan and P. Sinclair, *Modern International Economics*, Blackwell, 1990.



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Domestically, we see growing strain on higher education, water supply, sewerage and public transport; the imminent exhaustion of Britain's natural gas fields; fears of crumbling educational standards; an ageing population, with potential labour squeezed inexorably, especially after 2015-2020, by the twin forces of increasing longevity and reduced fertility; increasing regulation and diversion of expenditure from productive investment to unproductive bureaucracy; and pressures on the public finances from continuing rises in longevity. All these pose downside risks for any medium term growth forecast.

## 1.6. Supporting the Key Drivers of Growth

Output depends upon inputs, and the efficiency with which they are combined and deployed. Growth in output can be split into three components: changes in demand relative to potential supply; changes in potential and actual supply due to increased inputs; and greater efficiency, or "total factor productivity" (TFP).

The first of these can matter in a brief period, when you start with substantial slack in the economy. But with unemployment in 2007 close to its post-war average, Britain's trend growth rate over coming decades will be affected only trivially by this. The priority, as far as demand is concerned, must be to try to keep it growing *steadily* with appropriate adjustments in monetary policy instruments, ideally delegated. Pumping up demand, if it affects long run growth at all, probably only damages it.

The second source of growth in output, over an interval of time, is additions to inputs. Essentially this means some combination of two things:

1. Rising labour force participation, longer hours of work, or increases (through demographic change and net migration) in the working-age population, all of which raise the economy's inputs of labour services.
2. Net investment, rises in the economy's stock of aggregate capital.

It is difficult to know the impact of immigration on the rate of growth of GDP *per head*, as there is a complex interaction between migration levels, and the changes to the capital in the economy that accompany it. Section 2.1 looks at the quantity of labour and how it may grow in Britain, and Section 3.1 does the same for capital.

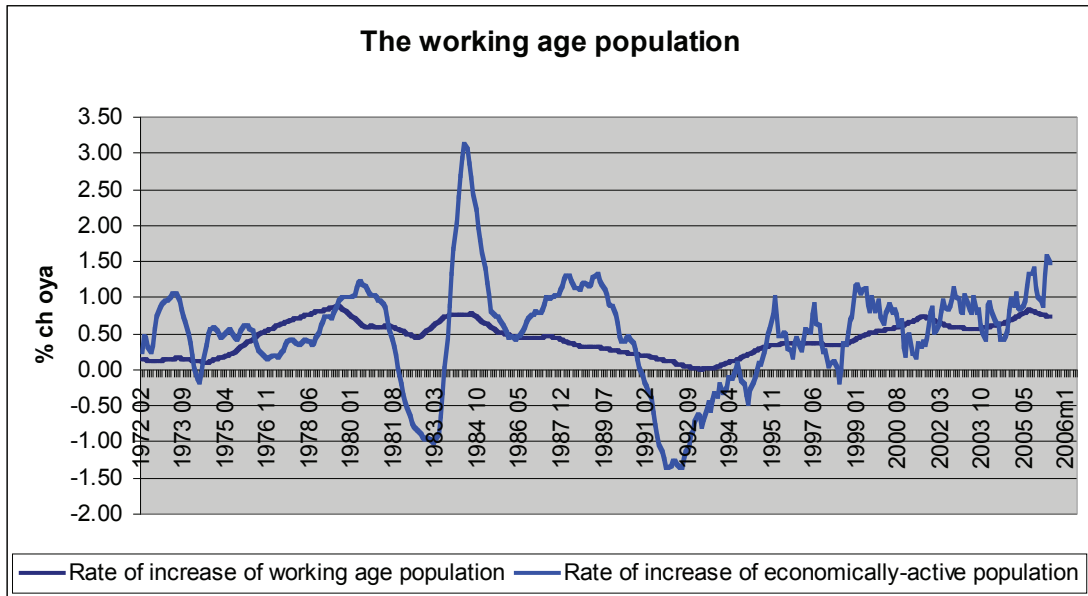
Increased efficiency, or total factor productivity, can occur in quite a variety of ways. One is to transfer inputs across firms or industries, from less to more productive or highly valued uses. Continental Europe boosted its early post-war growth, for example, by moving resources from agriculture to industry – something from which the UK had reaped gains much earlier. Finance also plays a key role here. So does the removal of barriers to international trade, such as tariffs or quotas on imports: there is expanded production in export industries where its comparative advantage lies. The long-awaited abolition of grossly wasteful agricultural protection, in the US and Japan no less than the EU, would provide a major fillip of this kind, and alleviate poverty in many developing countries as well. TFP could also be raised in the UK by successfully tackling the public sector productivity problem. Another way of raising TFP involves disseminating best-practice technology from leading to lagging plants and firms. (Dissemination can cross political borders: hence one of the attractions of inward foreign direct investment). A third takes the form of improved infrastructure, or cheaper or more efficient inputs such as transportation or electricity, which increases value added in businesses benefiting from them. A fourth consists of cutting costs through innovation (finding cheaper ways of making existing products). Then there is product innovation – first inventing, and then producing, something new, with a superior set of characteristics, which offers buyers better value for money than existing goods on the market. And finally there is education, training and the gains from experience at work, all of which should – in principle – tend to enhance the quality of the tasks labour performs.

## 2. The UK Labour Market: Current Issues

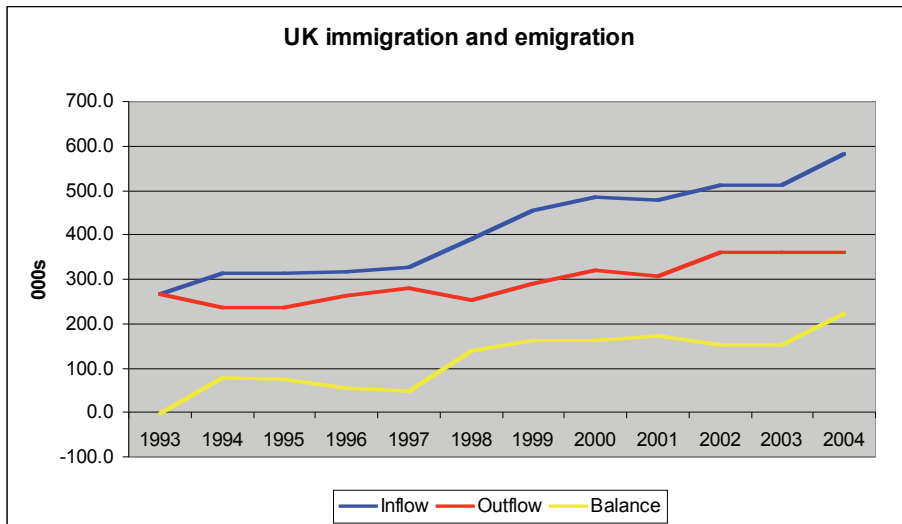
### 2.1. The Quantity of Labour

The growth rate of the economically-active labour force has risen recently to a historic high of around 1.5% a year, from about 0.65% on average in the second half of the 1990s. As Graph 1 shows, this reflects faster growth in the working-age population, and increased activity rates. The main recent influences on labour supply growth have been immigration and rising activity, both of people of normal working age, and in some cases of older people<sup>55</sup>. These are discussed below.

Graph 1



Graph 2



### 2.2. Immigration

The rate of net immigration into the UK (the number of immigrants minus the number

<sup>55</sup> In the past couple of years, there has been no trend in average hours worked per week.

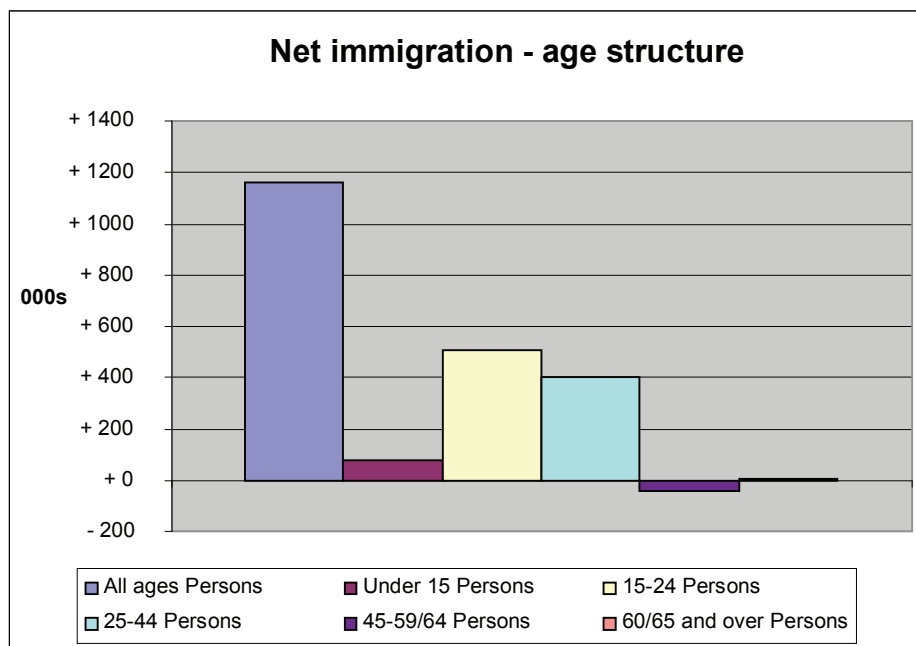
of emigrants) has increased very sharply in recent years. Graph 2 shows the figures up to 2005. Net immigration has risen from around 50,000 a year in the mid-1990s to 235,000 in 2005. 2004 was the year in which the EU was enlarged.

It became possible for citizens of the new EU countries to move to the UK and work here. Since May 2004, when the EU was enlarged, a total of 427,000 people from new EU countries (Poland in particular) have registered under the Home Office Worker Registration Programme. The net inflows of arrivals from the ‘New Commonwealth’ and from ‘other countries’ (outside the EU and the Commonwealth) have also risen greatly since the mid-1990s. Of course, many of those may by now have left the UK, and there is as yet no official estimate of the number of people from new EU countries are currently working here (though there is a recent admission that it may be as high as 600,000).

As Graph 3 shows, net immigration in the years 1998-2004 has brought the UK people overwhelmingly of prime working age: there were very few under-15s or over-45s. A large pool of labour in eastern Europe may remain available to the UK. The gross flow of immigrants from the countries joining the EU in 2004 has been maintained, even though the demand for labour in the UK has weakened. This represents a qualitative change in the UK labour market, somewhat like the advent in West Germany in the 1960s and 1970s of Gastarbeiter from Southern Europe and Turkey.

### 2.3. Increased Participation in the Labour Market

**Graph 3**



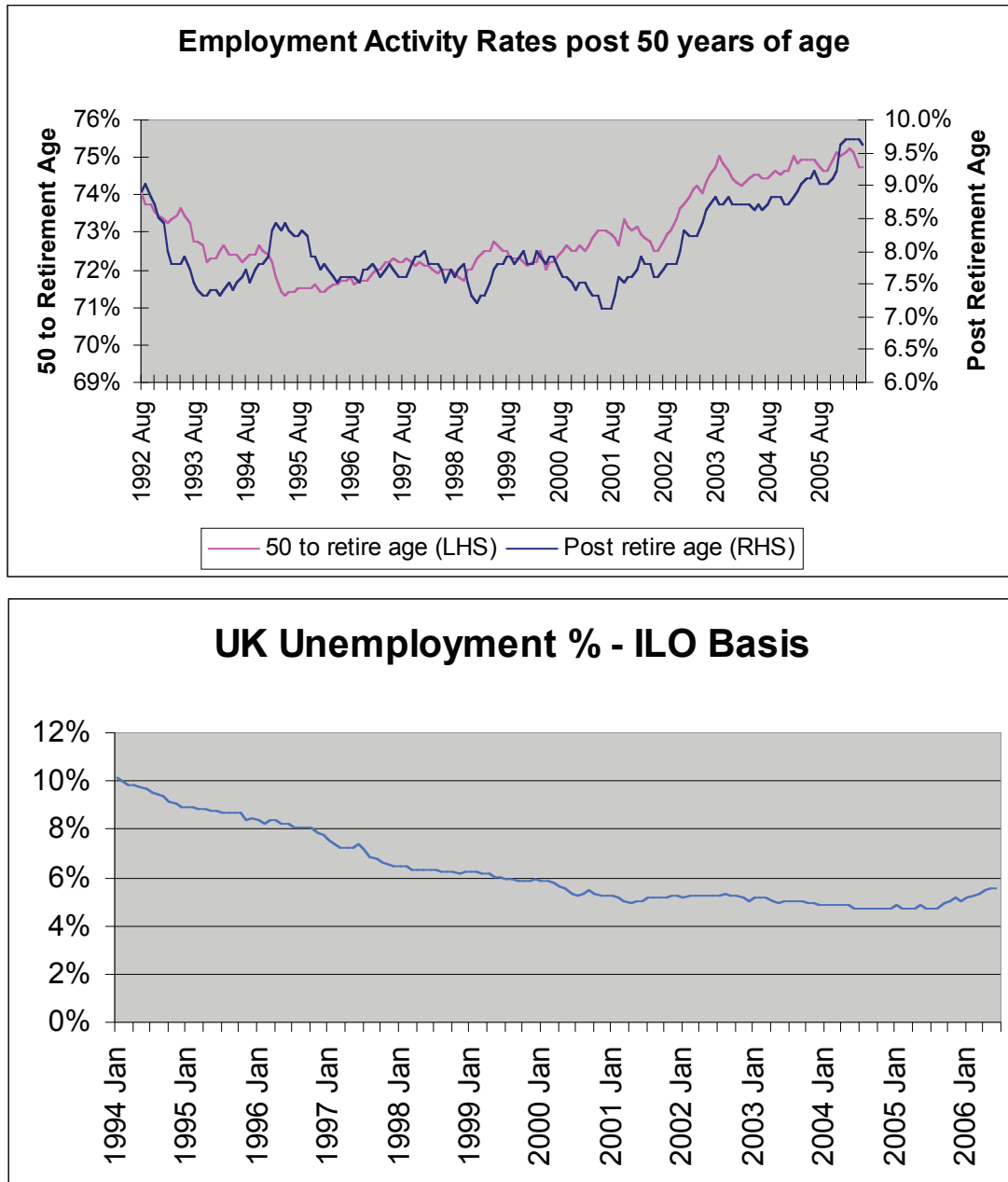
Another big change in the labour market has been the tendency of older people to retire later. The percentage of over 50s who retire before the normal retirement age (65 for men, 60 for women) is falling, and the percentage who go on working after it is rising. These trends are illustrated in Graph 4. Reasons may include better health, and anxiety about the adequacy of pensions. These influences, too, seem likely to persist. So the recent faster growth in the labour force available to the UK may well continue.

### 2.4. Consequences of Faster Growth of the Active Labour Force

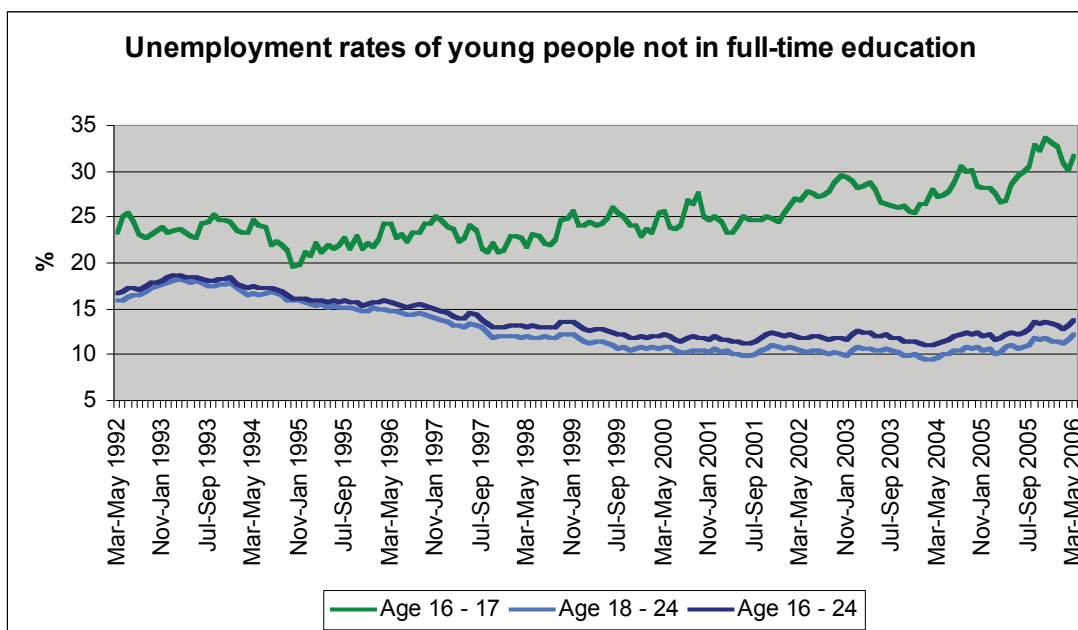
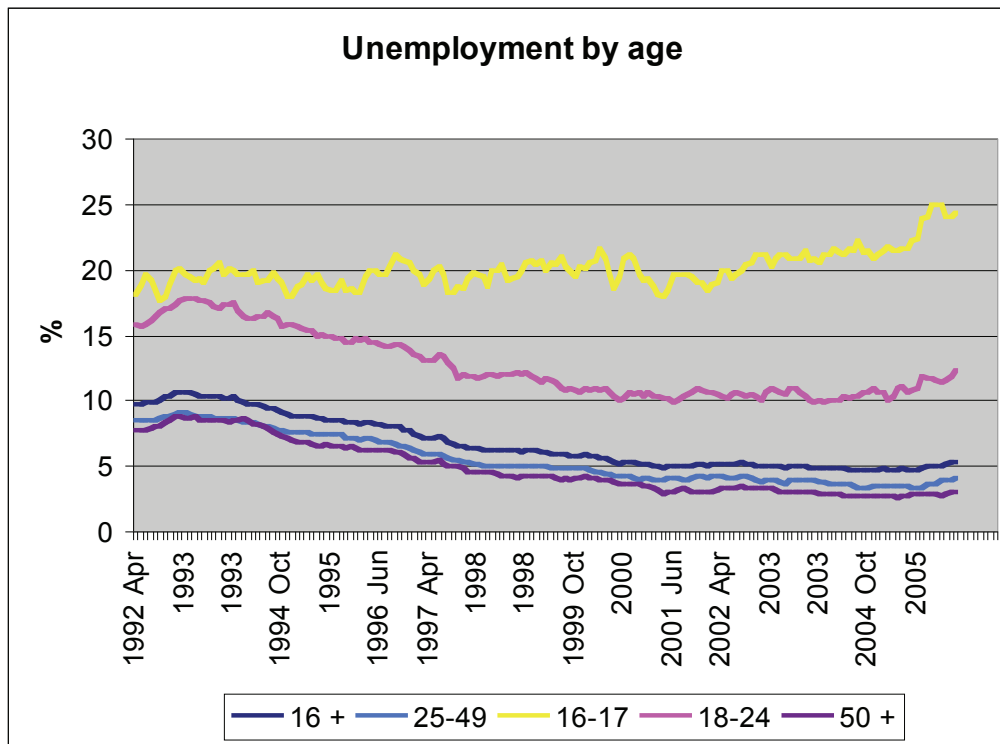
The increased availability of labour has had a powerful effect on the UK economy. Above all, it has enabled a combination of economic growth and low inflation to be sustained with much greater

success in the UK than, for example, in Continental European countries which have postponed extending the free access of people from the new EU countries. A quickening of the growth rate of the labour force of the kind that the UK economy is experiencing implies faster growth in the economy's supply capacity. It need entail no increase in unemployment, provided aggregate demand expands quickly enough to absorb the additional supply. And these immigrants, often skilled and well educated, will help to meet shortages in particular parts of the UK labour market.

**Graph 4**



In fact, unemployment has risen somewhat over the past year or so, after a long period when it was flat at historically low levels. Worse, the rise in unemployment has been disproportionately large among the young. It is not surprising that the level of economic inactivity is higher among young people than in the population as a whole, because many of them are being educated, but the rise in unemployment among youths not in full time education is disturbing.



What is the explanation, and what are the remedies? The problem might be purely temporary. It may result from a cyclical economic fluctuation, and vanish as the economy develops. But it could be that the unemployed lack the skills needed to hold down a job. With increasing globalisation, the demands of the labour market in high-income countries like the UK are becoming tougher, and a growing proportion of young people may be unable to meet them. If so, the remedy is training.

## 2.5. The Quality of Labour

The UK is a relatively rich country. However, it will be able to remain relatively rich in the long run only if the quality of labour in the UK is commensurately high. The table below shows gross national income per head in 2004 across a range of countries, measured in US\$<sup>56</sup>.

<sup>56</sup> These figures are converted at currency exchange rates prevailing in 2004. When adjusted to reflect differences in purchasing power, such data have always shown markedly less dispersion, partly because housing and services are

Country	Gross national income per head, US\$
UK	33,630
France	30,370
Germany	30,690
Poland	6,100
USA	41,440
South Korea	14,000
China	1,500
India	620
World average	6,329

As globalisation proceeds, labour in the UK must increasingly compete with labour in much poorer countries, notably China and India, where, as the table suggests, wages are far lower than in the UK. The gap will be closed mainly by wages in poor countries rising, rather than by wages in rich countries falling: for example, industrial wages in China have been increasing at around 14% a year, while inflation in China is quite low. Nevertheless, the adjustment process will be long and there are likely to be many transitional problems. In particular, there is a serious issue about whether the quality of labour in the UK will be adequate to enable us to maintain high living standards in years to come. The OECD's Programme for International Student Assessment (PISA) study for the year 2000 compared the proficiency of 15-year-olds in a range of subjects across OECD countries<sup>57</sup>.

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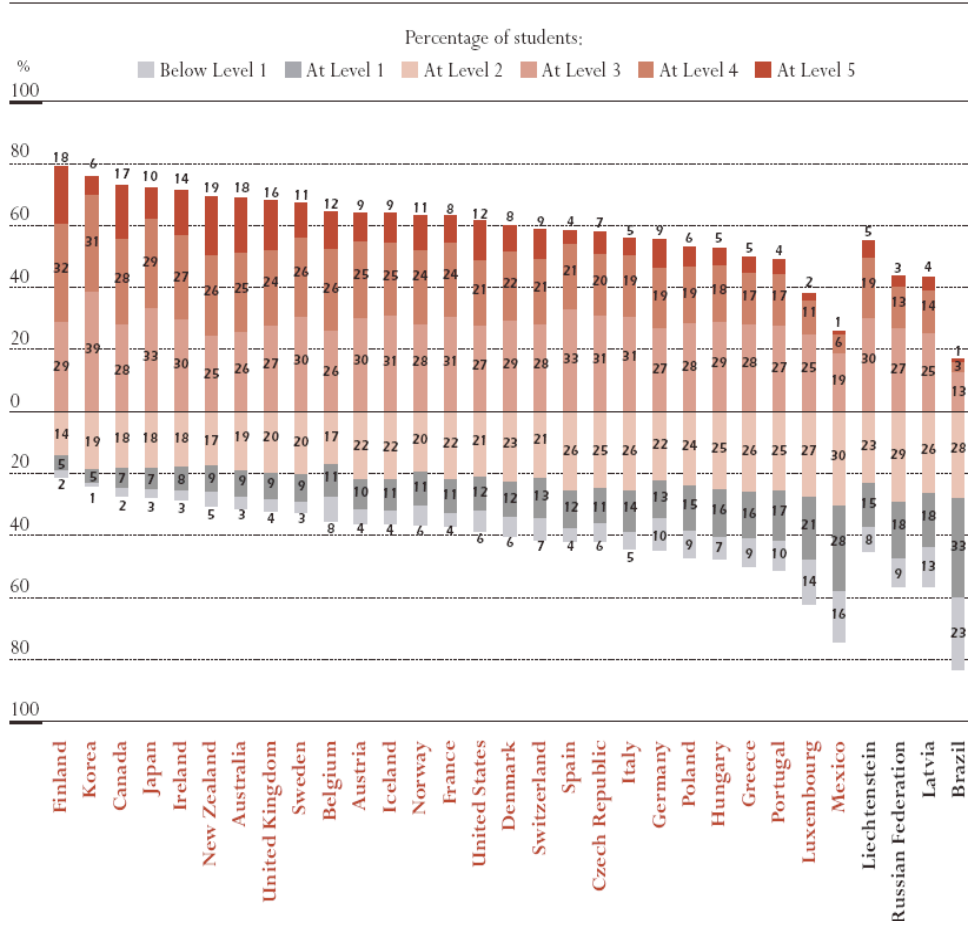
typically far cheaper in poor countries. But high quality data sets that make such adjustments have yet to calculate figures for years as recent as 2004.

<sup>57</sup> There was another PISA study in 2003, but the UK failed to meet the technical criteria for participation.



**Graph 8**

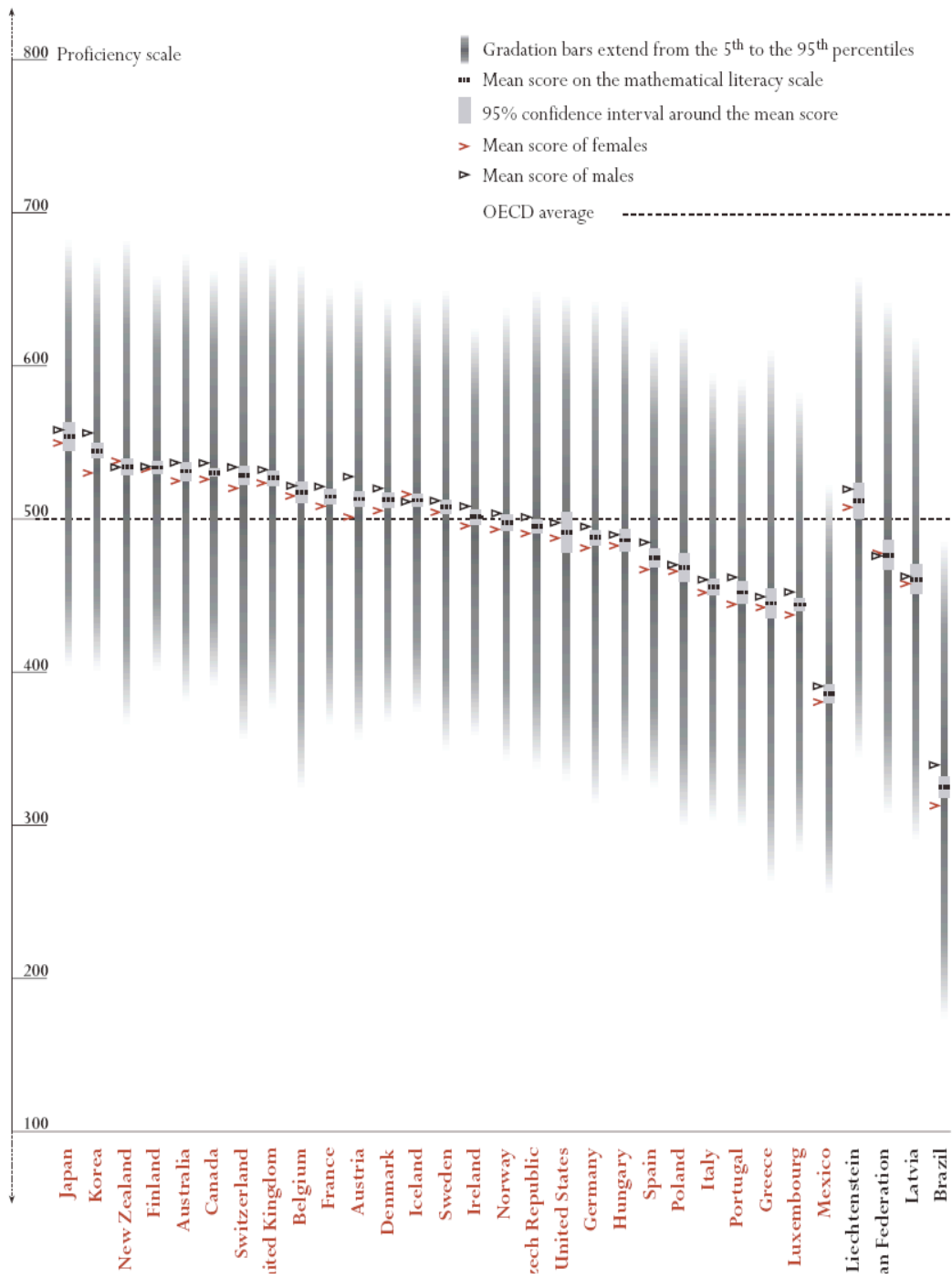
Percentage of students performing at each of the proficiency levels on the combined reading literacy scale



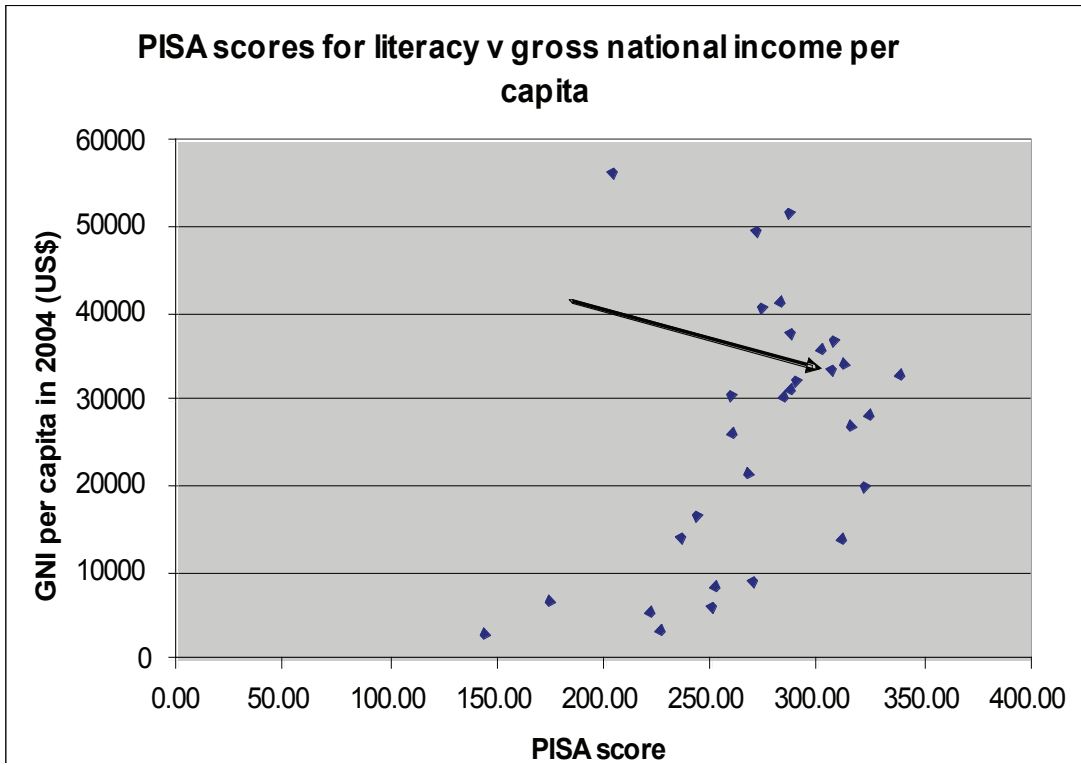
Graphs 8 and 9 summarise results for literacy and mathematics. They suggest that UK students are in the upper half of the OECD range, but also that they are not outstanding by OECD standards. There are several countries which have higher PISA scores but lower incomes than the UK. So the PISA results provide no reason to think that wages in the UK can be sustained at much above the OECD average, which, as the charts show, includes much poorer countries like Korea, Poland, Hungary and the Czech Republic. Graph 10, depicting the relationship between PISA scores and gross national income per head, illustrates this point. The point representing the UK is arrowed in Graph 10. In addition, the CBI has expressed concern about the quality of the people emerging from the UK’s education system, and has been lobbying for higher quality training. This suggests that education has to be a major priority of future UK governments.

**Graph 9**

Distribution of student performance on the mathematical literacy scale



Graph 10

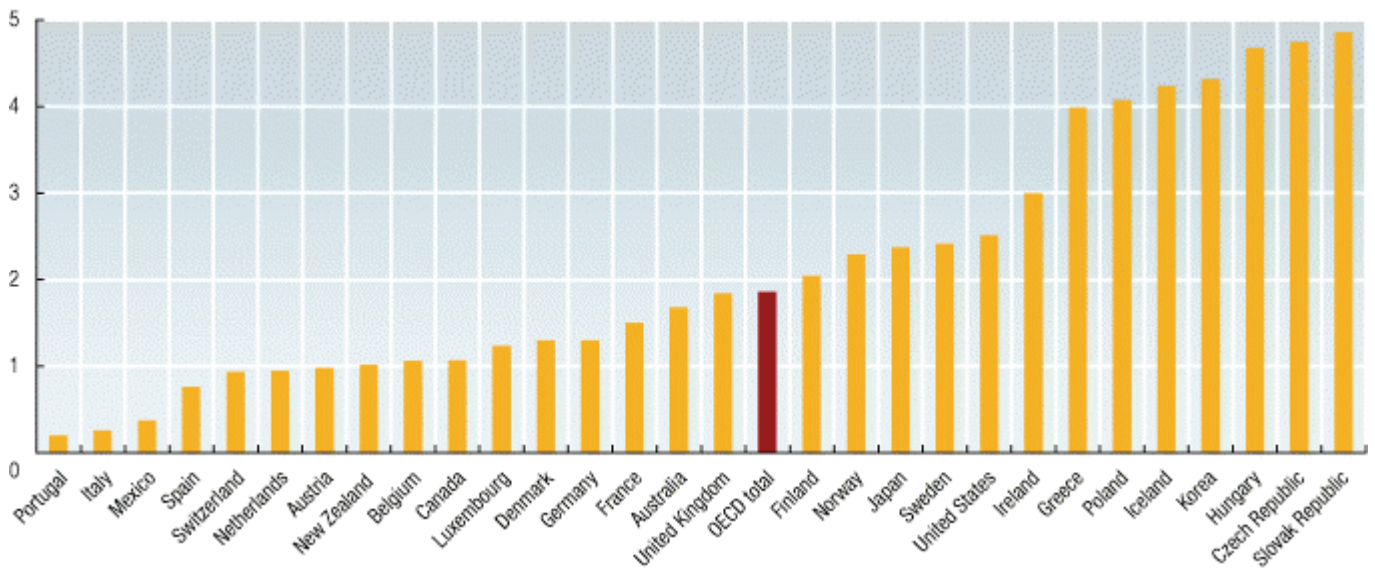


### 3. Capital and Other Non-Labour Outputs

#### 3.1. Investment in the UK

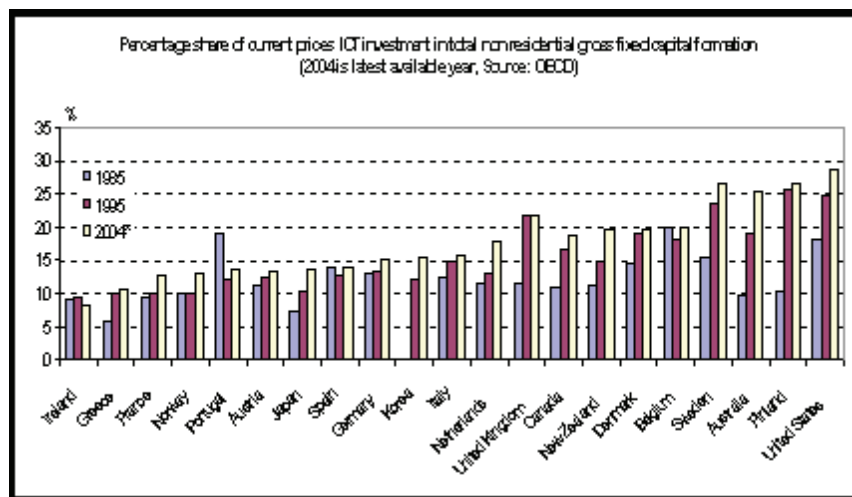
Productivity per hour grew at just over 2% per year from 1995 to 2004, slightly ahead of the OECD average. While it rose much faster than in Germany, and slightly faster than in Japan, France and the US outperformed the UK here. And the gap behind Ireland, South Korea, and four of the accession countries was really large. Lukewarm productivity growth can be explained by a number of factors, among them slow growth in capital.

**GDP per hour worked**  
Average annual growth in percentage, 2000-2005

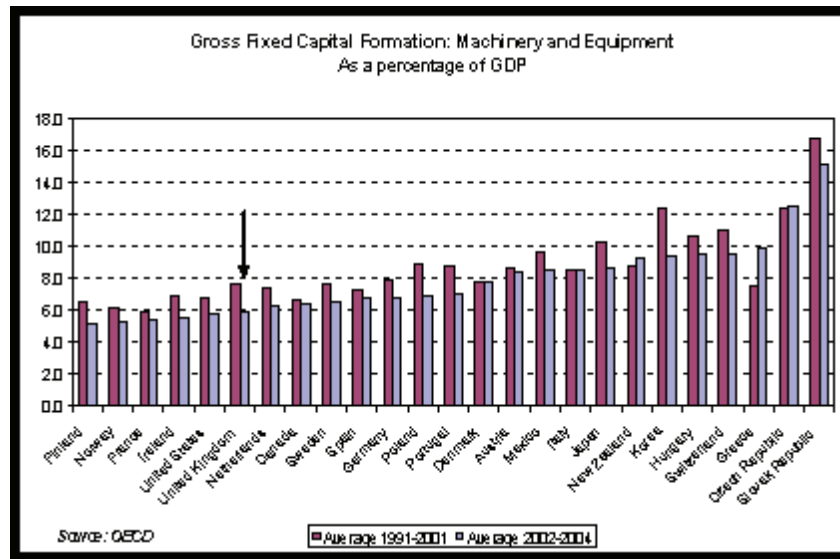


Source: OECD

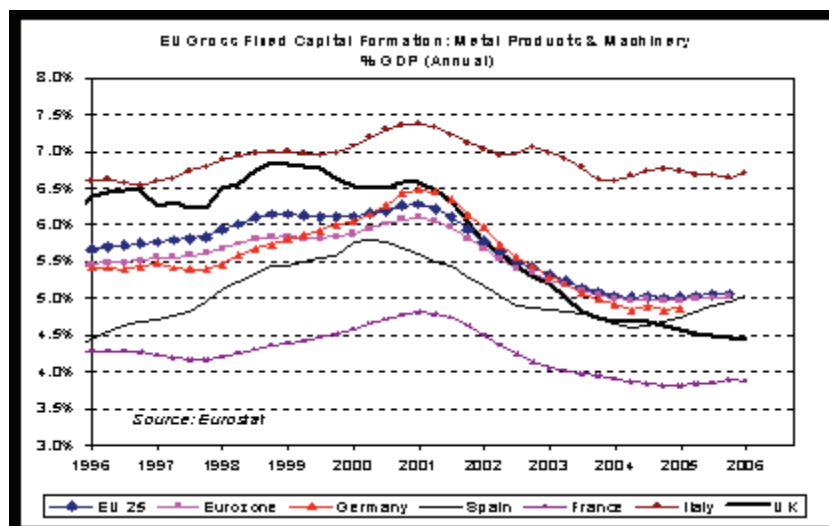
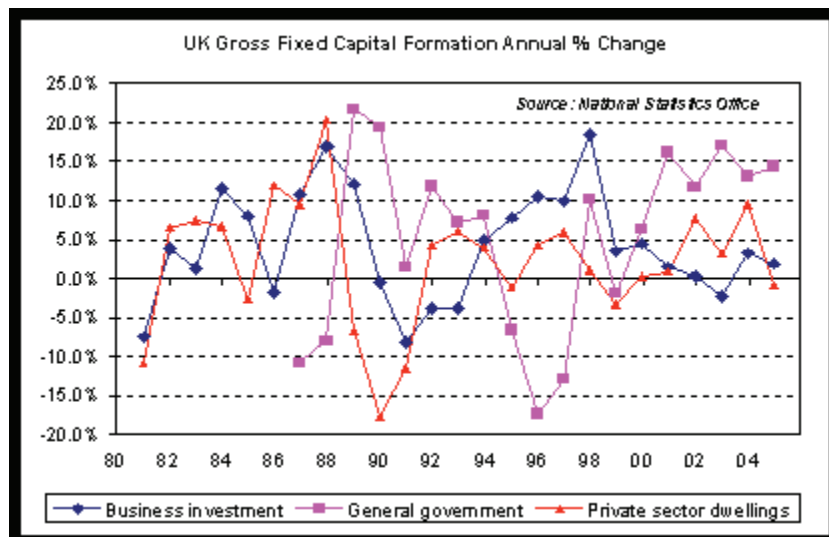
In theory, in the very long run, aggregate capital would be expected to increase at the same speed as aggregate output, and the common rate at which these two grow is implied by the sum of labour force growth in numbers of employees and hours, and labour productivity growth which reflects the quality of that work. But over decades, or shorter periods, capital can grow faster or slower than this sum. The *quality* of investment may be changing. The UK's share in information and communication technology (ICT) is higher than the OECD average. ICT has also a healthy share (over 20%) in total non-residential investment.



