Growing Businesses

Britain's Productivity Challenge

Nida Broughton
Ben Richards

Social Market Foundation

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CONTENTS

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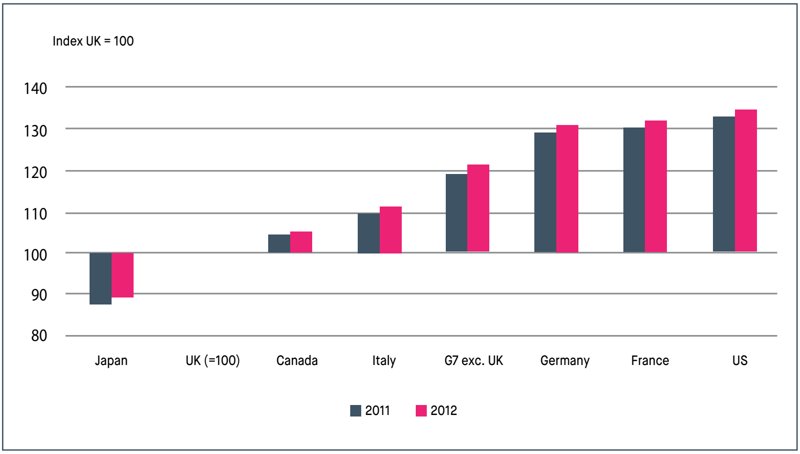
INTRODUCTION AND SUMMARY

THE GROWTH PROBLEM

The UK economy is finally recovering, with GDP surpassing its pre-crisis peak. But there is still a long way to go. Earlier in 2014, the Office for Budget Responsibility (OBR) estimated that GDP per capita will not reach its previous peak until 2017.[1] Meanwhile, unemployment - although not yet at its pre-crisis low - has been falling sharply. We have more people in work, but are producing less. The consequences are low productivity and falling real wages. The Office for National Statistics (ONS) has estimated that by the end of 2012, UK productivity was 12% lower than it would have been if it had continued to grow at the pre-crisis growth rate.[2]

Our productivity lags behind that of other G7 countries, as shown in the chart below. The most recent estimates of international comparisons by the ONS put the gap between UK output per hour and that of other G7 countries at the widest they have been since 1992.[3] Even the upward revisions to GDP published in September 2014 – which showed that the downturn was not in fact as deep as thought at the time – still indicate a marked deterioration in productivity over recent years.[4]

Figure 1: International comparisons of GDP per hour worked, G7 countries



Source: ONS, International Comparisons of Productivity – Final Estimates, 2012 (2014)

The causes of the so-called "productivity puzzle" have been widely analysed. Recent Bank of England analysis shows that low levels of business investment are at least partly to blame.[5] Business investment declined sharply – by almost a quarter in the immediate aftermath of the crisis in 2008, and has only recently started to recover.[6] This has meant less investment in equipment, innovation and research. There are also signs that credit has been slow to reach areas of the economy that are generating greater productivity growth.[7]

There are positive signs. The economy is growing, and growth has become increasingly widespread across a range of sectors. Business investment, which has been sluggish in recent years, is now starting to recover.[8] However, there is still substantial uncertainty as to whether the UK will be able to resume and sustain the trend growth rate seen pre-crisis. There are some key areas of concern:

- The UK compares well to the rest of the EU on levels of unemployment. However, youth unemployment is relatively high – at 20% in 2013.[9]
- Lending to businesses in the UK has fallen in every year since 2008.[10]

- The UK's net income from trade has been negative in every year since 1997.
- The World Economic Forum ranks the UK 28th on infrastructure out of the 148 countries surveyed, behind France, Germany, Japan, and the USA.[11]

This paper sets out the UK's performance and the problems left to resolve in eight areas, if businesses are to lead the way to greater productivity and growth, based on an extensive review of the literature and consultation events. The eight areas we look at are:

- Employment and skills
- Access to finance
- International trade
- Local growth
- Procurement
- Infrastructure
- Tax and regulation
- Europe

In each area we identify the top problems that policy-makers need to resolve.

Employment and skills	• There are simultaneously **skill gaps in some areas, especially in science, engineering and technology,** and **a lack of basic skills and training.** • There is a **lack of sufficient vocational and workplace training**, which is holding back progression for those on low pay. • **Lack of work experience and poor qualifications** are preventing many young people from accessing the world of work. • **Affordability of childcare** continues to be a concern for parents and can act as a barrier to employment.
Access to finance	• Lending to businesses continues to decline. This is particularly problematic for Small and Medium-sized Enterprises (SMEs), since they currently have **limited access to bond and capital markets,** and their **use of equity finance is relatively low.** • Equity finance is important for a small number of high growth potential firms, with a **structural deficit of funding** for companies seeking equity between £250,000 and £5 million. • There are **barriers to competition in the market for SME banking,** resulting in low levels of satisfaction and trust in the banking system. • Despite new funding being provided to SMEs by the **British Business Bank**, the l**evel of funding remains low** compared to the overall scale of SME lending.

International trade	• The **productivity problem** is likely to be fundamental to the UK's exports problem, but beyond this, there are other barriers that mean that we may not be capitalising on our strengths. • **Regulatory barriers,** such as differences in standards across countries, hold back export expansion. • **Lack of country and market specific knowledge and lack of language skills** among firms make it hard to find overseas customers and distributors, and to navigate the complexity of selling in overseas markets. • **Awareness of existing support is low.**
Local growth	• There is a **deep structural divide between London and the rest of the country;** this can only partly be explained by the fact that London is an urban area. • **Attempting to rebalance geographically is difficult and may, in some cases, be undesirable.** • **Improving transport links,** and reforming the planning system **to allow prosperous areas** to expand can help to ensure growth is shared across the population. • The UK is **currently among the most centralised developed countries,** reducing incentives for local government to take measures that increase local growth. • **Local Enterprise Partnerships (LEPs)** have given local businesses a voice, but **accountability and impact** remain two key concerns.

Procurement	•	Procurement processes in the UK are among the **most expensive** in the EU.
	•	**Opening up competition for contracts to more SMEs** could create greater competition for tenders and better value for money for the taxpayer.
	•	The UK **lags behind many other rich countries** in providing an **effective 'single market'** in public procurement that would reduce business costs of bidding, be more friendly to SMEs, and promote competition.
	•	**New proposals for further reform** - particularly to the Contracts Finder and Pre-Qualification Questionnaires (PQQs) - are promising, but need to be implemented fully and as quickly as possible in order to improve access for SMEs.
Infrastructure	•	The UK needs to address **serious capacity issues with its railways and airports.** The new High Speed 2 (HS2) rail link should help, but will take many years to complete; whilst concrete plans for expanded airport capacity in the South East have still not been decided upon. The UK's **roads are suffering from decades of underinvestment.**
	•	**Energy infrastructure is ageing** and needs to be replaced, and there are concerns about long-term energy security and the fulfilment of carbon targets.
	•	**Greater internet access** for smaller business premises and faster rollout of fibre would be advantageous.