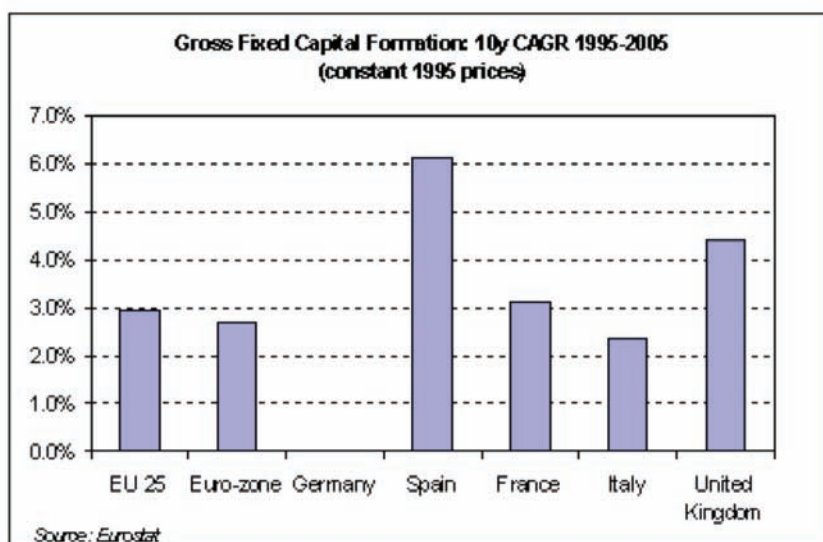
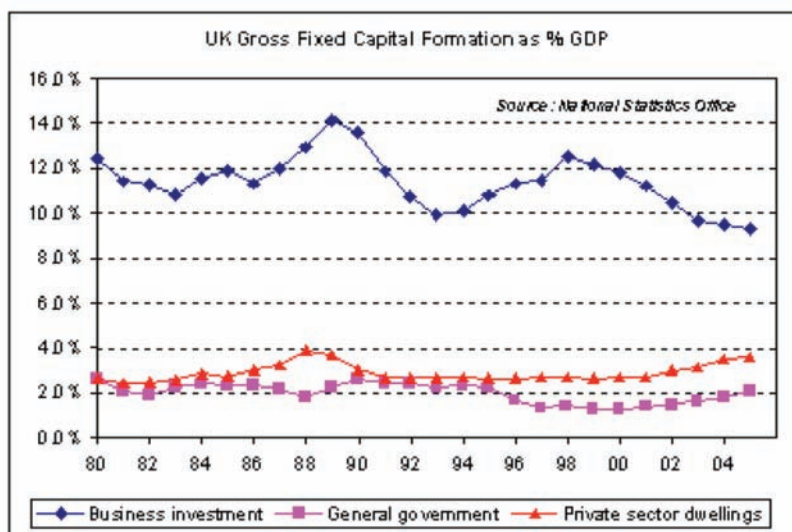
However, UK investment in machinery and equipment as a percentage of GDP fell in 2002-2004 when compared to the decade before (1991-2001), and is at its lowest point since records began. The share of business investment in GDP is also lower than most countries in the OECD, except the United States, Ireland, France, Norway and Finland (see chart).



Moreover, the proportion of national income spent on equipment investment is one of the lowest in the EU. Business investment has shown virtually no growth in the last decade, although this might also reflect price declines for capital goods (see below).



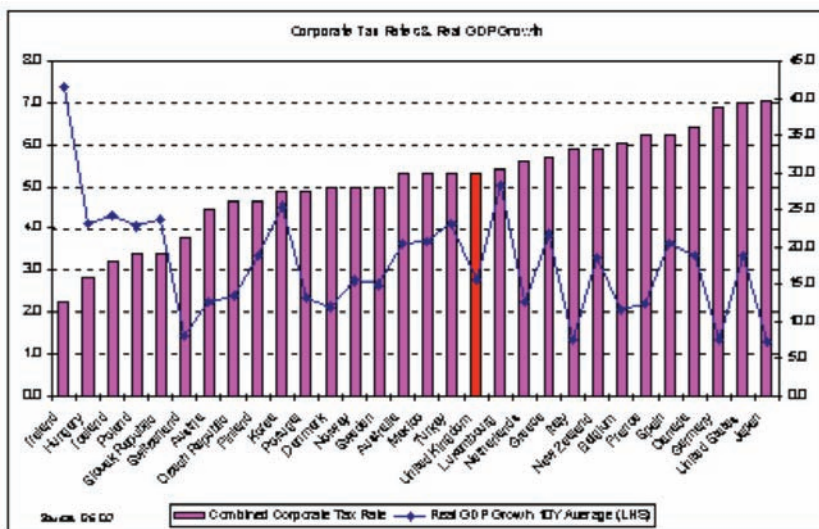
While business investment has dropped as a share of GDP, investment by general government and in private sector dwellings has gone up. Overall, in the past decade, Britain's gross fixed capital formation has risen faster than the EU average, and much more quickly than in Germany, where it stagnated.



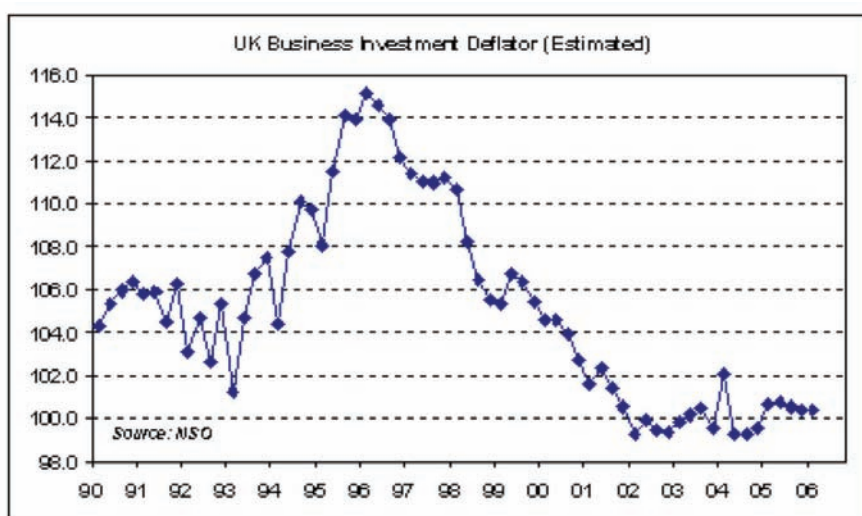
One possible reason for relatively low business capital growth is taxation. When saving is eventually flexible enough to tie down the after tax return on capital in the long run, a tax on capital falls ultimately on labour. What taxes like capital gains tax, corporation tax and inheritance duties really do, in the end, is squeeze the aggregate stock of capital in the country that levies them, with unambiguously negative implications for long run consumption, output and wages. And in the globalised world where capital can be moved over borders, “in the end” can mean “rather quickly”, as Ireland’s experience suggests.

This line of thinking provokes a question. Are corporation tax rates and growth rates negatively associated, when we look across a wide range of advanced countries, and a reasonably long period of time? The chart below provides a clear answer. Indeed they are. Ireland grows at 7.4% per year (the blue curve with diamonds) and levies corporation tax (CT) at little over 10% (the mauve bars, with rates on the right hand axis). At the other end, Japan tops the list on corporation tax at nearly 40%, and grows slowest (1.3%). There is the odd explicable aberration – the US grows quite fast, despite high CT – but this is due to its exceptionally rapid immigration.

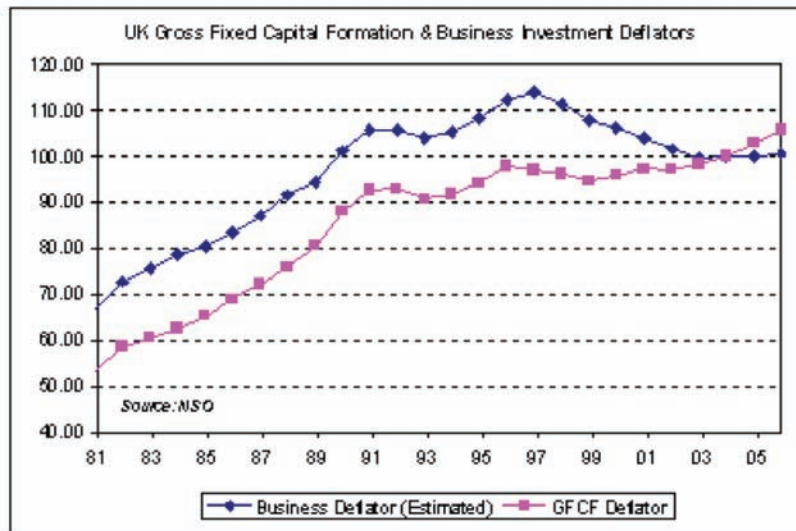




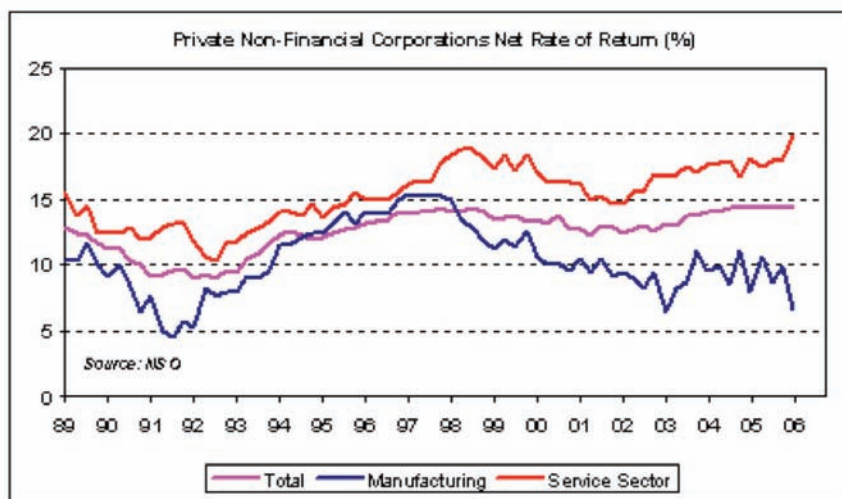
The idea that reducing taxes on capital helps labour in the long run is hard to put to electors. So political considerations may explain why it has not been done. But it is worth emphasising that the damage a tax does is roughly proportional to the square of the rate at which it is levied. That implies that halving capital tax rates would reap about three quarters of the benefits of abolishing them. Corporation Tax, nearly all of it levied at 30% but qualified by various deduction provisions, yielded £37.9 billion in Britain in 2005, while the gross operating surplus of corporations was £273 billion that year. This makes the case (investigated by the Forsyth Tax Reform Commission) for transition to a flatter corporation tax at a low rate, levied on all gross operating surpluses with fewer deductions.



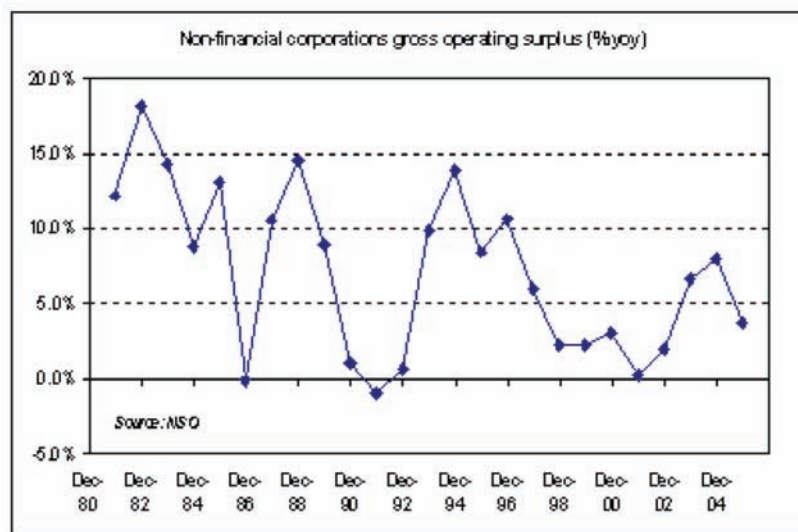
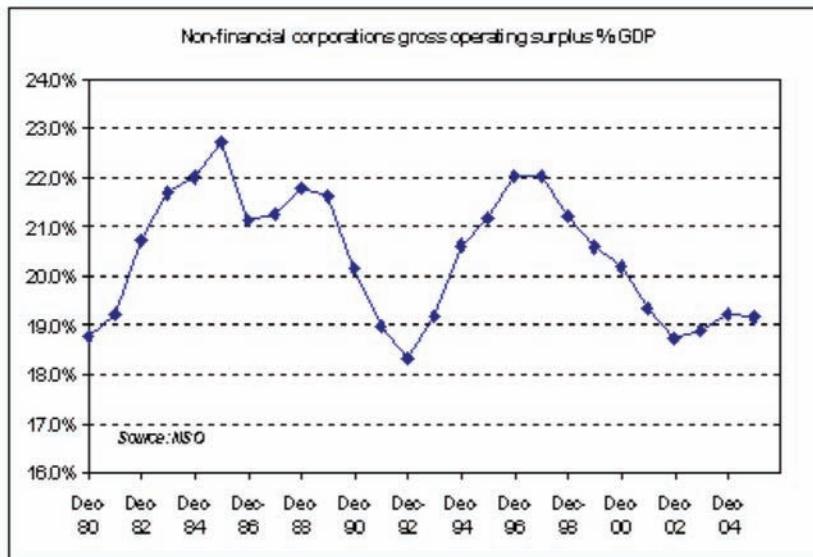
The next charts depict other salient features of investment in Britain. The prices of capital goods have tended to slip in recent years, especially for business investment. Computers are responsible for this: like for like prices have been declining by 30-35% per annum for decades, and their growing importance in corporate investment spending turns the deflators down after 1996. But for GFCF overall, which includes the value of new dwellings constructed, the trend in prices has been positive.



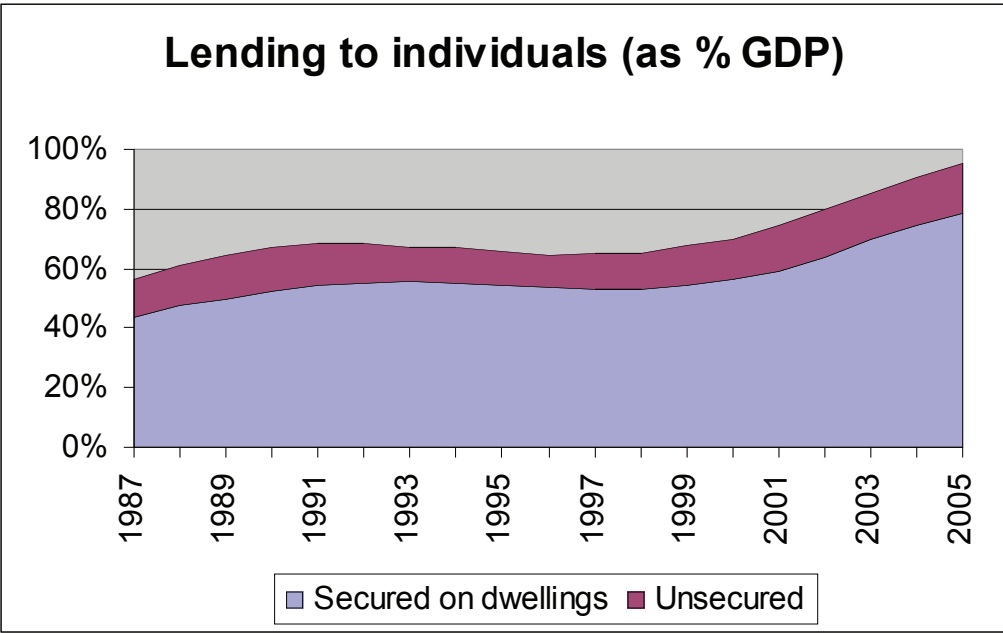
Falling capital goods prices might help to explain why Britain's overall investment figures have been weak: anticipation of future falls encourage delay. *Lower* capital goods prices imply more investment; *falling* capital goods prices imply less. The next chart shows what has been happening to rates of return in Britain's non-financial corporations: overall (pink curve), a dent in the early 1990s recession, recovery after exit from the ERM, and little change since.



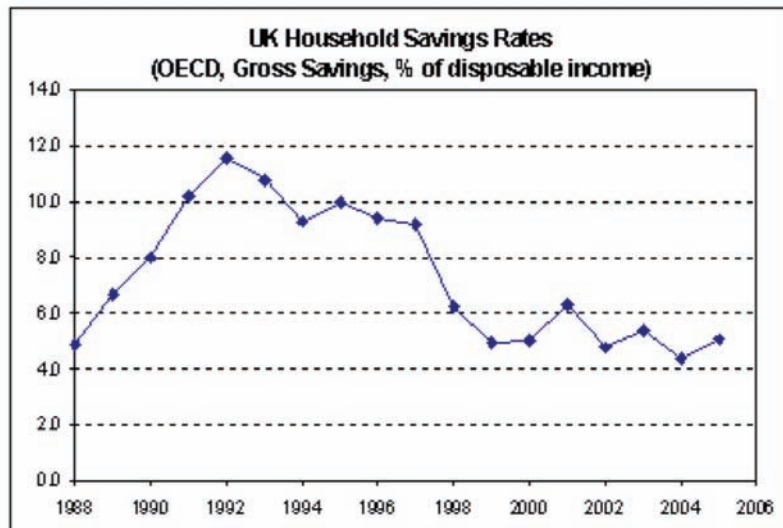
But note the sharply divergent experiences of services (red) and manufacturing (blue). The rate of return in the latter has halved since 1997-8. A similar story is evident in the next slides, which show non-financial corporations' gross operating surplus, first as a share of GDP, and then in annual growth rates. Declines in both for much of the past decade are all too plain. If tax and other factors make capital expensive, and profits are weak and sliding, investment is bound to falter.



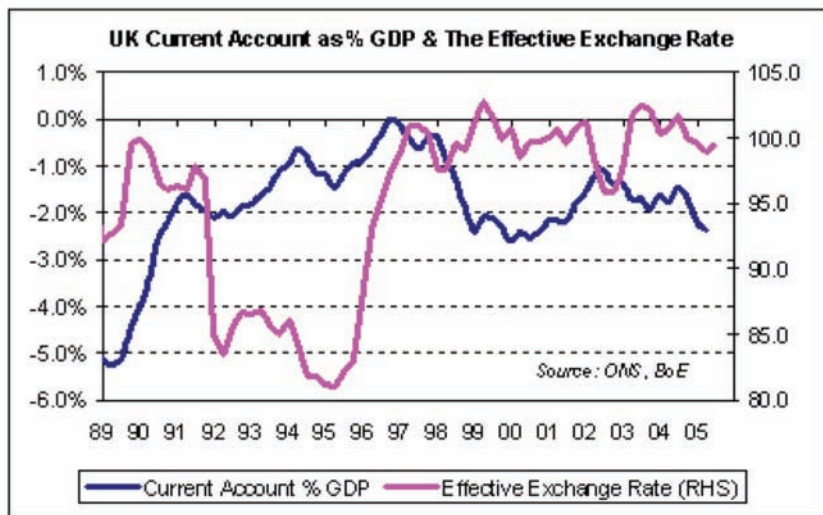
If business investment has been pallid, Britain’s housing markets have swelled with activity. The next charts depict two features of this – the rising ratio of dwelling-secured borrowing by individuals to GDP, and its growth year on year, in comparison to unsecured consumer credit, which boomed in the dying days of the last century and has receded in this. Further aspects of the UK housing market are explored below:



Britain saves a smaller share of its national income than most countries – and, on most criteria, a much smaller share than it should. High taxes on capital are part of the story. Part of the reason is that so much housing investment is sustained on mortgage, where the loan counts as negative saving. Then there is the belief on the part of many people on low incomes that governments will rescue them, as they have in the past, by additional welfare payments for retirees with next to no assets. What is of particular concern is the fact that although investment has been weak overall, saving has been even lower.



Witness Britain’s large current account deficit (the blue curve in the next chart - which reflects the excess of investment over saving).



Corresponding to the current deficits is the rising share of British equity owned outside the UK, depicted in the next chart. Foreigners have not just been buying UK shares; they have also invested directly in the UK. In the world as a whole, the UK is a major source, as well as destination, for foreign direct investment, as the next charts show. This is a healthy development.

There is no magic wand a British government can wave to make capital suddenly grow faster or more productively. Creating an environment where that can happen, given appropriate circumstances, is like planting a forest – a gradual process, beset by risks. You can cut trees quickly, but growing them takes time. There are several types of bad policy, which could expel capital or prevent its formation: high rates of corporation tax is a prime example, as are frequent changes in regulations that create uncertainty, or indications that government is far more interested in buying quick votes than ensuring the economy’s long term health. A pro-capital growth tax regime would see some shift in the tax burden away from income, especially capital income, towards consumption spending<sup>58</sup> (especially

<sup>58</sup> Useful steps towards this objective could be taken without any change in the standard rate of VAT: some switches from zero-rating to exemption, for example for food processing industries; a very stiff “supervat” on anti-social goods such as chewing gum, short life light bulbs, plastic packaging and bottles, aerosol spray cans, lighters, matches, sugar, musical amplifiers and junk mailing fees; and internationally coordinated charging of VAT on air journeys, and of fuel duty on airlines.



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ecologically and socially unfriendly consumption spending); and revenue-neutral steps to flatten, simplify and broaden the base for corporation tax, ideally followed by a further reduction in its rate. The Chancellor has acknowledged the dangers of the UK's high Corporation Tax rate by his proposal to cut it from 30% to 28% in 2008.

### 3.2. Other Financial Obstacles to Growth

Some other items of concern in the area of financial policy bear on economic growth. One is the high level of management fees levied on many financial products. In the case of non-tracker ISAs, for example, such fees erode much of the benefit from their tax-sheltered status. Fund managers claim that their superior expertise yields superior performance. Evidence does not support this. Some gaps between rates of interest on lending and saving products are justifiable on the grounds of marginal operating cost and risks, and a wider margin has the advantage of helping to promote financial stability. This said, modern models of economic growth imply that this gap *unambiguously lowers economic growth prospects indefinitely*. Then there are the foreign currency conversion commissions and implicit charges, usually amounting to 7%, and sometimes still higher, even on heavily traded US dollars and euros<sup>59</sup>. These are far above such fees set in most other countries, and can only deter foreign tourists; hamper commerce; and impair the various knock-on effects trade brings to growth.

Finally, it would be useful to have an independent study of the costs and benefits of the anti-laundering regulations hurriedly imposed on banks in most countries after September 11, 2001. Initial impressions from industry specialists are that these have done much more harm than good. Economic growth can rarely happen without flows of funds. Where these regulations have blocked innocent financial transactions, they will undoubtedly be reducing the prospects for economic growth not just here, but worldwide.

### 3.3. Infrastructure

We have already explored housing, in 5.2 above. There are also other ways in which infrastructure may aid or hamper growth. One concerns transport. Communist states set prices without much reference to market demand. That error contributed in the end to their widespread demise at the end of the 1980s. In Western economies, prices have the job of matching demand with supply. Sometimes they perform that task imperfectly. Information deficiencies, monopoly and third party effects ("externalities") are three main reasons why that can happen. But in an industrial democracy such as Britain prices play a vital role in allocating resources with reasonable efficiency in most areas of the economy. When supply exceeds demand at a zero price, as can happen, the good in question should be free. But when the price is zero and demand exceeds supply, you get trouble. There has to be some form of rationing. Usually this means queues, time wasted, higher costs, slower growth. And in no part of the economy is this more apparent than in Britain's roads.

### 3.4. Energy and Competitiveness

Transport is energy-intensive; energy is used to construct and operate capital goods, and is a critical input into the production of almost everything. Furthermore, reserves of fossil fuels (still the dominant source of energy for the UK and other countries) constitute a natural asset of immense, if volatile, value. Energy security is thus also a matter of competitiveness for UK industry, inasmuch as long term decisions are highly sensitive to the expectation of the price of energy inputs. It is therefore highly fitting that the final part of this section is devoted to exploring some of the main links between energy and competitiveness in the British context.

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<sup>59</sup> It is also odd that the UK still lacks specialised ATMs that can dispense cash in foreign currencies. The technology that allows this has been in use in some cities on the Continent for over 20 years.



There are four key points here that merit special emphasis:

1. The UK is fast losing its energy independence;
2. The UK is becoming dependent on Norway and Russia for imports;
3. The recent severe squeeze was short-lived, but structural issues remain;
4. The decisions on hydrocarbon dependence could have big competitive implications.

Overall UK energy consumption has only grown slowly, by less than 1% per annum, over the last decade. The end of the 20<sup>th</sup> century saw a mix shift, as the UK ‘dashed for gas’ away from coal, though this has stabilised since 2000, leaving gas as the largest energy source, providing 37% of the total, just ahead of oil. Overall, hydrocarbons are utterly dominant, supplying over 90% of the energy requirements.

	1994	2000	2004	Share of 2005 Total	CAGR 1994-2000	CAGR 2000-5
Natural Gas	57	87	85	37%	7.2%	-0.5%
Oil	83	79	83	36%	-0.8%	1.0%
Coal	50	37	39	17%	-4.8%	1.2%
Nuclear	20	19	19	8%	-0.6%	-0.8%
Hydroelectric	2	2	2	1%	3.1%	-1.1%
Total	211	224	227	100%	1.0%	0.3%

Source: BP Statistical Review of World Energy

The UK moves to a net deficit in oil (2006) and natural gas (2005), alongside the imports that support the coal and nuclear consumption. The deficit will rise sharply, reach 39% of oil and gas demand by 2010, a trend that will be aggravated as coal and nuclear capacity are decommissioned.

The two main sources of energy imports are Norway (75%) and Russia. Gross imports are high, as much domestic production is exported, particularly to the Netherlands. Coal imports meet 60% of UK demand, and come mainly from South Africa and Russia (28% each), with another 17% from Australia. The continental pipeline network obscures the origin of natural gas imports; 2005 imports (9% of demand and higher in winter) came mainly from continental Europe through the Interconnector, with small quantities of Liquid Natural Gas (LNG). Imports from Norway will soon rise, while the Interconnector supply will become more important - and increasingly dependent on Russia. We have no import figures for uranium, but overall mine production data (in the third column of the chart) highlight Canada and Australia.

Oil		Coal		Uranium	
Norway	75%	South Africa	28%	Canada	29%
Russia	14%	Russia	28%	Australia	22%
Saudi Arabia	3%	Australia	17%	Kazakhstan	9%
Venezuela	2%	Columbia	10%	Niger	8%
Other	6%	USA	6%	Russia	8%
		Indonesia	4%	Namibia	8%
		Others	7%	Others	16%

Sources: BP Statistical Review of World Energy, DTI, Uranium Info. Centre

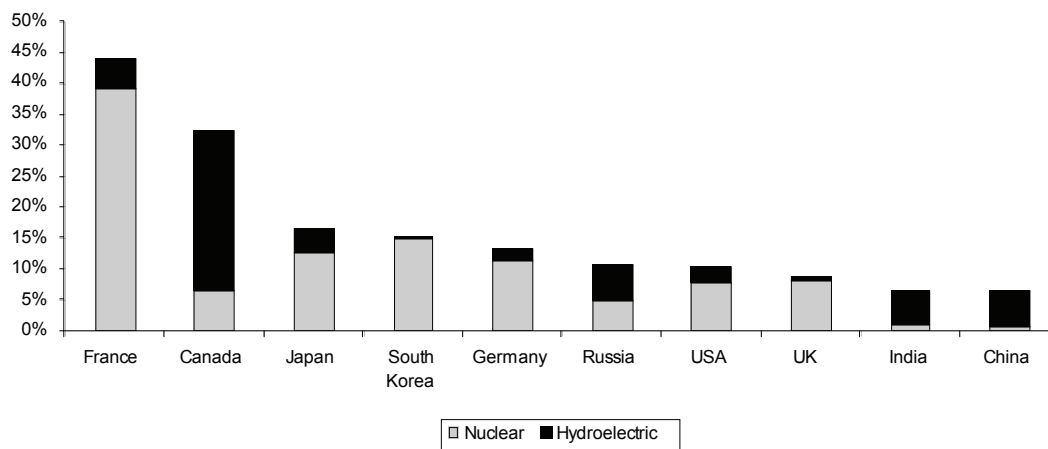
Note: Uranium figures based on mine production

Importing energy need not jeopardise competitiveness *per se*. Most advanced industrialised countries have always had to do this. And large energy discoveries can cause exchange rate appreciation,

damaging other sectors ('Dutch Disease'). The acute structural shortages of 2004-7 will fade. But there are two long-term issues: increasing dependence on Russian gas, with the UK exposed on the far end of the pipeline; and the lack of liberalised energy markets on the continent, which can expose UK manufacturers to adverse differential gas pricing. Continental prices are generally pegged to fuel oil, while the UK has a free market. The likely rise of LNG, which will be priced globally, should ease the problem, but pressure is still required to liberalise markets elsewhere in the EU.

The other crucial decision concerns the mix of hydrocarbons, renewables and nuclear. As the table below shows, the UK is towards the bottom of the table in 'hydrocarbon independence' amongst countries consuming more than 200 million tonnes of oil equivalent, though only Japan, France (with its nuclear capacity) and Canada (with its rivers) are much higher. The table excludes wind, geothermal, solar and biofuels. Barring radical action, the UK's hydrocarbon dependence will keep growing, given the creeping obsolescence of its current nuclear base.

**% Energy Consumption Non-hydrocarbon 2005**



An excessive dependence on hydrocarbons brings two risks, aside from issues of security of supply, both of them price related. The first unknown is the price of the hydrocarbons themselves, while the second is the price of carbon emissions. The current volatility of oil and gas prices reflects heightened geopolitical risk, but the structural trend is upwards, as new reserves get more expensive to find. The second element is even less predictable. On top of fears that some competitor countries' allocation policies are too lenient, Britain's lack of a diversified energy base could make its energy-intensive industries uncompetitive, if the hydrocarbon and carbon costs both moved the wrong way.

Unwelcome as higher energy costs may be to British producers, Britain's competitiveness is only affected if these increased costs bear more strongly than in the UK than elsewhere. Oil is in a world market; oil prices have a massive bearing on the prices of substitute fuels; if all countries face a parallel rise in energy prices, Britain's external competitiveness should be unchanged. And dearer energy brings one crumb of comfort: fossil fuels would be extracted more slowly, and with some mitigation in the uncertain but quite possibly enormous adverse effects on climate change. But it must be recognised that Britain's growing dependence on imports, in the case of gas much of it from Russia, will be yet another factor likely to impede growth in decades to come.

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## 4. Conclusions

On unchanged policies, coming decades are somewhat likelier than not to see Britain's overall trend growth rate slipping, below its post-war average of 2.5% per year. Real national income per head may grow well below 2% on average. Sustaining current large levels of immigration would raise the first figure somewhat, but lower the second. Growing at 0.5% per annum slower than past experience means that after ten years the UK will be 6% worse off, or around £90 billion less income.

Extrapolating more recent experience could produce an even lower figure. We should not rely upon inbuilt invisible stabilisers rescuing the economy whatever the government throws at it. If a government neglects for too long all the matters that it influences or controls that affect competitiveness, we could end up in the slow lane on a permanent basis. That will mean fewer jobs, fewer well paid jobs, and less tax revenue to pay for public services.

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# Working Paper 2

## Skills Training for a More Competitive Economy

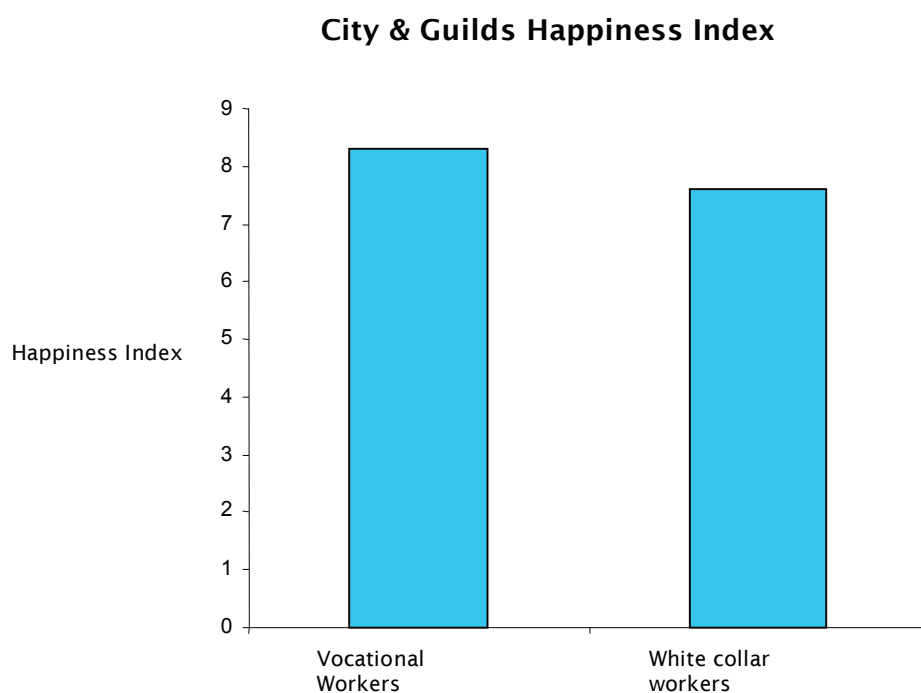
### 1. Executive Summary

#### 1.1. Why Skills Matter

Lord Leitch's Review of Skills Interim Report concluded that *“our nation's skills are not world-class. We run the risk that this will undermine the UK's long term prosperity. Productivity continues to trail many of our main international comparators. Much more needs to be done to reduce social disparities. Improving our skill levels can address all of these problems.”*

We agree with this sentiment. In a Parliamentary Answer on 23 November last year, the Secretary of State for Education and Skills said that, by 2020, Britain would need an extra five million highly skilled workers but three million fewer unskilled workers to remain competitive in global markets. A ready supply of appropriately skilled workers is essential to sustain a competitive economy.

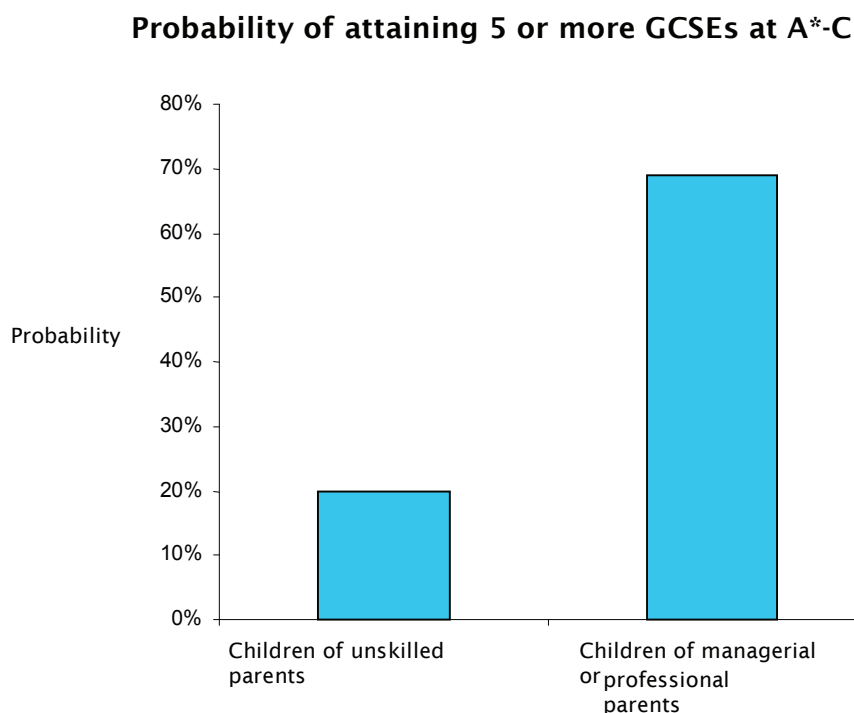
But there are other reasons – beyond direct effects on competitiveness – why skills matter. Skills provide people with a sense of worth and purpose. The index compiled by City and Guilds shows that skilled vocational work is particularly likely to provide job satisfaction:



*Source: City & Guilds Happiness Index, 28 March 2006*

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Skills also help to build social mobility. Children with parents in unskilled work have a 20% probability of achieving five or more GCSEs at grade A\* - C, compared with 69% for children with managerial or professional parents:



*Source: Interim Report, Leitch Review of Skills, p.34, 2005*

## 1.2. Present Problems

In Section 2 of this report, we rehearse the mounting evidence that Britain is not at present equipped with a system of training that is likely either to address the problems identified by Lord Leitch or to contribute in the way it could and should to our productivity, our competitiveness, our job satisfaction and our social mobility.

The picture is the same whether one looks (as we do in Section 2) at the numbers of our children acquiring basic skills, at participation in training, at international comparisons, at the complexity and mis-direction of funding, at the lack of transparency in our system of qualifications, or at Britain's poor record in productivity. All the evidence points in the same direction: our present system is not fit for purpose.

## 1.3. A Vision of the Future for Vocational Skills Training

To meet this challenge, we envisage a skills training framework in which employers and trainees have a much greater influence on the trainers' behaviour, both in terms of what is taught at the taxpayers' expense, to whom and to what level.

In our vision, the requirements of business – mediated through industry-specific Sector Skills Councils – should shape the training landscape.

We trust the consumer – whether self-employed, employee or company – to choose what is best in respect of current and future training needs, provided that the relevant information is freely available.

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The framework must provide a good service to prospective trainees, without placing any bureaucratic impediment on their ability to source the training that matches their needs.

Our vision entails significant cultural and social change, including breaking down the current distinction that is made between general and vocational education and the attendant class prejudices. The value of vocational training needs to be elevated within society, and there needs to be far greater flexibility for those wishing to move between vocational pathways and higher education.

## 1.4. Guiding Principles

We have derived several guiding principles during the course of our study:

- we should remain committed to free vocational training for 16-19 year olds;
- current government spending should be maintained, not reduced; but it is the role of government to facilitate, not centrally plan, the supply of state-funded skills training;
- to close the gap that currently exists between the needs of trainees and access to high quality training; individual prospective trainees and businesses need to be trusted to make decisions in their own best interests;
- the framework should recognise that larger enterprises have very different skills training needs from those of SMEs; and
- the roles of different supporting services need to be distinguished with much greater clarity.

## 1.5. Key Recommendations

In line with these guiding principles, we propose a radical overhaul of the way in which state funding for vocational skills training is allocated and how state services are delivered.

Money influences behaviour. **We propose that taxpayer funds should be allocated in accordance with the choices made by trainees**, rather than by the training provider; such a **demand-led framework** will encourage trainers to tailor their course content to better reflect the needs of the market. Funds would reach the trainer via the trainee's local authority, applying a set of eligibility criteria that take into account the applicant's attainment and weight the allocation of finite taxpayer funding towards the skills needs of the market. The current supply-led structure (overly influenced by the providers of training) would be transformed into a demand-led framework. The national and local LSCs, the SSDA and the RDAs would no longer be involved in the funding of vocational skills training; the regional and national bureaucracy would fall away.