	• **Public investment in infrastructure is very low** by rich-country standards, and suffers from an inconsistent accounting procedure that restricts public investment. • Private investment – the main focus of government investment strategy – suffers from **poor access to finance,** poor governance and lack of **long-term planning.**
Tax and regulation	• There is scope for **further simplification of the tax system** to reduce costs, increase transparency and boost competitiveness. • **Business rates have risen** substantially in recent years at a time when the economic climate has been difficult; and the way in which rates are levied **disadvantages some businesses more than others,** creating perverse incentives. • **Air Passenger Duty (APD) is the highest tax of its kind in the rich world.** It creates a competitive disadvantage for UK airlines and airports, but arguments in favour of scrapping it must be made in the context of other tax policies such as the zero-rating of aviation for VAT.

Europe	•	There are strong benefits to being part of the EU, in boosting trade and growth, but **reforms are needed to exploit the full potential of the Single Market.**
	•	More progress is needed on **completing the Single Market, especially in services.**
	•	The EU should continue to push on **reducing barriers to global trade.**
	•	There are **perception problems:** public attitudes tend to reflect the potential costs of EU membership but not the benefits.
	•	Government may need to pay more attention to the **distributional consequences** of EU membership.
	•	**Uncertainty** in this area could have a **dampening effect on business investment and growth.**

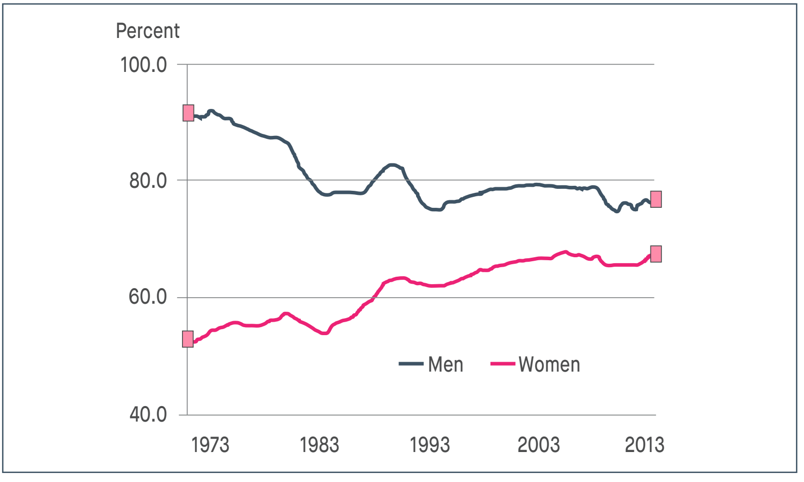
EMPLOYMENT AND SKILLS

EMPLOYMENT AND GROWTH

As the economy has recovered, so too has employment. In fact, as discussed in the introduction, employment has risen much faster than growth, implying a fall in overall productivity. So given the performance of the economy, employment and unemployment numbers are – if anything – surprisingly healthy.

However, there do remain some barriers to employment that are worthy of attention from policymakers. Female labour market participation rates are still below average, and there continues to be a gender pay gap, although substantial progress has been made. The availability of formal childcare has contributed to the growth in employment amongst mothers over recent years, however, there is evidence of substantial latent demand for formal childcare, which is unsatisfied due to lack of affordability. One study finds that around 55% of parents think that the expense of childcare is a problem for parents in their local area. Beyond the potential benefits of employment, there is also substantial evidence of the benefit for educational outcomes of early formal childcare. [12]

Figure 2: Employment rates by gender



Source: ONS, International Labour Market Statistics (March 2014)

Beyond this, given the UK's performance on employment and productivity, the key challenges for policymakers are in the area of skills. This is the focus of the rest of this section.

SKILLS AND GROWTH

Skills have an important part to play in productivity and growth. Research has found that around a fifth of growth in the UK in the late 1990s and early 2000s was due to changes in labour quality.[13] The 2006 Leitch Review, which set out ambitious targets for upgrading skills in the UK, estimated that achieving those targets would boost the growth of productivity by 15% and the growth of employment by 10%.[14] In contrast, a lack of a skilled workforce can hold back firms from growing and becoming more productive. Manufacturing firms that report skills gaps are less productive; and skill gaps can prevent them from upgrading to more profitable products.[15]

This effect of better skills on productivity means that higher skills levels are also vital to increasing wages in the future. The OECD finds that an additional three years in education is associated with a 45% increase in the likelihood of participation in the labour market, and increases wages by over 15% in the case of the UK.[16]

SKILLS AND EMPLOYMENT: STRENGTHS AND WEAKNESSES

The UK does have some strengths, including the quality of its universities. It has three universities in the top 10 Times Higher Education global rankings, and only the US has more universities in the world's top 100.[17] The attractiveness of UK universities means that they also see substantial demand from overseas students, with the sector worth around £17.5 billion in exports to the UK economy.[18] Further, the UK has done well in boosting participation in tertiary education, and in widening access: compared to other OECD countries, the UK performs well in terms of access to tertiary education among those from disadvantaged backgrounds.[19]

But there are significant weaknesses too. The skills problem in the UK manifests itself in three ways:

- Skills shortages in some areas;
- Lack of progression among the low skilled in employment;
- Youth unemployment among those with few skills

These are explained in more detail below.