We are proposing a national **Careers Advisory Service (CAS)** that is highly visible to aspiring skills trainees on every high street, on the internet and within schools. The CAS will be a **“one stop shop” for aspiring trainees**, providing them with access to:

- **skills training advice**, via Advice Desks, that is impartial, flexible, responsive and offered at a time and place to suit individuals and businesses; and
- **access to taxpayer funding**. CAS-based Funding Desks would advise on applicants' eligibility for taxpayer funding.

Over time we anticipate that the current myriad of state-funded skills training advice services will be merged or have their capabilities folded into the CAS.

**We propose bolstering the Sector Skills Councils (SSCs)** so that they influence DIUS-determined eligibility criteria for state funding, through the provision of labour market (i.e. employer) signals and skills research. We see the SSCs as having a major role to play in ensuring that taxpayer spending on



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vocational skills training is market-led and want to see all of them quickly reach a level where they are fully equipped to play this role.

**We believe that apprenticeships should be re-professionalised and brought under the full control of employers.** Employers should be encouraged to develop their own apprenticeship schemes, licensed by the Sector Skills Councils. Currently £1 billion is spent annually on apprenticeships (less than 10% of the LSC's annual budget); we propose that this should be increased by redeploying some of the money that the LSC spends on unnecessary bureaucracy rather than directly on education and training. Pilot schemes of new Group Training Associations (GTAs) should be launched, to assist SMEs that lack the capacity to offer apprenticeships, led by employers who already run successful apprenticeship schemes.

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## 2. Existing problems within vocational training

### 2.1. The “Skills Gap” and the Skills Shortage

Lord Leitch has identified that the UK is suffering a “skills gap” between the needs of potential trainees and the availability of high quality, relevant training.

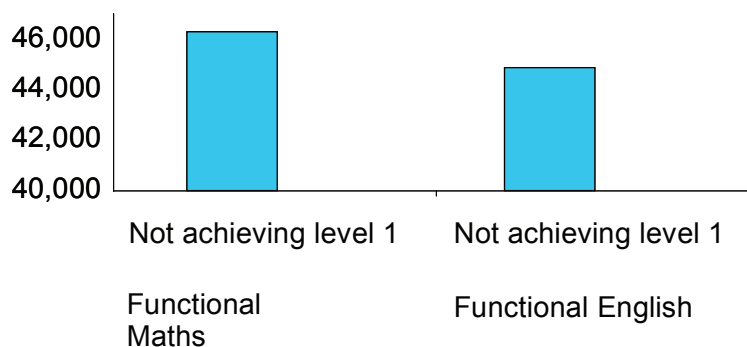
Others have pointed to a skills shortage, consisting in the fact that the number of people with level 3 and level 4 qualifications fails to meet the demand of the market. This has a significant effect on earnings – since, although there is little sign of wage increases being caused by the difference between level 1 and level 2 qualifications, there is a 6% male and 5% female wage increase caused by the difference between level 2 and level 3 qualifications<sup>60</sup>.

### 2.2. The Lack of Basic Skills and Skills for Life

Employers do not always expect candidates to come with job-specific skills; employer training will generally provide these. However, the National Employer Skills Survey (NESS) makes clear that employers do look for basic literacy and numeracy, as well as the “skills for life”.

The challenges facing employers are highlighted by the fact that the literacy level of one in six UK adults is less than is expected of an 11-year-old child.<sup>61</sup> The situation for numeracy is both worse and more confusing, because the tests are weaker and the evidence is controversial. However, estimates of the percentage of adults having “some numeracy problems” range from 30% to 50%<sup>62</sup>, and the Government itself admits that over 40,000 young people leave school every year either illiterate or innumerate.

**Functionally innumerate and illiterate school leavers in 2005**



*Source: Hansard, Answer to Written Question, 22 May 2006*

Perhaps partly because of this lack of basic skills, the number of young people who ‘drop out’ of education, employment and training after the age of 16 is high (1.3 million) and has increased worryingly by 15% since 1997:

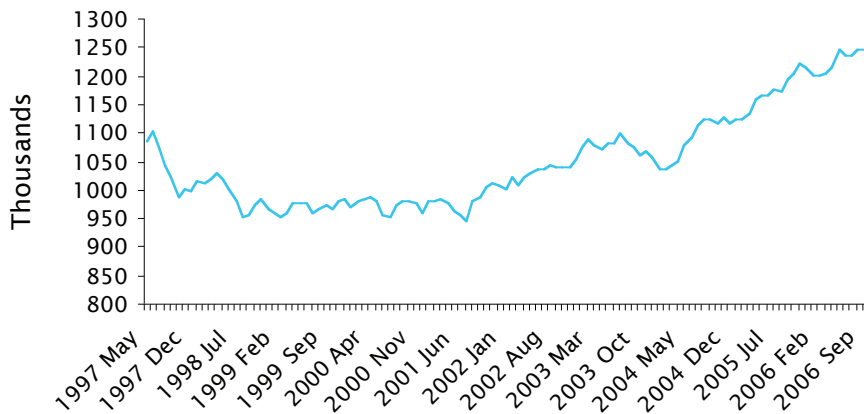
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<sup>60</sup> Source: SSDA

<sup>61</sup> Leitch Report

<sup>62</sup> Moser Report

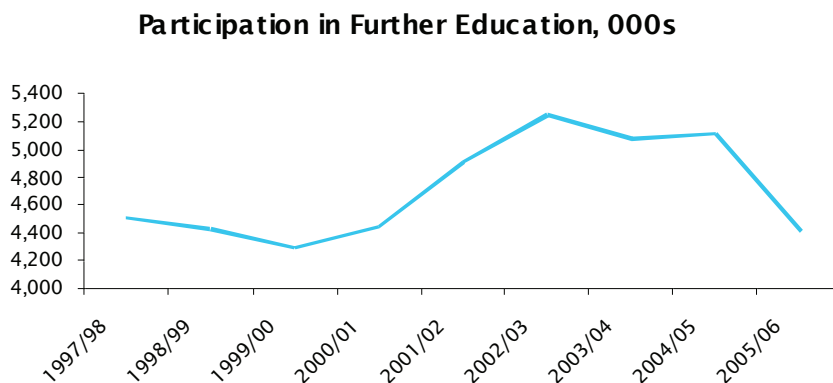
**Young People (16-24) not in Education, Employment or Training ('NEETs')**



Source: ONS, Series AGOL & AGPM

According to evidence we have taken, another effect of the lack of basic skills is that many of those school leavers who do enter vocational training are not equipped to start rigorous intermediate skills training. With trainers' funding dependent upon trainee numbers, it is understandable that trainers are sometimes inclined to accept weak candidates, that vocational skills courses are watered down to accommodate trainees' weak basic skills, and that skills training suffers accordingly.

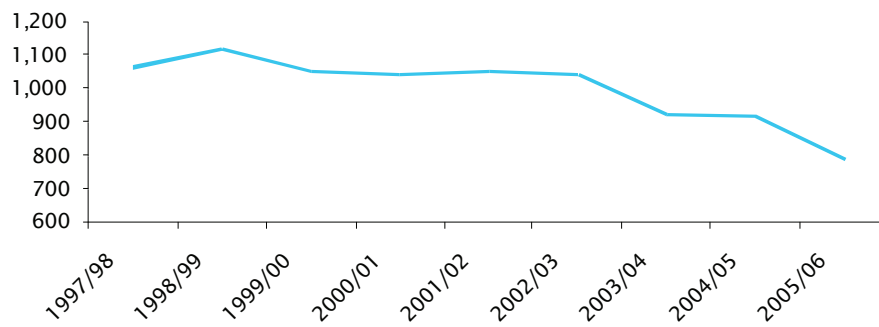
It seems likely that consequent deficiencies in the quality of our training, as well as mismatch between the training provided and the demands of the market, have contributed to the stubbornly low participation rates that we have witnessed in further education. After considerable efforts to raise participation in Further Education over the past few years, participation fell by 13.6% over the last year and is now back to where it was in 1997:



Source: DfES Statistics, December 2006

Participation in Adult and Community Learning has also fallen persistently, and is now well below 1997 levels:

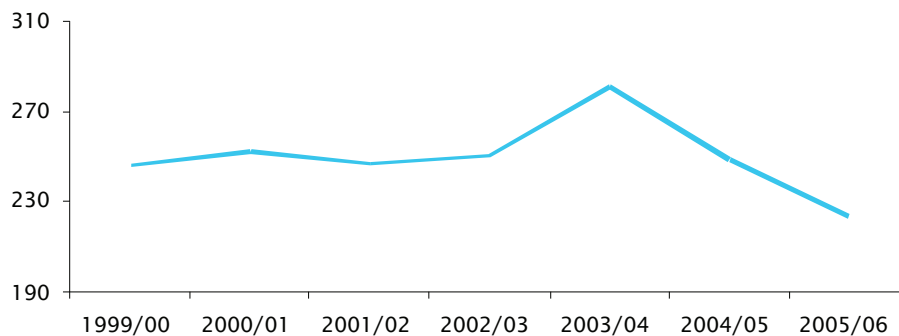
### Adult and Community Learning, 000s



Source: DfES Statistics, December 2006

Meanwhile, starts in work-based learning have remained low, and are below the levels of 1999/2000, when the figures were first compiled:

### Starts in Work-Based Learning, 000s

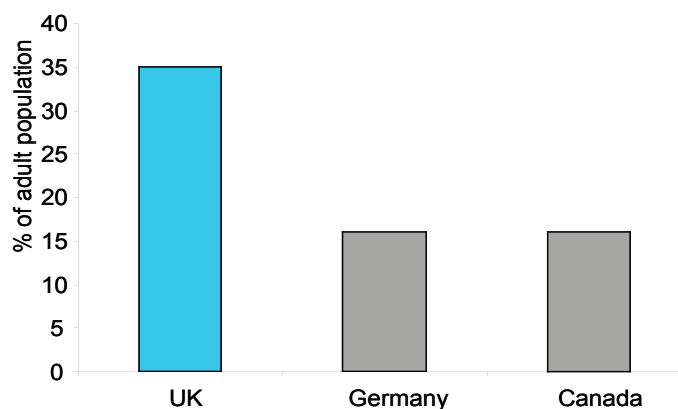


Source: DfES Statistics, December 2006

## 2.3. International Comparisons

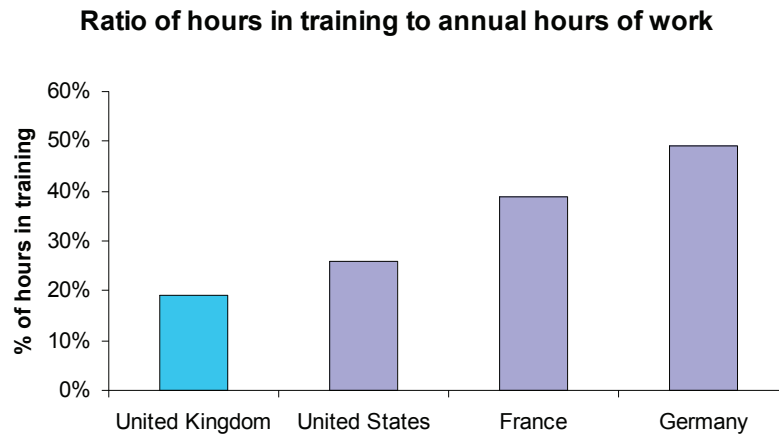
The same broad picture emerges when one compares our skills training with that in other comparable countries. Over one third of British adults do not have a basic school-leaving qualification, double the proportion in Canada and Germany:

### People without upper or secondary level qualifications



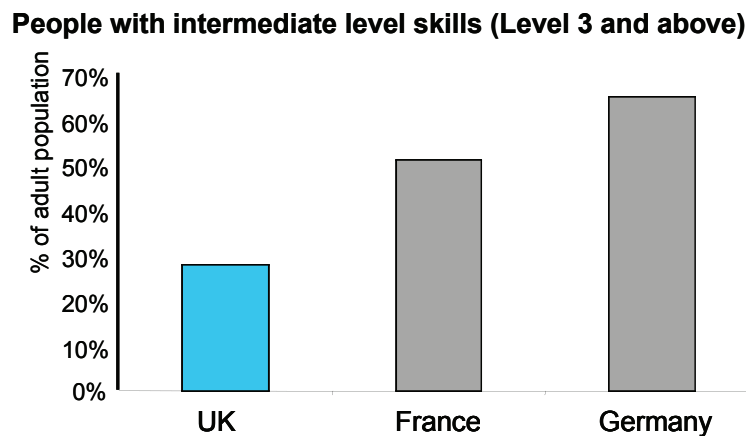
Source: Education at a Glance 2006, OECD, Table 2.1

British workers spend less time in job-related training relative to their total working hours than workers in key competitor countries:



Source: *Education at a Glance 2006, OECD*

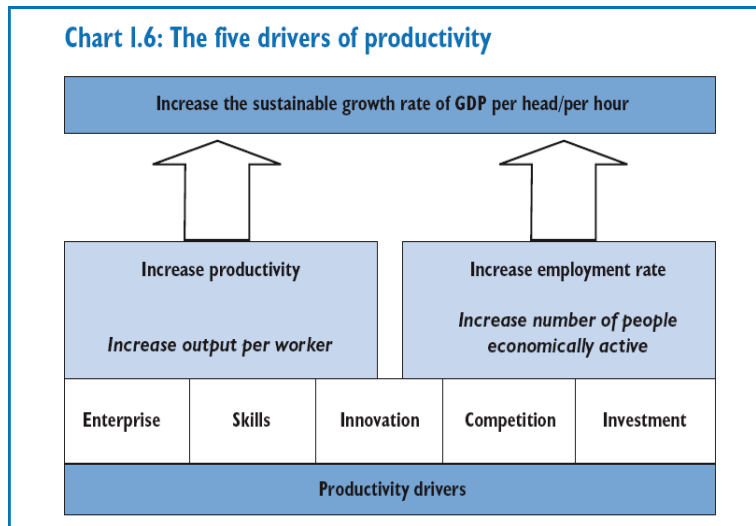
Just 28% of Britons are qualified to apprentice, skilled craft and technician levels, compared to 51% of the French and 65% of Germans:



Source: *The Guardian, 4 April 2006*

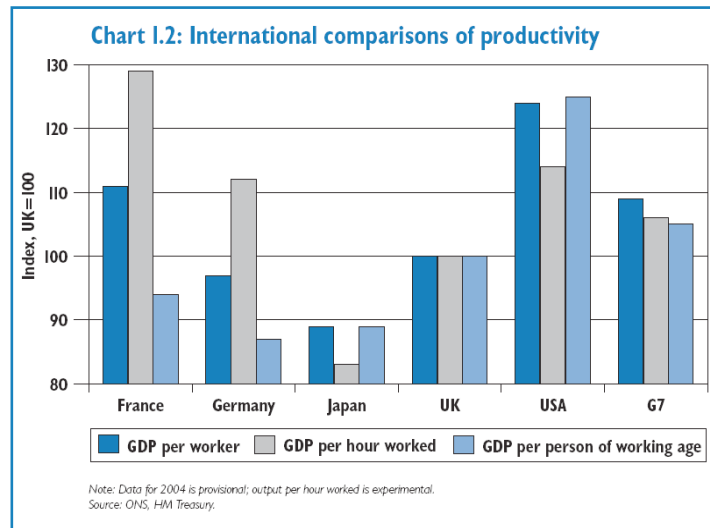
## 2.4. The Effect of Skills on Productivity

There can be little doubt that Lord Leitch is right to associate this poor relative performance in skills and training with our lagging national productivity. As Lord Leitch illustrates, skills are one of the obvious drivers of productivity:



Source: *Leitch Review of Skills, 2006*

The UK is the fourth largest economy in the world and has the highest employment rate in the G7 group of industrialised nations. However, in terms of productivity per hour worked, our performance lags that of our main competitors:



Source: *Leitch Review of Skills, 2006*

Output per hour worked is nearly 30% higher in France and more than 10% higher in Germany and the USA. Research suggests that as much as a fifth of the productivity gap with France and Germany can be explained by the UK's comparatively poor skills. Lower skill levels also have an indirect effect on productivity by reducing the benefits of innovation and investment.

Eliminating the productivity gap with the rest of the EU is equivalent to adding £80 billion to GDP. If the UK successfully trained just 5% more of the workforce in a given year then £40 billion could be added to the economy<sup>63</sup>. It has been demonstrated that a 5% increase in the proportion of workers trained in an industry leads to a 1.6% increase in wages, but a 4% increase in value-added per worker – the increase in productivity is more than double the increase in wages.

<sup>63</sup> SSDA



These indicators of the UK's poor standing in international skills league tables are not the exception – they are the rule:

- the UK has a higher proportion of the workforce with low or no qualifications compared with its main competitors in the US, France and Germany;
- the UK is 17th out of the 30 OECD countries in a comparison of post-16 rates of participation in the economy;
- among the working age population, UK secondary educational attainment ranks 22nd in the OECD ranking;
- the proportion of the UK workforce with level 4 qualifications ranks 11th in the OECD; and
- the UK is placed 17th on the World Economic Forum's Human Capital league.

## 2.5. The Qualifications Framework: The Need for Clarity

The current system of awarding qualifications for vocational studies is confusing not only for students but also for UK business. Employers giving evidence to our group told us that the relative value of different qualifications is hard to assess and that they found it difficult to tailor qualifications to their own needs. We were also told that costs are high, with colleges spending on average £250,000 a year on examination fees, and with yearly increases well above the rate of inflation.

Because of these problems, a number of FTSE 100 companies, including Marks & Spencer, report that they have withdrawn from NVQ awarding programmes, citing an “inability to meet our needs”, bureaucracy, an over-emphasis on health and safety and inappropriately qualified inspectors. Tesco has now resumed with the NVQ programme, but only on the basis of being able to run the entire programme in-house. Interestingly, following the decision, Tesco has created a thriving NVQ programme that is a model for other businesses and industry.

We believe that the root of dissatisfaction on the part of employers is the lack of qualification transparency, enabling prospective employers to assess both the general (nationally transferable) and the specific (reflecting the sector or locality) skills that will have been acquired by a given trainee with a given qualification.

Part of the explanation for our poor performance on training undoubtedly lies in the fact that our FE qualifications do not provide an appropriate ladder of achievement. There are 2015 vocational qualifications approved for use by those under 18 within this vast array. There is no clear path of progression from vocational qualifications taken at school through to further education, apprenticeships and skilled employment. A third of all vocational students are on courses which do not lead to higher education, either directly or through further training. This confusion helps to explain high levels of non-completion and switches between courses:

	% terminated early or failed		% of whom successfully completed a different qualification
GNVQ Advanced	43	}	26
GNVQ Intermediate	41		
BTEC First	44	}	31
BTEC National	34		
City and Guilds	72		34
RSA	58		35
NVQ (Full-Time Education)	49	}	16
NVQ (Work-based)	38		

Source: J West and H Steedman, *Finding our way: Vocational Education in England*, LSE 2003

## 2.6. The Funding Puzzle: Where's All the Money Gone?

Despite their dissatisfaction with the framework of vocational qualifications, UK companies invest heavily in their human capital, spending around 3.6% of their payroll on training, compared with a European average of 2.3% and 2.5% in the US. A recent survey from the Learning and Skills Council (LSC) put employer investment in training at around £33bn<sup>64</sup>.

The LSC's budget is now £11bn far more than that of the Royal Navy.

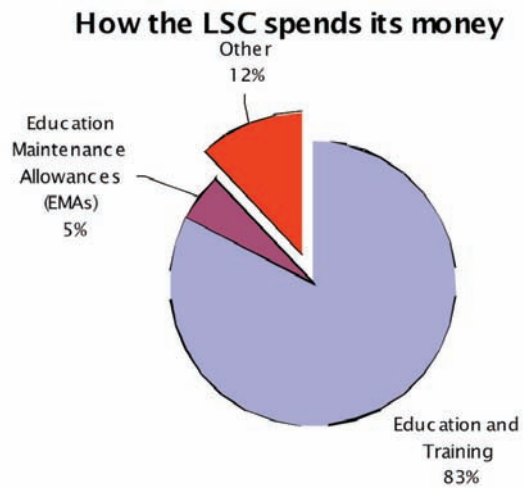
These statistics are puzzling. If all this money is being spent, where is it all going? Part of the explanation is that the LSC money isn't going where one might think it would go. Instead of being spent on intermediate (level 3) skills, it is being spent in a host of other ways.

£1.8 billion of the LSC's Annual Budget of £10.4 billion does not go directly into Education and Training:

<b><u>Funds not spent on Education and Training</u></b>	<b><u>£ millions</u></b>
<b>Learning Participation:</b>	
Area Inspections	43.2
Other Learning Participation Programmes	34.7
<b>Learner Support:</b>	
16-18 Discretionary Support for Students	40.6
Care to Learn	14.7
Dance & Drama Awards	13.8
Career Development Loans	17.3
Adult Discretionary Support for Students	82.0
<b>Local Intervention &amp; Development</b>	148.1
<b>Capital</b>	376.9
<b>Education Maintenance Allowances</b>	406.6
<b>Other programmes (non-DfES, ESF, etc)</b>	293.2
<b>Administration:</b>	
Pay Costs	172.4
Non-Pay Costs	88.3
Depreciation	23.3
<b>Total</b>	<b>£1,755.1</b>

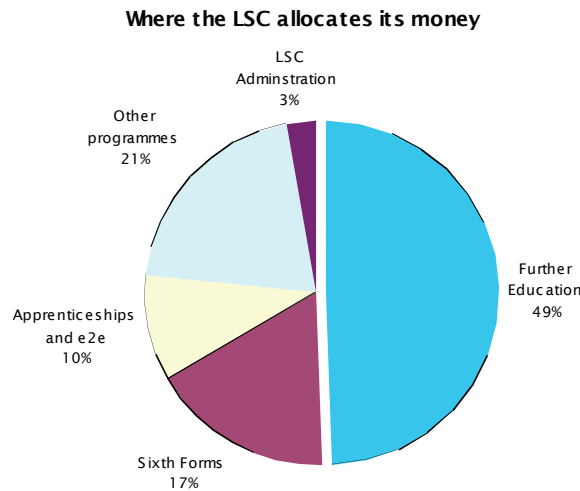
*Source: LSC Annual Report and Accounts 2005/06  
LSC letter to John Hayes MP, November 2006*

<sup>64</sup> Leitch Report



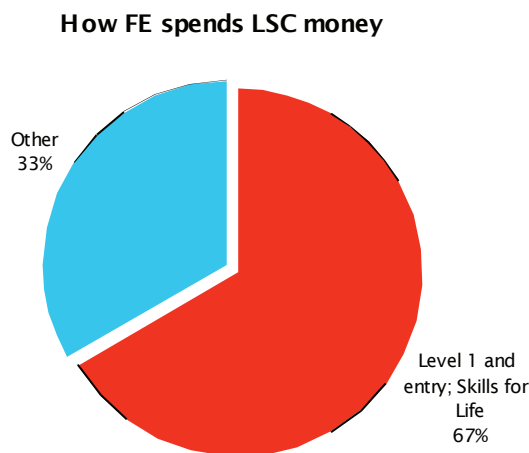
Source: LSC Annual Report and Accounts 2005/06

And less than half of the budget goes to Further Education (£5.16 billion):



Source: LSC Annual Report and Accounts 2005/06

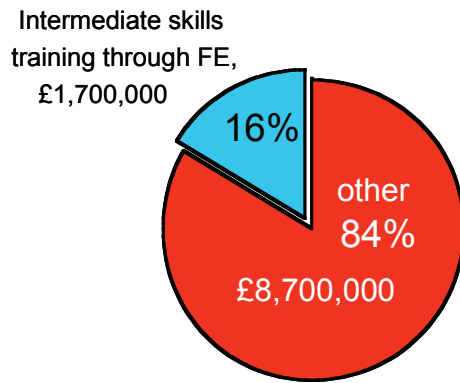
...of which over 60% is spent on remedial training at level 1:



Source: Hansard, Answer to Written Question, 30 November 2006

...leaving only 16% of total funds actually allocated to intermediate skills training:

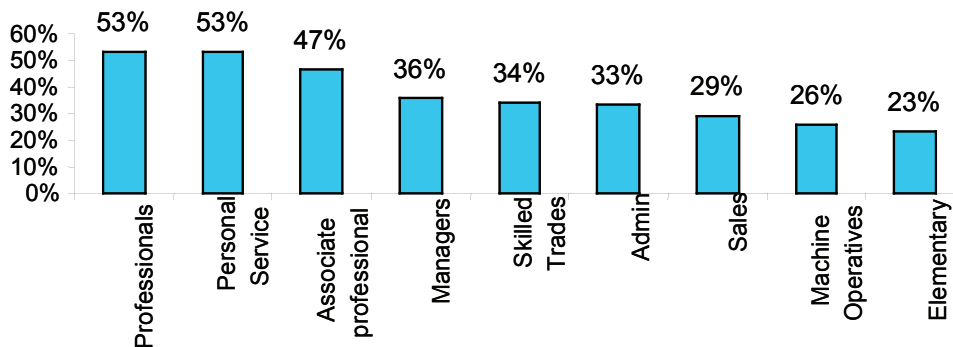
## How the LSC spends its budget



Source: LSC Annual Report and Accounts 2005/6 in answer to Written Question, 30th November 2006

The same pattern – of money going to items other than intermediate training – is evident when one looks at the training budgets of employers. Although solid figures here are hard to come by, anecdotal evidence presented to our group suggests strongly that, instead of focusing on intermediate training, employers are focusing their training on compensating for failures elsewhere in the system (i.e. remedial training) and on higher level skills. A concentration on higher level skills is also suggested by the fact that 53% of professionals received “off-the-job training” between 2004 and 2005, compared with less than a third of administrators, sales staff, machine operators or elementary staff:

### Distribution of 'off-the-job' training as a proportion of employment by occupation



Source: LSC National Employer Skills Survey, 2005

## 2.7. Complexity of the Funding Architecture

The failure of money to reach intermediate skills training is not, however, the full explanation of the funding puzzle. The money that does reach such training comes through so bewildering an array of funding streams as to leave all those involved gasping for breath.

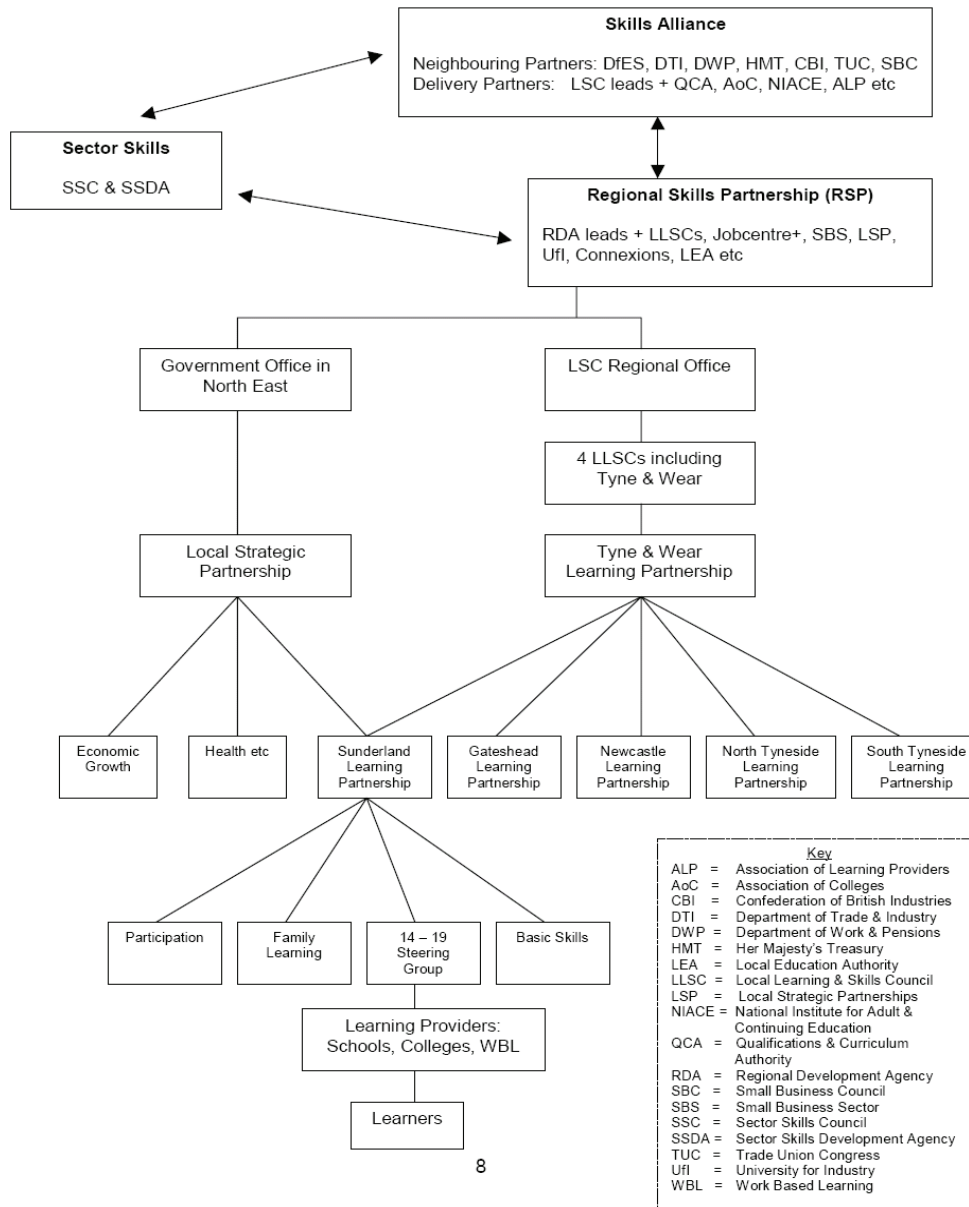
### 2.7.1. Funding at the Local Level

Figure 1, below, illustrates the complexity of the current framework in the context of a single English location (Tyne and Wear). There are clearly too many decision-making and policy-setting bodies: few have a clearly defined remit, and consequently their activities often overlap; the result is a lack of accountability, convoluted decision-making and effort duplication, all paid for by the taxpayer.

Part of the problem is the attempt to marry the regional and the sectoral approach to skills development. This resulting confusion of organisations results in appropriate training provision either

being unavailable or difficult to source. Conversely, Scotland has a single body (the Scottish Funding Mechanism, see the Appendix) and the Welsh Assembly has assumed direct responsibility, having abolished the quangos.

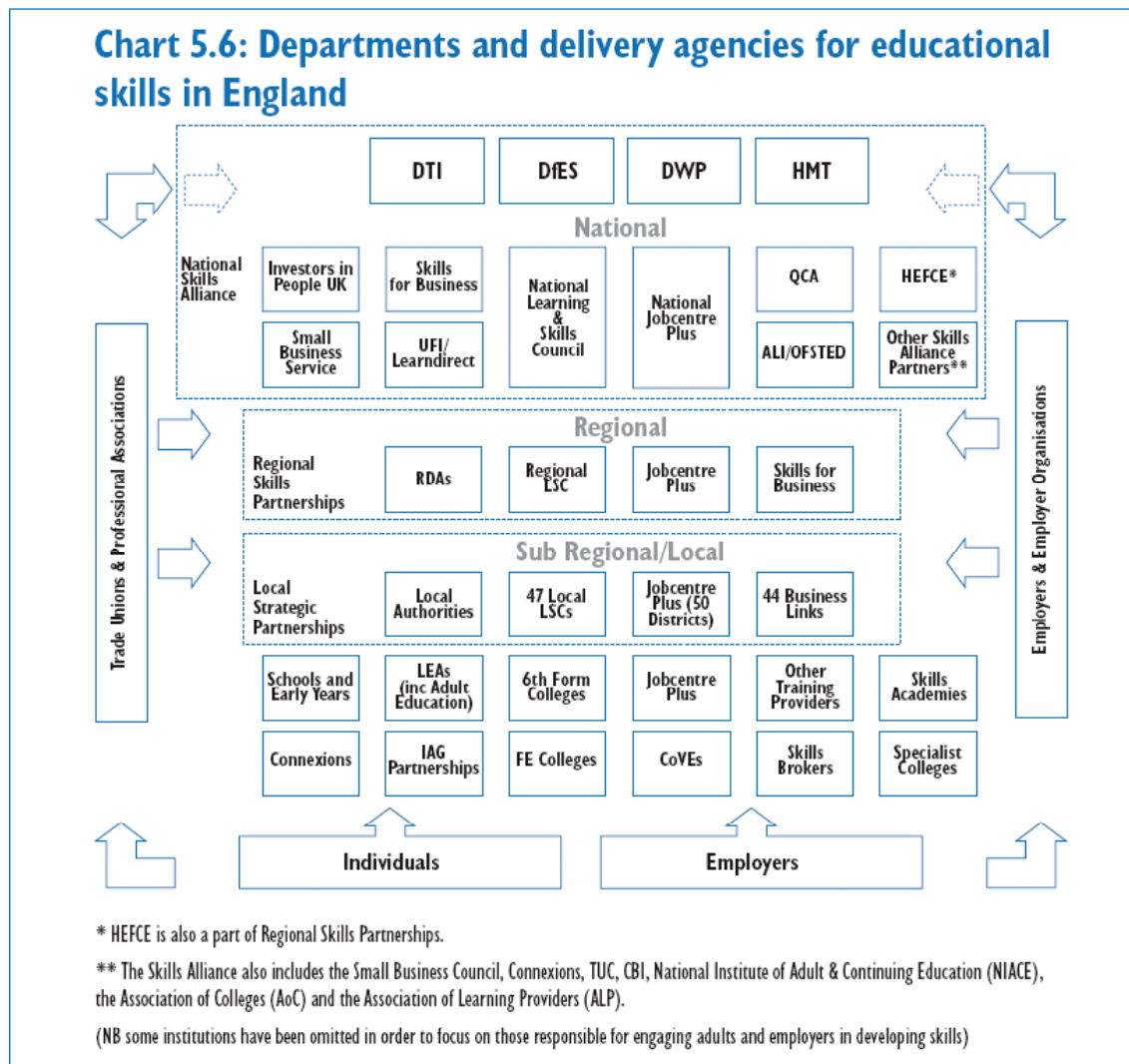
Figure 1 **The New Landscape of Post-16 Learning: Nationally, Regionally and in one Locality**



Source: "A New Learning and Skills Landscape?" Frank Coffield, Richard Steer, Ann Hodgson, Ken Spours and Ian Finlay. Presented at the ESRC Teaching and Learning Programme Conference, Cardiff, November 2004.

## 2.7.2. Funding at the National Level

The chart below illustrates the multi-dimensional complexity of funding streams at the national level. Central to the current convoluted structure for distributing taxpayer funding is the National Learning and Skills Council (LSC), with its network of nine regional (by statute) and 47 local offices (moving to 148 partnerships to become more local). This geographic basis of decision-making is out of step with (sectoral) market forces and there is too much overlap between national, regional and local representatives.



*Lord Leitch's Interim Report; Review of Skills December 2005*

It is easy to understand why prospective trainees are confused. The Local LSCs work alongside the Sector Skills Councils (SSC), the SSDA and RDAs, amongst others, within Regional Skills Partnerships; a lack of accountability results. There are too many entities attempting to perform the same roles.

The regional bodies are dominated by the LSC because it is the main source of money, while the LSC and DIUS have clashing responsibilities.

Evidence presented to us suggests that the LSC lacks a global mindset and insufficiently appreciates the future skills requirement that UK plc. requires to compete within the global economy. We have been told that it often fails to recognise which skills non-UK companies look for when deciding to invest in UK plc.



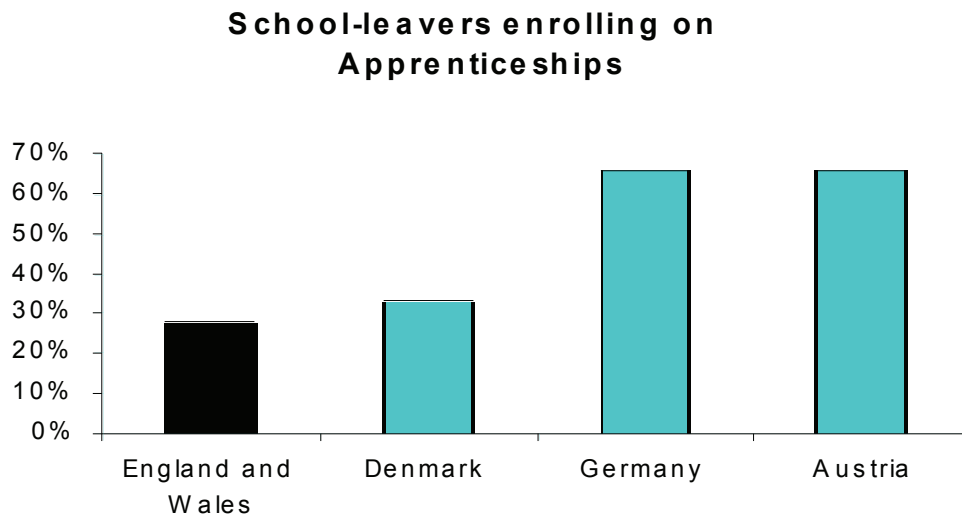
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### 3. Apprenticeships

#### 3.1. Failings of the Current System

##### 3.1.1. Apprenticeships Today: A Supply-Led Model

Just 28% of school-leavers in England and Wales enrol on apprenticeships compared to a third in Denmark and roughly two-thirds in Germany and Austria:



*Source: England and Wales data, DfES Annual Report 2006; European data, Institute of Directors 2002*

Moreover, the drop-out rate for apprenticeships here is also much higher than in other European countries; only 53% of apprenticeships in England and Wales are completed successfully compared to 79% Germany.<sup>65</sup>

Differences between the way the apprenticeship system operates in Britain and the way it operates in other European countries help to account for inferior British results. In countries such as Germany and the Netherlands, offers of apprenticeships enable individual firms to signal skill needs to young people. In Britain, apprenticeships are delivered through a supply-led system via the bureaucracy of the Learning and Skills Council (LSC). Each year, the Government imposes on the LSC a target for the number of apprenticeship places, which the LSC then divides among Local LSCs. Each Local LSC then divides this target amongst a network of training providers, the vast majority of which are either local authorities, FE colleges or independent training providers.<sup>66</sup> These non-employer training providers then search for employers prepared to place existing employees on schemes. Naturally enough, a high proportion of these existing employees have already acquired skills; in many cases, their “apprenticeship” consists of having these skills assessed by the training provider.

The subservient and often passive role of employers in our apprenticeship system is further evidenced by the fact that only about one fifth of apprenticeship places are allocated to employers; there are no records of the employers who provide training for the apprenticeship system via other training

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<sup>65</sup> Source: Data for England, Office for National Statistics; Data for Germany, Martin Baethge et al: *Berufsbildung im Umbruch – Signale eines ueberfaelligen Aufbruchs*, 2007.

<sup>66</sup> Source: Hilary Steedman, *CentrPiece*, 2002

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providers; and only around 5% of employers, most of whom are large national or multi-national companies, actually provide training directly themselves through apprenticeships.

The absence of work-based training within apprenticeships limits the opportunity for apprentices to acquire practical on-the-job know-how. This lack of training in practical wisdom is reinforced by the fact that – in contrast to traditional apprenticeships, which emphasised the role of work-place mentoring by a highly skilled and experienced craftsman – some current apprenticeship frameworks fail even to stipulate the need for each apprentice to have a mentor in the workplace. This lack of workplace experience and mentoring also means that there is often little motivation to acquire the kind of soft-skills, such as punctuality, that employers say new recruits often lack.