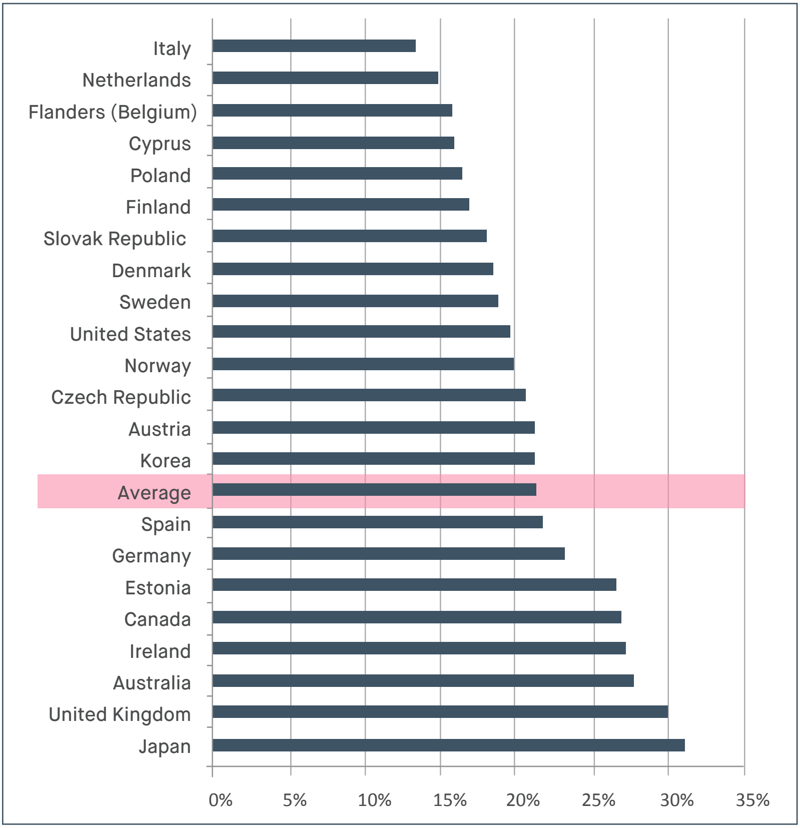
SKILLS SHORTAGES IN SOME AREAS

The UK Commission for Employment and Skills (UKCES) finds that almost three in ten vacancies are reported by employers as being hard to fill, with shortages in suitably skilled, qualified and/or experienced workers the main reason for this. [20] Of all occupations, "skilled trades" have the highest proportion of vacancies that were hard to fill – 39%. This is followed by professionals, and caring and leisure. Across sectors, manufacturing has the highest proportion of hard to fill vacancies.

Employers that reported having vacancies that were hard to fill due to skill shortages were also asked about the specific skills that were lacking among applicants. Almost two thirds of these vacancies were hard to fill due to lack of technical, practical or job-specific skills. Planning and organisational skills, oral communication skills and customer handling skills were also cited as hard to find. Other basic skills are often also lacking: the OECD finds that the UK adult population performs below average on literacy and numeracy scores.

At the same time, OECD studies show that a very high proportion of workers in the UK say that they are over-qualified for the jobs that they do. Combined with the evidence on skills shortages, this would suggest that existing skills investment is not sufficiently focused on the demands of businesses and the economy.

Figure 3: Proportion of workers whose highest qualification is higher than that needed to obtain their job



Source: OECD, PIAAC Survey of Adult Skills, Skills Outlook 2013

Looking ahead to the future, analysis of Working Futures finds that whilst there are shortages in skilled trade occupations now, in the future, the number of roles in this area is likely to decline. Instead, job growth is expected to be in occupations such as managers and professionals, including: science, research, engineering and technology professionals; health professionals; teachers; and business, media and public service professionals. The fact that shortages are already apparent in some of these areas is concerning.

A previous SMF report found an annual shortfall in the UK of 40,000 graduates in science, technology, engineering and mathematics, with a further need for more of those taking vocational qualifications in the same area to progress from Level 2 to Level 3 qualifications. Whilst the UK tends to produce a similar number of science graduates compared to other developed countries, it produces many fewer graduates in applied areas, such as engineering, manufacturing and construction. The main factor holding back the number of suitably qualified individuals in this area is an insufficient number achieving good maths and science qualifications at GCSE level that would allow them to progress onto further vocational or academic study.

The problem is partly one of insufficient numbers, but that is not the complete story. Whilst those with physics and maths degrees, for example, have among the highest hourly wage rates, they are also less likely be employed after graduation. This could be because those who have more specialised skills are likely to require more time to find a job that matches their skillset. However, another explanation is the quality of some courses. Employer surveys highlight difficulties in recruiting graduates with core discipline knowledge and of a sufficient calibre.[21] Examples include computer science degrees, where employer groups have argued that many courses labelled as "computer science" in fact contain little computer science content.[22] Combined with evidence on over-qualification rates presented above, the fact that there are skill gaps in certain areas suggest a skills mis-match problem.

HIGH PROPORTION STUCK IN LOW-SKILLED, LOW PAY JOBS

Whilst there are shortages of suitably qualified workers in some high skilled areas, there is also a large group of workers that are in persistent low paid employment that requires a low level of skill.[23] A previous SMF report found that one in eight workers in the UK start off in low pay and remain in low pay for at least a year.[24] And one quarter of those in low pay remain low paid for at least a decade.[25] From the perspective of the taxpayer, this is hugely costly, as the state spends £21 billion in tax credits topping up the incomes of those in low pay. It is additionally problematic since it undermines productivity.

Many of those in low pay have low levels of qualifications, and 51% of those in low pay have no qualifications at all. Further, in many sectors and occupations where pay is low, employers say that they face skill deficiencies which are holding back their productivity.[26] So both employees and employers should – in theory at least – have incentives to invest in skills and training for those already in work. A study by the Department for Business, Innovation and Skills (BIS) found that taking vocational qualifications could increase wages by 3% to 20%.[27]

But in practice, those with low skills are less likely to be given workplace training or given time off for training than those with higher level qualifications.[28] One reason is that employers are less likely to offer training to this group: less than one in ten men with no qualifications have access to training.[29] This is likely to be at least partly because in many cases the types of skills that are lacking are generic rather than firm or role-specific. Evidence shows that firms are less likely to invest in generic training when there is a possibility of employees then switching to another employer, or when employees are likely to be with the firm for only a short period (for example if they are on temporary contracts).[30]

But low provision by employers is not the only reason for the lack of in-work training. When they are offered training, those on low pay are less likely to take it up than higher paid colleagues. Reasons include the cost of training and time constraints.[31]

YOUNG PEOPLE OUT OF WORK

Unemployment is falling – the latest figures show it was 6.4% for April to June 2014. Inactivity rates are falling too – on the latest figures 21.9% of the 16-64 population were not looking or were unavailable for work.[32] However, a high proportion of young people are affected by worklessness: 13.5% of people aged 16-24 are not in education, employment or training (NEET)[33]. Around half of these are unemployed; the rest are inactive, that is not seeking work. Whilst the proportion of young people not in work or education has not dramatically increased in recent years, it still remains high compared to other OECD countries.

Lack of work experience, poor qualifications and health problems all play a role. Almost half of those without work have had no paid work experience. 68% have only GCSE level qualifications or below – although that does still leave a reasonable proportion that have A-level, degree or equivalent qualifications that are out of work. Finally, around a third are not looking for work for a number of reasons, including caring responsibilities, or being long-term sick or disabled.[34]

Within the category of young people out of work, those aged 16-17 are now more likely to be in full-time education than a decade ago. However, the proportion of those aged 18-24 that are out of work or education remains high.[35]

THE KEY PROBLEMS

It is clear that a lack of skills is holding back productivity. At the same time, those without the necessary skills are being held back in the labour market. In summary, there are two key problems:

- **Lack of basic skills** needed to progress onto further study and employment. Lack of these types of skills means fewer are able to take up further study in areas where there are skill shortages. It also makes it harder to obtain employment, and harder to progress within a job, as these skills are less likely to be paid for by the employer.
- **Potential "skills mis-match"**: not all those who progress onto higher qualifications are rewarded by better work. There remain concerns about the extent to which different courses really meet the needs of employers; and the fact that around 30% of young people out of work and education have A-level or higher qualifications may suggest that some young people are not obtaining skills in the right areas.