### **3.1.2. Growth of Apprenticeships: Appearance and Reality**

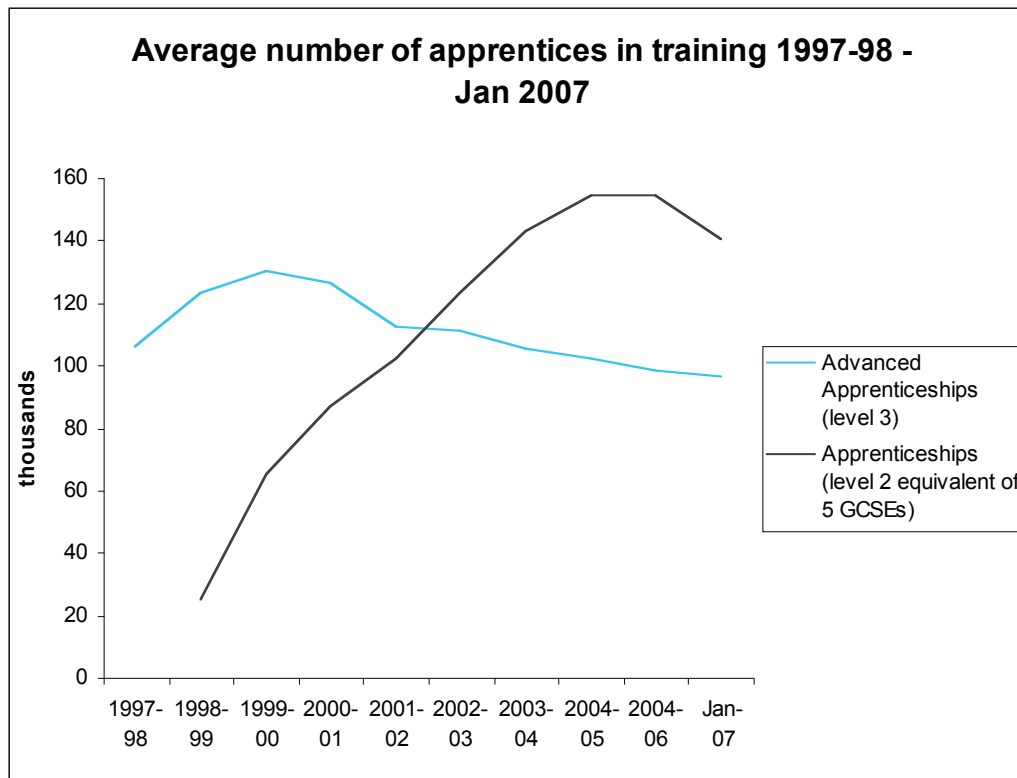
Against this background of a supply-led apprenticeship system with little active employer involvement and little sign of true on-the-job mentoring, the Government has now apparently reached its target of 28% of school-leavers enrolling on apprenticeships. The Leitch Review of Skills has advocated further expansion of the system with the number of apprenticeships being doubled from 250,000 to 500,000. But this “achievement of target” and planning for expansion does not mean what at first appears. It has been achieved only by including lower qualifications – below level 3 – within the apprenticeship framework.

When the ‘Modern Apprenticeship’ (MA) was introduced in 1994, its aim was to establish a work-based pathway for young people, leading to level 3 qualifications, in order to boost the UK’s stock of intermediate/ technician level skills.

In 2001, the present Government introduced the concept of a ‘vocational ladder’ to encourage progression along the work-based pathways. The second rung on the ladder was named a ‘Foundation Modern Apprenticeship’ leading to a level 2 qualification, equivalent to five GCSEs. The original, level 3 Modern Apprenticeship – given to those who had already attained GCSE qualifications – was renamed as an ‘Advanced Modern Apprenticeship’. These changes effectively abandoned the previous Conservative Government’s attempt to create a distinctive work-based pathway.

In 2004, the present Government made a further change when the whole programme was renamed, ‘Apprenticeships’. The lower, level 2 qualification is now called an ‘Apprenticeship’ – still equivalent to five GCSEs – whilst the original, higher level 3 Modern Apprenticeship, is called an ‘Advanced Apprenticeship’.

While Government statistics show that participation in the apprenticeship system as a whole is increasing, the take-up of Advanced Apprenticeships, leading to the original level 3 qualification offered by Modern Apprenticeships, is in fact in decline. 102,000 people participated in Advanced Apprenticeships in 2004/05, down from 130,000 in 1999/2000 and below the level in 1997. By including lower level qualifications under the banner of ‘an apprenticeship’, the Government has managed to disguise the fact that we are actually training fewer people in intermediate technical skills. This dilution of the apprenticeship brand may help to explain why the number of people in apprenticeship training as a whole is now in decline.

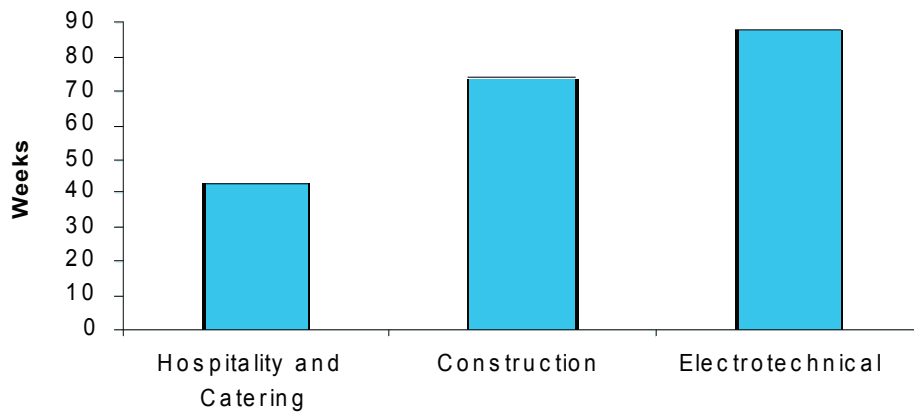


*Source: Office of National Statistics 2007*

The purported scope of the apprenticeship system is also illusory. Although the apprenticeship pathway now consists of some 300 separate ‘frameworks’ covering around 90 different occupational areas – from engineering to nail services – the vast majority of apprentices are located in 12 sectors: automotive; business administration; construction; customer service; early years care and education; electro-technical; engineering; hairdressing; health and social care; hospitality; plumbing; and retail. Many of the other remaining frameworks have either very small numbers – often less than six – or no apprentices at all.

Moreover, even within purportedly identical qualifications, there are in fact great differences of quality and value. While apprenticeships in some sectors (such as engineering) are highly valued, trainees in sectors where there is no tradition of apprenticeships are often denied the same level of technical education and the possibility of progression to higher qualifications. This lack of consistency is reflected in the vastly differing length of time it takes to complete different apprenticeships. For example, to complete the Advanced Apprenticeship (level 3) in engineering takes, on average, 156 weeks, compared to 64 weeks in retail. To complete an Apprenticeship (level 2) in hospitality and catering takes 43 weeks compared to 88 weeks to complete an electro-technical (level 2) qualification:

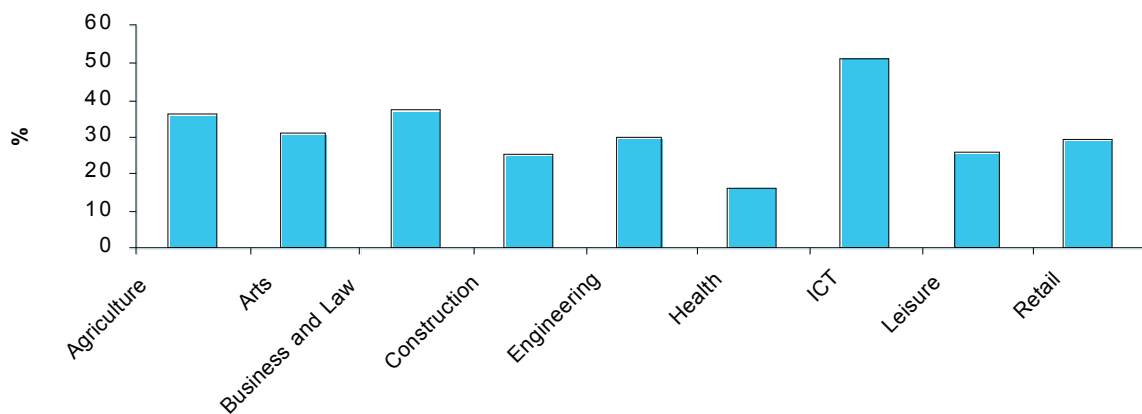
### Length of Apprenticeships programmes



Source: Learning and Skills Council

Furthermore, completion rates for apprenticeships vary significantly between sectors:

### Success rates for apprenticeships by sector



Source: Hansard, Answer to Parliamentary Question, 27 February 2007

In 2001, a review of apprenticeships led by Sir John Cassells highlighted the inadequacy of the competence-based NVQs in developing apprentices' vocational knowledge. Some sectors, such as engineering and electro-technical, have always included knowledge-based technical qualifications, such as BTECs, in their frameworks. But, despite an effort on the part of the Government to include technical certificates in all frameworks from 2003, the LSC has now relaxed the rules to allow these knowledge-based qualifications to be dropped.

### 3.2. Why Fund Apprenticeships?

The argument in favour of the state providing payments for apprenticeships is 'market failure'. We have been told that employers will frequently not pay for enough intermediate skills training because so many of the skills that are required are general in nature and, therefore, merely enable apprentices to work for other employers. We have further been told that potential apprentices are unlikely to pay for their own training because they cannot afford to, or because other forms of education, notably those

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offered through further and higher education, are either free or are highly supported by the taxpayer and would therefore be more attractive than apprenticeships for which the trainee had to make a contribution.

A further argument for providing taxpayer funding for work-based apprenticeships, is that the workplace can provide up-to-date equipment and techniques, supervision and teaching by expert mentors, and experience with team-work and working to deadlines, in a way that no simulated work environment ever can. But this argument evidently applies only if the employer is taking a lead and is willing to make a substantial investment (at least of time) in apprentices.

### 3.3. The Way Forward: Reprofessionalising Apprenticeships

Our first conclusion is that apprenticeships are valuable if, and to the extent that, they represent a shared commitment between employer and apprentice to complete a programme of training that adds value both to the organisation and to the individual. **Apprenticeships should, therefore, be under genuine employer control and should be substantially work-place based. While receiving government support, they should require a substantial commitment of resources – financial and organisational – by the employer and should always involve mentoring by experienced employees.**

Our second conclusion is that, when a substantial body of employers within an industry is committed to sponsoring apprenticeships, this body of employers should be encouraged and enabled to develop their own apprenticeship scheme. There is no better way of ensuring that the employers contribute substantial resources of their own to the apprenticeships and, therefore, have a commitment to see their funds well-spent. One obvious way of bringing a substantial body of employers within a given industrial sector to focus on apprenticeships and to develop their own programmes, is through Sector Skills Councils. **We accordingly recommend that Sector Skills Councils, as employer-led organisations, should license apprenticeship schemes, working – as appropriate – with established professional bodies.**

However, to make modern apprenticeships fulfil their original, noble ambition of providing a clear pathway to higher-level qualifications, and to enable them to become a ‘gold standard’ recognised by employers, **the qualifications component of apprenticeship frameworks needs a radical overhaul. For the reasons identified in Section 3.1.2 of this report, as part of SSC licensing, qualifications earned through apprenticeships should be reformed so that they always test genuine vocational knowledge, and to a comparable level in each field. A general education component in apprenticeships should be a condition of taxpayer support, but there should be greater flexibility over its nature and content.**

Small- and medium-sized businesses often lack the capacity to offer apprenticeships. Group Training Associations (GTAs) once existed in many parts of the country, providing excellent off-the-job training and making it possible for SMEs to take on apprentices and ensure that they had appropriate breadth of training. During the late 1980s and early 1990s, a lot of GTAs turned themselves into “providers” of Youth Training – paid directly by the taxpayer – and in the process lost their close links with employers. In line with our other recommendations, therefore, **pilot schemes of new GTAs should be launched, led by employers who already run successful apprenticeship schemes, and who could expand their programmes beyond their own employment needs, acting as group training providers for SMEs which struggle to deliver full apprenticeships.**

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## 4. The Proposed Framework

Reform of the apprenticeship system is a necessary – but by no means a sufficient – step towards improving intermediate-level vocational training in Britain.

To overcome the current problems identified in Section 1 of this report, and to realise the vision outlined in that Section, **we believe that a new, simpler, and far more demand-led framework needs to be established for vocational training as a whole.**

Our proposals relate to England only. The Scottish Funding Mechanism (which – see the Appendix to this report – is in any case developing broadly in line with the direction we advocate) would be unaffected, as would training in Wales, which is controlled by the Welsh Assembly.

### 4.1. The Funding Mechanism

**We propose a single, integrated, funding architecture for all state-funded vocational skills training, irrespective of who is providing the training. Taxpayer funds should, in our view, follow directly the individual trainee, regardless of whether that trainee is unemployed, self-employed, a school leaver or a company-sponsored employee.** This fundamental shift to a system in which the money follows the trainee is, in our view, the only effective way to increase incentives for training providers to tailor their products to meet the trainees' requirements.

**We propose that the flow of funds should be from the DIUS to the trainee's local authority, and from the local authority, on behalf of an individual trainee, to a training provider:**



Local authorities are already geared up to administer individual grants as part of both education and regeneration. They are familiar with handling payments systems and other process functions, such as school place applications, increasingly through websites. The trainee's pre-training home address can determine which local authority will act on his or her behalf. **In our view, within a system in which money follows the trainee, the local authorities can more than adequately replace the current, complex funding architecture of LSCs, SSDA, RDAs and LLSCs, whose involvement with vocational skills training can cease.**

### 4.2. Sourcing Advice: The Careers Advisory Service

To provide trainees with relevant and practical advice on the choice of course, **we propose the establishment of a Careers Advisory Service (CAS), separate from (and partly replacing) the current Connexions services.** We envisage that the CAS would be highly visible to prospective trainees on every high street, on the internet and within schools, and that it could provide a “one stop shop” for the vast majority of aspiring trainees, by offering:

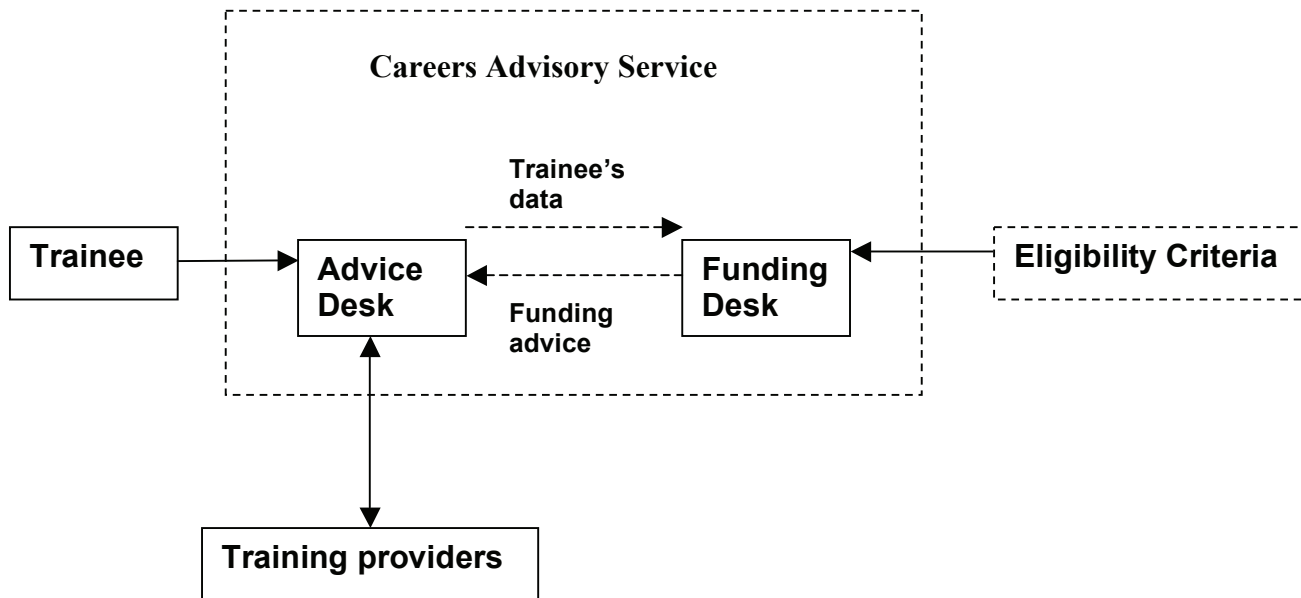
- (i) **skills training advice**, via Advice Desks, that is impartial, flexible, responsive and offered at a time and place to suit individuals and businesses. Our aim is to ensure a single point of access for the prospective trainee to all sources of advice, including Business Links, Jobcentre Plus, the Manufacturing Advisory Service, Skills for Business, the Small Business Service and other Skills Alliance Partners. Over time, we anticipate that training and careers advice provided by these services may merge or have their capabilities folded into the CAS; and



- (ii) **access to state funding.** We propose that CAS-based Funding Desks should advise applicants on their eligibility for state funding, applying a set of basic criteria (see 4.4).

In addition, we propose that the CAS should provide careers advice in schools, with CAS representatives visiting all schools in their local area to provide professional careers advice to the pupils, rather than relying on schools to provide this service.

Since we recognise that the CAS will be used primarily by the less informed purchaser of skills training (notably school leavers, the unemployed and SMEs), we propose that applicants should need to interact only with a single CAS Advice Desk, whose staff would liaise on behalf of the trainees with the Funding Desk and with other relevant parties including the training providers.



Typically, the larger companies will have little need for advice since they know already what apprenticeship or other training programmes they want to buy and from where (including in-house). Under our proposals, they would be free to liaise directly with the providers of training and to apply for funding from local authorities on behalf of each employee who is a prospective trainee. However, such employers (including employers not seeking any taxpayer funding for training) would be able, if they wished, to seek advice from the CAS.

**We believe that our proposed local authority and CAS framework represents a significant simplification of the current convoluted access architecture and would give trainees a single point of contact for advice and state funding. However, before it is propagated across England we believe that it should be piloted to confirm that it serves the needs of aspiring trainees and of employers.**

### 4.3. The Role of the Sector Skills Councils (SSCs)

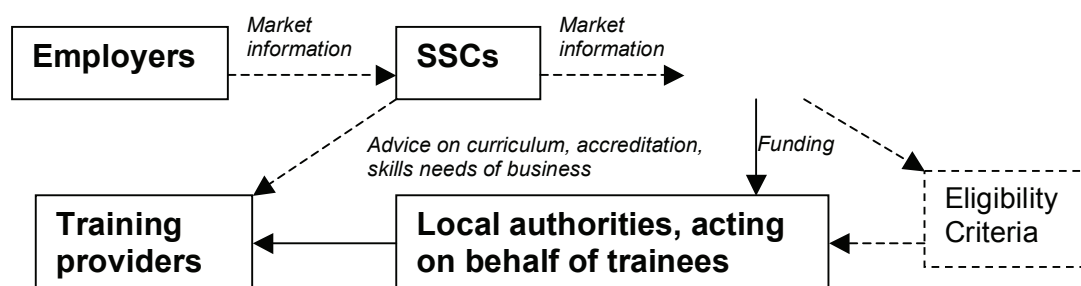
**We envisage an empowered, professionalised cadre of Sector Skills Councils that replace the LSC as the primary providers of skills research and labour market signals to the CAS and to training providers.** Our recommendation is that the SSCs should play a major role in ensuring that taxpayer spending on vocational skills training is market-led, and we want to see all of them quickly reach a level where they are fully equipped to play this role. We recognise the need to ensure that they have well established relationships with employers in their sector as well as drawing on the skills and expertise of the relevant representative organisations.

We propose that the enhanced SSCs should conduct surveys of the members of their respective industries and forecast future skills needs, providing information that the CAS will use when communicating with prospective trainees and trainers. We believe that the SSCs should in addition continue to:

- (i) support their member-firms in **designing training programmes with training providers**, working with other industry bodies (e.g. BCC, CBI, EEF and FSB); and
- (ii) **work with accreditation bodies to shape qualifications** to reflect the needs of industry, and to keep training providers abreast of developments.

The SSCs are also a key source of market information and advice for the DIUS, within which we propose that a specialised unit should accumulate all the different SSCs' input to establish the national picture of employers' demand for skills.

To emphasise the demand-led nature of our proposed state financing of skills training, the flows of market information from employers and funding to trainees and training providers is summarised as follows:



#### 4.4. Trainees' Eligibility Criteria for State Funding

Given that the availability of taxpayer funds is finite, we propose the introduction of a simple set of DIUS-produced eligibility criteria that will weight the allocation of funding towards the skills needs of the market as identified by the Sector Skills Councils. This would have the effect of ensuring that the current supply-led structure (overly influenced by the providers of training) becomes markedly more demand-led.

We recommend that SSC input should be reflected in ranked categories of skills training leading to level 3 and level 4 qualifications. The categories should reflect the needs of UK plc., with weighting in respect of funding being applied accordingly.

Given the expertise of local authorities in local education and regeneration, a future Conservative government should consider the extent to which local authorities, working with the relevant SSCs, should have scope to accommodate local variations in the ranking of categories of skills training and hence in the funding available for courses of different kinds in different localities.

Funding should be linked to basic skill achievement levels. For example, applicants with level 2 attainment should obtain intermediate skill funding ahead of applicants without level 2 qualifications.

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**In addition to the banding system, we recommend that there should be a funding allowance for apprenticeship training that involves on-site residence**, given that their success rates and levels of attainment are currently higher in such training than in non-residential courses. We also recommend that the age ceiling for state funded apprenticeships (currently 25) is increased to at least 35 in order for employers to take on more mature apprentices so that – within available funding – those between 25 and 35 can compete for apprenticeships on fair terms.

## 4.5. Allocating the Finite DIUS Budget

Under our proposals, the flow of market information from the SSCs to DIUS would significantly influence the eligibility criteria for state funding, and the flow of market information from the SSCs to training providers would significantly influence the training offered by training providers. These would become the mechanisms by which the SSCs effectively bid for training on behalf of their respective industries. Once the Treasury and DIUS have set cash-limits on overall training budgets and the eligibility criteria for trainees, and the training providers (using the same SSC-based market information) have offered courses for that year, there would be no remaining need for government to create a top-down system of funds allocation: funding would simply be available on an annual basis via local authorities to establish who best meets the entry criteria set by the colleges or other training providers.

## 4.6. Training Incentives

The question of whether the government should offer training incentives in addition to government funding of training courses is intertwined with issues such as benefit payments and other societal objectives. Consequently we do not address this issue here, other than to raise the possibility, if and when public finances permit, of offering fiscal incentives to encourage employers, especially SMEs, to place a greater emphasis on training. We recognise, however, that – in addition to making corporate taxation more complex – such reliefs would need to be policed in order to ensure that firms did not undertake unnecessary training for the sake of the tax relief.

## 4.7. The Trainees' Perspective

### 4.7.1. Individuals

Individuals have a strong incentive to acquire skills which have a shelf-life of more than the next year or two, and also typically have a good, informal feeling for the local labour market and their own position within it. The vast majority of adults approach education and training with a clear, rational perspective. Our proposals, under which the money genuinely follows the individual trainee, aim to reinforce individual responsibility by bringing the individual trainee much more actively into arrangements than is currently the case. Our proposed framework does not alter the current training entitlement for 16-19 year olds, but the establishment of the CAS as a one-stop shop for advice on courses and funding should materially assist young people to identify more clearly what training is available and what training is suitable, so that they can make informed choices about which skills and qualifications to seek, and where to take the taxpayers' money in order to obtain those skills and qualifications.

### 4.7.2. SMEs

SMEs are often overlooked by government training initiatives and most cannot afford to run in-house training programmes, because there is typically no critical mass of trainees and it is difficult to release staff. Our approach of funding following the individual ensures that, if SME employees have an entitlement, they can go to their chosen location to obtain the intermediate skills they seek. We

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believe, however, that – once the new funding framework is in place – **government should also consider taking steps to encourage larger companies to open up their in-house training programmes so that employers of SMEs can use taxpayer funds to purchase places**; trainee and trainer would then benefit from economies of scale. Greater collaboration in respect of training amongst SMEs should also be encouraged in our view – although agreements to prevent poaching of employees may be required to allay fears held by the SME community.

## 4.8. The Providers of Training

Our proposed funding structure does not distinguish between public and private sector providers of training; we envisage open competition for taxpayer funding to drive up standards. One of the reasons for the simpler structure is to encourage more private sector and third sector (social enterprise) participation in skills training, thereby creating a flexible skills training environment.

Over time, we expect that trainees’ “spending power” will prompt the trainers to distinguish more clearly between effective, intermediate vocational skills training and mere time-occupation schemes. Under pressure from the market-place, poor courses will tend to wither, and the demand for better courses will increase – a demand that the market-based curriculum and accreditation advice received from the SSCs will help the training providers to accommodate.

Equally, we recognise that there is a need for more training opportunities *at the workplace*; much of tomorrow’s workforce is already working. Workplace training is the key to achieving success as it motivates and engages people who would not normally attend college, particularly men. Under our proposals, such training, too, will compete for taxpayer funding via the attraction of the trainee.

## 4.9. Supporting Services

### 4.9.1. Accreditation Bodies

The existing problems with the current qualifications framework identified in Section 2 indicate that the system of awarding qualifications for vocational studies is out of step with today’s industry and unable to cater for the real needs of UK business.

Our new approach does not reinvent the structure of accreditation – many of the existing accreditation bodies have a strong and well-deserved reputation. What our proposed structure creates is a clearer framework that enables the trainee in the market-place, acting with the SSCs, to exert real influence over the nature of courses at a local and specialised level. Over time we expect this to lead to improved course quality. It may be that the merits of HNDs, B.Techs and foundation degrees are reinforced (perhaps at the expense of GNVQs); since they are still understood in the workplace and get strong employer support, they are likely to be attractive to trainees.

### 4.9.2. The Role of Skills Brokers

Skills brokers match up trainees and trainers by identifying courses that meet trainees’ needs and negotiating with trainers seeking to sell their services. Brokers are currently employed by the taxpayer (within Train to Gain) but we recommend that, over time, as the CAS takes over the function of providing basic information to trainees, any brokers not becoming employees of the CAS should join the private sector and become licensed and regulated competitors to the CAS (akin to the IFA model). In contrast to the largely supply-driven Train to Gain programme, their revenue should in the long-term depend upon their placement performance in respect of appropriately accredited training courses, in order to avoid the deadweight costs of supply-driven schemes and the mere certification of existing skills as a proxy for the development of new skills.

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### **4.9.3. National Skills Academies**

Not all National Skills Academies will take the role of training trainers in the way that the Fashion Retail Academy has. Some Academies, rather than provide courses and qualifications, will take an advisory role within their sector. We believe that employers, working closely within the context of the relevant SSC, should be responsible for designing the roles of each of the individual Skills Academies.

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## Appendix: The Scottish Funding Mechanism

On 3 October 2005, as part of the Further Education and Higher Education Act, the merger of the Scottish Further Education Funding Council and the Scottish Higher Education Funding Council was announced. A review of the Scottish Funding Methodologies commenced on 2 June 2006 and is planned to be completed in 2008. This review was designed to identify strengths and weaknesses of the current funding methodology through direct inquiry to colleges and universities.

### Goals of the merger:

- to create greater links between further education institutions and higher education institutions;
- to address inequalities between FE and HE;
- to create a uniform funding mechanism for FE and HE that accounts for sector skills; and
- to avoid a labyrinth of funding regimes.

### Draft principles of Scottish Funding Scheme:

1. To fund a system of autonomous institutions that make their own strategic decisions about the mix of provision they offer, taking account of the needs of the market in which they operate and the national policy context by Ministers.
2. Funding methodology should be policy neutral at its base so that it enables good, fit for purpose provision, but neither discourages nor encourages particular types of provision or delivery.
3. Funding should reflect the cost of delivery of institutions and provision.
4. A methodology should not run counter to institutional responsiveness in a changing context, but should be able to provide incentives if desired.
5. Must account for possible changes in the resources available.
6. A methodology that is based on averages whilst recognising diversity in modes of delivery and be able to justify funding differentials.
7. Facilitate institutions' strategic forward planning.
8. Based on evidence or clear rationale and sound measurement – remain transparent.
9. Ensure funding is used efficiently within institutions.
10. Ensure quality is maintainable across sectors – quality in teaching and delivery methods.
11. Reduce burden of providing data on the use of funding – must show that funding is based on good evidence and data, and is used appropriately, whilst not overburdening institutions and funding bureaucracy.

### Current SFC College funding method:

1. Colleges are funded by SFC on a basis of agreed target-weighted student units of measurements (WSUM) for each academic year.
  - A SUM is equivalent to one Scottish Qualification Authority unit and activity is weighted according to subject areas (i.e. business studies carries a lower weight than engineering based on expense of delivery in regards to staff/student ratios and equipment costs).
2. A price per WSUM is applied to agreed target and the assumed tuition fees generated by the target volume are subtracted (the WSUM includes assumed fees).
3. Colleges must fulfil the agreed volume target each year or funding is reduced. No additional funding if a college is above target.
4. In addition to core SFC recurrent funding, other elements are included to promote support of a particular policy or to reflect significant justifiable additional costs that affect some colleges. These include:
  - entry cost – cost of recruiting and attracting students;



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- social inclusion entry cost- accounts for entry of students from deprived areas;
  - social inclusion retention and achievement – a rate per SUM for students from deprived areas as they progress through their course;
  - rural and remoteness – an institutional element and rate per student for colleges serving remote and rural areas; and
  - achievement – a rate per SUM achieved.

**Current SFC HEI funding method:**

1. Funded by SFC to deliver a target of full-time equivalent (FTE) funded student places each academic year. Unlike with FEIs no weight is applied to the funded places; instead, they are separated into subject groups and separate units of resource applied to the funded places in each group (i.e. the unit of resource is higher for engineering and technology than social sciences).
2. Assumed tuition fees are subtracted.
3. HEIs must fulfil funded places or face funding cuts.
4. SFC funding includes additional elements to promote widening access and equal opportunities. These include:
  - part-time incentive premium – to encourage more part-time provision and enrolment;
  - widening access premium – a rate per FTE for students from underrepresented areas; and
  - Disabled student premium – a rate per FTE for students in receipt of disabled students allowance.

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# Working Paper 3

## Pensions

### 1. Occupational Pension Schemes

Retirement savings and occupational pensions schemes are of huge importance, particularly as Britain's state pension is commonly regarded as the lowest in the OECD. Millions of pensioners rely upon income from these sources. In addition, the money-flows associated with these forms of national saving have large (and sometimes unintentional) effects on investment and competitiveness.

We propose measures to resuscitate occupational pension schemes. We describe, and then address, the damaging unintended consequences of the accounting and regulatory environment together with Mr Brown's tax on dividends received by pension funds and against the background of low interest rates, poor equity performance in 2000-2001, poor bond performance in the last two years, and tightening mortality assumptions, have catalysed the closure of so many occupational schemes. We consider the taxation of occupational pensions in the context of the overall tax treatment of savings. We conclude that reintroducing the dividend tax credit for pension funds would be unlikely to undo the damage that has been done to occupational pensions. In addition, it is possible that changes to stamp duty, other capital taxes or the benefits system would have more impact on saving behaviour overall.

We advocate risk sharing schemes between employer and employee, introducing the idea of a "core pension" whereby the employer commits to preserve contributions, with the employee assuming the risk on returns in excess of this.

We propose allowing companies to use a discount rate when measuring their pension scheme liabilities which more appropriately reflects the individual circumstances of each pension fund. We propose removing the onerous nature of some pension guarantees for future schemes and urge a future Conservative government to persuade the Accounting Standards Board to reconsider FRS17 and IAS19 (responsible for introducing excessive balance sheet volatility). Finally, in respect of DC occupational schemes, we propose removing the obligation to purchase an annuity (at any age) and removing any limits on the maximum age for activating a pension.

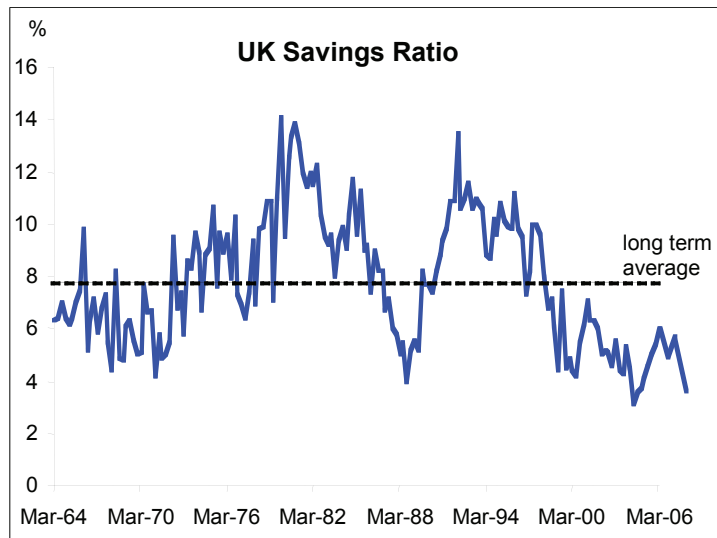
In respect of private retirement saving, we propose that individuals should be allowed to bequeath unused retirement assets, excluding annuities, to their children's retirement savings accounts. In addition, we believe that there should be a degree of pre-retirement access to personal money purchase pension savings. Access to savings is one of the reasons why ISAs and 401k plans (in the USA) have been so successful. This will also assist in promoting retirement saving because of the reference to "savings" rather than "pensions".

#### 1.1. The UK's Savings Track Record

##### 1.1.1. The Household Savings Ratio

The savings ratio, which measures the proportion of gross disposable income households save (including pensions contributions) rather than spend, is strongly associated with the economic cycle. Higher ratios are recorded when the economy is in recession and unemployment is high. Over the last forty years the ratio has varied from a high of 14.1% in 1979 to a low of 3.1% in mid-2004; the

average has been 7.8%. In addition to cyclical effects, the savings ratio decline since 1994 can partly be explained by aggressive property buying using debt (the ratio is a net figure, savings minus borrowings).

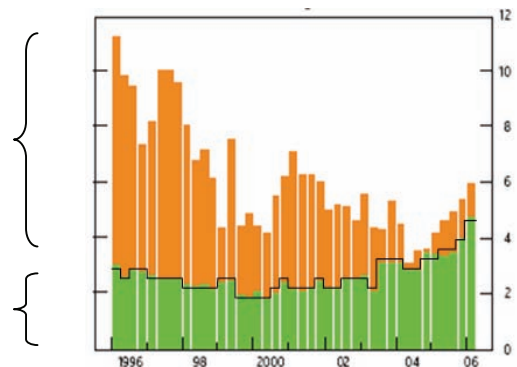


Source: ONS

Over recent years, the retirement savings component within household savings has risen – as the graph below shows. This may be in part due to favourable treatment for personal pension saving. But it is also likely to reflect increasing awareness of reduced benefits from traditional occupational pension schemes, and of the fact that the UK’s basic state pension is amongst the lowest in Europe – with a fall in value<sup>67</sup> as a percentage of national average earnings for full time employees from 23.7% in 1981 to a projected 14.2% in 2012<sup>68</sup>.

Non-pensions savings as a percentage of household savings

Net pension fund flows (contributions less receipts) as a percentage of household savings



Source: Bank of England Inflation Report 2006

## 1.2. Occupational Schemes

Worker participation in company-sponsored (occupational) pension schemes has been declining for many years. Since 1997, over 60,000 occupational pension schemes have wound up or have begun the process of winding up<sup>69</sup>.

In 1997 some 5.8 million private sector workers were in employer schemes; ten years later (against the background of rising labour force participation rates and rising levels of employment) this had fallen to 4.7 million. Even after taking the public sector into account where generous employer based pension

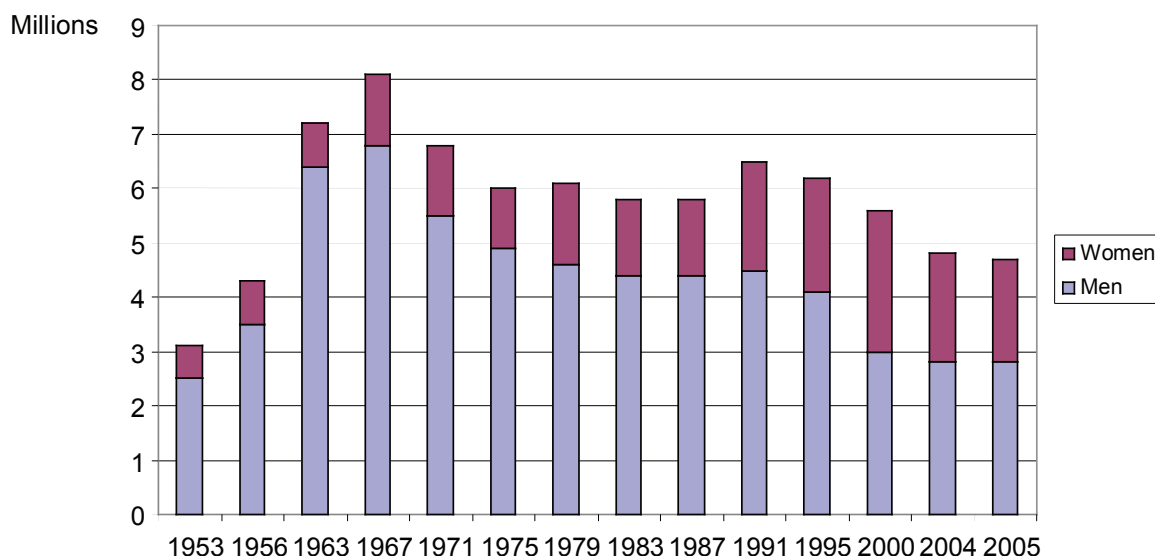
<sup>67</sup> Source: ONS

<sup>68</sup> Using assumptions in the pre-Budget report 2006

<sup>69</sup> Hansard, 6 February 2006, Col. 878WA

schemes have continued regardless of cost, between 1997 and 2005 the proportion of employees in defined benefit pension schemes fell from 46% to 35%.

### Active employee members of private sector pensions schemes<sup>70</sup>

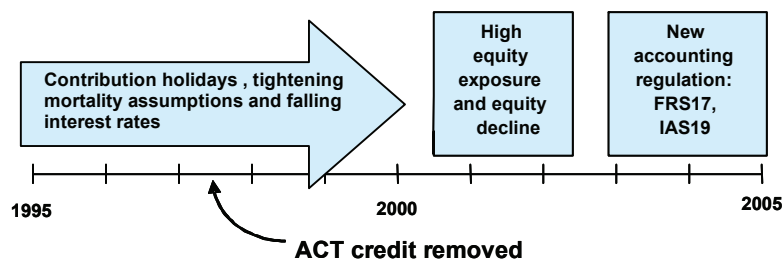


#### 1.2.1. Poor Prospects in Retirement

Following publication of the Turner Report, it is commonly acknowledged that the low household savings ratio, the low state pension, lower money purchase valuations, occupational schemes switching from defined benefit to the less generous defined contribution, and their declining availability, all mean that people working today will receive a lower income in retirement than many expect. Unless addressed, this is likely to give rise to significant problems for society, either in the form of an increased tax burden to fund means tested benefits or widespread pensioner poverty.

#### 1.2.2. Background

Occupational scheme provision in the UK enjoyed fairly steady growth from the 1950s until the late-1990s. Since then there has been a steady decline, attributable to a number of independent events occurring within a relatively short timeframe.



The serious demise of occupational schemes was catalysed by Gordon Brown's abolition of the ACT tax rebate on dividends from UK companies in 1997. This terminated the ability of pension funds to reclaim tax deducted at source on share dividends, thereby reducing the cashflow into pension funds by some £5bn per annum, and eliminating the capital gains within the funds that would otherwise have

<sup>70</sup> GAD 2005 survey "Occupational Pension Schemes"

accrued from this cashflow. The continued capital and income effect of this change cost pension funds an estimated £100 billion.

Before the ACT credit was removed, the potential cost of company schemes had been increased by the conversion of discretionary benefits, such as inflation-proofing, spouses' pensions and upgraded benefits for early retirees, into legally enforceable contractual obligations. During the 1990s, the size of many funds began to dwarf the balance sheets of the sponsors, introducing nervousness in the boardroom.

After 2001, we entered a period of low long term interest rates worldwide, combined with poor equity performance and tightening mortality assumptions, (i.e. people expect to live longer<sup>71</sup>). This resulted in sharply reduced annuity rates for individuals and rising company scheme deficits which were then over-zealously brought to the surface by new accounting rules and changes in regulation.

As a result of all of these events and circumstances, a tipping-point was reached. During 2006, one in ten private sector final salary schemes closed to new members. More than two-thirds<sup>72</sup> of final salary pension schemes, offered by firms in the private sector, are now closed to new employees. Only in the public sector are the majority of final salary schemes still open to new joiners.

### 1.2.3. The Unintended Consequences of Accounting and Regulation

Against the general background illustrated in Section 3, the accounting and regulatory onslaught of 2002 onwards, whilst well intentioned, brought with it significant, and very damaging, unintended consequences.

### 1.2.4. Cashflow Diversion

Companies have been required to divert cashflows away from productive investment to close fund deficits.

The evidence of low productive investment is stark. As the graph below shows, UK business investment – instead of remaining at traditional levels during a period of sustained economic growth – has persistently declined since the late 1990s:



It is equally clear where the money that business has not been investing has gone: between 1996 and 2000, employer contributions to self-administered pension funds ran at £15bn-20bn per annum – whereas the figures for 2003 and 2004 were £31bn and £36bn respectively and for the first quarter of 2006 investment was £12.2bn, up 58% or £4.5bn on the same quarter in 2005.

<sup>71</sup> In 1950, a 65-year-old man had an average of 11 years left to live; today he has 20 years; in 2050, he is expected to have 24.

<sup>72</sup> The annual National Association of Pension Funds (NAPF) survey, 2006

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The regulator now requires sponsors to meet funding targets within 10 years and one estimate is that this will consume 15% of companies' total cashflow, with 10%-15% of companies losing as much as 25%-100% of their cashflow.

These substantial diversions of cashflow into funding the deficits of remaining occupational pension funds are bound to affect UK competitiveness in the medium term. They also inevitably affect competition amongst UK companies, as older companies with substantial pension schemes (and companies with pension legacies in some cases dating back to the days of nationalised ownership) try to compete against newer companies that may not offer occupational schemes at all. A prime example is BA's competitive position, as a formerly state-owned entity, against Easyjet.

### **1.2.5. Volatile Financial Statements and Deficits**

The introduction of accounting standard FRS17 (over 2002-03) moved the reporting of company sponsored pension schemes to mark-to-market valuation methods, providing for the immediate full recognition of pension liabilities. Transparency is fine, but FRS17 requires the use of an unrealistically low discount rate (equivalent to the yield on AA rated corporate debt), excessively boosting the size of liabilities. Note that this discount rate bears no relation to the actual asset risk mix and return expectation of a typical pension fund that will have a significant proportion of funds invested in equities and, increasingly, alternative assets classes including private equity, hedge funds and property.

Weaker schemes, in particular, have been encouraged to "de-risk" and switch out of equities into bonds, and they have further suffered because, subsequently, bond capital growth has been poor relative to equities. Assessment of the health of pension funds is further confused because rising interest rates (which cause fixed rate bond prices to fall) lead to increases in the discount rate used to measure the liabilities, and this acts to reduce any asset-liability deficit, although the funds have lost money on their bond investments.

Since January 2005, UK listed companies have been required by EU law to adopt international financial reporting standards (IFRS). For pension cost disclosures, UK companies have adopted international accounting standard IAS19, which is broadly similar to the UK accounting standard FRS17 which it replaces.

The mark-to-market aspect of FRS17 / IAS19 introduced the scope for significant volatility in company accounts, partly because of the inherently volatile nature of equities and long bond rates. Consider, for example, the combined deficit for the FTSE 100 defined benefit pension schemes. In March 2003, it was £90bn; but, by January 2007, it had fallen to £32bn. The two main reasons for this substantial reduction are rising bond yields (and therefore a higher rate at which the liabilities are discounted) and rising share prices (around 60% of company pension scheme assets). In the interim, however, there has been considerable volatility; the combined FTSE 100 deficit started 2006, for example, at £54bn, plummeted to £29bn just three months later only to rise to £36bn<sup>73</sup> in July.

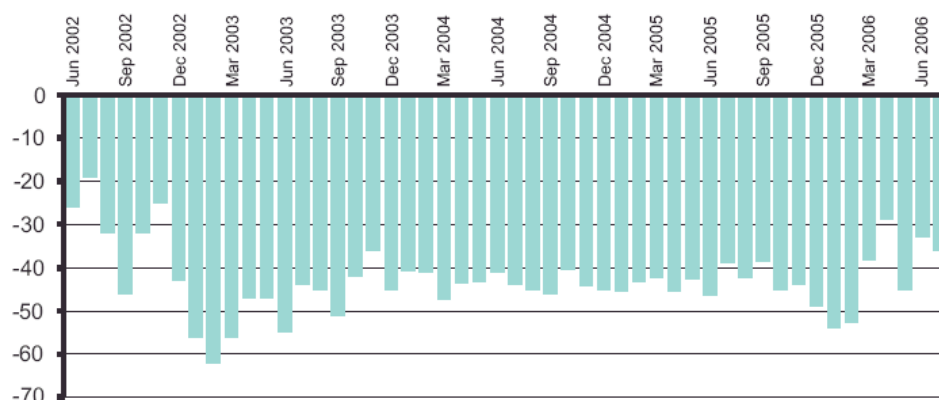
This volatility, hard to control, is a source of real concern to management, equity analysts and shareholders; and one by-product of this has been a reduction in corporate M&A activity as pension deficits, and the uncertainty surrounding them, act as potential poison pills (e.g. the failed takeover of WH Smith).

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<sup>73</sup> Lane Clarke & Peacock, Actuaries



## Estimated FRS17 / IAS19 deficit for the FTSE100 companies (£bn)<sup>25</sup>



A more dramatic measure of a company defined benefit (“DB”) pension scheme deficit is the “buy-out” cost, the cost of eliminating all scheme obligations by securing benefits in full from an insurance company. This is much higher than the disclosed IAS19 liability; the total buy-out deficit of the FTSE 100 companies was over £175 billion in July 2006.

Deficit volatility is not confined to the largest UK companies; the total defined benefit scheme deficit for the FTSE 350 stood at £47bn<sup>74</sup> in September 2006, compared with £65bn 12 months before. At the same time the funding ratio of assets to liabilities in September 2006 stood at 85%, up from 79% a year ago. This improvement is, however, influenced by the one-off special payments made by employers in the run-up to 31 March 2006 to reduce their levy payable to the Pension Protection Fund (introduced a year earlier in the Pensions Act 2004).

### 1.2.6. Artificially Low Bond Yields: The “Gilts Bubble”

There are mixed opinions about the extent to which asset-liability matching requirements have prompted pension fund managers to reallocate their assets in favour of long dated, very low yielding fixed income instruments, notably government bonds (“gilts”). The average equity allocation of UK funds has reduced by 6% over the last three years (68% in 2003 to 62% by end-2005), but this remains high by international standards<sup>75</sup>:

#### Pension fund asset allocation:

	<u>Equities</u>	<u>Bonds &amp; property</u>	<u>Other</u>
France	28%	60%	12%
Germany	31%	56%	13%
Ireland	60%	33%	7%
Netherlands	33%	63%	4%
Spain	40%	38%	22%
Switzerland	33%	52%	15%
UK	62%	35%	3%

The total value of long-dated sterling bonds currently in existence is around £300bn<sup>76</sup> and between £150bn and £200bn of this is held by defined benefit (DB) pension funds. In early 2006 there was a regulation-inspired squeeze on a narrow part of the market – long-dated *index-linked* gilts. The stock of these, in early 2006, was just £41 billion and defined benefit pensions funds had assets of £800

<sup>74</sup> PricewaterhouseCoopers

<sup>75</sup> Mercer Investment Consulting pension fund allocation survey, September 2006

<sup>76</sup> KPMG

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billion.

Looking to the future, as some funds approach surplus they will be encouraged by the accounting and regulatory environment to transfer their equity holdings into long-dated sterling bonds. One estimate of the likely requirement is around £515bn, but with only £100bn to £150bn of long-dated Gilts available to satisfy this possible future demand, pension funds are likely to increase their exposure to corporate bonds. These are more risky than Gilts, and therefore yield more, but given that they are priced relative to Gilt yields, the low yield environment will continue (unless corporate bond credit spreads widen dramatically).

### **1.2.7. The Boardroom Perspective**

Given that control of pension schemes has been wrested away from companies through legislation and regulatory requirements, many boardrooms have come to the conclusion that it is commercially unwise to guarantee (long into the future) the pensions of employees at a time when life expectancy is sharply rising. Consequently, many companies are transferring the risk of pension provision away from themselves and onto their employees by setting up defined contribution (“DC” or money purchase) schemes. More than 90% of the FTSE 100 companies have a final salary scheme, but most have closed to new members; 2006 announcements included Friends Provident and RBS. Some companies are going further and ceasing future accrual of benefits for current members. (Rentokil was first to do this within the FTSE 100, and other non-FTSE 100 companies have followed, including Debenhams, Jardine Lloyd Thompson and WH Smith).

Some in the actuarial profession<sup>77</sup> believe that dozens of FTSE 100 companies are set to close their final salary schemes between now and 2012 in an attempt to cut pension costs. This, however, is not without risk because of adverse employee relations, and because it cuts off the flow of member contributions that fund pensions in payment. That said, some companies are getting out of pension provision altogether; and there is a growing interest in the concept of pension buy-outs, where companies can pay an insurance company to take on their pension liabilities.

### **1.2.8. Occupational Schemes: Conclusion**

Most company schemes are not in crisis, but most funds are in deficit. The idea of the company pension is dying rapidly. Employers are pulling out of pension provision, because the accounting and regulatory environment is imposing risks upon them that are outside of their control and unrelated to their core businesses. Furthermore, when they move from a DB to a DC scheme, they sometimes take the opportunity to reduce their contribution rates. 20% used to be common; today it is more likely to be nearer 10%.

Actuarial estimates of future pension payments have become bond-like commitments and best efforts promises and discretionary bonuses have become cast-iron contractual obligations, which encourages “risk-averse” investment policies. The move from voluntary to compulsory pension improvements (spouses, index-linking) has increased the cost to employers and the introduction of FRS17 and the imposition of discount rates linked to low-risk corporate bond yields has boosted scheme liabilities.

It is ironic that the predicted growth in the number of schemes closing is blamed in part on recent legislation designed to encourage companies to do more to tackle their pension deficits. The new legislation makes it more likely that more schemes will close and pension provision in the future will be greatly reduced.

The conclusion is that private defined benefit pension provision is in rapid decline, and many in the

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<sup>77</sup> Lane Clarke & Peacock

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industry believe this to be terminal. This is at a time of an increasingly meagre State Pension.

## 1.3. Proposals to Resuscitate Occupational Schemes

### 1.3.1. The Role of Government

Government incentives to encourage occupational schemes can take the form of:

1. Interventions through the tax system;
2. Reducing the regulatory burden on occupation schemes;
3. Persuading the Accounting Standards Board (ASB) to adopt accounting standards that support the long-term nature of pension scheme liabilities;
4. Facilitating an environment that will stimulate product innovation such as longevity bonds or other new mechanisms that will enable pension schemes to adapt to changing demographic conditions;
5. Education, encouraging people to take more responsibility for their own pension provision.

There is a danger that government could stray into areas that are the preserve of the markets; for example, should government use taxpayers' funds to promote a freely tradeable market in pensions rights and liabilities so that the market, rather than accountants or regulators, may assess the viability of schemes? Government could, for example, promote such a market by offering to offload some its (unfunded) public sector pensions liabilities. The problem with doing this is the cost, so we do not recommend it.

### 1.3.2. The Taxation of Pensions Saving

It is important to consider the taxation of occupational pensions in the context of the overall tax treatment of savings. Housing, pensions and ISAs cover the saving activity of the bulk of the population, and in general the tax system for each of these complies with the principle that the effective tax rate on the normal returns to saving should be zero – what is usually understood as avoiding 'double taxation'. In simple terms, in the case of housing and ISAs, saving is out of taxed income but there is no tax on returns or withdrawals, though with some important exceptions. For pensions, saving is out of untaxed income, fund income is also untaxed, but withdrawals are taxed. The biggest exception to this is the tax-free lump sum, which makes the pensions tax system more generous. In addition, employers' pension contributions are particularly advantaged since they are not subject to either employer or employee National Insurance at the time of contribution or when the pension is withdrawn.

A number of other taxes result in a higher taxation of saving in many circumstances than would be implied by the income tax and National Insurance regimes alone. Stamp duty on shares and property, council tax, capital gains tax and inheritance tax all increase the effective tax rate on saving in particular circumstances. The benefits system can also significantly reduce incentives to save. For example, many means-tested benefits create very strong disincentives against building up financial assets worth more than £6,000. Similarly, a basic rate taxpayer who received relief at 22% on their contributions may be eligible for pension credit in retirement and see their pension income effectively taxed at 40%, or over 90% if they also face withdrawal of housing benefit and council tax benefit.

Another complex area is the interaction between the personal and corporate tax systems. In particular, since Gordon Brown's decision in 1997 to abolish the payable dividend tax credit, there is no relief for

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corporation tax paid on dividends that are paid out to pension funds. Since April 2004 the same is true of dividends paid into equity ISAs. It is now clear that the abolition of the payable dividend tax credit was a significant factor in the decline of occupational pensions. However, given the discussion in the previous sections, it is far from obvious that reversing this change would be sufficient to undo the damage that has already been done.

Reintroducing the payable dividend tax credit would also be extremely expensive, raising the question of whether the same money could be used more effectively in other ways. The discussion above makes it clear that the tax treatment of savings is a complex issue, and any changes should be seen in terms of how they affect the system as a whole. It is possible that reforms to stamp duty, other capital taxes or the benefits system would have more impact on saving behaviour overall. For example, a recent Oxera study commissioned by several city institutions found that stamp duty on share transactions reduces the average occupational pension fund by up to £11,500, depresses share valuations by up to £146bn, and reduces business investment by up to £6.4bn a year by raising the cost of capital.<sup>78</sup> As discussed in the next section, non-tax changes such as improvements in the flexibility of savings products could also be effective in increasing the amount of saving for retirement.

### 1.3.3. DC Schemes

We recognise the reality that DC schemes will become the dominant form of occupational scheme in the future. The following proposals are intended to reinforce the message that DC occupational schemes are an important and valuable form of saving:

<b>Annuities:</b>	There should be no obligation to purchase an annuity at any age.
<b>Activation:</b>	There should be no maximum age for activating a pension.
<b>Generational transfer:</b>	On death of a scheme member, the remaining pension fund assets should be transferable to the children's pension funds.

### 1.3.4. Meaningful Deregulation and Addressing the Nature of the Promise

The Pensions Bill refers to a “deregulatory review” which would offer support to employers operating existing pension provision. However, in the summary of the responses to the Bill, it is clear that the Government has backed off from the original scope of this review, since they point out there could be “losers” – individual or groups who would be disadvantaged if some of the regulations were removed. This is an inevitable consequence of meaningful reforms.

Meaningful deregulation would have to go beyond removing unnecessary red tape and get to the heart of the issue. Past governments have sought to “improve” on pension promises. A basic intention to offer a pension was recast as a commitment or guarantee to provide the benefit. Furthermore, the benefit itself was improved. No longer was there just a basic pension from age 65, but that pension had to have guaranteed increases in payment. Enhanced terms for early payment were offered. Guaranteed indexation before retirement was granted to leavers. There was no escaping these provisions, which were backed up by compulsory insurance.

If employers could go back to the days of “best intentions”, they might be prepared to offer some form of defined benefit. We propose, accordingly, that a future Conservative government should consider, in respect of future occupational pension promises, separating out the core element of a pension promise, a pension payable from state pension age as increased from time to time, from all other aspects, such as spouse's pensions, indexation, early retirement and so forth. The core aspect would be subject to the current level of protection for employees. All other aspects would be wholly deregulated,

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<sup>78</sup> Oxera, “Stamp duty: its impact and the benefits of its abolition”, prepared for ABI, City of London Corporation, IMA and London Stock Exchange, May 2007

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but of course high levels of protection could and would be offered by good employers with the cash flow to do so.

### **1.3.5. Accounting Standards**

The UK government is not in a position to legislate changes to accounting standards, but it can seek to persuade the Accounting Standards Board (ASB) to consider the full implications of particular rules. In particular, we highlight the fact that companies which switched their pension scheme assets towards bonds to avoid balance sheet volatility under FRS17 and IAS19 have actually created volatility by drawing on a very short supply of long-dated bonds. In 2006, Sir David Tweedie, the architect of FRS17 in the UK, acknowledged the “daft” consequences of the current method of determining corporate pension liabilities.

### **1.3.6. The Discount Rate for Liability Assessment**

A primary cause of scheme deficits is the unrealistically low interest rates at which pension scheme liabilities are being discounted (currently based upon the yield on AA rated corporate debt). We propose making a change in the Companies Act to enable companies that do not wish to retain the current AA rated corporate debt-based discount rates, to use instead a discount rate which more appropriately reflects the individual circumstances of each pension fund, taking into account the asset mix, membership demographics and mortality expectations (both those working and in retirement) and promised benefits. (The health of the sponsoring company and the level of any scheme under-funding are excluded from this assessment; they are taken account of in the calculation of the Pension Protection Fund (PPF) levy.)

The onus should, in our view, be placed on the actuarial profession to determine a blended discount rate for each individual client, and the methodology behind the calculations should be made public. Crucially, given that the typical company has pension liabilities that are linked to price inflation, the assumption for future price inflation should also be disclosed so that the *net* discount rate is transparent.

### **1.3.7. Risk Sharing Schemes**

There are three alternative pension fund contribution sources: the employer, the employee and the taxpayer. The challenge is to strike the right balance so that employers are not dissuaded from maintaining, or even establishing, occupational schemes.

The essence of a shared scheme is that the employer provides certainty in respect of a “core pension”, set at a minimum interest rate on capital contributions. This is therefore a guarantee (“hard” obligation) from the employer, along the lines of a DB scheme. One of the attractions of a shared scheme is that it increases employee confidence, encouraging employee contributions (on which the employee assumes the investment risk, akin to a DC scheme) to top up the employer promise.

The Swiss have adopted this approach and the minimum interest rate promised by employers on their capital contributions is currently 2.5% per annum, reviewed annually by the government (from 1985 to 2003 it was 4.0%). Schemes still have solvency risk as the gross performance needed for an average Swiss pension fund is at around 3.5% to 4.0%, well above the government bond yields of around 2%.

Risk sharing schemes have significant implications for fund asset allocation<sup>79</sup>. Those who offer such schemes have to adopt different strategies (less equities and more bonds and cash guarantee):

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<sup>79</sup> Mercer: European Institutional Market Place Overview, 2006

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	<u>UK</u>	<u>Switzerland</u>
Equities (foreign and domestic)	64%	34%
Bonds (foreign and domestic)	31%	41%
Property	3%	15%
Cash / other	2%	10%

Whilst this reduces the scope for high fund returns, it also dampens the prospect of significant fund valuation volatility which damages confidence and deters company sponsors.

Our objective is to foster an environment where a new generation of more radical risk sharing plans can thrive, under which employer and employee jointly share the benefits and burdens of unknown future events. This could include conditional indexation, as in the Netherlands, under which indexation is given only if financial conditions permit, or revalued career average benefits up to a salary limit and DC on salary over the limit.

Under current legislation occupational pension schemes are classified either as DB (under which normally all of the investment and longevity risks are taken by the employer) or as DC (where all the risks are borne by the employees). The few existing risk sharing schemes have been classified as DB schemes – discouraging participation from employers, who receive no regulatory benefits for shedding some risk. This needs to be addressed but without introducing new regulatory constraints that would undermine the position of pure DC funds.

## 1.4. Promoting Private Retirement Savings

### 1.4.1. Overview

There are currently numerous private retirement products and governing rules in place. 401k plans are the successful American form of stakeholder-type defined contribution retirement savings scheme. They allow earnings to be “deferred” and put into Individual Savings Accounts (IRAs) and savings may be drawn down from age 59.5 onwards (or on earlier retirement) and are taxable as income on withdrawal.

The plans are open to all companies *and* the self-employed, but not government bodies. Over 77% of eligible workers participate and 95% of plans involved some form of company contribution. The average 401k participant saves between 5% and 7% of pre-tax salary.

The key features of 401k schemes are:

- Equality amongst executives and other staff. If executives want good schemes for themselves, they have to offer similar terms to all employees. For example, executives’ contributions cannot be more than 2% above the average percentage contribution of low paid workers;
- Company contributions at the discretion of the employer but limited to \$15,000 (2006). Employers offer 401k plans as a way of attracting employees;
- The over 50’s may make additional catch up contributions of \$5,000 p.a. (pre-tax) and can make additional contributions on an after-tax basis;
- Pre-tax contributions are taxed on withdrawal;
- Most schemes are set up on the basis that employees can choose from a selection of mutual funds. The trustees determine investment strategy in respect of schemes set up under trustee arrangements;



- Draw down is allowed from age 59.5 or upon retirement if earlier. There are no limits on the rate of drawdown but by age 70.5 an annuity must be taken or a percentage of funds (based on life expectancy) must be withdrawn each year. 10% penalties are applied to withdrawals before 59.5;
- Loans are allowed for purchase of primary residence, college tuition fees, medical expenses, prevention of eviction from home, funeral expenses and home repairs. The loan must be repaid with interest;
- If the participant dies before distribution commences, the benefits are distributed to the beneficiary either over a five year period or over the expected lifetime of the beneficiary (depending on the plan rules). The beneficiary pays tax on the withdrawals.

The success of 401k plans, in terms of high participation rate, suggests that there are a number of attractive features that should be considered for the wider range of retirement savings products in the UK.

By contrast, stakeholder pensions – which were introduced in April 2001 and were aimed at helping more people provide better for their retirement (particularly those without access to occupational pension schemes) – have not been a success. The main benefit, apart from 22% tax relief, is the low running cost (capped at 1.5% for the first 10 years and 1% thereafter), and therein lies one of the two main reasons why they have failed to capture significantly the public interest. The obsession with cost has come at the expense of a product that really works; there is no advice and no mechanism for those needing advice to obtain it; and the low fees have deterred insurance companies from assertively marketing the product.

Interestingly and importantly, alongside SIPPS, personal pensions and group personal pensions, ISAs – which are not strictly a retirement savings product – have in fact been used by many people as a core part of their retirement savings. The market value<sup>80</sup> of total ISA assets (cash, insurance, stocks and shares) has grown dramatically since 2000:

Year to April	§2000	2001	2002	2003	2004	2005	2006 (prov.)
Market value, £ billion	28.7	62.0	82.8	104.8	125.6	153.0	181.4

The product is broadly understood by the population; witness the 13 million new accounts in fiscal 2005-2006 (£31 billion subscribed) and nearly 10 million new accounts (£19 billion subscribed) from April to October 2006. ISAs are simple, provide tax-free income in retirement, are free of capital gains tax, have a sensible annual contribution limit of £7,000 and are readily accessible (pre-retirement). They pass the basic “common sense” tests for almost everyone. Indeed, if everyone opened an ISA in their mid-30’s and contributed £1,500 per year thereafter, until retirement, pensioner poverty, and reliance on means-tested pension credits would gradually disappear.

The conclusion we draw is that private retirement savings products should in effect provide individuals with their “own private bank”. The first objective is to encourage people to start saving early and to continue to do so over their lifetime. The second objective is to ensure that, following retirement, these products can be drawn down at will, with no requirement to purchase annuities.

We accordingly put forward proposals for consideration by a future Conservative government which would have the effect of enabling such savings to be more readily and more flexibly accessible.

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<sup>80</sup> Inland Revenue

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### **1.4.2. Asset Eligibility**

We propose that there should be no limitations on the type of asset that can be held within a private retirement savings product – with the exception of residential property, since the risk of a substantial property price bubble is considerable.

### **1.4.3. Pre-Retirement Asset Access via a Loan Arrangement**

We believe that there should be encouragement for a multiplicity of savings products that allow people to manage effectively the balance between saving and spending throughout life. Consequently, we advocate freedom as to how and when funds can be drawn down. The ability to access funds when required will, we believe, encourage people to save what they can when they can without the fear of their money being irrevocably tied up for a long time.

We propose that at least 50% of the asset value of private retirement savings products should be accessible pre-retirement in the form of a loan from a recognised commercial lender. We propose that, to minimise the administrative burden, there should be no restrictions on loan usage (e.g. checking use of proceeds) and that such a loan should not trigger any adverse tax consequences and could be withdrawn to put down a deposit on a house or undertake additional training.

The loan system would, however, have to be structured to avoid abuse. There would need to be a set of controls to encourage repayment; for example, if at retirement, any of the loan were still outstanding then the account-holder would be ineligible for the 25% tax-free lump sum. There would also need to be restrictions on the term of the loan, taking account of the borrower's age.

People should also be able to withdraw up to 100% of the fund for the deposit on the purchase of their first owner occupied property, and/or to pay for an approved training place.

### **1.4.4. Contributions from Third Parties**

We propose that – in line with our recommendations for DC occupational pension schemes in Section 1.3 – unused private retirement savings assets (excluding annuities) should be transferable to children's savings accounts free of IHT liabilities, subject to a lifetime limit per beneficiary. This will encourage a wealth cascade down the generations, within a pensions environment, and also reinforce the sense of real ownership of the assets.

### **1.4.5. Tax Treatment**

We propose in addition that a future Conservative government should consider working towards the following tax treatment for all retirement savings products:

1. Contributions derived from earned income (excluding contributions from third parties), should attract tax relief;
2. Capital gains on assets within the retirement fund should be tax exempt;
3. When the investor reaches the state retirement age, up to 25% of the capital value of assets should be available as a tax-free lump sum.



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# Working Paper 4

## Effective Regulation for a More Competitive Economy

### 1. Introduction

*Our aim is to liberate the economy from the burden of unnecessary regulations so that businesses can thrive and deliver the jobs, incomes and taxes that make for a better society for **all** our citizens.*

#### 1.1. Executive Summary

Some regulation can be helpful in promoting competition, assisting in protection of the environment or in requiring high safety standards. All too many regulations hinder people and businesses, and can achieve the opposite of the praiseworthy ambitions behind their creation. Regulation imposes costs, ties-up resources and limits innovation. As a result, jobs are lost, taxes rise and consumers ultimately suffer. Regulation also often restricts our freedoms.

The causes of bad regulation are ingrained in our political culture and processes. The current Government and its predecessors have failed to eradicate them, and more and more bad regulations continue to be made. The challenges we face are therefore considerable. But we believe that our proposals, if given proper government support, could make a huge difference – helping to produce regulation that is better thought through, simpler and more effective.

In Section 2 we address the flow of new regulation. Our first guiding principle is that we should have regulations where the benefits outweigh the costs. But ***our ability to measure costs and benefits is relatively poor, and should be improved.*** Draft regulations do not currently receive adequate scrutiny, and departmental Regulatory Impact Assessments are recognised to be ineffective. ***The National Audit Office (NAO) should scrutinise all regulatory proposals and provide Parliament with the support that it needs to give them proper consideration.***

In Section 3 we address the existing stock of regulation. Regulatory budgets are a potentially useful tool to help reduce the cumulative regulatory burden. ***Regulatory budgets based on the Standard Cost Model should be introduced within a year, and more sophisticated regulatory budgets by the end of a first term.*** We also propose that ***an urgent review of current regulations should be carried out*** to identify those that are overly burdensome. ***The urgent review should include regulations under the Social Chapter, the Working Time Regulations, and a number of other specific pieces of legislation. A statute of repeals should be introduced each year.***

Section 4 explains why cultural considerations are vital, and why ***Ministers must take the lead in reforming government culture, and explaining to the public the costs of regulation, that new legislation is not the answer to every crisis, and why it is not possible to create a risk free world.***

Section 5 addresses other issues, including ***European regulation***, which now imposes a huge cost on UK and EU business and ***the need to reduce the disproportionate burden on SMEs.*** ***The UK government should engage more pro-actively in EU negotiations, and try to build a broad coalition of Member States for regulatory reform,*** including greater scrutiny of EU regulatory proposals. ***The***

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***UK Government should also work with other Member States to repeal EU regulations identified as overly burdensome across the EU as a whole, but if that is not possible should seek to negotiate an opt-out for the UK and any other like-minded countries.***

*This report has been prepared for the Steering Committee of the Economic Competitiveness Policy Group by the Deregulation Working Group. It is the result of several months of evidence gathering, in the form of meetings and written submissions. Contributors were encouraged to place the economic interests of UK plc ahead of any partisan considerations.*

## **1.2. Guiding Principles Derived from our Study**

As a result of the work of our groups, we have formulated nine principles, which we believe should guide a future Conservative government in its approach to regulation:

1. Government should impose regulations only where the benefits outweigh the costs;
2. The cumulative direct and indirect costs of inefficient regulation are huge and affect us all: business is driven overseas, jobs are lost, innovation is stymied and customers end up paying more for less;
3. Many of the causes of bad and unnecessary regulation are ingrained in the culture of our politicians, civil servants, press and population as a whole;
4. It is not possible to live in a risk free world. Vain attempts to achieve the elimination of risk often strangle the vitality of society and undermine individual responsibility;
5. Regulations can have unintended consequences, sometimes achieving the opposite of what was intended, and sometimes contradicting one another;
6. Before imposing traditional ‘heavy’ regulation, government should always consider whether the ends could be achieved by less burdensome means, such as through competition, incentive schemes, or self-regulation;
7. Regulations can impose a disproportionate burden on small businesses. This is unfair, dampens competitive rivalry and reduces productivity;
8. European regulations are responsible for a large share of the overall regulatory burden: the UK government should work harder to improve the quality and implementation of EU legislation where necessary, and ultimately must act to protect and promote the competitiveness of the UK economy;
9. The regulatory burden should be measured and reduced year on year.

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## 1.3. A Conservative Vision for the Future of Regulation

### 1.3.1 The Need for Regulatory Reform

We believe that regulatory reform by an incoming Conservative government could reap huge benefits. Individual liberties could be regained, enterprise freed-up, and the position of the UK as a globally competitive economy restored. The investments necessary to bring this about should pay for themselves many times over: the regulatory burden accounts for approximately 12% of GDP, and the Better Regulation Task Force has estimated that every £1 spent on regulatory reform could potentially produce a GDP increase of £450.<sup>81</sup>

**Good regulation can be hugely beneficial** saving lives, promoting competition, creating stability and protecting the environment. Regulation is necessary where markets fail, for example because of the existence of externalities or the abuse of market power. It may also be justified to protect vulnerable consumers from exploitation, and to ensure that people have access to basic goods and services.

Regulation also, however, imposes a huge **cumulative burden**, borne by all of us. The burden often falls most directly on business. Regulation raises costs, ties-up resources, reduces or distorts investment incentives and limits innovation. It also has many indirect costs – jobs are lost, taxes rise and customers pay more money for worse products and services. Government expends valuable resources both enforcing regulation and complying with it. Our freedoms are restricted.

### 1.3.2. The Impact on UK Competitiveness

The UK's competitiveness is suffering from too much, poor quality regulation. We live in an increasingly globalised world. The costs imposed by unnecessary regulation increase the price of goods and services produced in the UK, making them less competitive in foreign markets and the UK less attractive for foreign investment. Government policy can send (and has sent) whole industries away: the UK's primary position in the global financial services market is, in large part, owed to a measure introduced in 1963 by President John F Kennedy (the Interest Equalisation Tax), which drove the international bond market from New York to London.

The current Government has enacted a huge quantity of legislation, with little regard for the effect of the resulting growing cumulative burden. Partly as a result, since 1998 the UK has fallen from 4th to 10th in the World Economic Competitiveness rankings. In contrast, in the same period Finland has risen from 15th to 2nd, in part as a result of enlightened regulatory reform. If the UK does not improve, it will continue to lose jobs and investment to rapidly growing economies such as India and China and to more lightly regulated economies closer to home such as those in Scandinavia, Eastern Europe and Ireland.

### 1.3.3. Measuring the Regulatory Burden; Benefits Must Outweigh the Costs

Our starting point of principle is that we should have regulations only where the benefits outweigh the costs. We believe that, before a regulation is enacted, thought should be given to all of its likely consequences, and that new regulations should be carefully scrutinised to see if their objectives could be achieved by less restrictive means. Too often this is not done, and unnecessarily burdensome regulations are enacted with little or no detailed analysis or challenge. There are a number of reasons for this.

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<sup>81</sup> Estimate included in the “Less is More” report of the Better Regulation Task Force. Even if this estimate is overly optimistic, it gives an idea of the sort of returns that could be achieved.



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1. **The immediacy of the media.** We live in a 24/7 media age which creates enormous pressure for immediate action by politicians to solve whatever problem is generating interest at the time. This pressure has been fed by the current Government's obsession with managing its business by media headline. The headline provided is often additional regulation;
  2. **Distrust of politicians.** The ability of politicians to resist calls that "something must be done" is weakened as a result of widespread mistrust of the political class. This makes it increasingly difficult for any voices of authority to oppose the superficially attractive demands of pressure groups for an instant legislative remedy;
  3. **Self interest in the regulation factory.** To a large extent, civil servants, employees of QANGOs, trade bodies, lawyers and in some cases the businesses that have to comply with regulation all have a common interest in preserving the existing regulatory regime. At its simplest, the regulation industry provides livelihoods for those who work within it;
  4. **Flaws in the regulation-making process.** There are flaws in our regulation-making processes which mean that draft legislation is not given the detailed attention and scrutiny that it ought to receive from civil servants, politicians and those who will be affected by it;
  5. **The search for a risk-free world.** The current Government, in particular, has propagated "nanny statism" and the idea that our lives must be de-risked. But it is not possible to create a risk free world, and regulating to try to achieve it strangles the vitality of society, undermining individual responsibility and civil society groups such as charitable and voluntary organisations.

We believe that the present regulatory position in the UK can be significantly improved. This does not mean that regulation has to become 'lax', but that it must become sensible, proportionate and, quite simply, better. The challenges that must be overcome should not be underestimated. Many of the drivers of unnecessary regulation are ingrained in our political culture, and many of the steps necessary to reduce the stock and flow of regulation require detailed work that is unlikely to grab headlines. If they are to be a success, our proposals will require sustained political support from across government. But with that support, we believe that they could make a huge difference.

## 1.4. Proposals

### 1.4.1. The Flow of Regulation

**Proposal 1:** A team should be established to develop a methodology for measuring policy costs and benefits and, if possible, to improve the Standard Cost Model by learning the lessons of its recent use in the UK and other European countries. The team should be headed by a senior figure and possess relevant experience (including that of developing and applying measurements systems such as the Standard Cost Model, and of completing and evaluating Regulatory Impact Assessments (RIA)).

**Proposal 2:** The National Audit Office (NAO) should independently audit each RIA, reporting to Parliament and relevant Select Committees.

**Proposal 3:** A standard should be identified below which RIAs are "failed" by the NAO (e.g. because they are incomplete or inaccurate). If an RIA is "failed" the department should do the work again before the proposal is introduced to Parliament.

**Proposal 4:** If a regulation is deemed to be urgent a Secretary of State should be able exceptionally to urge the House to accept rapid passage, even without a satisfactory RIA. However, such a regulation

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should have a sunset clause so that it falls after six months unless a proper RIA has been produced and debated by the House.

**Proposal 5:** Where the NAO deems an RIA to be unsatisfactory, the Better Regulation Executive (BRE) should work alongside the relevant department in completing the RIA and should ensure that the department understands why the RIA has failed and what it must do in respect of future RIAs to ensure that they are consistent with good practice.

**Proposal 6:** The NAO should work with the BRE and central government departments to improve the quality of RIAs, e.g. by incorporating more sophisticated cost and benefit measurement systems as they are developed, creating templates for particular types of regulations, educating Departmental Regulatory Units (DRU) as to regulatory good practice and setting targets for improvements in RIAs. The NAO should also continue to publish regular reports on the RIA performance of departments.

**Proposal 7:** RIAs should include not just estimates of costs (or "point" estimates), but the full range of costs and benefits that result from consultation, with maximum and minimum expectations.

**Proposal 8:** Individual civil servants should sign RIAs to confirm that they are satisfied that RIA procedures have been followed before they go to the NAO.

**Proposal 9:** The statement confirming RIAs should be altered so that it becomes "I have read the Regulatory Impact Assessment and I am satisfied that the benefits outweigh the costs", and ministerial introductions to RIAs should be clearly identified as independent of the RIA itself.

**Proposal 10:** All new regulations should have an RIA attached to the drafts for scrutiny and debate.

**Proposal 11:** Statutory Instruments should be divided into two categories: Regulatory Statutory Instruments and Process Statutory Instruments. They should be published, numbered and ordered separately.

**Proposal 12:** All new Regulatory Statutory Instruments that apply nationally should be debated before approval.

**Proposal 13:** A Select Committee should vote on every Regulatory Statutory Instrument before it is debated. The outcome of its votes and any reports it produces should be published.

**Proposal 14:** When reviewing RIAs, the NAO should identify those regulations that are most likely to benefit from more detailed Parliamentary scrutiny.

**Proposal 15:** All Regulatory Statutory Instruments should be amendable by Parliament.

**Proposal 16:** The Better Regulation Executive or Better Regulation Commission should investigate and report on when light touch and less prescriptive regulation could most usefully be adopted. The resulting guidance should be taken into account by the NAO when reviewing RIAs.

**Proposal 17:** Greater use should be made of "codes of practice" rather than direct regulation, and of regulatory drafting that is less prescriptive than traditionally used in the UK.

**Proposal 18:** As part of its audit of RIAs, the NAO should be vigilant to ensure that the Department has considered the inclusion of sunset clauses wherever appropriate. Sunset clauses should be standard where there is considerable uncertainty over costs and benefits, civil liberties are significantly restricted, or the regulation is in response to a crisis or public or media outcry.

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**Proposal 19:** The Government should set a conspicuous example of deregulatory intent by identifying a department or area of activity for a multiple sunset clause under which all regulations would be repealed by a specific date unless they can be justified.

**Proposal 20:** Guidance should be drawn up and built into RIAs requiring more frequent consolidation of legislation.

**Proposal 21:** Government should provide an online service that brings together related primary and secondary legislation so that people can see what law applies to them.

**Proposal 22:** Government departments should draw up a list of key activities and areas on which regulation is imposed and then identify all the applicable regulations and the *total* regulatory burden.

**Proposal 23:** Lead Departments should be appointed for each regulated sector, and should be responsible for keeping updated information on the regulations and burden imposed on that activity.

**Proposal 24:** RIA procedures should require departments considering further regulation of an activity to identify in RIAs all the regulations already governing that activity, and to take into account the cumulative regulatory burden in deciding whether further regulation is justified.

**Proposal 25:** RIA procedures should require departments to discuss proposed new regulations with other departments that regulate an activity, to ensure that contradictory requirements are not imposed and that different regulations fit sensibly together.

**Proposal 26:** Ministers should sign an additional statement on RIAs certifying that the regulation does not contradict any other regulation.

**Proposal 27:** Lead Departments should publish guidance explaining the different regulatory obligations governing each regulated sector.

#### **1.4.2. The Stock of Regulation**

**Proposal 28:** The team responsible for developing measurement methodology should consider how “full” system of regulatory budgets can most effectively be introduced, with a view to this taking place before the end of a first term.

**Proposal 29:** An incoming Conservative government should use the Standard Cost Model to assess the impact of all regulations and impose burden reduction targets based on this by the end of its first year.

**Proposal 30:** An urgent review should be carried out to identify regulations for repeal, consolidation or significant amendment, with the objective of repealing or reforming a significant number of regulations by the end of the first year in office.

**Proposal 31:** A Statute of Repeals should be introduced every year to help departments hit their targets for reducing their regulatory burden.

**Proposal 32:** All the deregulation proposals in the Conservative Party’s 2005 “Action on Deregulation” document that have not yet been implemented by the Government require urgent review. This particularly applies to small business thresholds and rules governing money laundering and speed cameras.