Downward pressure on migration makes skills shortages even more problematic from a business perspective. Whilst areas where shortages are especially severe are placed on a "skills shortage list" to help determine the allocation of Tier 2 visas, in the context of political pressure to reduce net migration, it may be less likely that employing workers from overseas will be able to play a substantial role in filling skill gaps in the future. This increases the pressure to ensure that skills provision in the UK is sufficient to cope with the needs of businesses.

There are a range of policies designed to tackle these problems. They include:

- Apprenticeships, which provide a route into vocational and on-the-job training. Subsidies are available for employers to incentivise them to take on apprentices. Whilst this has had some success, there remain concerns that not enough apprenticeships are at higher levels and of sufficient quality.[36] And small businesses are less likely to offer apprenticeships.
- Schools reform, including the introduction of academies and free schools. If this succeeds in raising standards, this could reduce the proportion of those leaving education without sufficient skill levels.
- Qualification and curriculum reform, including reforms to 16-19 vocational qualifications and introducing a new computing curriculum.

It is too early to tell how successful these will be. Arguably, there continue to be gaps in promoting in-work training and in making significant in-roads into the skills shortages both present and future. There remain questions about the balance of responsibility between individuals, employers and the state. Employer-led training may have a greater role to play in ensuring that skills provision better meets the needs of businesses. In the case of tertiary education, costs have been shifted from the state to individuals, and there have been concerns that this could dampen access – although there has been little evidence that this has materialised in practice.

What policymakers need to address

- There are simultaneously **skill gaps in some areas - especially in science, engineering and technology** - and **a lack of basic skills and training.**
- There is a **lack of sufficient vocational and workplace training,** which is holding back progression for those on low pay.
- **Lack of work experience and poor qualifications** are preventing many young people from accessing the world of work.
- **Affordability of childcare** continues to be a concern for parents and can act as a barrier to employment.

ACCESS TO FINANCE

THE ACCESS TO FINANCE PROBLEM

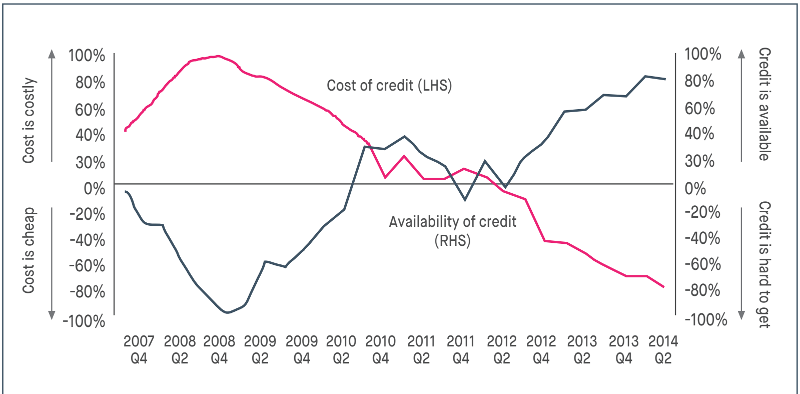
Business lending has fallen substantially since the onset of the financial crisis. In some ways this is unsurprising given the very high levels of growth in lending seen immediately preceding the crisis: 2007 saw lending to businesses grow by annualised rates of over 20%.[37] More stringent capital requirements for banks and subsequent deleveraging have led to a continued decline in business lending, with a decrease in every year since 2008.[38] This trend is exacerbated by the fact that, in comparison with other advanced economies, the UK has a particularly high level of dependence on banks, with other sources of business finance being relatively underdeveloped and small in magnitude. However, access to finance varies widely between households and different types of firm, with household lending increasing at a time when business lending is still in decline, and larger firms faring significantly better than SMEs.

TRENDS SINCE THE CRISIS FOR LARGER AND SMALLER BUSINESSES

In the wake of the financial crisis, trends in financing depended markedly on the size of the firm in question. Faced with tougher economic conditions, large businesses tended to shore up their balance sheets, with many running substantial surpluses. The reduction in the availability of credit coincided with a fall in lending to large businesses, but the fall in lending was due in large part to demand side factors. Large businesses' dependence on banks has also been lower due to their much greater reliance on equity and bond markets for finance. Overall, small and new firms have been most affected by financing constraints.[39]

More recently, improving economic conditions have led to large firms facing much greater availability of credit and at a lower cost than previously, as demonstrated by Deloitte's survey of large businesses, shown in Figure 4. In addition, with many large firms running large surpluses for several years previously, and with prospects for growth being more positive in the coming years, Chief Financial Officers (CFOs) of large businesses report much greater appetite to take additional risk onto their balance sheets.[40]

Figure 4: Large businesses have easier access to cheaper credit



Source: Deloitte CFO Survey 2014 Q2

However, smaller and medium sized enterprises (SMEs) have had different experiences. The use of equity finance is very low for SMEs, and they do not generally access bond or capital markets due to their small size and the correspondingly small amount of finance they are seeking.[41] In Germany and Italy there has been some recent progress in building a retail bond market targeted at SMEs; and similar attempts in the UK include the creation of the Orderbook for Retail Bonds (ORB), launched in 2010. The ORB, however, has been mainly dominated by large firms that already had good access to bond markets.[42] Building societies have limits imposed on their lending where that lending is not secured on residential property, restricting the extent to which they can lend to businesses. SMEs are, therefore, highly dependent on banks for finance.

Looking at conventional sources of debt finance, the use of external finance has been declining in recent years for all SMEs, but is particularly low for the smallest companies with no employees, as shown in Figure 5. Conceptually, 'no employee businesses' are quite different to firms with employees, and may consist mainly of self-employed people who, in some respects, theoretically have more in common with employees than with firms. As can be seen from Figure 5, however, the use of external finance has been declining for all sizes of SME, but is at a lower level for smaller firms.

Figure 5: Use of external finance for SMEs of different sizes, 2011 - 2014

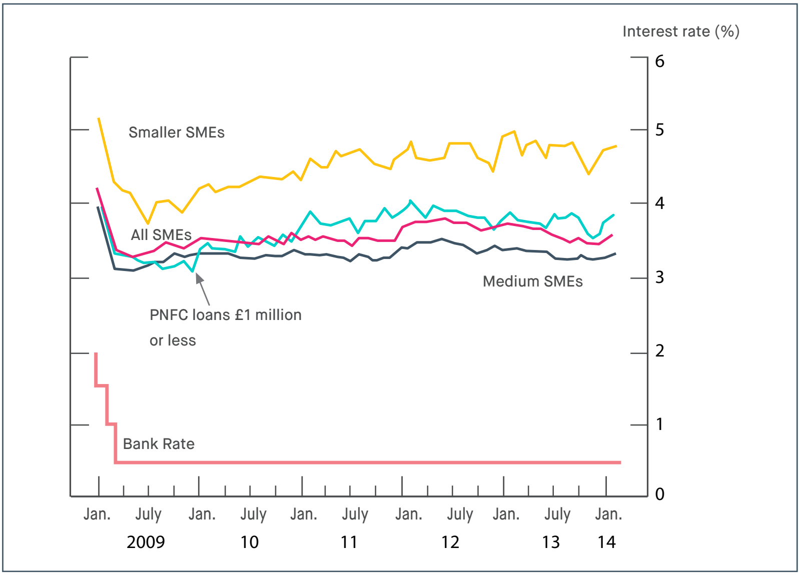
Source: SME Finance Monitor, Wave 12 - Q1 2014

SUPPLY AND DEMAND FACTORS IN THE DECLINE OF SME FINANCE PROVISION

Both supply and demand factors may be contributing to the decline in the use of external finance amongst SMEs. Bank deleveraging has been driven in part by new regulations on capital requirements in the wake of the financial crisis, which have meant that banks have kept substantial sums rather than lending to businesses. The 'Liquidity' part of the Capital Requirements Directive has reduced the amount of money banks have available to lend to businesses; and the 'Capital' part of the directive has increased the amount of capital banks are obliged to hold, thereby driving the cost of loans to businesses higher than they otherwise would be, although a dramatic reduction in the base rate has helped subdue interest rates, as shown in Figure 6.[43]

This has meant that, despite perceptions to the contrary, SMEs are paying less for finance after the crisis than they were in 2008, although margins compared to the Bank Rate are now higher.[44] Reduced lending by the banks is a particular problem because businesses in the UK are heavily reliant on banks in comparison with other countries: nearly three quarters of business credit is from banks, compared to only 25% in the US and around half in Australia.[45]

Figure 6: Indicative (median) interest rates on lending to SMEs



Source: Bank of England, Trends in Lending, April 2014

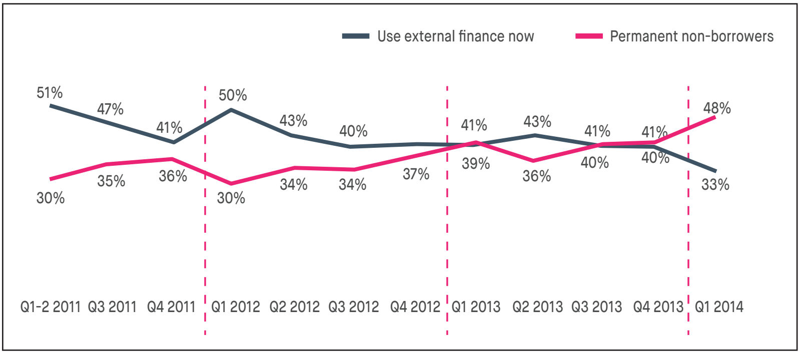
In some cases structural market failures exist which affect the supply of finance to SMEs, in particular relating to imperfect or asymmetric information between lenders and borrowers.[46] It may be the case that, since the UK relies on large banks whose comparative advantage is not centred on understanding SMEs, smaller businesses are at a disadvantage in accessing finance, since potential measures taken by banks to understand their business are either expensive or require greater scale.[47]

Recent work by the Competition and Markets Authority (CMA) has found a number of problems in the market for SME banking more generally. These include significant barriers to entry that mean that business banking is heavily concentrated, with the four largest providers accounting for 90% of business loans. Levels of satisfaction and trust remain low.[48] These issues may also contribute towards the facts that smaller businesses pay higher interest rates than larger businesses, and a larger proportion are rejected in applications for finance.

There are also some key demand-side explanations for the reduction in SME lending. The BIS Small Business Survey shows a marked increase in the numbers of SMEs citing working capital or cash flow as a main reason for borrowing following the events of 2007-8.[49] From this perspective, the reductions in lending seen in subsequent years could be viewed as a positive thing, as businesses recover from the tight conditions seen in the recession years as the economic climate improves.

This trend can be seen as part of a broader move towards reduced SME demand for external finance. Figure 7 shows the proportions of 'permanent non-borrowers' – those not using external finance and showing no inclination to do so – and those using external finance at a given time, based on data from the SME Finance Monitor survey.[50] The graph shows a gradual trend away from the use of external finance. Some of these firms may use trade credit instead, or use an injection of their personal funds. However this trend has gone alongside a gradual reduction in the numbers injecting their own personal funds – and in particular a reduction of those doing so because they 'had' to – as economic conditions have improved.[51] Nevertheless, some of the decrease in demand may be related to a perception by some businesses that they are unlikely to be accepted for finance, often as a result of being declined for finance previously. Amongst the smallest businesses – those with less than 10 employees – being declined previously led to a reluctance to reapply for 80% of those surveyed.[52]

Figure 7: Fewer SMEs are inclined towards using external finance



Source: SME Finance Monitor, Wave 12 - Q1 2014

EQUITY FINANCE AND HIGH GROWTH POTENTIAL FIRMS

Equity finance currently makes up a very small proportion of SME financing – only around 2% of employer SMEs seek equity finance in a given 12 month period.[53] However for some businesses this type of finance may be extremely important – and the type of businesses that are likely to use equity finance tend to be firms with high growth potential.[54] Medium sized businesses are more likely to seek equity finance than small or micro businesses, but there is evidence of a structural deficit of funding for companies seeking equity between £250,000 and £5 million.[55] The equity finance market was heavily affected by the economic downturn with, for instance, a 30% fall in available finance between 2010 and 2011.[56]

These problems may be exacerbated by the fact that the UK, like many countries, has a tax bias that favours debt finance over equity finance. The fact that debt interest payments are deductible in calculating corporate income tax payments, coupled with the fact that no corresponding tax relief applies to equity finance, creates a distortion in favour of companies using debt finance.[57]

Recently some innovative changes in the way equity finance is implemented have taken place in a number of countries, including the UK. For instance, crowd funding platforms have the potential to increase the availability of finance; although they remain small in comparison to other sources, growth rates are very high, albeit from a low base. These platforms can provide both equity and debt finance, but although their rapid growth offers the potential to compensate for reductions in bank lending, they currently are too small compared to the magnitude of bank lending to make much impact. The British Business Bank has committed funds targeted at SME lending through debt-based crowd funding platforms, but these are still estimated to constitute less than 1% of the overall SME funding market.[58]