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**Proposal 33:** Specific legislation that should be included in an urgent review, in respect of reform, includes:

- Legislative and Regulatory Reform Act 2006
- The Equipment and Protective Systems Intended for Use in Potentially Explosive Atmospheres Regulations 2005
- Money Laundering Regulations 2003
- Waste Incineration Regulations, 2002
- Employment Act 2002 – Dispute Resolution Procedures
- Private Security Industry Act 2001
- Health and Social Care Act 2003
- Integrated Pollution Prevention and Control (IPPC), 2000
- Welfare Reform and Pensions Act of 1999
- Data Protection Act 1998
- The Employment Tribunals Act of 1996
- The Package Travel Regulations 1992
- Health and Safety at Work Act 1974 – Risk Assessment and Employment Law

### **1.4.3. Cultural Reform**

**Proposal 34:** Civil service high flyers should be promoted into senior posts responsible for deregulatory reform.

**Proposal 35:** Civil service promotion should be linked to deregulatory good practice through the formal appraisal process.

**Proposal 36:** A new award should be introduced for civil servants who deliver innovative and deregulatory solutions to policy problems.

**Proposal 37:** Civil service bonus payments should contain an incentive to hit regulatory budget targets, and further incentives for going under them.

**Proposal 38:** The number of regulations and regulatory burden created and removed by Ministers and departments should be gathered and published. The NAO should publicly rank departments in terms of their regulatory good practice.

**Proposal 39:** Current civil service inward and outward secondment programmes should be expanded.

**Proposal 40:** Guidance should be shorter, and proportionate, addressing the most common situations but without attempting to cover every possible eventuality. Guidance should also be produced by those responsible for implementing policy.

**Proposal 41:** The civil service should be more prepared to express opinions about the meaning of regulation; responses that essentially say “we don’t know” are unacceptable.

**Proposal 42:** From its first days in office, a Conservative government should challenge the public and press assumptions that encourage excessive regulation, and explain the likely effects of and reasons for its regulatory reforms.

**Proposal 43:** Government needs to explain to the business and legal communities the harm caused by overly-cautious behaviour, and encourage a proportionate response to regulation.

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**Proposal 44:** Greater steps should be taken to increase the involvement of business in deregulatory reviews and proposals. All current consultations should be listed on a single website as well as on individual departmental websites.

#### 1.4.4. Specific Themes

##### *Europe*

**Proposal 45:** A Conservative government should ask the House of Commons to establish an EU legislation scrutiny committee with powers akin to the Danes' Europaudvalge. This committee should be able to grill ministers and prevent the government signing up to EU legislation.

**Proposal 46:** A Conservative government should enhance the effectiveness of UK government lobbying in Europe, by using more senior ministers and senior domestic civil servants in negotiations; and embrace the idea of seeking to renegotiate down the regulatory burden on behalf of *all* Community members.

**Proposal 47:** A Conservative government should build on the Movement for European Reform, seeking to establish a broad coalition of like-minded countries to prevent EU regulatory initiatives which are excessive, unduly hasty or badly undertaken, pro-actively advocating mechanisms to restrain the regulatory flow.

**Proposal 48:** A Conservative government should press for all EU regulations to be subject to an Extended Impact Assessment (EIA) which genuinely challenges regulation. This will tend to reduce gold-plating and elaboration at the national level.

**Proposal 49:** A Conservative government should make the case for the EU whether to expand the role of the [Court of Auditors] or to found a new body, equivalent to the UK's National Audit Office, answerable to the European Parliament, which could review the effectiveness of the EU's RIA system.

**Proposal 50:** Carry out an urgent review, to be completed within six months, to consider which EU obligations impose the greatest regulatory costs and which could most usefully be repealed or reformed.

**Proposal 51:** In addition to building a broad coalition among EU Member States for the purposes identified in Proposal 48, the UK should also seek to obtain support for that coalition for the reform of specific existing EU regulations.

**Proposal 52:** If EU-wide reform proves impossible to achieve, the UK should seek to negotiate an opt-out from the most burdensome regulations.

**Proposal 53:** The urgent review of EU regulation should include the Working Time Regulations 1999 and regulation under the Social Chapter.

**Proposal 54:** Where EU legislation exists, and no opt-out is available, avoid applying a second layer of domestic legislation designed to achieve similar or even contradictory objectives. Similarly, where EU legislation only applies above a certain threshold (e.g. based on turnover or other appropriate criteria), if any domestic legislation is to be adopted for companies below the threshold, the domestic legislation should be tailored so far as possible to ease the transition for companies moving between the two (i.e. in terms of substantive and reporting obligations).

**Proposal 55:** Where appropriate EU Directives should be implemented in the UK less prescriptively by adopting wording that is the same as or very similar to that used in the Directive.

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**Proposal 56:** A Conservative government should promote more regulatory competition within the EU to benefit all Member States.

**Proposal 57:** A Conservative government should encourage employer organisations to be more effective at a pan-European level (as has been done by Unions).

#### *SMEs*

**Proposal 58:** Regulatory exemptions should be created where appropriate for businesses that meet either the DTI, Companies Act 1985 or European Commission criteria to be an SME.

**Proposal 59:** Specific reference should be made to the regulatory costs on SMEs in the new and more robust regulatory impact assessments put forward in proposals 1-10.

**Proposal 60:** SMEs should be exempt from specific categories of regulation where the evidence of policy success is lacking and the RIA identifies a disproportionately high productivity impact.

**Proposal 61:** The urgent review of legislation referred to in Section 12.1 should pay particular attention to the position of SMEs, looking for opportunities to repeal or exempt SMEs from legislation that imposes a disproportionate burden on them.

#### *Consumer contracts*

**Proposal 62:** A feasibility study should be carried out into how a plain English “responsibility” warning could be incorporated into consumer contracts, warning consumers that they are responsible for their own actions and requiring them to acknowledge this in some way (e.g. by signing). The study should consider how such a warning would interact with existing requirements of UK and EU law.

**Proposal 63:** The merits of having a new “regulatory court” serving retail consumers (akin to the small claims court) should be assessed, as part of a feasibility study of responsibility warnings.

#### *Financial Services*

**Proposal 64:** We propose that an incoming Conservative government should use the powers under Section 12 of the Financial Services and Markets Act to appoint an independent expert to conduct a review of whether the FSA is using its guidance giving powers to best effect in assisting firms to comply with regulatory change.

**Proposal 65:** We propose that a general presumption should be added to the FSA’s rule making powers in Part X of the Financial Services and Markets Act 2000 that pre-existing UK categories of financial instrument and investment services should not be maintained where the same ground is covered by its implementation of relevant European requirements. The FSA should be required to produce a specific justification and attached cost-benefit analysis if it considers such super-equivalence to be necessary.



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## 2. The Flow of Regulation

### 2.1. Measuring the Costs and Benefits of Regulation

Our first guiding principle is that government should enact regulations only where the benefits outweigh the costs. But the ability of governments and business communities across the world to measure regulatory costs and benefits is relatively poor. Different results are produced by different measurement systems. This is worrying, given the number of regulations that are now enacted each year and the harm caused by the growing cumulative burden.

#### 2.1.1. Background

Regulation imposes administrative and policy burdens on business. The administrative burden is the cost in time or money of complying with inspection and enforcement obligations, including form filling; it is typically 30% of the total costs of regulation. The policy burden is the cost of complying with the substantive requirements of a regulation, for example by reorganising a factory to comply with health and safety legislation.

Some of the first attempts to measure the regulatory burden were made by trade associations and other non-governmental bodies. The British Chamber of Commerce (BCC) in particular has looked at this through its Burdens Barometer.<sup>82</sup> In 2006 the BCC estimated the cumulative compliance costs to business of new regulations since 1998 to be £50.27 billion, and the increase from 2005 to 2006 to have been £11.37 billion. Other bodies have estimated that by 2003 the cumulative extra cost since 1997 was £22 billion,<sup>83</sup> and the annual increase in 2002 to have been £5.92 billion.<sup>84</sup> These figures illustrate the extent to which measurement results can diverge, but also that the overall regulatory burden is undoubtedly huge and measured in tens of billions of pounds.

The Dutch Government recently adopted the Standard Cost Model (SCM), a method of measuring administrative costs. In March 2005, in conjunction with the 2005 budget, two reports commissioned by the UK Government were published: “Less is More”, commissioned from the Cabinet Office by the Prime Minister and produced by the Better Regulation Task Force (BRTF), and the Hampton Report, produced at the request of the Chancellor of the Exchequer. Both reports highlighted the unacceptable burdens currently being imposed on businesses and offered recommendations to solve the problem and made sensible proposals which were fully supported by the Government at the time and which it promised to act on.

Specifically in relation to measurement, the “Less is More” report recommended new procedures to measure the administrative burdens faced by businesses and other organisations using an approach based on the SCM. The Government has acted on this recommendation, and the process has highlighted some of the more general problems relating to regulation in the UK. In particular, before reduction targets could be set, it was necessary to establish exactly what burden was currently being imposed. Very few departments had a good understanding of which regulations were currently in force; let alone what their impact on business was. Nor is there information across government, identifying where regulations overlap or where different government departments have created conflicting obligations.

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<sup>82</sup> <http://www.chamberonline.co.uk/czP1NeJohOhB8A.html>.

<sup>83</sup> The Peninsula Group. This group, which specialises in employment law, also conducted a survey of 3,000 businesses in January 2003. It found that the amount of time spent dealing with government regulation by the average employer increased from three hours in 1997 to nine in 2003, and that the average financial cost per business was up by 50% to £26,762 in 2002. A recent ICAEW survey shows that each British company spends an average of £13,464 a year implementing new legislation.

<sup>84</sup> The Institute of Directors.

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## 2.1.2. Our Measurement Proposals

The Standard Cost Model (SCM) represents a welcome step forward. However, the SCM does not produce a statistically accurate measure of *administrative* burdens – a fact that has not been recognised fully by the UK Government, which continues to refer to figures as if a statistically accurate process has been conducted. Perhaps more fundamentally, there remains no agreed method for measuring regulatory *policy* costs (the economic costs of complying with the regulation, such as purchasing new equipment), which constitute the majority of regulatory costs. Nor is there any agreed method of measuring regulatory benefits.

We accept that it is unlikely that certain types of costs and benefit can accurately be measured, at least over the medium term. For example, while it may be possible to quantify the benefits of an education in terms of increased earnings, a great deal more work on the measurement of well-being (currently being investigated by the Conservative Quality of Life Policy Group) will be required before it is possible even roughly to quantify the enrichment to a person's day-to-day life that an education also provides. But the fact that our measurement abilities are never likely to be perfect does not, in our view, mean that we should not strive to improve. The better our ability to measure costs and benefits, the less our assessments of the merits of regulations will have to rely on anecdotal information, intuition and guesswork, and the fewer inefficient or counter-productive regulations will be enacted.

**Proposal 1:** A team should be established to develop a methodology for measuring policy costs and benefits and, if possible, to improve the Standard Cost Model by learning the lessons of its recent use in the UK and other European countries. The team should be headed by a senior figure and possess relevant experience (including that of developing and applying measurements systems such as the Standard Cost Model, and of completing and evaluating RIAs).

## 2.2. Regulatory Impact Assessments (RIAs)

### 2.2.1. Current Problems with RIAs

Regulatory Impact Assessments (RIAs) are the way in which departments currently attempt to analyse whether a regulation is necessary and what form it should take. The Better Regulation Executive's (BRE) website states:

*“An RIA must set out the issue you want the policy to address and the options available to do this. The options you consider must include a 'do nothing' option and non-legislative options such as Codes of Practice, industry standards or accreditation schemes. A good RIA will address the questions 'What is the best way of achieving the objective?’”*

We wholly support these aims, but current practice falls far short of the principle. The National Audit Office's (NAO) 2006 report on RIAs<sup>85</sup> concluded:

*“RIAs are often not used in the right way. The purpose of RIAs is not always understood; there is a lack of clarity in the presentation of the analysis; and persistent weaknesses in the assessments ... As a result, RIAs are only occasionally used to challenge the need for regulation and influence policy decisions ... the RIA process was often ineffective if started late, the policy area was politically sensitive or regulations needed to be introduced quickly ... Departments have focussed primarily on the introduction of new regulations and had largely neglected to evaluate the impact of new regulation after it is introduced ... There was inconsistency between policy officials' understanding of the need for RIAs, when they should*

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<sup>85</sup> Evaluation of Regulatory Impact Assessments, 2005-06.

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*be started and the level of analysis required ... RIAs were often seen by officials as a bureaucratic task rather than being integral to the process of policy-making”.*

These problems are enduring. The NAO noted that, “this is our third year of evaluating the quality of RIAs and overall results have been disappointing. RIAs ... have not yet been a tool which has dramatically altered the regulatory landscape or the way government thinks about regulations”.

### **2.2.2. An Independent Body Accountable to Parliament to Review and Assess RIAs**

These problems are not surprising. Regulatory good practice is not well understood in government departments, and is likely to be in tension with a ministerial and civil service culture focussed on getting new legislation onto the statute book as quickly as possible. However, we believe that RIAs are a potentially useful tool if they are used more effectively.

We do not believe that the answer is to remove primary responsibility for completing RIAs from departments. Such a move would take RIAs out of the hands of those who are familiar with the policy detail and hamper attempts to integrate RIAs into the policy-making process. But RIAs must improve, and we consider that this is most likely to happen if RIAs are closely scrutinised by an expert body outside of the government departments. We think this should be the NAO, which is well respected, has experience of scrutinising RIAs and is staffed by expert economists and accountants.

Further, the NAO should act as a support to Parliament, which is the main body responsible for assessing laws and their impact, but which is not currently able to scrutinise the huge number of regulations enacted each year. We expand on this further below.

**Proposal 2:** The National Audit Office (NAO) should independently audit each RIA, reporting to Parliament and relevant Select Committees.

### **2.2.3. A Sanction of Delay**

If the scrutiny process is to be effective, there must be some sanction where the NAO (or, alternatively, the relevant Select Committee on the NAO’s recommendation) deems an RIA to be unsatisfactory. Given that many of the drivers of bad regulation are ingrained in our political culture and processes, it is necessary to create hurdles to try to make it more difficult for government to enact legislation that has not been properly thought through.

We consider that the NAO should develop some measure of RIA quality, so that it is possible to identify RIAs that are poor, in the sense that they have either not been carried out properly (e.g. are incomplete or inaccurate) or have not been produced at the right stage in the policy development process. A standard should be identified below which RIAs are “failed” in the sense of being deemed unsatisfactory. If an RIA is “failed” the department should have to do the work again before the proposal is introduced to Parliament. Subsequent compliance should be substantive. The department should actually consider whether the regulation is necessary, or whether its objectives could be achieved in a less burdensome way – a box ticking exercise should not be sufficient.

**Proposal 3:** A standard should be identified below which RIAs are “failed” by the NAO (e.g. because they are incomplete or inaccurate). If an RIA is “failed” the department should do the work again before the proposal is introduced to Parliament.

Where an RIA is failed, we would normally expect Ministers not to introduce the regulation to Parliament until the RIA has been properly completed. We accept, however, that in a very limited number of cases there may be an urgent need for legislation which overrides RIA considerations. In such cases, the relevant Secretary of State should take responsibility for authorising the passage of a

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regulation without a satisfactory RIA, and a sunset clause should be included to ensure that a full and satisfactory review of the impact of the regulation is subsequently carried out.

**Proposal 4:** If a regulation is deemed to be urgent a Secretary of State should be able exceptionally to urge the House to accept rapid passage, even without a satisfactory RIA. However, such a regulation should have a sunset clause so that it falls after six months unless a proper RIA has been produced and debated by the House.

#### 2.2.4. Improving RIAs

It would be undesirable if large numbers of RIAs have to be “failed”. That is not our objective. Rather it is that NAO review supported by a sanction of delay should give departments an incentive to learn to implement RIAs effectively. Processes should be put in place to ensure that the NAO’s reports and the wide experience of RIAs that it will gain are used to educate departments about RIA and regulatory good practice. We consider that the BRE could play a useful role in this respect.

**Proposal 5:** Where the NAO deems an RIA to be unsatisfactory, the Better Regulation Executive (BRE) should work alongside the relevant department in completing the RIA and should ensure that the department understands why the RIA has failed and what it must do in respect of future RIAs to ensure that they are consistent with good practice.

**Proposal 6:** The NAO should work with the BRE and central government departments to improve the quality of RIAs, e.g. by incorporating more sophisticated cost and benefit measurement systems as they are developed, creating templates for particular types of regulations, educating Departmental Regulatory Units (DRU) as to regulatory good practice and setting targets for improvements in RIAs. The NAO should also continue to publish regular reports on the RIA performance of departments.

#### 2.2.5. Changes to RIAs and RIA Processes

We consider that RIAs and RIA processes should be amended so as to improve the scrutiny of regulations and the quality of legislation enacted by Parliament. Often the valuation of the costs and benefits of any particular regulation are arrived at after a period of consultation, but do not reflect that consultation.

**Proposal 7:** RIAs should include not just estimates of costs (or "point" estimates), but the full range of costs and benefits that result from consultation, with maximum and minimum expectations.

Civil servants should be focussed on ensuring that they have followed RIA procedures.

**Proposal 8:** Individual civil servants should sign RIAs to confirm that they are satisfied that RIA procedures have been followed before they go to the NAO.

The ministerial statement is only that the benefits justify the costs – not that the benefits outweigh the costs, and lengthy ministerial statements are often attached to the front of RIAs.

**Proposal 9:** The statement confirming RIAs should be altered so that it becomes "I have read the Regulatory Impact Assessment and I am satisfied that the benefits outweigh the costs", and ministerial introductions to RIAs should be clearly identified as independent of the RIA itself.

At present, RIAs are published only with enacted regulations. RIAs should instead be published as part of the process of making regulations and should always be attached to regulations when they are laid before Parliament. RIAs should also be published where regulations are withdrawn.

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**Proposal 10:** All new regulations should have an RIA attached to the drafts for scrutiny and debate.

## 2.3. Parliamentary Procedures

In addition to RIA reform, we consider that other changes to the regulation-making process would improve the ability of Parliament, including Select Committees, to scrutinise proposed regulations.

Parliament currently struggles to identify which regulations impose the greatest burden or would benefit most from closer consideration, in part because of the huge number of regulations that are passed each year.

One problem is that, as well as imposing regulatory obligations, Statutory Instruments (SI) deal with matters of process in government, i.e. things which are not regulation at all. This makes it difficult to identify what is regulation and what is process, making it harder for Parliament to identify on which SIs it should focus.

**Proposal 11:** Statutory Instruments should be divided into two categories: Regulatory Statutory Instruments and Process Statutory Instruments. They should be published, numbered and ordered separately.

Many regulations are passed in the form of a Statutory Instrument, often through the negative resolution procedure, which means that they become law unless Parliament votes against them. Evidence suggests that 2,000 SIs are, in effect, rubber stamped in this way by Parliament each year<sup>86</sup> (notwithstanding the ability of an alert opposition to demand a debate and vote on a negative resolution). We do not believe that it is healthy that so many regulations are given no scrutiny by Parliament.

**Proposal 12:** All new Regulatory Statutory Instruments that apply nationally should be debated before approval.

In part to provide support to the House in advance of its debates, one of the existing Select Committees, perhaps the Statutory Instruments Review Committee, should review and vote on every Regulatory Statutory Instrument. This should be the same Select Committee to which the NAO sends its reports on RIAs. Where appropriate, for example because it considers there to be issues that require further scrutiny, the Select Committee should be able to write a brief report on the regulation. The outcomes of the Select Committee's votes and any reports should be published.

**Proposal 13:** A Select Committee should vote on every Regulatory Statutory Instrument before it is debated. The outcome of its votes and any reports it produces should be published.

The Select Committee itself is likely to struggle to identify the regulations to which it should give most attention, or to identify the main potential improvements. We therefore consider that when the NAO reviews RIAs, as well as assessing whether the department has properly followed the RIA process, it should also identify those regulations that are most likely to benefit from more detailed scrutiny by the Select Committee and Parliament as a whole. This may involve identifying those regulations which impose the greatest burden, or those where there is a real issue as to whether the regulation is necessary or whether its objectives could be achieved through less burdensome means (we are not suggesting that the NAO should second guess the relevant department in this respect, stating whether or not it agrees with the department's assessments - merely that the NAO should identify where issues exist on which reasonable people may differ).

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<sup>86</sup> Tim Ambler and Francis Chittenden (2006) *The Management of Secondary Legislation*, Vol II: Evidence, House of Lords Paper 149-II, 192-6



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**Proposal 14:** When reviewing RIAs, the NAO should identify those regulations that are most likely to benefit from more detailed Parliamentary scrutiny.

The quality of regulatory SIs often suffers as a result of the fact that, even when they are debated, they are not amendable by Parliament. If the additional information that we believe should accompany regulations laid before Parliament is to be capable of being put to good use, this needs to be changed.

**Proposal 15:** All Regulatory Statutory Instruments should be amendable by Parliament.

## 2.4. A New Approach to Regulation

One of the main reasons for measuring regulatory costs and benefits more seriously, and for arming Parliament with the means of scrutinising regulatory statutory instruments more effectively is to encourage a shift in the Government's approach to the type of regulation that it adopts and the type of provisions that it includes in new regulations. We believe that what is required is a culture within Whitehall that favours "light touch" and less prescriptive regulation, and sunset clauses.

### 2.4.1. Light Touch and Less Prescriptive Regulation

If government wants to achieve an objective, there are many tools at its disposal as alternatives to regulation, some of which are less burdensome than others. The spectrum of possible alternatives is well known in regulatory theory, and includes: making an act a criminal offence, imposing sectoral rules policed by a regulatory body, introducing competition, requiring the provision of information to customers, creating financial incentives, and encouraging self-regulation. Other non-traditional methods are also being developed.

RIAs already require government departments to consider alternatives to more traditional but more burdensome types of regulation. The problem is that this is not being done as much as it should be. For example, greater use could be made of industry codes of practice, as an alternative to full regulation. We consider that further research should be carried out in relation to when "light touch" regulation could most usefully be adopted. The resulting guidance should be taken into account by the NAO when reviewing RIAs.

In comparison to our European neighbours, the UK tends to adopt regulations that are extremely prescriptive. Such regulation removes any scope for those bound by it from choosing precisely how they are to achieve the required end result (e.g. by choosing the method that is least burdensome for their company). It also limits the possibility for sensible judicial interpretation to take into account the circumstances of each case, and can produce legislative requirements that quickly date, particularly in this time of rapid technological change. We think there is scope for increased use of less prescriptive regulation (e.g. through the use of "broad" definitions).

**Proposal 16:** The Better Regulation Executive or Better Regulation Commission should investigate and report on when light touch and less prescriptive regulation could most usefully be adopted. The resulting guidance should be taken into account by the NAO when reviewing RIAs.

**Proposal 17:** Greater use should be made of "codes of practice" rather than direct regulation, and of regulatory drafting that is less prescriptive than traditionally used in the UK.

### 2.4.2. Sunset Clauses

The consequences of a regulation often differ from what was originally envisaged. A regulation may not achieve its objective as well as was hoped, or the costs it imposes may be greater than expected.



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On other occasions, regulations have significant perverse or distorting effects; for example, following the imposition of a 48 hour target for GP's surgery appointments, surgeries did not allow appointments to be booked outside of that time.

Sunset clauses are particularly appropriate where there is considerable uncertainty over the costs and benefits of a regulation, where a measure extends the power of the state or restricts civil liberties, or where the action is in response to a crisis or public or media outcry. Much of this is captured in the Cabinet Office's guidance which asks policy makers to "look for opportunities" to use sunset clauses. But there have been few examples of sunset clauses in practice.

**Proposal 18:** As part of its audit of RIAs, the NAO should be vigilant to ensure that the Department has considered the inclusion of sunset clauses wherever appropriate. Sunset clauses should be standard where there is considerable uncertainty over costs and benefits, civil liberties are significantly restricted, or the regulation is in response to a crisis or public or media outcry.

### 2.4.3. A Multiple Sunset Clause

In addition to helping to limit the flow of regulation, a particular type of sunset clause could also help reduce the stock of regulation (discussed in Part III). One of the difficulties with deregulatory initiatives is that Ministers and civil servants can find it difficult to get away from a presumption that new regulations are necessarily a good thing. When reviewing existing regulations, their instinct is often to assume that the regulation should stay in place unless there is an overwhelming and immediately obvious reason why the regulation should be repealed, rather than asking whether the regulation's benefits outweigh its costs and questioning whether the regulation should have been enacted in the first place.

One potentially useful method to reverse this way of thinking, and which could bring about a significant reduction in the overall burden, is to impose a multiple sunset clause (e.g. of two years) on a large group of regulations. The regulations targeted could be, for example, all the non-EU regulations of a government department or agency, or all those relating to a particular type of activity (such as one that suffered from a particularly great cumulative burden). The body or bodies responsible for the regulations would then have to review them and justify why the regulations should be retained before the expiry of the sunset period. Any regulations that could not be justified would automatically be repealed at the end of the sunset period.

We consider that it would be beneficial to impose such a multiple sunset period in the early years of a first Conservative term. Subsequent multiple sunset clauses could be imposed on departments or agencies that were performing poorly from a deregulatory perspective.

**Proposal 19:** The Government should set a conspicuous example of deregulatory intent by identifying a department or area of activity for a multiple sunset clause under which all regulations would be repealed by a specific date unless they can be justified.

## 2.5. The Cumulative Regulatory Burden

It is the cumulative burden of regulation that is the major concern of many businesses. The burden imposed by any single regulation may not be great, but companies find themselves subject to numerous regulations that have piled on top of one another over time, each imposing their own costs – a case of death by a thousand cuts. Often, so many different regulations are potentially applicable to an activity that both government departments and businesses struggle to identify them all. One of the reasons for this is that law makers do not do enough to see the world from the perspective of those that have to comply with regulation.

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### 2.5.1. Consolidation

Simply identifying relevant regulations can often be difficult and time consuming. Rules governing essentially the same thing may be contained in tens of Acts and SIs. Parliament should do a better job of communicating the regulatory framework to the public and those who have to navigate through it. More frequent consolidation of legislation may take more time for civil servants and Parliamentary draughtsmen, but the costs would be outweighed by the resulting reduction in the compliance burden.

**Proposal 20:** Guidance should be drawn up and built into RIAs requiring more frequent consolidation of legislation.

Even where regulations are not actually consolidated, we consider that government should provide an online service which effectively “consolidates” both primary and secondary legislation for the user. The service should also inform users of related pieces of legislation, for example where SIs have been enacted under various different sections of an Act. Similar services are provided by other governments across Europe. Currently, such services are provided in the UK by private providers, for example to law firms and barristers’ chambers. But these private services are expensive, and out of reach of many smaller companies.

**Proposal 21:** Government should provide an online service that brings together related primary and secondary legislation so that people can see what law applies to them.

### 2.5.2. Coordination between Government Departments

Many regulatory problems are caused or exacerbated by the fact that the same activity is governed by regulations produced by several different departments, but each department does not know what the other departments have done or are doing. As a result, when making a new regulation governing an activity, a department may have little knowledge of what obligations and burdens are already imposed on that activity by other regulations. As a result, departments fail to take into account the cumulative burden that already exists in relation to that activity, and sometimes impose new obligations that contradict or are in tension with existing obligations.

We propose that the Government should identify all the regulations that govern certain key activities, in particular important business processes.

**Proposal 22:** Government departments should draw up a list of key activities and areas on which regulation is imposed and then identify all the applicable regulations and the total regulatory burden.

This will require different departments to work together, and we consider that the task could be coordinated by the BRE. Trade associations should be consulted for the purpose of selecting the relevant business processes. The regulatory burden imposed on each activity should then be calculated, and kept updated by a Lead Department (e.g. the department responsible for imposing the greatest burden).

Any department considering enacting a new regulation should ascertain all the other regulations that already apply to the same activity and take into account the existing cumulative burden, in deciding whether further regulation is justified. A department should also discuss its proposals with other departments regulating the activity, to ensure that contradictory requirements are not imposed and that the different regulations fit sensibly together, minimising the cumulative regulatory burden as far as possible. The relevant Lead Department should publish guidance explaining the different regulatory obligations governing each activity. The guidance should be updated with each new regulation that is published.

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**Proposal 23:** Lead Departments should be appointed for each regulated sector, and should be responsible for keeping updated information on the regulations and burden imposed on that activity.

**Proposal 24:** RIA procedures should require departments considering further regulation of an activity to identify in RIAs all the regulations already governing that activity, and to take into account the cumulative regulatory burden in deciding whether further regulation is justified.

**Proposal 25:** RIA procedures should require departments to discuss proposed new regulations with other departments that regulate an activity, to ensure that contradictory requirements are not imposed and that different regulations fit sensibly together.

**Proposal 26:** Ministers should sign an additional statement on RIAs certifying that the regulation does not contradict any other regulation.

**Proposal 27:** Lead Departments should publish guidance explaining the different regulatory obligations governing each regulated sector.

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## 3. The Stock of Regulation

### 3.1. The Failure of Past Deregulatory Initiatives

The 2006 Legislative and Regulatory Reform Act is the latest statutory attempt at facilitating deregulation. However, quite apart from the danger of increased regulation being generated by this Act, we are sceptical about whether this latest mechanism will in practice produce much deregulatory activity, because the problem is not primarily with the relevant empowering Acts, but with deeper problems ingrained in our political processes. There have been numerous deregulatory initiatives over the past 20 years, most of which have had limited effect. The paper, “Deregulation or Déjà Vu? UK Deregulation Initiatives 1987/2006”, by Tim Ambler and Francis Chittenden, neatly summarises previous deregulatory initiatives and why they mostly failed. The authors describe the traditional sequence of events as follows:

- Government agrees that there is excessive regulation and requests examples of regulations that can go;
- Industry finds it hard to substantiate examples because it has become inured to the regulations, and doubts anything will change. Challenging regulations is time consuming, especially as the problem is not a single regulation, but the cumulative effect of many regulations, which are often interconnected;
- Eventually a list is compiled;
- The civil service welcomes the list and expresses enthusiasm. It then takes many months, behind closed doors, to consider each item. The civil servants reject those they can and express good intent and more study for most of the others. A very few regulations are promised to be axed so that the Minister in charge can claim it was all a great success;
- Announcements are made or responses provided in answer to parliamentary questions about the number of proposals implemented or rejected. However, it should be noted that the civil service regards as “implemented” anything where the policy has changed, i.e. they have agreed it can be implemented. That does not mean it is implemented, i.e. axed, in practice.

The Conservative’s Deregulation and Contracting Out Act 1994 resulted in only 26 deregulations, from 53 firm proposals. Labour’s Regulatory Reform Act 2001 resulted in 27 deregulations, again over a four year period. The failure of deregulatory initiatives has little to do with party politics and everything to do with the difficulty of turning a regulation factory into a deregulatory one, with all the attendant cultural challenges.

This is why deregulatory reform is very difficult, and why many of our proposals are aimed at putting in place processes which require good practice when regulations are made, rather than merely piously recommending deregulation. It is also why deregulatory reform can only be successful if cultural problems are addressed at the same time – we deal with this in Section 4. Nonetheless, so long as the proposals in this Part are adopted as part of a broader package of deregulatory reform, we consider that they can usefully assist reducing the huge existing stock of regulation.

### 3.2. Regulatory Budgets

#### 3.2.1. Sophisticated Regulatory Budgets before the End of a First Term

The cumulative regulatory burden grows and grows. Regulatory budgets are a potentially useful tool to check this growth, and to ensure that the regulatory burden is reduced over time. They would address both the stock and flow of regulation.

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Regulatory budgets are already a part of Government policy – the Government’s Simplification Plans are a form of regulatory budget for administrative costs. But the plans do not address policy costs, and the Government has not embraced the “one in, one out” approach to regulation advocated by the Better Regulation Task Force in its “Less is More” report.

One of the major potential difficulties of regulatory budgets, namely the absence of a reliable system for measuring regulatory burdens, will progressively be addressed by our proposals in Section 5. Other challenges are to ensure that regulatory budgets do not spawn a large bureaucracy and that the target-setting inherent in regulatory budgets does not either distort incentives (e.g. because departments focus only on the specified targets at the expense of other aspects of regulatory good practice) or allow for ‘cheating’ by ‘figure fiddling’. Given the need for a proper system of cost-benefit analysis to be introduced before the regulatory budgets can be effective, and given also the significant practical issues that need to be addressed and resolved if regulatory budgets are to be a net benefit, we believe that the team responsible for developing a measurement methodology should also consider how a system of regulatory budgets could most effectively be introduced, with a view to this taking place before the end of a first term. Consideration should be given as to whether it would be possible to ‘trial run’ a system of regulatory budgets (e.g. with one department), allowing for the possibility of improvements to be made before the system is introduced across government.

**Proposal 28:** The team responsible for developing measurement methodology should consider how a “full” system of regulatory budgets can most effectively be introduced, with a view to this taking place before the end of a first term.

### **3.2.2. Immediate Application of Deregulatory Targets Based on the SCM**

While we consider that careful thought needs to be given before any “full” system of regulatory budgets is introduced, we also consider that a simpler system of targets based on the SCM could play a useful role in the first few years of a Conservative government, pending the development of a more sophisticated system. The SCM – however imperfect – has already been used for the purpose of the current Government’s Simplification Plans. Burden measurements should be taken of all regulations based on the SCM, and burden reduction targets, set for departments, by the end of the first year. These targets can then be refined in the light of further burden measurements conducted as the SCM is developed and improved.

**Proposal 29:** An incoming Conservative government should use the Standard Cost Model to assess the impact of all regulations and impose burden reduction targets based on this by the end of its first year.

## **3.3. A Programme for Regulatory Reform: Specific Regulations for Consideration**

### **3.3.1. The Need for a Review of Regulations to be Repealed or Reformed**

Given the evidence we have received, we strongly believe that individuals, companies and the UK economy as a whole will significantly benefit if a number of regulations are repealed and reformed – and this is not surprising, given the current absence of any effective, detailed analysis of the costs and benefits of a proposed regulation before it is enacted, and the widespread failure to consider whether the objectives could be achieved by less burdensome means.

Nonetheless, before a final view is taken on this, we consider that a more detailed assessment than our working group has been able to conduct would be appropriate. It may be, for example, that instead of simply repealing a regulation in its entirety and putting nothing in its place, the most appropriate course may be to introduce one or a combination of:

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1. some form of light-touch regulation (e.g. self-regulation);
  2. consolidation of several regulations; and
  3. to significantly amend a regulation.

We therefore propose that an incoming Conservative government should carry out an urgent review to identify regulations that should be repealed, consolidated, or significantly amended. The review should take into account administrative costs, as has been done in the current Government's Simplification Plans, but also policy costs. It should take into account the cumulative burden imposed on specific regulated activities, and the extent to which difficulties are caused by the interaction of different regulations. The review should also pay particular attention to how the burden of regulation could be reduced for SMEs. We consider that the objective should be to have repealed or reformed a significant number of regulations by the end of the first year in office, and that the review and repeal and reform process should continue into subsequent years.

**Proposal 30:** An urgent review should be carried out to identify regulations for repeal, consolidation or significant amendment, with the objective of repealing or reforming a significant number of regulations by the end of the first year in office.

**Proposal 31:** A Statute of Repeals should be introduced every year to help departments hit their targets for reducing their regulatory burden.

### **3.3.1.1. Specific Regulations to Be Included In the Urgent Review**

In this section we identify a number of specific regulations that we consider should be included in the urgent review (although the urgent review should not be limited to these regulations). We have reached no final view as to whether these regulations should be repealed or how they could best be reformed, but we consider that they warrant close scrutiny in this respect.

To the extent that the regulations implement EU law in the UK, as is the case in several instances, we consider that they should be included in the review and that if reform is considered appropriate, action should be taken in line with the strategy set out in the section dealing with European legislation (where we comment further on certain regulations under the Social Chapter and the Working Time Regulations).

### **3.3.1.2. The “Action on Deregulation” Document**

The Conservative Party document “Action on Deregulation”, published in early 2005, specifies 63 deregulation proposals, some of which have now been acted upon by the Government. The majority, however, remain in place. We consider that many of the proposals appear to have merit, including proposals relating to small business thresholds and rules governing money laundering and speed cameras.

**Proposal 32:** All the deregulation proposals in the Conservative Party's 2005 “Action on Deregulation” document that have not yet been implemented by the Government require urgent review. This particularly applies to small business thresholds and rules governing money laundering and speed cameras.

### **3.3.1.3. Specific Regulations for Consideration**

In addition to the “Actions on Deregulation” proposals, we have received evidence on and considered a number of other specific regulations that we think should also be included in the urgent review. It has been pointed out in several submissions that many regulatory burdens stem not from the actual statute law itself, but from a variety of shortcomings, including:



1. imposition of excessive bureaucracy (i.e. paperwork);
2. multiple enforcement regimes developed to implement the same legislation;
3. replication; some legislation covers the same ground as other in-force legislation; for example the Housing Act 2004 followed by the Clean Neighbourhoods and Environment Act 2005;
4. civil servants having wide ranging and sweeping powers which will led to yet more Statutory Instruments; the Legislative and Regulatory Reform Act 2006 is a prime example (and was highly controversial during the committee stages); and
5. a lack of detail in the Act itself, with most of the clauses creating the power to make changes via Statutory Instruments which themselves are also very short and do not help to clarify the situation.

Consequently the following list of legislation, business-related given our economic competitiveness perspective, includes candidates for reform, be it through amendment or consolidation<sup>87</sup>. Small firm exemptions are dealt with in the section on SMEs.

<b>Legislation</b>	<b>What was it intended to do?</b>	<b>Why may it be a good idea to reform it?</b>
Legislative and Regulatory Reform Act 2006	The Act is intended to promote productivity and ease the burden of regulation. It aims to enable Ministers to reform unnecessary or over-complicated legislation quickly, giving them broad powers to amend existing legislation and to promote regulatory principles without having to progress an amending Bill, which can be slow.	The deregulatory objectives behind this Act are fine; we disagree with the approach. All reform Acts utilise SIs and therefore actually make the legislation even more difficult to track. A better approach is to produce a single piece of legislation which coherently updates and consolidates the existing multiple layers (Acts and supporting SIs) of the current damaging legislation. These layers are then repealed. The need for the Legislative and Regulatory Reform Act then disappears.
The Equipment and Protective Systems Intended for Use in Potentially Explosive Atmospheres Regulations 2005	Regulations for equipment used in association with powders and other circumstances in which there is a 'potentially explosive atmosphere.'	Guidance available is inadequate and so companies must go to the full measures to prevent any risk, which comes at great cost and time, which are out of proportion to the actual level of risk. To avoid this, companies may hire consultants, but these, too, are costly, and they also err on the side of recommending potentially unnecessary expenditures.
Money Laundering Regulations 2003	Details identification, record-keeping, internal control and communication procedures to prevent money laundering.	The regulations lack clarity, are inconsistently applied and are illogical in respect of many situations.

<sup>87</sup> This list includes some of the regulations identified in the IoD's regulation case studies "In their own words: Volume II".

Waste Incineration Regulations 2002	This stipulates that any waste stream, no matter how harmless, to be burned in accordance with the Waste Incineration Directive (WID) if the Environment Agency so require.	It is accepted that general mixed waste ought to be subject to such regulations in order to prevent harmful emissions. However, the inflexible nature of regulations, and the manner in which they are enforced, is acting as a disincentive for companies to reuse or recycle waste materials. The Environment Agency / DEFRA has failed to provide a mechanism for gaining exemption based on actual environmental impact; industry therefore has to comply with the WID, which is expensive.
Private Security Industry Act 2001	The Act outlines a system for the statutory regulation of the private security industry.	The legislation is so vague that the Security Industry Authority (set up to police the Act) is effectively in a position to write their own rule book. The SIs used to support the Act are equally vague and have effectively allowed the Authority to interpret them as they see fit. Suggested approach: repeal all of the clauses and SIs other than those relating to the creation of the SIA and start again.
Health and Social Care Act 2003	Create a regulatory framework for health and social care.	The legislation established the Healthcare Commission and the Commission for Social Care Inspection as two separate regulatory bodies. The Government has since proposed their merger, but has failed to allocate the requisite Parliamentary time. We believe this reform must be proceeded with to reduce the number of regulatory bodies which provider organisations are subject to.
Integrated Pollution Prevention and Control (IPPC) 2000	It is a regulatory regime for controlling pollution from certain industrial sectors, such as energy, metal processing, minerals, chemicals, waste-management, and others.	Pollution control is clearly required; but data collection, reporting and permit fee run the risk of rendering medium-sized companies uncompetitive. The fee is about £6,000 p.a. and reporting is time consuming 10 business days a year. The IPPC is designed for large businesses but is being applied to medium sized companies; the measurements determining the size of a company, and therefore its obligations, are arbitrary.
Welfare Reform and	Small businesses with five	The burden on a small business is

Pensions Act of 1999	or more employees must offer a stakeholder pension.	too great and the scheme has failed to take off in the way intended. It should be repealed as part of the revamp of pensions – as is foreshadowed in the Government’s Personal Accounts White Paper.
Data Protection Act 1998	The Act gives the right to access information held about the applicant by organisations. It also governs how organisations can use the personal information that they hold – including how they acquire, store, share or dispose of it.	The use of good practice guidance from the regulator ratchets up requirements without going through the types of controls which would apply to the creation of new requirements. In this case, Section 51 (which creates the good practice guidance power for the Data Protection Commissioner) does not (i) require any cost benefit to be done before guidance is issued or (ii) create hard coded consultation requirements on guidance.
The Employment Tribunals Act of 1996	Defines the rights of employees to challenge employers in an inferior court, usually relating to unfair dismissal.	This Act is skewed in favour of employees who challenge their employers because the former do not suffer any monetary consequences for filing frivolous cases. Businesses are therefore left vulnerable to exploitation, and must often cover their own legal expenses resulting from the case. This decreases efficiency as unproductive workers are retained for fear of legal action (particularly affecting smaller businesses).
The Package Travel Regulations 1992	The Regulations control the sale and performance of packages sold or offered for sale in the UK.	They have failed to keep up with the way in which people now book holidays.
Health and Safety at Work Act 1974 – Risk Assessment and Employment Law	Improve safety at work	Inspection regime has no sense of proportion, failing to consider context and business implications.

The Data Protection Act 1998 deserves a specific mention as it imposes a huge regulatory burden. The BCC’s Burdens Barometer estimates that the Act imposes a recurring annual cost of £2.3 billion – the third highest recurring cost of all the new regulations on business legislated in the last 10 years. The Act implements EU law in the UK, and we are also conscious that people are increasingly concerned about how governments and large organisations use their personal data. Nonetheless, we strongly suspect that it would be possible to reform the Act in order to reduce its burden. We are also concerned that the Act as currently drafted may limit the ability of government departments to share innocuous data in order to reduce the administrative burden.

The Working Time Regulations 1999 and regulations enacted under the Social Chapter are discussed in more detail in Section 5.1.6.

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**Proposal 33:** Specific legislation that should be included in an urgent review, in respect of reform, includes:

- Legislative and Regulatory Reform Act 2006
- The Equipment and Protective Systems Intended for Use in Potentially Explosive Atmospheres Regulations 2005
- Money Laundering Regulations 2003
- Waste Incineration Regulations, 2002
- Employment Act 2002 – Dispute Resolution Procedures
- Private Security Industry Act 2001
- Health and Social Care Act 2003
- Integrated Pollution Prevention and Control (IPPC) 2000
- Welfare Reform and Pensions Act of 1999
- Data Protection Act 1998
- The Employment Tribunals Act of 1996
- The Package Travel Regulations 1992
- Health and Safety at Work Act 1974 – Risk Assessment and Employment Law

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## 4. Cultural Reform

### 4.1. Regulatory Culture: Government

Many of the proposals put forward in earlier sections of this report are intended to alter the ministerial and civil service culture and incentives which currently support the creation of more regulation without a sufficiently detailed analysis of whether it is really required or could be enacted in a less burdensome form. This culture needs to change, but there is also a need for a broader cultural change in society as a whole, including the groups to which Ministers and civil servants are responding – such as the business community, legal profession, the press and the wider public. Addressing these wider cultural issues will be a huge challenge, but significantly improving our regulatory performance will be very difficult until it is done. This and the following section discuss these issues and set out our proposals.

Over the past 150 years, regulation has brought about huge benefits for the UK: banning dangerous work practices, establishing the framework for basic services to be provided for the poorest in society, and putting in place stable frameworks encouraging the development of new industries. These days, however, the benefits of new regulation are often more marginal – in many cases, what is required is not new regulation but better implementation of existing rules. And the costs of new regulation are greater today as a result of the cumulative burden that has built up over time.

However, when the public, press or interest groups cry that “something must be done” in response to an event, with more regulation being the most obvious thing, Ministers and civil servants generally lack the incentives or authority to resist. Regulating provides immediate and tangible political benefits: the government and sponsoring MPs are seen to be addressing the problem, and the debate about the issue and legislation brings associated publicity. In contrast, regulatory good practice is detailed, time consuming and grabs no headlines. There is also little personal loss resulting from over-regulation (or gain resulting from regulatory best practice) for Ministers and civil servants over the medium to long term, as those responsible for a regulation have often moved on by the time that its effects become evident.

#### 4.1.1. Leadership and Incentives

Effective organisational and cultural change requires strong leadership. It is tempting for politicians to blame the ills of government on the civil service. But within departments leadership should come in the first instance from Ministers. Ultimately, civil servants do what their Ministers tell them to do. To be effective, regulatory reform requires strong leadership from Ministers across government.

Strong leadership is also required within the civil service. While we consider that the experience of the civil service could usefully be broadened, parachuting people from outside government into senior civil service positions is often not the best approach: they can lack the detailed knowledge of the apparatus of government necessary to get things done, and civil service morale can be damaged. It is important that those responsible for delivering regulatory reform are talented, hold senior positions and are genuinely committed to the reform programme.

**Proposal 34:** Civil service high flyers should be promoted into senior posts responsible for deregulatory reform.

Senior and junior civil servants should be given incentives to adopt regulatory good practice.

**Proposal 35:** Civil service promotion should be linked to deregulatory good practice through the formal appraisal process.

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**Proposal 36:** A new award should be introduced for civil servants who deliver innovative and deregulatory solutions to policy problems.

**Proposal 37:** Civil service bonus payments should contain an incentive to hit regulatory budgets or targets, and further incentives for bringing the regulatory burden down below budget or target.

#### 4.1.2. Transparency

Ministers and government as a whole should be accountable for their actions in the field of regulation. The cold light of day needs to shine on what they do. If the position were more transparent, there would be greater accountability, and some element of informal competition to deregulate might be created.

**Proposal 38:** The number of regulations and regulatory burden created and removed by Ministers and departments should be gathered and published. The NAO should publicly rank departments in terms of their regulatory good practice.

#### 4.1.3. Broadening Perspectives

When making regulations, government often fails properly to understand the position from the perspective of the regulated. One way to improve this is to increase cross-fertilisation between the private sector and the civil service (in particular civil servant high fliers and those parts of the civil service responsible for creating and implementing regulation).

**Proposal 39:** Current civil service inward and outward secondment programmes should be expanded.

#### 4.1.4. Approach to Risk

One of the reasons why regulatory guidance is so detailed and complex is that an attempt is often made to cover all possible eventualities, however remote they may be. There is a fear that, if this is not done, the civil service will get the blame. This is not sensible. We also consider that, in order to minimise the risk of bias, guidance should be written by the part of government responsible for implementing regulation, rather than devising policy.

**Proposal 40:** Guidance should be shorter, and proportionate, addressing the most common situations but without attempting to cover every possible eventuality. Guidance should also be produced by those responsible for implementing policy.

Related to this, there is reluctance on the part of the civil service to give clear answers to questions about what regulations require, again probably because of a fear of being blamed. We were told that one businessman asked both the Dutch and the British Governments for guidance on a prospective EU directive. The British Government sent more than 150 pages with a huge disclaimer basically saying "we don't know"; the Dutch Government sent about 9 pages, explaining quite simply what they expected the consequences to be.

**Proposal 41:** The civil service should be more prepared to express opinions about the meaning of regulation; responses that essentially say "we don't know" are unacceptable.

## 4.2. Regulatory Culture: Beyond Government

The reason why politicians and the civil service act as they do is in large part driven by broader society, including the public and press. Too often people respond to problems by calling for an immediate change in the law, when other action may be more appropriate. New regulations get



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attention, whereas more detailed, low-key work does not. And when things go wrong, we all like to find someone to blame.

Government needs to begin challenging these tendencies more forcefully, and to explain the need for regulatory reform to a wider audience. If regulation-making is to take more time, with delays resulting where RIAs are failed, the reasons behind these changes must be explained. This should be done in particular in the early days of a Conservative government, when its power to affect public debate is at its greatest.

**Proposal 42:** From its first days in office, a Conservative government should challenge the public and press assumptions that encourage excessive regulation, and explain the likely effects of and reasons for its regulatory reforms.

Another factor tending to increase the size of the regulatory burden is the fact that lawyers, as well as civil servants, tend to be overly cautious. Legal advice frequently tells or encourages business to adopt the most cautious alternative, even where it is inefficient and not demanded by regulation.

**Proposal 43:** Government needs to explain to the business and legal communities the harm caused by overly-cautious behaviour, and encourage a proportionate response to regulation.

Finally, the business community needs to be encouraged to play a greater role in improving regulation. Many businesses have a love-hate relationship with regulation: while they may criticise its costs, some appreciate the certainty it provides, and others have developed an embedded culture attuned to supporting a complex regulatory environment.

Businesses need to be encouraged to come forward with deregulatory proposals, and to be heavily involved in reviews considering deregulatory reform. Consultations should be widely published to ensure that trade associations, companies and individuals all have an opportunity to submit their comments and concerns.

**Proposal 44:** Greater steps should be taken to increase the involvement of business in deregulatory reviews and proposals. All current consultations should be listed on a single website as well as on individual departmental websites.

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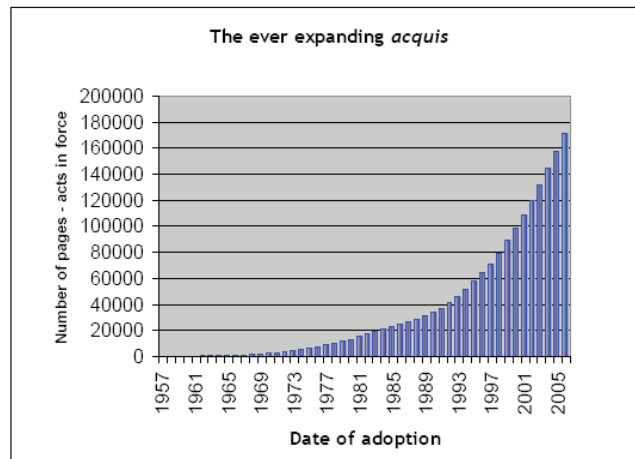
## 5. Specific Themes

### 5.1. European Regulation

#### 5.1.1. The European Regulatory Burden on Europe

In October 2006 EU Industry Commissioner Gunter Verheugen reported that EU legislation now costs European business €600 billion (£405 billion) a year; 5.5% of total EU GDP. This was seen by many as an admission from the Commission that the benefits of the single market are now being outweighed by the costs of the extra regulation required to create it.

Also in October 2006, ICM published the results of a poll of 1,000 British Chief Executives which supported this view; the majority of CEOs felt that the costs of EU regulation now outweighed the benefits that the EU's single market provided for their company. The growth trend in the volume of the active part of the EU's *acquis communautaire*, the body of legislation we have to comply with, further reinforces the concerns.



*Source: EU database Eur-lex*

The adverse effects of regulation coming from the EU on the competitiveness of the UK economy are now impossible to ignore; a significant proportion of the regulation imposed on the UK economy is developed, implemented and, to some extent, enforced at the EU level. The EU is responsible for four of the five most costly regulations on UK businesses (the Working Time regulations being the largest). The total cost of these EU regulations to the UK's economy was over £30 billion between 1998 and 2005 alone. Half of the regulations that impose a burden on UK business originated in the EU. More importantly, 77% of the *cost* of regulation on UK business since 1998 has been driven by EU legislation<sup>88</sup>.

The current European Scrutiny Committee and three EU Standing Committees are too weak to deal with the flood of EU legislation. The government can readily override MPs who explicitly ask it not to sign up to a proposal until it has been discussed at Westminster (the "scrutiny reserve").

**Proposal 45:** A Conservative government should ask the House of Commons to establish an EU legislation scrutiny committee with powers akin to the Danes' *Europaudvalge*. This committee should be able to grill ministers and prevent the government signing up to EU legislation.

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<sup>88</sup> "Just how big is the *acquis communautaire*?" Open Europe, 2007

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### 5.1.2. A More Pro-Active, More Effective Approach to Working with the EU

UK governments and Ministers have historically placed a much lower priority on participating in EU business than other Member States and their politicians. This has been for a range of reasons – some obvious, namely the national ambivalence towards the EU, others less evident, namely a feeling that there is little political benefit achievable by Ministers from participating in negotiations. This has meant that UK interests have not been promoted as actively as they should have been, and that unnecessarily burdensome regulation has been enacted, to the detriment of the UK and the EU as a whole.

**Proposal 46:** A Conservative government should enhance the effectiveness of UK government lobbying in Europe, by using more senior ministers and senior domestic civil servants in negotiations; and embrace the idea of seeking to renegotiate down the regulatory burden on behalf of *all* Community members.

Notwithstanding the “Better Regulation” agenda being developed in the EU, the process for developing EU law suffers from many of the same problems that are present in the UK. Commissioner McCreevy has been very assertive about the need for a period of minimum new regulation and legislation, combined with a very serious and sustained shift of EU efforts to the neglected areas of implementation and enforcement. The UK should aspire to become a world-leader in regulatory good practice, and once we have satisfied ourselves that we have an effective approach, be bold in advocating our methods to the European Commission and other Member States, attempting to build a broad coalition for regulatory reform. EU regulations impose a burden across all EU businesses, not only those in the UK, and we believe it is in the interests of the UK for the EU as a whole to become more competitive globally.

**Proposal 47:** A Conservative government should build on the Movement for European Reform, seeking to establish a broad coalition of like-minded countries to prevent EU regulatory initiatives which are excessive, unduly hasty or badly undertaken, pro-actively advocating mechanisms to restrain the regulatory flow.

### 5.1.3. UK Negotiation with Europe

As in the UK, a great deal of EU legislation is not subject to a proper economic impact assessment. A recent study by the British Chambers of Commerce found that only 0.5% of EU regulations are subject to Regulatory Impact Assessments (RIAs) in the UK; at the EU level this figure is only 0.2% of regulations. Many of these were published too late to matter and they are often of very low quality.

**Proposal 48:** A Conservative government should press for all EU regulations to be subject to an Extended Impact Assessments (EIA) which genuinely challenges regulation. This will tend to reduce gold-plating and elaboration at the national level.

**Proposal 49:** A Conservative government should make the case for the EU whether to expand the role of the [Court of Auditors] or to found a new body, equivalent to the UK’s National Audit Office, answerable to the European Parliament, which could review the effectiveness of the EU’s RIA system.

### 5.1.4. Reducing the Burden from Existing EU Regulations

We proposed in Section 12.1 that an incoming Conservative government should carry out an urgent review of UK regulations to identify those obligations that could most usefully be repealed or reformed. That review should include UK regulations which implement EU law in the UK.

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For some regulations, the answer may be that all of its obligations could usefully be repealed. However, that may not be the position in all cases, and a more nuanced approach is likely to improve the prospects for success in our next proposed stage, discussed below.

**Proposal 50:** Carry out an urgent review, to be completed within six months, to consider which EU obligations impose the greatest regulatory costs and which could most usefully be repealed or reformed.

### 5.1.5. The Need for Regulatory Competition

Once appropriate obligations have been identified, we consider that a Conservative government should seek to persuade the EU Member States and institutions to agree to implement the UK's proposed reforms. A number of Member States increasingly recognise the importance of regulatory reform, and we consider that it may be possible to build a coalition.

**Proposal 51:** In addition to building a broad coalition among EU Member States for the purposes identified in Proposal 48, the UK should also seek to obtain support for that coalition for the reform of specific existing EU regulations.

If the government's efforts to work with other Member States yield little reduction in the regulatory burden, Britain should seek to negotiate an opt-out for the UK from the most burdensome regulations. In an enlarged EU, significant differences between the circumstances or priorities of different Member States will arise more and more frequently. Permitting opt-outs from EU legislation is one way of taking these differences into account.

**Proposal 52:** If EU-wide reform proves impossible to achieve, the UK should seek to negotiate an opt-out from the most burdensome regulations.

### 5.1.6. The Working Time Regulations and the Social Chapter

We do not think that the urgent review of regulations should be limited to those that we identify in this report. We do, however, consider that the review should include in particular the Working Time Regulations 1999 and regulations enacted under the Social Chapter. These regulations limit the flexibility of UK and EU businesses, on which their ability to react dynamically to future market developments depends.

The BCC's Burdens Barometer estimates that the recurring annual cost of the Working Time Regulations is £2.3 billion, suggesting that it is the single most burdensome regulation facing UK business today. The Regulations have a particular impact in the UK because we have a highly developed services sector, the nature of which means that many of those working within it are likely to be on call at various hours. The Regulations also have potentially serious consequences for the provision of health services because of how they impact on the training of junior doctors. We believe it is generally recognised across Europe (not least because we understand the Commission has claims ready to be launched against the majority of member states) that the Regulations were not thought through. The concept of ensuring that all workers have sufficient rest is fine; the implementation in the Regulations is flawed.

The Social Chapter covers a very broad area – very different types of regulations may be made under it. Some of the regulations may be beneficial, such as equality legislation and rules relating to parental leave. We are not advocating any change in such beneficial proposals. Other regulations, however, are overly prescriptive and burdensome, taking away from businesses many of the choices that they should remain free to make for themselves. We agree with the current Conservative Party position that the UK should seek to negotiate a more flexible position in relation to the Social Chapter, under which

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the UK (and potentially other Member States) are free to opt-in or opt-out of Social Chapter regulations. We consider that Social Chapter regulations should be included in the urgent review, and be dealt with in accordance with our proposals above.

**Proposal 53:** The urgent review of EU regulation should include the Working Time Regulations 1999 and regulation under the Social Chapter.

### 5.1.7. Flawed Implementation of European Regulation in the UK

The Davidson review has recently considered the extent to which the UK over-implements EU regulation in the UK. We are in broad agreement with Davidson's proposals. There are, however, two areas to which we draw particular attention.

First, we emphasise the need to ensure that EU and UK regulation fits together in a way that minimises the overall regulatory burden, including the need to avoid 'double banking'. We suspect that in some cases the UK government prefers to adopt its own model of regulation in addition to or in conjunction with EU regulation, because it thinks that 'it knows' best, rather than choosing to rely solely on the EU model. Regardless of whether or not the UK or EU model is the best when viewed independently, once the EU model has been adopted, the regulatory burden is likely to be minimised by relying solely on that method – otherwise business has to cope with two different systems.

**Proposal 54:** Where EU legislation exists, and no opt-out is available, avoid applying a second layer of domestic legislation designed to achieve similar or even contradictory objectives. Similarly, where EU legislation only applies above a threshold (e.g. based on turnover or other appropriate criteria), if any domestic legislation is to be adopted for companies below the threshold, the domestic legislation should be tailored so far as possible to ease the transition for companies moving between the two (i.e. in terms of substantive and reporting obligations).

Second, the UK has traditionally adopted a very prescriptive approach when drafting legislation, setting out the detail of what is required. As stated above, we consider that in some situations it would be better to be less prescriptive. One area where this approach could apply is when the UK is implementing EU Directives, where it could enact legislation that adopts wording the same as or very similar to that used in the Directive, rather than attempting to translate the requirements of the Directive into a very different set of UK-style provisions.

**Proposal 55:** Where appropriate EU Directives should be implemented in the UK less prescriptively by adopting wording that is the same as or very similar to that used in the Directive.

### 5.1.8. Regulatory Competition

A critical problem with EU regulation is its tendency to harmonise excessively, rather than allowing different Member States to explore appropriate regulatory alternatives. The rhetoric and theory underpinning the EU is that of competition, but the reality is that EU regulation frequently fails to encourage competition between national regulatory regimes and authorities.

The rationale behind the EU's single market objective is to encourage competition, and a by-product of this is competition between regulatory environments to attract businesses. However, such regulatory competition is unacceptable to many in the EU. It is viewed as intrinsically harmful to the rightful authority of important national institutions. A range of Member States are thus unwilling to countenance the possibility of mutual recognition for fear that their national authorities might lose out in an internationally competitive environment, as indeed some are bound to do. There is also concern that competition between regulatory regimes may encourage the adoption of Anglo-American practices and business culture. Such an outcome is objectionable to many Member States. The

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unacceptability of regulatory competition provides a strong incentive for continued, and progressively more, regulatory centralisation and harmonisation.

**Proposal 56:** A Conservative government should promote more regulatory competition within the EU to benefit all Member States.

### 5.1.9. UK Employer Organisations and Europe

Unions are increasingly operating on a pan-European basis, and becoming more effective at the EU level as a result. Employer organisations should be encouraged to take a similar approach.

**Proposal 57:** A Conservative government should encourage employer organisations to be more effective at a pan-European level (as has been done by Unions).

## 5.2. SMEs

### 5.2.1. Defining a SME Company

SME is the recognised abbreviation for Small and Medium Sized Enterprises but there is no common agreement on what qualifies as an SME.

There are 4.3 million businesses in the UK and using the DTI's definition<sup>89</sup>. 99.9% are SMEs, 99.3% being small firms with fewer than 50 employees and 0.6% being medium firms with 50 to 249 employees. The Companies Act 1985 defines a small company is one that has a turnover of not more than £5.6 million, a balance sheet total of not more than £2.8 million and not more than 50 employees. A medium-sized company is defined as having a turnover of not more than £22.8 million, a balance sheet total of not more than £11.4 million and not more than 250 employees. The European Commission<sup>90</sup> defines a small enterprise as one with a headcount of less than 50, and a turnover or balance sheet total of not more than €10 million. A medium-sized enterprise has a headcount of less than 250 and a turnover of not more than €50 million or a balance sheet total of not more than €43 million.

**Proposal 58:** Regulatory exemptions should be created where appropriate for businesses that meet either the DTI, Companies Act 1985 or European Commission criteria to be an SME.

### 5.2.2. SMEs are Very Important to UK Plc

SMEs, using the DTI definition, are the engine of the economy. They deliver 51% of the GDP, provide 59% of the jobs we enjoy as a nation, and around two thirds of commercial innovations. SMEs generate, in one way or another, a large proportion of the entire tax take by the Exchequer which pays for the arts, pensions, education, healthcare and the levels of environmental support and investment we've come to expect from government.

The regulatory burdens on smaller businesses are, however, disproportionately high when compared with larger businesses. In many cases it takes just as much time, effort and expense for a small business to setup systems to comply with new regulations as it does for a large counterpart. The £15,000 implementation cost for a new regulation might reduce the productivity of a small firm with 10 staff by 5%, when the effect on a large firm with 1,000 staff might be a little as 0.05%. The new regulation might drive a small firm into a loss-making position, whereas the large firm simply absorbs the tiny chink in their annual profit. Over-regulation strikes at the heart of a small firm's productivity,

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<sup>89</sup> Small and Medium Sized Enterprise Statistics for the UK 2005, published by the DTI, 31st August 2006

<sup>90</sup> [Recommendation 2003/361/EC](#), effective from 1st January 2005



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profitability and, often, its viability. It is time to fight back for the sake of British jobs, incomes and economic prosperity.

Consider an example; the Integrated Pollution Prevention and Control (IPPC) 2000 regulations. These detail a regulatory regime for controlling pollution from certain industrial sectors, such as energy, metal processing, minerals, chemicals, waste-management, and others. The data collection, time consuming reporting (10 business days a year) and permit fee (£6,000 p.a.) run the risk of rendering medium-sized companies uncompetitive. The IPPC is designed for large businesses but is applied to smaller companies too, hindering their competitiveness.

### **5.2.3. Measuring the Regulatory Burden on SMEs**

A small increase in the productivity of SMEs can yield a huge return for the economy, so regulatory impact assessments must quantify the productivity impact on small and medium sized businesses. SMEs must not, therefore, be left as an afterthought when reviewing the potential impact of regulations; they must be at the very heart of such consideration.

**Proposal 59:** Specific reference should be made to the regulatory costs on SMEs in the new and more robust regulatory impact assessments put forward in proposals 1-10.

When the British Retail Consortium consulted with SMEs, the SMEs were perhaps understandably found to be concerned about small businesses exemptions from specific regulations (e.g. race discrimination). They were also concerned that exemptions might provide perverse incentives for businesses to avoid growth beyond a particular threshold and for larger businesses to split into smaller business units to avoid being caught in the net. However, much of the argument holds water only if relatively low thresholds are used, where there are proportionately large numbers of firms at the margin.

**Proposal 60:** SMEs should be exempt from specific categories of regulation where the evidence of policy success is lacking and the RIA identifies a disproportionately high productivity impact.

### **5.2.4. The Stock of Regulation (In Respect of SMEs)**

**Proposal 61:** The urgent review of legislation referred to in Section 12.1 should pay particular attention to the position of SMEs, looking for opportunities to repeal or exempt SMEs from legislation that imposes a disproportionate burden on them.

### **5.2.5. Consumer Contracts**

One area in which the attempt to remove risk is evident is in the field of consumer protection. We strongly support the existence of consumer protection measures to protect the most vulnerable from exploitation. However, we consider that, in certain areas, consumers are now over-protected too much, and that excessive levels of protection are leading some not to take proper responsibility for their actions.

We are conscious that this is a difficult and complex area, not least because of the interaction in the UK between UK and EU legislation. We are also anxious that legitimate consumer protection measures are not undermined. We do, however, consider that the principle of “buyer beware” should be given greater weight in some circumstances, and be brought home to consumers to encourage them to take their responsibilities seriously. We propose that further work be done to consider how this could best be done.

**Proposal 62:** A feasibility study should be carried out into how a plain English “responsibility” warning could be incorporated into consumer contracts, warning consumers that they are responsible

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for their own actions and requiring them to acknowledge this in some way (e.g. by signing). The study should consider how such a warning would interact with existing requirements of UK and EU law.

We consider, however, that the reverse side of enhancing consumer responsibility is to improve the ability of consumers to seek effective remedies in the courts or another forum without prohibitive cost.

**Proposal 63:** The merits of having a new “regulatory court” serving retail consumers (akin to the small claims court) should be assessed, as part of a feasibility study of responsibility warnings.

## 5.3. Financial Services

### 5.3.1. European Financial Services Regulation

The EU’s Financial Services Action Plan (“FSAP”) has resulted in over 25 new pieces of legislation with far reaching implications for the UK financial services industry. The pace has slowed recently, with Internal Markets Commissioner McCreevy initiating a period of consolidation and focus on implementation and enforcement issues. We welcome this change of emphasis. The FSAP directives are still, however, being implemented. The sheer quantity is huge and covers areas ranging from capital markets and capital issues to purely consumer related matters.

### 5.3.2. The Big Problems with European Regulation

The aims of the FSAP are admirable. But its implementation has been defective in two respects. First, were the reams of regulation required? The need for the regulations at the European level were glossed over or assumed and most were implemented without any cost/benefit analysis. For example, we believe (along with many in the industry) there was no need for the Insurance Mediation Directive and that this area was better left to national regulators. Secondly, the gap between the aims and the reality are substantial. This appears (as we have noted elsewhere) in both European and national regulation, but is, perhaps, more acute in Europe. The best example of these failures is the Markets in Financial Instruments Directive (“MiFID”) which is due to be implemented in late 2007.

### 5.3.3. Markets in Financial Instruments Directive (“MiFID”)

The promise of MiFID was to create a genuine single market in financial services across Europe: an admirable aim begun with the old Investment Services Directive (the “ISD”). MiFID both broadens the scope and the substance of the ISD. On the positive side, MiFID extends the “passport” (under which firms can provide services in another member state without becoming separately regulated in that state). But the price paid is radical change to the prescription of conduct of business rules at European level. This now covers areas such as information which must be sent to customers, the definition of whom is a retail or a professional customer, and the meaning of “best execution” of orders. The ISD included high level principles only on conduct of business rules, leaving it to member states to impose their own requirements.

### 5.3.4. Mismatch between Aims and Reality

Our first criticism is that the detail of MiFID was not properly tested against the official objectives set by the Commission at the outset. Indeed, some bear no relation to these objectives. One has only to look at the controversy surrounding the execution of client orders off the proprietary trading book of a firm to see this (the so called systematic internalisation debate). In reality, the final shape of these provisions had more to do with the political alliance between parts of the Commission and certain member states with little serious capital market activity (but with votes in the Council) than any justifiable policy position.

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Another example was the hard fought bargain on “execution only” business which allows clients and firms to take a “low-cost” option under which the firm is not obliged to determine whether an investment is appropriate for the client if the latter has decided to sign up to an execution only dealing service. This has always been permitted (although restricted) in the UK and has allowed the spread betting industry to thrive. MiFID allows this liberal approach to continue in relation to equities or fund units but not in relation to financial spread betting (sports spread betting is outside MiFID in the first place). This position has nothing to do with a reasoned cost/benefit analysis but was based on the political balance of forces in the European Parliament’s Economic and Monetary Affairs Committee and the Council of Ministers.

There are many more examples, with the cumulative effect of damaging not just the UK but the European financial services industry.

### **5.3.5. Ambiguity as a Result of the Political Process**

The second problem at European level is the way in which financial services directives are negotiated and drafted. Of course, it is true that UK domestic financial services legislation sometimes contains inconsistencies and ambiguities but the role of Parliamentary draftsmen and government lawyers has a critical function in minimising these.

European financial services directives are a creature of political compromise and the balance of forces within the Commission, Council and European Parliament. The result is a legal framework in which ambiguity has become in many ways a deliberate policy choice when negotiating directives. This has potentially highly damaging results. To give one topical MiFID example, we noted above that one of the arguable steps forward is the move away from host state regulation (i.e. regulation by the state in which the consumer is located). At the moment, this means that if one wants to sell a financial service cross border within Europe one needs to consult the laws of every member state you will sell into. This is an expensive and time consuming process and MiFID replaces it. However, there is a fundamental ambiguity as to what it replaces it with. The problem is that MiFID is ambiguous on the situation in which a service is provided from a branch. For example, if a German bank has a branch in London which then does business with investors around the rest of Europe, common sense would say that the relevant conduct of business regulation should be that of the UK; but this is not what MiFID says. MiFID simply says that the branch member state has responsibility for conduct of business rules in relation to “services provided within its territory”. The problem is that it is not clear whether a service to an investor in another country from the branch is provided within the branch territory or not. If one seriously has to plan on the basis of applying German rules in our example for business done from London this has significant cost implications. This is not an isolated example and the cumulative effect of these types of ambiguities is very significant.

### **5.3.6. Domestic Gold Plating**

There are various domestic implementation issues in relation to MiFID which also illustrate problems that have arisen in relation to a number of other directives. The most talked about problem is that of “gold plating”. Both the Treasury and FSA have moved in the direction of avoiding the problem in financial services regulation by using so called intelligent copy out of directive provisions; and, on MiFID, this has been a particularly welcome development. However, copying out what is sometimes confusing and occasionally meaningless EU financial services directives will only create cost and confusion for firms unless there is some way of getting proper guidance from the FSA on whether a firm’s implementation approach is acceptable. In the market abuse area, there is a high powered team at the FSA which firms can ring if they are unsure of the application of the requirements. Whilst we recognise the dangers of over implementation if the FSA issues too much guidance on best practice which implicitly becomes binding, this type of reactive guidance facility is very different. Replicating the reactive guidance capacity in either areas besides market abuse would help cut costs for firms

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during the highly complex implementation phase by giving them the necessary hand holding facility to guide them.

**Proposal 64:** We propose that an incoming Conservative government should use the powers under Section 12 of the Financial Services and Markets Act to appoint an independent expert to conduct a review of whether the FSA is using its guidance giving powers to best effect in assisting firms to comply with regulatory change.

More fundamental problems remain in the second area of imposing European requirements on top of domestic ones which are not then removed. One example of this is the way that the Treasury has imposed the new MiFID definitions of what is a commodity derivative on top of the already existing definitions so that a firm will now need to go through a “cumulative” analysis on every occasion to determine whether it is in one or both of these regime.

To give an example, only some physically settled trades in commodities for future delivery are treated as financial services instruments under the UK domestic regime or MiFID. The UK regime appears to be stricter than the MiFID regime in maintaining a more general intention test as to whether the instrument is for investment or commercial purposes and a broader list of indicators of when it will be an investment (and so regulated). No proper justification has been given for this super equivalence against the new MiFID definition.

**Proposal 65:** We propose that a general presumption should be added to the FSA’s rule making powers in Part X of the Financial Services and Markets Act 2000 that pre-existing UK categories of financial instrument and investment services should not be maintained where the same ground is covered by its implementation of relevant European requirements. The FSA should be required to produce a specific justification and attached cost-benefit analysis if it considers such super-equivalence to be necessary.

## 5.4. Conclusions

Regulation is viewed by many as a dry subject, but the burden it imposes on business has enormous implications for the competitiveness of UK plc, and therefore the wellbeing of our citizens. We are now drowning in a regulatory Niagara, much of it self-imposed.

Too often, regulation is the first resort of government, despite the fact that it is widely accepted that over-regulation stifles business and that investing in deregulation is fantastically good value for money. Relatively small levels of investment will product increases in GDP that are huge by comparison.

Deregulatory reforms are now sweeping the western world. Governments all across Europe, including the EU, are embarking on repealing, simplifying and improving the enforcement of regulations. The UK should be at the forefront of these reforms, instead we are in danger of being left behind.

The persistent failure of past deregulatory initiatives is partly the result of the difficulty of turning a regulation factory into a government machine focused on deregulation. The deregulatory challenge boils down to working out how to influence the behaviour not only of the regulation factory itself but also of those carrying the regulatory burden.

We put forward in this report a more professional approach to assessing the merits of proposed new regulations, including the development of a more sophisticated system for measuring regulatory costs and benefits, and greater scrutiny of the alternatives to traditional regulation. We also put forward in the report proposals that will promote a change of culture away from today’s prescriptive rule book to a more principles-based, proportionate approach.



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# Working Paper 5

## Energy

### 1. Executive Summary

The security of energy supply, and climate change, are intertwined issues. Both issues are closely linked to international events: addressing climate change clearly requires concerted international action; and any serious approach to energy security needs to take into account not only the fact that hydrocarbons are the dominant primary energy source, but also the fact that the majority of the world's remaining oil and gas reserves are in challenging geopolitical locations.

The UK's energy market has delivered huge investment in infrastructure and some of the lowest domestic (but not industrial) gas prices in Europe. Our energy policies should support the UK's economic competitiveness by delivering competitive, secure, affordable and low carbon energy supplies. To achieve all the desired outcomes simultaneously, government has to provide the right policy framework, which acknowledges that the 21st century will almost certainly see climate change continue, and that this poses significant economic and social challenges.

Our policies should be predicated on allowing energy markets to deliver and minimising distortions, which act as impediments to investment and undermine the ability of the market to deliver. At the same time, we need to recognize that the market will deliver significant environmental benefits only if it incorporates a properly functioning carbon market. There is a role here for the state to facilitate a cap-and-trade market structure, and therefore a single market “commodity” price for all carbon emission, irrespective of source, so that it can be built into energy market economics and long term investment decision making.

This then opens up the way for us to tackle the major question of nuclear. We believe that, unless our existing nuclear power generating capacity is replaced with new nuclear stations, it is likely to be difficult to achieve the combined goals of secure electricity and sharply reducing carbon emissions in the future. However, without a proper market value for carbon, new nuclear stations are not commercially viable. An incoming Conservative government's energy policy should therefore facilitate the development of the carbon market, working with the rest of the world rather than in isolation, to overcome the current market failure.

The difficulty in obtaining planning permission is another major obstacle to updating our energy infrastructure. Without planning reform, the private sector cannot make the necessary investment to deliver a secure supply of energy at reasonable cost; difficulties in respect of underground gas storage illustrate the problem.

In order to integrate renewable and efficient electricity fully into the UK's energy mix, an incoming Conservative government will need to address our overall electricity architecture. The planning regime should enable the UK to place the concept of diversity of supply at the heart of the nation's energy infrastructure, also helping to address the security of supply issue. Instead of an electricity supply based almost exclusively on relatively few, massive, centralised, fossil-fuel power stations, we believe that a Conservative government should work towards an energy architecture that can integrate tens of thousands of smaller, distributed generators and combined heat and power plants- an energy internet in place of the current mainframe approach.



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The rapid recent deterioration in the UK's energy balance of payments underlines the importance of optimising the value of the UK's remaining energy resources. An incoming government should work to improve the fiscal treatment of decommissioning costs in the North Sea so that assets end up in the hands of companies willing to invest in them and extract maximum economic rent for themselves and UK plc.

The inescapable difficulty with renewables is that, for the vast majority of applications, renewable energy costs more than fossil energy. There is no reason to expect this to change in the next two decades. We should expect an electricity system based on 20% renewable electricity to incur an economic penalty equivalent to at least 1% of GDP.

However, the opportunity for the creation of substantial new businesses based upon renewable energy is huge. In the coming 30 years a staggering \$16 trillion (\$550 billion per annum) will need to be invested in the world's energy infrastructure. If the world is to meet the targets for emissions reductions, at least 20% of this will need to be spent on new and renewable energy technologies; more than \$100 billion per annum. Given that current investment in renewables is around \$25 billion per annum, we have a market that looks set to grow at 15-20% per annum for at least a decade. Over the next 30 years, half of this will go into developing countries which rely on technology and finance from the developed world. There are great opportunities for UK companies to capture this business so long as the UK is a leader in the sector, and not a laggard.

The UK should look to best utilise its energy resources and skills base in all areas to boost competitiveness, including Aberdeen's offshore oil and gas industry skill base, our existing technologies and our clean technologies R&D capabilities. Britain should be a world leader in emerging energy technologies. We have the strongest materials science and biochemistry base outside North America, and some of the world's best renewable energy resources. Yet we are behind the USA, Japan, Germany, Canada and even Denmark in energy technology research and development.

In all of this we have one wonderful competitive advantage: the City of London. Shifting world energy usage over the coming decades will require trillions of pounds of investment. It will also require the development of whole new markets in emission credits. Britain can and should be the world's leading centre for the financing of renewable energy and energy technology.

Finally, an incoming Conservative government should encourage energy efficiency (as part of its corporate and social responsibility ethos).

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## 2. Proposals

### 2.1. Making New Nuclear Plants Possible

We propose that an incoming Conservative government should:

- expedite planning permission for new replacement nuclear stations in the existing locations of such nuclear plants;
- expedite granting safety certificates to the three or four best technologies currently available in the world for new civil nuclear facilities; and
- set out the standard of waste treatment and decommissioning it will expect for anyone undertaking the investment in a nuclear facility, and require that provision be made over the life of the asset by the owners.

It will only be when the government has met these requirements in full, and knows exactly what the requirements of the nuclear industry are to establish specified projects, that it will be able to come up with a judgement about whether nuclear is a technology capable at a realistic price of sustaining and driving forwards the UK's wish to lower its carbon emissions whilst also guaranteeing reasonable supplies of energy.

### 2.2. Build a Stable Investment Environment for Energy Sources

Government should facilitate the optimal use of our own natural resources, not least because of the dramatic deterioration in our energy balance of payments. Consequently, we propose that an incoming government should:

- focus on providing coherent strategic frameworks (e.g. licensing a particular nuclear or gas storage technology) to give the private sector the certainty necessary for long term investment decision making;
- remove fiscal uncertainty on decommissioning costs in the North Sea so that assets may end up in the hands of companies willing to invest in them and extract maximum economic rent for themselves and UK plc;
- simplify the UK's upstream fiscal regime. For example, some fields still pay Petroleum Revenue Tax (PRT) but all fields are liable to Corporation Tax and SCT. Other petroleum provinces can offer greater clarity in fiscal terms than the UK as measured against the remaining reserve potential and cost profile of the UK;
- encourage local government to give planning permission to projects that add to the UK's diversity of energy supply and increase the proportion of non-carbon fuels therein;
- make a clear statement of long term commitment to renewable electricity sources. The Government is likely to miss its 10% goal for renewable energy in 2010. But we should support the goal of 20% renewable electricity by 2020 and 60% (or at least 50%) by 2050;
- consider the introduction of a Carbon Disclosure requirement, first for large and then for mid-sized companies, based on the proven methodology of the Carbon Disclosure Project. If investors are given sufficient information to assess companies' exposure to future greenhouse

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gas liabilities, they will tend to direct funds towards those that are working to mitigate emissions; and

- seek to remove energy policy from the party-political agenda. Industry will appreciate consensus on a realistic target for carbon, non-carbon and renewable fuels for electricity generation; investment can take place to produce the diversity that is essential to deliver supply security.