EXISTING GOVERNMENT POLICIES

There are a number of Government initiatives designed to increase lending to and investment in small businesses. In terms of bank lending, these include the Funding for Lending scheme, under which the Bank of England offers lower interest rates to banks lending to small and medium sized businesses (SMEs) until 2015. In addition, under the Enterprise Finance Guarantee, lenders can offer loans partly guaranteed by Government, allowing them to lend to businesses that lack collateral or the ability to offer a proven track record. Over the longer-term, the Government plans to expand the British Business Bank to house and manage Government programmes designed to encourage lending to smaller businesses.[59] However the level of funding provided by the Business Bank is still relatively small compared to bank lending: the British Business Bank Investment Programme has committed £400m of public funds, compared to £17bn of bank loans to SMEs in 2012.[60]

There is also a range of Government measures focused on making private investment in small businesses more attractive. These include the Business Finance Partnership, which provides funding to fund managers that invest in SMEs and a Business Angel Co-Investment fund, focusing on small businesses. Finally, the Seed Enterprise Investment Scheme (SEIS) offers investors tax reliefs for those who invest in early-stage companies.

The state also lends directly through its Start-Up Loans programme, although the amount on offer is relatively small (loans of around £2,500 each). Government also offers some direct funding. The Technology Strategy Board offers grants for research and development. The New Enterprise Allowance provides a weekly sum of money to those on certain benefits who wish to start a business.[61]

What policymakers need to address

- Lending to businesses continues to decline. This is particularly problematic for SMEs, since they currently have **limited access to bond and capital markets**, and their **use of equity finance is relatively low.**
- Equity finance is important for a small number of high growth potential firms, with a **structural deficit of funding** for companies seeking equity between £250,000 and £5 million.
- There are **barriers to competition in the market for SME banking**, resulting in low levels of satisfaction and trust in the banking system.
- Despite new funding being provided to SMEs by the **British Business Bank,** the **level of funding remains low** compared to the scale of SME lending.

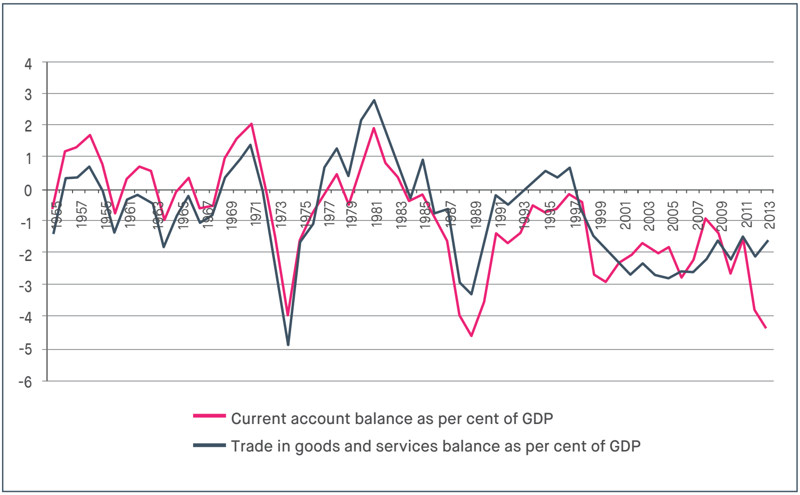
INTERNATIONAL TRADE

THE TRADE PROBLEM

One of the major structural weaknesses in the UK economy is its dependence on domestic household consumption for growth. Recent OBR figures suggest that so far, the recovery has been driven by stronger consumer spending offset by lower savings rates.[62] As households run down their savings, firms will have to look elsewhere for sources of growing demand.

We need to find other sources of growth. The primary candidate is net trade. Our net income from trade has been negative in every year since 1997. Our current account balance – which is the combination of net income from trade and net earnings on foreign investment – has been negative every year since 1983. Having a current account deficit means that we are effectively borrowing from abroad, and is the "flip side" of our over-reliance on debt to fund consumption and investment.

Figure 8: Trade and current account balances as a proportion of GDP

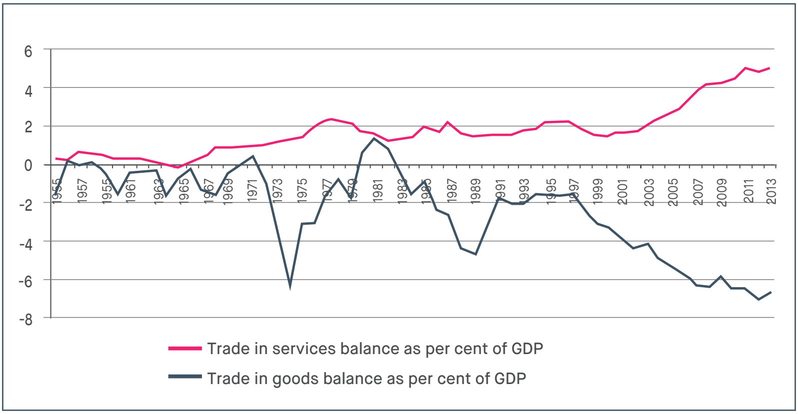


Source: ONS, Pink Book, 2013

Prior to the financial crisis, the high value of the pound was often cited as one reason why British firms found it hard to export to other countries: because our goods were priced too high. But even the depreciation of sterling, by more than 25% between Q3 2007 and Q1 2009, failed to make a substantial difference to the trade balance.[63] One reason is the dependence of our net trade on financial services. Another is simply that many of the countries we export to experienced downturns too, reducing their demand for goods and services imported from the UK.

There are some positive notes. World GDP is now recovering, especially in emerging markets, providing potential opportunities for UK exports. In addition, whilst it has not been enough to balance our worsening net trade in goods, a trade surplus in services has kept our overall trade balance from more substantial deterioration over the past decade. And the OBR expects our income on foreign assets to recover in the following years. [64]

Figure 9: Balance in goods and services as a proportion of GDP



Source: ONS, Pink Book, 2013

However, the fact that even before the economic downturn we had a weak position on net trade and on the current account balance suggests that we cannot rely on an uptick in global growth alone to boost exports. As we set out below, between 2000 and 2012, the UK's exports doubled; over the same period, Germany's trebled. There is potential to do much better, but we need to catch up quickly if we are to grow our share of sales to emerging markets.

The issue of low productivity is fundamental to the export problem in the UK. Without improvements in productivity that make our goods and services more attractive to overseas markets, it will be hard to improve the UK's trade position. These productivity issues are in turn related to problems around skills and infrastructure as explored in other sections of this paper. There are also other elements of Government policy such as regulation and taxation that may have some impact on trade – one potential example is Air Passenger Duty, which we also explore elsewhere in this paper. But beyond these wider factors there are, arguably, other existing problems specific to international trade as a potential market for UK businesses. The next section looks at reasons why the UK has struggled to boost exports in the past, and the current barriers.

DO WE HAVE A PROBLEM?

The UK economy is especially reliant on services, which make up over three-quarters of GDP; trade in services accounts for just under a fifth of GDP.[65] One potential reason why our net trade looks persistently negative could be that services trade, where we have a surplus, is harder to measure, and so may be under-estimated relative to the value of our trade in goods. For example, analysis by the OECD finds that the services content of world trade is larger than would be apparent from the high-level trade statistics, once exported goods are broken down into different goods and services inputs.[66] For some sectors, it is difficult to calculate the full effect on net exports: for example, tourists may spend on services whilst in the UK, but this is not necessarily captured in the export statistics.

However, even if services are underestimated in trade figures, this would affect both export and import figures, mitigating the overall effect on net trade. And it seems unlikely to be a large enough effect to conclude that there is no problem at all.

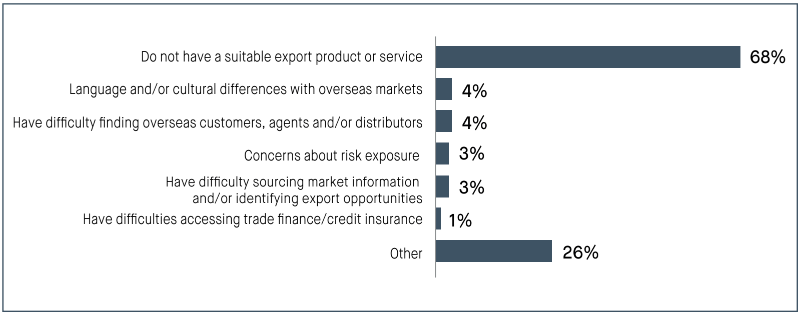
The rest of this section looks at firstly what firms perceive to be the barriers to exporting, and secondly, the potential wider economic barriers to boosting exports.

FIRMS' PERSPECTIVES

Over two-thirds of firms who do not export say it is because they do not have a suitable product or service to sell abroad. There are questions as to whether, with the right support combined with a perceived need to find other, non-domestic markets, some of these firms could adapt their products and services for overseas markets. However, aside from this, there are other barriers to becoming an exporter, and to expand exports across markets, as shown in Figure 10 below.

Across those who could become exporters, the main challenges are access to market knowledge and difficulty in finding customers in less familiar territories. A BCC survey of its member firms found that the key barriers are language and cultural differences; difficulty finding overseas agents, customers and distributors; concerns about risk and difficulty sourcing market information and identifying export opportunities.[67] Similarly, among those who used to export, the same survey found that 20% would export again if they had access to agents or distributors in other countries. [68]

Figure 10: Principal reasons for not exporting (base: non-exporters who are unlikely to export in the future)



Source: BCC International Trade Survey 2014

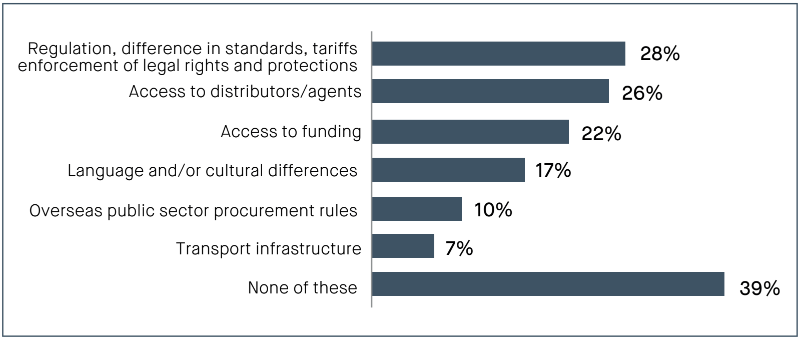
Those who already export also cite these barriers to expanding their overseas sales. However, they also have more specific concerns. Around 28% of them cite regulation, differences in standards, and tariffs, as factors.

Specifically, having to comply with standards and certification procedures for products and services, which often differ across countries, is seen as the main difficulty, followed by foreign customs and excise duties.[69] A survey commissioned for UKTI also found that the most important barrier was legal and regulatory, with 43% of surveyed businesses citing it as a significant challenge, a proportion that actually increased with the size of the firm.[70] The same survey found that 23% of exporters were concerned about the risks of not being paid and having problems enforcing contracts. This factor was also cited by 43% of firms as a reason for not entering a new market.[71] Across both non-exporters and exporters, better access to finance would encourage them to export more.[72]

There is existing support available through sector and business organisations, and state-provided support in the form of UKTI. However, awareness of UKTI needs to be improved. A recent survey by OMB found that a third of businesses were unaware of UKTI and just over half were unaware of its role in providing assistance to businesses that want to sell overseas. Awareness was even lower among smaller companies.[73] This must be addressed so that firms know where they can obtain the support they need.

UK Export Finance (UKEF) has been set up to boost credit available for exporters, with the 2014 Budget announcing an expansion in its direct lending programme.[74] However, with access to finance still one of the top factors preventing firms from expanding export sales, we need to do much more to increase the level of credit available to exporters. In addition, awareness of UKEF is poor. Two-thirds of mid-sized businesses are unaware of UKEF.[75]

Figure 11: Principal barriers preventing export sales expansion (base: current exporters)



Source: BCC International Trade Survey 2014

But support agencies are not the only way of helping SMEs to better navigate the complexity of selling overseas. Employees with language skills and local market knowledge can also help. Studies find that from the perspective of increasing exports, the most valuable migrants are those who are skilled and from countries where our existing trade links are weak.[76] Lifting visa restrictions could therefore provide a way of solving the difficulties that firms that want to export more have with lack of market knowledge, cultural differences and language. However, with political pressure to reduce migration, this is currently difficult to implement.

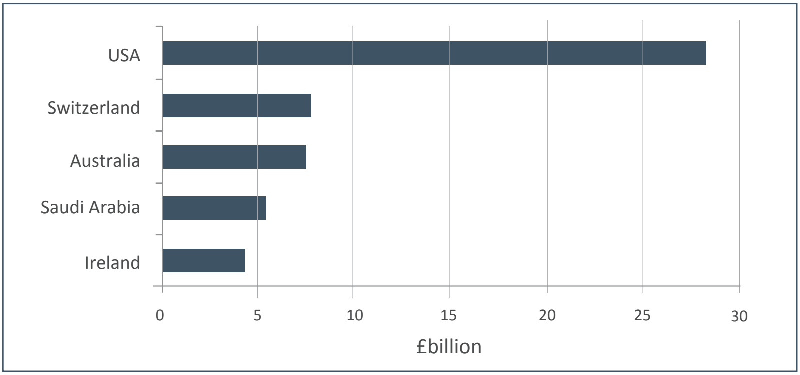
THE WIDER PERSPECTIVE

There are also wider factors that have been pointed to as explaining the UK's structural net trade problem. These include: whether we have the right product strategy; whether our domestic supply chains are sufficiently developed; and whether our large army of SMEs are able to overcome the fixed costs of expanding into foreign markets.