## 2.3. Act Internationally

We can and must have influence beyond our shores. An incoming government should:

- push for a “Son of Kyoto” to extend emissions targets to rapidly-developing countries, bringing America back into the process;
- aim to reform the European Union Greenhouse Gas Emission Trading Scheme (ETS). We want it to work, and we want it to work in London. An incoming Conservative government should announce a clear intention when elected to support and extend it, and to negotiate its inter-operability with other emissions trading schemes springing up around the world in New Zealand, Australia, Japan, Canada and various US states. We want to strive for, ultimately, a single global cap-and-trade carbon market;
- demand that the EU state a long-term “monetary policy” on emissions. An annual reduction of 1.1% will produce a 20% reduction in 20 years, and a 60% reduction in 50 years. If that’s what we want to achieve, let’s say so, and then set up an independent emissions “central bank” to police the targets. Under the current system, it is up to national administrations to propose and administer their own National Allocation Plans, much as they administer their own budgets under the discredited Euro Growth and Stability Pact;
- work towards an international agreement on including air transport in global, EU and national greenhouse gas emissions targets;
- set up a scholarship programme for engineers from developing countries to study renewable energy in the UK; and
- encourage export of low-emissions technologies to developing countries via Kyoto’s JI and CDM mechanism and by means of a focused, well-funded trade development / export credit programme.

## 2.4. Encourage Improved Energy Efficiency throughout the Economy

A relentless drive for energy efficiency must lie at the heart of emission reduction efforts, for the sake of economic competitiveness as much as for the reduction of emissions. We should propose a full range of measures to encourage capital investment by individuals, companies and the public sector. Ideas include:

- the possibility of offering a reduced Stamp Duty for energy efficient homes. More will need to be done, though, to encourage the majority of householders not thinking of moving house to bring forward improvements. An EU VAT rebate on energy-saving DIY products and services would be an interesting supplementary measure;
- increasing the differentials in Vehicle Excise Duty to penalise less efficient vehicles;

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- extending the Enhanced Capital Allowance scheme to encourage business take-up of energy-efficient plant and equipment, and Combined Heat and Power systems;
  - helping investors and consumers to demand change by trialling a voluntary labelling scheme for companies wishing to promote low emissions products and services in energy-intensive sectors, such as cars, housing and holidays; and
  - requiring carbon disclosure by government departments and local authorities, and introducing carbon-intensity as a factor in public procurement.

## 2.5. Foster Innovation

The next Conservative government must foster innovation in energy technology. To achieve this, it should:

- consolidate responsibility for renewable energy deployment into a single National Renewable Energy Agency; we currently have a patchwork of government departments and regulators that all award research, investment and capital grants as part of the Sustainable Energy Policy Network. Responsibility, and budgets, should be located in one Agency with management held accountable for achieving the country's renewable energy targets – unlike the current situation where targets are missed but no one is to blame;
- streamline the research grants system for research into climate change and renewable energy;<sup>91</sup>
- improve access for smaller companies and start-ups to EU research grants. Most currently require a combination of matching funds, pan-European partnerships and tolerance of bureaucracy which is not found in entrepreneurial organisations; and
- identify and remove legislative barriers to the implementation of new energy technologies, such as those that impede the sale of distributed energy to the National Grid, or that place unnecessary restrictions on the transport and use of hydrogen.

## 2.6. Protect Individuals

Moving to a widespread use of renewable energy sources will have general benefits for the population of the country and of the world. However, it will also have negative effects on specific local populations. In the rush to meet what are often artificial, political targets, we must not ignore the risks to affected communities. An incoming government should:

- retain or restore the normal planning process for renewable energy projects; and
- develop policy mechanisms to ensure that increases in energy costs which result from increased renewable energy usage do not fall disproportionately on economically disadvantaged groups, especially pensioners.

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<sup>91</sup> A confusing patchwork of grants and subsidies is currently available via the Carbon Trust, Energy Savings Trust, Department of Trade and Industry, Defra, Department of Transport, Ministry of Defence, NERC, EPSCRC, ESRC.

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### 3. Energy Security

Energy security is being taken very seriously in the USA. Many Americans are concerned about being dependent on others for their oil supplies. As North Sea oil production begins to decline, turning the UK from a net exporter to a net importer, a high and volatile oil price may well focus the minds of British voters.

Even the most optimistic experts accept that global oil production will peak within the next 40 years<sup>92</sup>. Already we are seeing end-game-style competition for remaining oil resources. China has declared that securing energy supplies is one of the prime targets of its foreign policy and the Chinese President Hu Jintao has visited oil-rich Gabon and Algeria and signed oil deals with Cameroon, Nigeria and Angola. A UN Security Council resolution condemning Sudan for human rights abuses in Darfur was blocked by China – not coincidentally Sudan's most important oil investor.

But energy security is not just about oil. The past decades have seen natural gas emerging as the fuel of choice for practically every use barring transportation. Cleaner and cheaper than coal or oil, natural gas's contribution to the UK's energy mix has grown from 5% in 1970 to around 40% today. The story looks similar across much of Europe; the USA, where coal still plays a pivotal role in electricity generation, is some way behind, but catching up fast. Looking to the future, if current trends persist, natural gas is forecast to contribute over 60% of Europe's energy needs within 15 years. As North Sea supplies peak and dwindle, an ever greater proportion of our gas will be imported, mainly from countries such as Algeria, Libya, Saudi Arabia, Kazakhstan, Turkmenistan, Uzbekistan, Yemen, Angola and Russia<sup>93</sup>.

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<sup>92</sup> US Geological Survey.

<sup>93</sup> Manfred Heffner, Observatoire Méditerranéen de l'Énergie.

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## 4. Energy Efficiency – Necessary But Not Sufficient

Any discussion about shifting our energy use away from fossil fuels must start by looking at energy efficiency. Since 1970, the energy intensity of the UK economy (in other words the amount of energy used per unit of GDP) halved<sup>94</sup>. However, if we keep up that sort of progress our emissions will not drop of their own accord because over that same period, from 1970, the UK's economy has more than doubled in size. The net effect was that our energy usage, despite the dramatic improvement in efficiency, has actually increased by around 15%. Over the next 20 years our GDP is expected to grow by more than 40%<sup>95</sup>; we will have to improve unit energy efficiency by an equivalent amount just to stay still.

This will be harder than it was in the past. First of all, much of our heavy industry has been replaced by less energy-intensive services and high technology industry- and this trend cannot continue at the same rate indefinitely. We were also substantially helped by a one-off switch from coal to natural gas. Natural gas is around 50% less carbon-intensive per unit of energy than coal, but with coal now supplying only around 15% of our national energy requirements, a further reduction in emissions from this source of even 5% would be optimistic.

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<sup>94</sup> Energy Consumption in the United Kingdom, DTI / National Office for Statistics, 2002, updated July 2004. HM Treasury, GDP Deflators and money GDP, 30 June 2004.

<sup>95</sup> Based on the Treasury's real long-term GDP growth forecast of 1.75% per annum; we would hope and expect the figure to be higher under a Conservative government.



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## 5. From Energy Mainframe to Energy Internet

Before we can begin integrating renewable energy into the UK's energy mix on a substantial scale we need to address our overall energy architecture. What is needed is an energy infrastructure which has at its heart the concept of diversity of supply. Instead of a power system based almost exclusively on relatively few, massive, centralised, fossil-fuel power stations, we need an energy architecture that can integrate tens of thousands of smaller, distributed generators and combined heat and power plants. Think of it as an energy Internet in place of the current mainframe approach.

This sort of architecture would allow us to achieve the following critical goals:

- it would open up the system to the full range of renewable energy resources at our disposal in the UK, and so reduce our emissions;
- it would make the UK less dependent on any individual overseas energy supplier, and more resilient to attack by terrorists at home; and
- it would encourage competition between energy providers and energy sources, continuing the process begun by the privatisation and deregulation policies of past Conservative governments.

There are regulatory, technical and financial hurdles to be overcome. Transforming an energy infrastructure is not something that can be achieved overnight – it will take decades, substantial investment, and a government that understands and can lead the process.

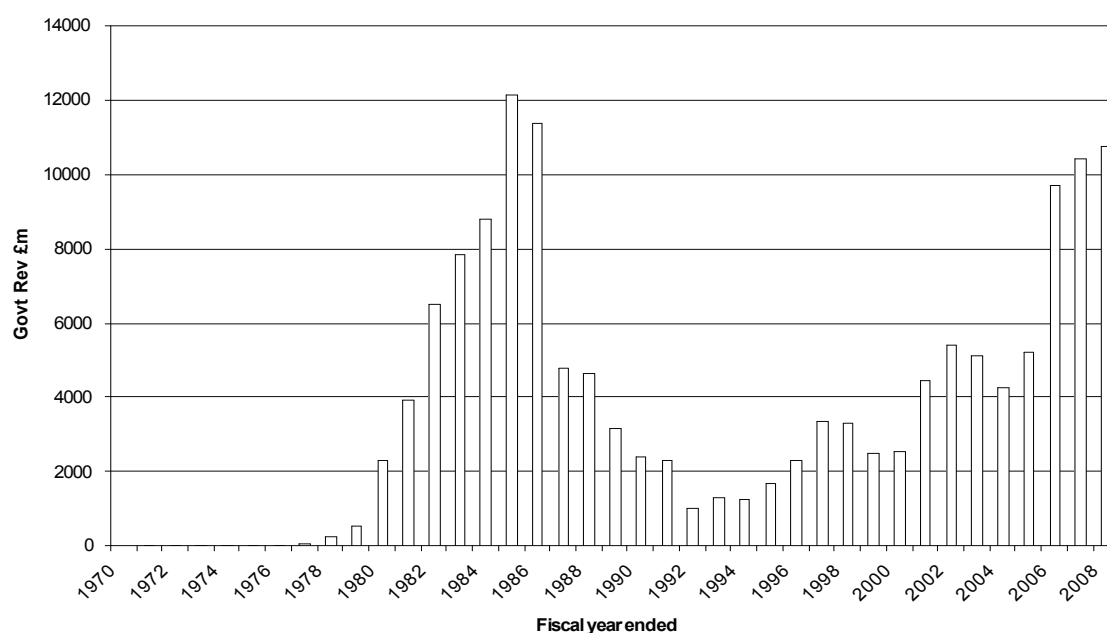
## 6. Oil and Gas from the North Sea

The UK has been fortunate among European countries in having a successful domestic oil exploration and production industry since the 1960s. Both UK oil and UK gas production have now peaked, however, and we are already an importer of significant quantities of natural gas (mainly from Norway). Nevertheless, the UK Offshore Operators' Association (UKOOA – now known as Oil & Gas UK) estimates that domestically produced gas could still meet more than 60% of UK demand in 2010<sup>96</sup>. But this depends on timely investments being made by the industry.

Taxation is a key factor in determining the amount and timing of investment, as is the overall commerciality of developing a UK field as against foreign reserves. We recommend a review of costs borne by the industry which are increased by unnecessarily restrictive regulations, for example the treatment of produced water. There should also be a review of the regulatory powers of the DTI to ensure investment is made whilst there is still serviceable infrastructure in place to fully exploit our natural resources.

Since the late 1970s, the taxation of the profits from oil and gas exploration and production has provided significant government revenue. This revenue stream is now, once more, providing approximately £10 billion per annum of revenue to the Exchequer, the result of high product prices and the imposition of a Supplementary Corporation Tax (SCT) charge on the industry since 2002/03, now levied at 20%.

**Figure 1: Government Revenues from Oil and Gas Production**



**Source: DTI**

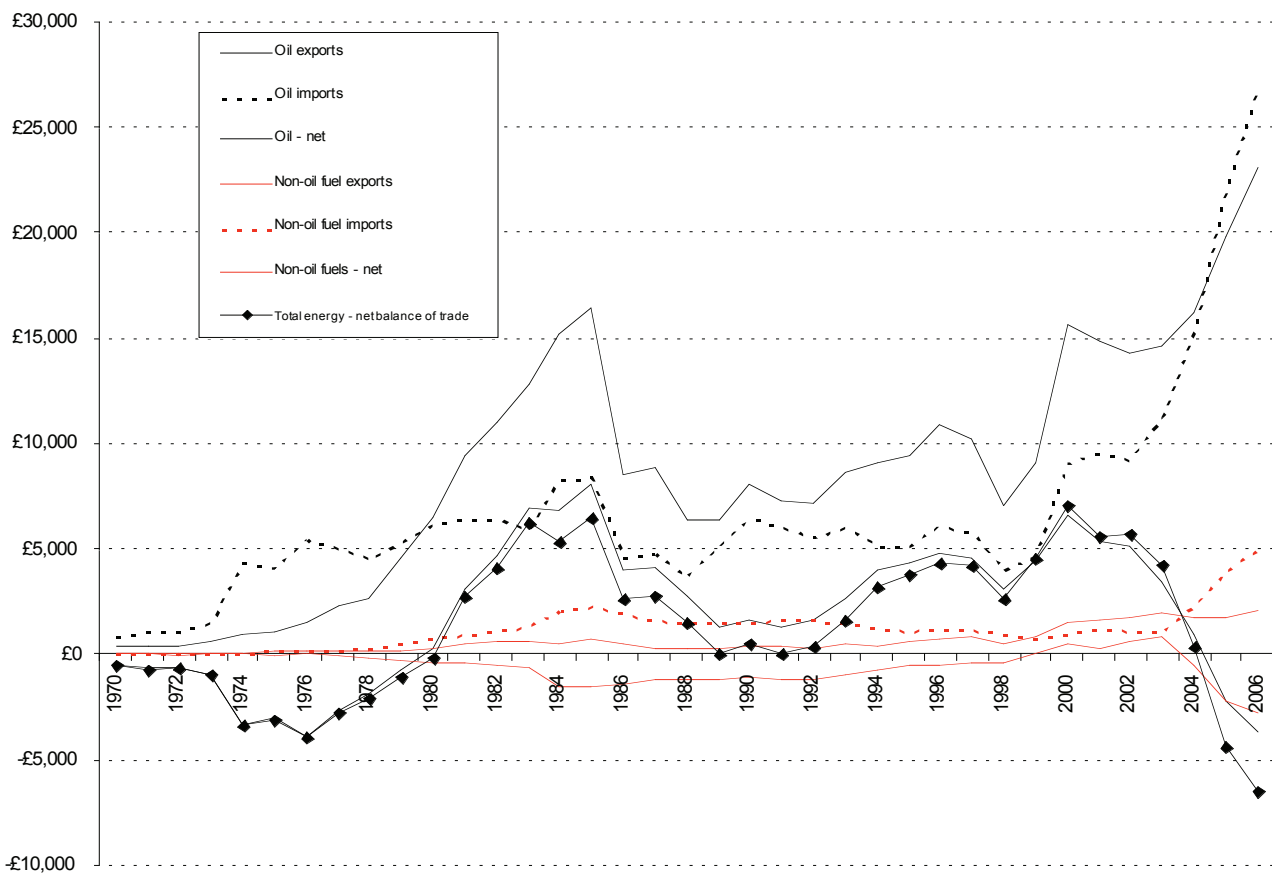
The UK's oil taxation regime is complex, being the product of frequent modification by governments of both complexions. Some fields still pay Petroleum Revenue Tax (PRT) and all fields are liable to Corporation Tax and SCT. The current situation is unlikely to result in the optimisation of recovery of hydrocarbons from this important national resource because other petroleum provinces can offer greater clarity in fiscal terms than the UK as measured against the remaining reserve potential and cost profile of the UK.

<sup>96</sup> UK Offshore Operators Association Activity Survey, 2006

Specifically, investment in the UK sector of the North Sea is being impeded by uncertainty on the future tax treatment of decommissioning costs. As a consequence of this, the asset sale market is drying-up at a time when one would expect an active transfer of assets from large multinational companies to smaller independent operators for whom extracting the marginal barrel is more commercially material. The industry is lobbying for clarity on this matter and a fiscal review is underway on the future of Petroleum Revenue Tax; this will be available within the term of this parliament.

When the current review is completed, this policy area should be examined thoroughly with the aim of removing fiscal uncertainty on decommissioning such that oil and gas field ownership can be transferred into the hands of companies that see the maximum commercial potential. The balance of payments benefits implications of optimising oil and gas reserves could be considerable, as can be seen in Figure 2. During the 1980s, rapidly rising oil exports produced a significant energy surplus, but since 2000 there has been a rapid deterioration in the energy balance of payments as imports (oil and non-oil) rocketed. A small energy surplus in 2004 became a significant deficit in 2005 (£4.4bn), which further deteriorated in 2006 (£6.5bn).

**Figure 2: UK Balance of Payments: oil and non-oil fuels (£m)**



**Source: ONS**

The rapid recent deterioration in the energy balance of payments underlines high contribution this sector has made in the last three decades and the importance of optimising the value of the UK's remaining resources by minimising the impediments to asset transactions and access to infrastructure.

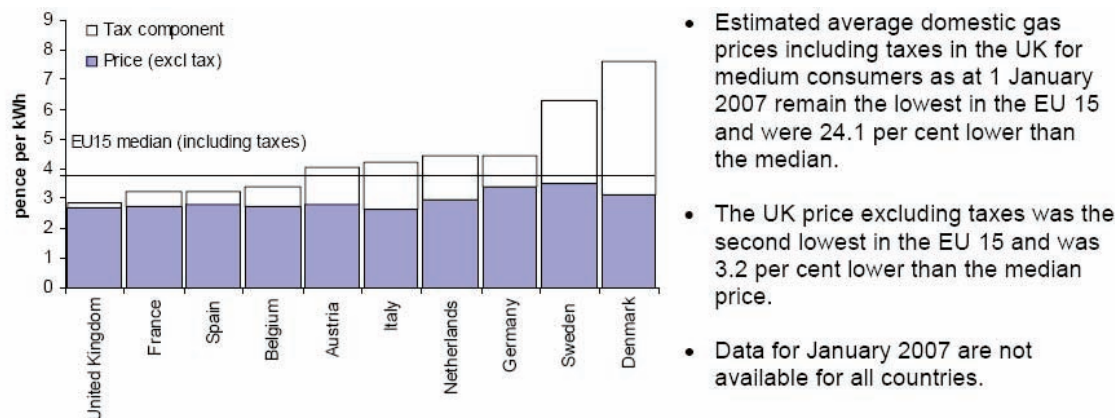
## 7. Natural Gas Facilities

Largely as a legacy of its offshore gas production, the UK is a substantial user of natural gas compared with many European countries. Gas currently provides 37% of the UK's primary energy requirement<sup>97</sup>. This is high compared with other major European countries (e.g. Germany 23%, France 16%) but comparable to the Netherlands, which has its own domestic gas production, and Italy, which has built this market share for gas by augmenting a modest level of domestic production through contracting gas from several different sources in Europe, North Africa and Russia.

In 2006, 36% of electricity supplied in the UK came from gas<sup>98</sup>. Natural gas became the fuel of choice for new power generation in the UK during the late 1980s and 1990s as a result of improvements in the efficiency of gas fired electricity generation at a time of growing recognition that natural gas generates the lowest CO<sub>2</sub> emissions of the carbon-based fuels. Unless the UK implements a programme of new-build nuclear generation capacity, gas is set to grow even further, which would have a detrimental effect on supply diversity, as well as CO<sub>2</sub> emissions. We believe that maintaining energy diversity is the key to achieving secure, affordable and low carbon energy supplies and this is discussed further below and in Section 9. Electricity Generation.

Despite having to make substantial investments in infrastructure, since privatisation the UK's gas industry has delivered one of the lowest domestic natural gas prices in Europe.

**Figure 3: Estimated Average Domestic Gas Prices from Medium Consumers in the EU as at 1 January 2007.**



Notes: Estimated data for 1 January 2007 is not available for Finland, Greece, Ireland, Luxembourg and Portugal. Medium consumers are defined as having an annual consumption of 23,260kWh per annum. We have estimated that the excluding tax price in Portugal is above the median but the including tax price is around the median, and that prices in Ireland and Luxembourg are below the median price but above the UK price.

Source: Derived from Eurostat Statistics in Focus Electricity prices for EU households on 1 July 2006 and Energy Advice Ltd Electricity and Gas Price Comparisons: January 2007. The UK price is estimated by the DTI.

**Source: EdF**

The UK continues to be the only fully deregulated natural gas market in Europe, despite successive directives from Brussels, as can be seen in Figure 4. This has implications for gas supply security in the UK, which from the point of view of accessing North African, Dutch and Russian pipeline gas, lies at the end of the gas supply chain.

<sup>97</sup> BP Statistical Review of World Energy, 2006 for UK and other countries.

<sup>98</sup> Energy Trends, March 2007.

**Figure 4: Level of Competition in Natural Gas Markets in EU Countries 2004** Source: European Commission Directorate General for Energy and Transport

Level of competition	Countries
Not functioning	All new member states, Finland, Portugal and Greece
Initial steps only	Germany, Luxembourg, Sweden, Belgium (fr)
Some Progress	Austria, Belgium (nl), France, Italy, Denmark
Well Developed	Netherlands, Ireland, Spain
Complete	UK

Unfortunately, markets are only as good as the information they receive and, therefore, increased liberalisation of the gas market on the Continent is highly desirable, particularly as we become increasingly connected to, and reliant upon, increasing quantities gas by this means.

Concerns on supply security came sharply into focus during the gas crisis in the winter of 2005-06. Supplies from Russia to the West were interrupted as a consequence of a dispute over pricing with Ukraine and this was shortly followed by a period of extreme cold weather in Eastern Europe. The UK experienced high gas prices during this period, as one would expect in the absence of gas inventories to buffer the short term effects of these events.

As the UK becomes a significant gas importer, gaining access to a diversity of supply sources is clearly important for security. The private sector has responded to the decline in UK gas production; more than twenty companies from ten different countries have invested £10 billion in new infrastructure. This includes two additional pipeline links to Norwegian gas fields, one new link to the continent, the expansion of the existing Interconnector and liquefied natural gas (LNG) terminal construction or expansions in five different locations.

Together with diversity of imports, the availability of gas storage facilities is vital for supply security and minimising price volatility. The UK currently has operational capacity of 4.2 BCM, including LNG facilities<sup>99</sup>. This represents approximately 4% (15 days) of annual consumption<sup>100</sup>. While the UK was self sufficient in natural gas, this low level of storage was appropriate, but with imports now growing rapidly, it no longer is. A further four projects (amounting to 1 BCM of underground storage) are under development and could be on stream by 2012. The private sector wants to build at least another 8.2 BCM of underground gas storage facilities, but based on the current schedule of planning permissions, this could take up to 2015 to become operational (assuming planning permissions are granted). A future Conservative government should seek to streamline the planning process to facilitate private sector investments in underground gas storage.

<sup>99</sup> Billion cubic metres. Source: UKOOA, April 2007

<sup>100</sup> BP Statistical Review of World Energy, 2006

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## 8. Coal

The UK coal industry is a shadow of its former self: the casualty of too many years as a nationalised industry where poor management and endless political rows helped to ensure its rapid decline. The UK still has huge coal reserves underfoot and under the sea, but only has seven surviving larger deep mines supplemented by considerable open cast output. Coal output fell to 20 million tonnes in 2005, split roughly fifty-fifty between open cast and deep line production. Open cast production is unpopular with the local communities and it is difficult to get planning permissions to expand the activity.

There is considerable discussion about the opportunities to develop clean coal technology. Whilst progress has been made in cleaning up the output of gases from a coal fire power station, more needs to be done to make it an attractive option in a world which is increasingly concerned about CO<sub>2</sub> emissions from power generation. Linking coal fire generators to district heating schemes in CHP developments would help; developing carbon capture technology may also be an important part of the process of cleaning coal.

A Conservative government should back more intensive research and development in the clean coal area as the long-term future of Britain's energy requirements will entail a shift from reliance on North Sea oil and gas to domestic coal if we wish to be sure of our supplies.



## 9. Electricity Generation

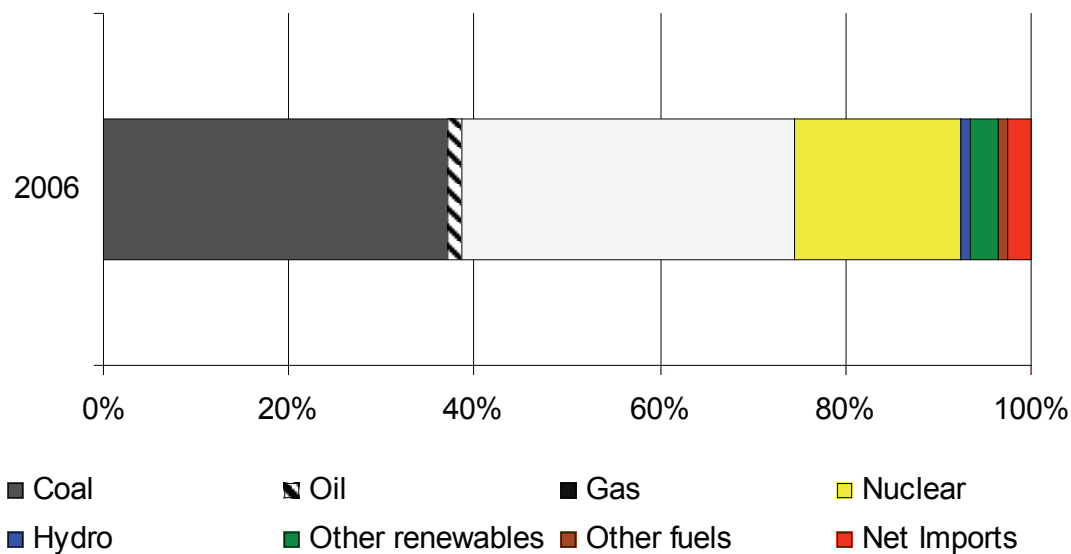
### 9.1. Overview

The electricity generation sector presents both a large challenge and a considerable opportunity in respect of tackling climate change. It accounts for around a third of the UK's greenhouse gas emissions, but energy supply infrastructure cannot be changed overnight; it is typified by very large, long-term investments. Changing quickly from one technology to another is therefore not possible, but the opportunity is that many of the power stations built in the 1960s and 1970s are nearing the end of their useful lives. The debate is about how these stations should be replaced, so that the UK makes the most of the opportunity to lock-in a lower carbon energy supply for many decades to come.

There is general agreement that it would be good to generate more from renewable sources, and general enthusiasm for local energy schemes. However, it is clear that renewables will be unable to provide sufficient baseload generation capacity within the foreseeable future.

Figure 5 shows the current breakdown of UK electricity supply by fuel type. There is a danger that private industry will decide that it is cheaper to build gas and coal power stations, thereby reducing diversity and increasing CO<sub>2</sub> emissions, rather than nuclear unless government enacts a clear policy on new-build nuclear.

**Figure 5: UK Electricity Supplied by Fuel Type**



Source: Energy Trends

### 9.2. Nuclear Electricity Generation

Nuclear power stations currently supply around 20% of the UK's electricity. The Sustainable Development Commission's (SDC's) 2006 report 'The Role of Nuclear Power in a Low Carbon Economy' report concluded that a new nuclear programme of 10GW would save 6.7 MtC (million tonnes of carbon) per annum, compared to the alternative of gas fired generation. This is 4-5% of the UK's 1990 carbon emissions; and if the current fleet of nuclear were replaced (13GW) this would save 8 MtC per annum if we assume that it is displacing 100% gas fired generation, or 20 MtC if we assume this new nuclear is displacing 100% coal fired generation.

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Consequently, replacing the current nuclear fleet and displacing gas fired generation is equivalent to 42% of the 2005 carbon emissions from UK passenger cars<sup>101</sup> or 100% of carbon emissions from UK HGVs or 19% of carbon emissions from the UK domestic sector<sup>102</sup>.

Almost all of our nuclear electricity generating capacity is scheduled to be decommissioned by 2020. Given the difficulty of replacing this by renewable sources and the undesirability of increasing our dependence on imported gas even further (to say nothing attendant of the attendant CO2 emissions implications), we simply cannot afford to put off the question of how to replace the 20% of our electricity generating capacity provided by nuclear fuel. We are persuaded that it is difficult to guarantee electricity supply and to continue downward pressure on emissions without at least attempting to replace the existing nuclear stations with new nuclear. A crucial benefit from nuclear, as a low carbon source of electricity, is that, unlike many low carbon technologies, it is not intermittent. Renewable technologies such as wind are not predictable and cannot provide baseload electricity. Nuclear's predictability allows for stable operation of the national grid and security of supply.

Nuclear is a long term investment, even in the context of energy infrastructure. The costs of nuclear are considerably weighted towards the beginning of the life of an investment and substantial costs are incurred even before starting to build the station. It is not for government to decide whether nuclear is an economic technology with which to reach climate change, security of supply and affordability goals. It is the role of government to say what the climate change goals are, and which technologies (e.g. which nuclear power station designs) are acceptable from a safety, local environmental, and security point of view.

Framing the debate as nuclear versus renewable energy is a false choice. We doubt that the UK can achieve a reduction in its greenhouse gas emissions over the next twenty years without building new nuclear capacity, whatever the policy on renewables. We believe that, unless our existing nuclear power generating capacity is replaced with new nuclear stations, it will be difficult to achieve the combined goals of secure electricity and sharply reducing carbon emissions in the future.

We therefore recommend that a new Conservative government should offer the following framework:

- First, the government should expedite planning procedures for new replacement nuclear stations in the existing locations of such nuclear plants. There should be a clear process for making existing sites available to potential developers. Only in the event that commercial arrangements cannot be agreed between investors and site owners should the Government intervene in this process;
- Second, the government should expedite granting safety certificates to the three or four best technologies currently available in the world for new civil nuclear facilities. Given the length of time since a new nuclear power station has been built, none of the modern nuclear designs are licensed for use within the UK. We would look at a pre-licensing process that establishes suitable designs from the UK perspective such that all acceptable designs can be considered by investors when they look at specific sites;
- Third, the government should set out the standard of waste treatment and decommissioning it will expect for anyone undertaking the investment in a nuclear facility. It should also seek to agree the associated funding arrangements prior to new-build nuclear taking place. New investors (as well as the general public) need clarity on both the nature of the arrangements and how they will be funded. The cost of waste and decommissioning should be paid for by new nuclear power stations over the life of the investment.

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<sup>101</sup> Total passenger car emissions in 2005 were 19 MtC. Source: Defra

<sup>102</sup> Total UK domestic emissions in 2004 were 42 MtC. Source: Defra

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It will only be when the government has met these requirements in full, and knows exactly what the requirements of the nuclear industry are to establish specified projects, that it will be able to come up with a judgment whether nuclear is the best technology at a realistic price capable of sustaining and driving forwards the UK's wish to lower its carbon emissions whilst also guaranteeing reasonable supplies of energy.

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## 10. What About Kyoto?

Under Kyoto, the UK has a legally binding commitment to reduce greenhouse gas emissions by 12.5% relative to 1990 levels over the period 2008 to 2012. The Government has set an additional goal to cut carbon dioxide emissions to 20% below 1990 levels by 2010. Britain is broadly on track to meet its Kyoto targets, largely because of our ongoing, one-time switch from coal to natural gas and continued shrinkage of our manufacturing industries, although we look set to miss the more aggressive 20% target.

The EU Commission's prediction was that Kyoto would reduce 2010 GDP by just 0.1%; the Union of European Industries (UNICE) believes the true cost is 0.4-0.8% of GDP.<sup>103</sup> UNICE's analysis also suggested that over 20% of CO<sub>2</sub> emissions apparently saved in Europe are in fact simply displaced by the movement of manufacturing to less energy-efficient locations.

Kyoto puts no restrictions on the growth in emissions from rapidly emerging economies, probably the single biggest long-term threat to the environment. When India and China reach half of the current UK energy use per capita, they will have driven global CO<sub>2</sub> emissions up by 40%.

This certainly does not form any justification for scrapping Kyoto. On the contrary. The UK produces only 2.5% of the world's greenhouse gases. Even if we can cut that figure by 50%, this in itself is not enough to have a major impact on global climate change or energy security in itself. What is needed, and quickly, is a successor to Kyoto that addresses its glaring weaknesses, bringing rapidly emerging economies into its framework, and re-engaging the United States. The best outcome for the UK and for Europe would be for us to use the diplomatic capital we have earned from the implementation of Kyoto to push for a more comprehensive and better-designed treaty.

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<sup>103</sup> Competitiveness and EU Climate Change Policy, COWI for UNICE, October 2004, [www.Unice.org](http://www.Unice.org)

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## 11. Renewables

### 11.1. Renewables: The Reality

The inescapable difficulty with renewables is that, for the vast majority of applications, renewable energy costs more than fossil energy. We are unaware of anything in the technology pipeline that is likely to change this in the next two decades.

How much more expensive renewable energy is than fossil-based energy depends on many factors—most notably, estimates of future fuel costs, plant life-time estimates, long-term financing costs, and the extent to which fossil-based power will ever be made to bear the cost of pollution. A good working estimate is that it is two to five times as expensive, with significantly higher capital costs partially offset by lower or zero fuel costs<sup>104</sup>. The differential ought to reduce as renewable equipment manufacturing gains volume, but is unlikely to disappear quickly.

The bottom line is that we should expect an energy system based on 20% renewable energy to incur an economic penalty equivalent to at least 1% of GDP<sup>105</sup>. To put it in perspective, wiping 1% or £10 billion off the GDP of the UK would be roughly equivalent to shutting one FTSE 100 company every year. It is not a trivial cost, by any means. However, before we recoil in horror, we need to weigh also the opportunity for the creation of substantial new businesses.

### 11.2. Renewables: The Opportunity

The International Energy Authority estimates that in the coming 30 years a staggering \$16 trillion (\$550 billion per annum) will need to be invested in the world's energy infrastructure. If the world is to meet the targets for emissions reductions to which politicians are becoming addicted, at least 20% of this will need to be spent on new and renewable energy technologies; more than \$100 billion per annum. Global investment in renewable power-generation, biofuels and low-carbon technologies rose from \$28 billion in 2004 to \$71 billion in 2006<sup>106</sup>.

Just under half of all this energy investment, and hence of all renewable energy investment, over the next 30 years will go into developing countries – in particular China and India, which rely on technology and finance from the developed world. Are there opportunities for UK companies to capture this business? The answer has to be yes, as long as we are a leader in the sector, and not a laggard.

In all of this we have one wonderful secret weapon: the City of London. Shifting world energy usage over the coming decades will require trillions of pounds of investment. It will also require the development of whole new markets in emission credits. London can and should be the world's leading centre for the financing of renewable energy and energy technology.

Britain should be a world leader in emerging energy technologies. We have the strongest materials science and biochemistry base outside North America, and some of the world's best renewable energy resources. Yet we are behind the USA, Japan, Germany, Canada and even Denmark in energy technology research and development. The best way for governments to promote innovation is to ensure generally high levels of education and infrastructure, and low levels of tax and bureaucracy. These should anyway form part of any Conservative programme.

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<sup>104</sup> Michael Liebreich, CEO, New Energy Finance.

<sup>105</sup> The International Panel on Climate Control's 2001 Working Group III on the costs of mitigation estimated the cost at 0.2-2% of GDP in 2010 for those countries signed up to meeting its 2010 reduction targets.

<sup>106</sup> New Energy Finance.

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## 12. Tackling the Carbon Emissions Issue

### 12.1. Overview

Given that renewable energy costs more than fossil-based energy, and is likely to continue to do so for the next two decades, its adoption runs against the short-term economic interests of energy producers and users, whether individuals or businesses.

A certain amount can be achieved through transparency; ensuring individuals have the information and tools at their disposal to make ethical, rather than economic choices on their own energy usage. Experience with Green Power schemes shows that not everyone chooses the cheapest electricity provider. Government procurement can also play a role in ensuring a growing proportion of renewable energy in the mix. But sooner or later a clear position is required on the fiscal and regulatory measures necessary to achieve a step change in the UK's usage of renewable energy.

In essence there are two alternative approaches; a carbon tax or cap-and-trade. A carbon tax can be used to increase the cost of fossil fuels (and remove the "free ride" that fossil fuel users have been enjoying); or a cap-and-trade system can be instituted, whereby an overall limit for carbon is set, forcing users to buy credits if they exceed it.

### 12.2. Carbon Tax: the Climate Change Levy (CCL)

The Climate Change Levy ("CCL") is imposed on energy used by business, but not on individuals, and charitable and public-sector organisations. Although it is intended to reflect the value of carbon in the cost of energy, very different values of carbon are reflected in the different rates of CCL applicable to the various fuels. If your business activities meet certain criteria, you can avoid 80% of the cost of the CCL by improving your energy efficiency. Only businesses within sectors that have an industry-wide agreement are able to do this.

The climate change levy can also be avoided by sourcing renewable or good quality Combined Heat and Power produced electricity, but not nuclear; so the tax is not directly related to carbon emissions.

### 12.3. Carbon Trading

The main mechanism for valuing carbon in the current energy market is the European Union Emissions Trading Scheme (EU ETS)<sup>107</sup>. The EU ETS is a cap-and-trade scheme that limits emissions but permits trading of those emissions between parties to ensure the most cost effective carbon emission reductions are made. EU ETS has so had less impact on longer term investment than it could have done, as the phases of carbon allocations and caps are too short: phase one was three years and phase two (2008-2012) will be five years. Despite forward pricing of carbon, these short phases do not give investors sufficient confidence that their investments will continue to be affected by a consistent trend of carbon values long into the future.

### 12.4. Carbon: The Way Forward

To create a low carbon economy, carbon emissions require a value. Business will then factor the cost of carbon into new investment, favouring the lower cost, low carbon options, as well as seeking the most cost effective ways of reducing existing emissions.

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<sup>107</sup> There is also the Renewables Obligation, introduced in April 2002, which requires all licensed electricity suppliers in England and Wales to earn Renewable Obligation Certificates by supplying a growing proportion of their electricity from a choice of eligible renewable sources, or else to buy them on the open market. It is administered by the DTI.



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Currently the carbon market is seriously flawed, evidenced by the extremely low price of phase one carbon emission permits. We need a more robust, and ideally global, carbon trading market that has the long term confidence of investors. The market should:

- provide greater transparency within the EU ETS, operating over longer phases of operation than currently;
- cover a broad range of carbon emitting activities to ensure a meaningful reduction in emissions; and
- provide consistent mechanisms so that investors are not caught between regulatory instruments (as happened with both the Large Combustion Plant Directive requirements on reducing sulphur dioxide emissions reductions, and the EU ETS in phase one).

There is a role here for government to facilitate a cap-and-trade market structure, and therefore a single market “commodity” price for all carbon emission, irrespective of source, so that it can be built into energy market economics and long term investment decision making. Government must think internationally and pursue a number of different initiatives in parallel, to overcome the current market failure, including:

- push for a “Son of Kyoto” to extend emissions targets to rapidly-developing countries, bring America back into the process;
- declare support for the European Union Greenhouse Gas Emission Trading Scheme (ETS). We want it to work, and we want it to work in London. An incoming government should announce support, and extend it, negotiating its inter-operability with other emissions trading schemes springing up around the world in New Zealand, Australia, Japan, Canada and various US states. We want to strive for, ultimately, a single global cap-and-trade carbon market;
- demand that the EU state a long-term “monetary policy” on emissions. An annual reduction of 1.1% will produce a 20% reduction in 20 years, and a 60% reduction in 50 years. If that’s what we want to achieve, let’s say so, and then set up an independent emissions “central bank” to police the targets. Under the current system, it is up to national administrations to propose and administer their own National Allocation Plans, much as they administer their own budgets under the discredited Euro Growth and Stability Pact; and
- work towards an international agreement on including air transport in global, EU and national greenhouse gas emissions targets.