Wrong products?

The UK is more successful in exporting to some countries compared to others. The UK tends to run surpluses against North and South America, and Africa. It runs a deficit against the EU, Europe and Asia; that is, we import more than we export to these places.[77] Our largest surplus is with the US. Generally, the UK tends to be more successful in exporting to richer countries, as shown in the chart below.

Figure 12: Top 5 countries ranked by size of UK's trade surplus



Source: ONS, Pink Book, 2013

The UK has made less progress than other developed countries in exporting to new, emerging markets with higher growth rates. From 2000 to 2012, the value of UK exports doubled, but those of Germany trebled.[78] A key reason is likely to be that countries with growing demand are not purchasing the types of export products and services that the UK has to offer.

The UK tends to perform better in goods and services that target higher income countries and consumers. Over 96% of the UK's service export firms sell to high income countries, compared to 30% that export to an emerging or high growth market. This includes, for example, pharmaceuticals, high tech machinery, and luxury goods such as art work and spirits.[79] One response to this is to argue that we need to boost exports in products and services that emerging markets are currently demanding.

However, emerging markets are themselves developing their production and export capabilities in these areas. As these markets become more prosperous, demand for the types of goods and services that the UK has an advantage in is likely to increase. But this does not mean we can be complacent. Although our main competitors for exports at the moment tend to be developed countries, emerging markets will also increasingly compete in the same areas.[80]

This makes trying to manage a switch away from the "wrong" products to the "right" products all the more uncertain. What is likely to be a better strategy is to capitalise on the areas where we currently have an advantage, to ensure that we continue to innovate, develop and sustain that advantage in the future.

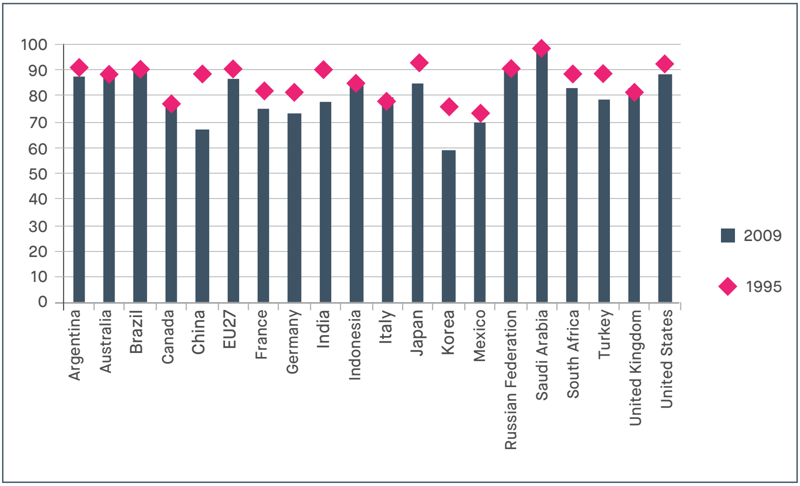
Too many exports need imports?

As global supply chains have developed, trends in imports and exports have become much more interlinked. This means that if exports are boosted, imports of intermediate and raw materials are likely to increase as well, dampening the overall effect on net exports. One response to this is to argue that the UK should develop a more robust domestic supply chain in sectors where we want to boost exports. [81] However, a look at the statistics suggests a note of caution is required.

The chart below shows the proportion of gross exports that are made up of domestic inputs or value-added. In the UK, the domestic content of our gross exports is 83%; the reliance on imports for our exports is not especially high. This is likely to be at least partly due to the strong role of services, which are less likely to have dispersed value chains. But it is also worth noting that countries such as Germany that have been successful at increasing goods exports over the period actually increased their reliance on global supply chains since 1995 rather than reduced it. In addition, even for some specific manufactured goods such as electronics and transport equipment, Germany has either similar or greater reliance on imported goods for its exports.[82]

In many cases, if other countries have a competitive advantage in producing intermediate products, then switching towards domestic supply chains could increase costs, reduce productivity and make our exports less competitive. As with our industrial and export strategy more generally, there are likely to be greater benefits from building on our existing advantages rather than trying to build advantage in newer areas.

Figure 13: Domestic content of gross exports (percentage)



Source: OECD/WTO TIVA database, May 2013 release

Many SMEs?

The proportion of SMEs in the UK that export – 21% - is lower than the EU average, but on a par with similar sized economies such as France and Germany.[83] However the UK does tend to have a large proportion of small businesses compared to other developed countries.[84] Smaller firms are less likely to export than their larger counterparts – partly because some of them are younger, and so have had less time to grow into new markets.[85]

Whilst smaller firms do not tend to report experiencing greater barriers, this is likely to be largely due to the fact that they have had less experience in selling to overseas markets, especially ones where barriers are higher.[86] In general, it is likely that the types of challenges preventing firms in general from exporting more are likely to weigh more heavily on smaller companies. For example, they are less likely to be able to dedicate resources to navigating regulatory and tax barriers; and are more likely than larger firms to have difficulties in accessing credit for expansion. This means that in the UK, there may be a greater need for support for small companies to overcome these difficulties.

Not capitalising on our existing strengths?

The UK's trade balance is positive in many services sectors. Within services, knowledge-based business services account for around a third of the UK's services exports and over a tenth of its total exports. [87] Creative services and education are other areas of services where the UK has a global advantage. However, barriers to trade in services remain, and are high compared to barriers to trade in goods, an issue we explore in more detail in the chapter on Europe.

What policymakers need to address

- **The productivity problem** is likely to be fundamental to the UK's exports problem, but beyond this, there are other barriers that mean that we may not be capitalising on our strengths.
- **Regulatory barriers,** such as differences in standards across countries, hold back export expansion.
- **Lack of country and market specific knowledge and lack of language skills** among firms make it hard to find overseas customers and distributors; and to navigate the complexity of selling in overseas markets.
- **Awareness of existing support is low.**

LOCAL GROWTH

When the current Government came into power, one of its objectives was to rebalance the economy geographically, in the face of a dominant London and South-East. This section outlines the growth disparity, the extent to which policy can - and should - address it, and existing policy initiatives.

THE GROWTH DISPARITY

London outperforms the rest of the country by a considerable amount. It has by far the largest share of gross value added across the UK (a measure of regional GDP). As shown in Figure 14, it also has the highest level of gross value added per hour worked and per job, and, in addition, has seen the fastest recovery and growth since the downturn.[88] As a consequence, it also has the highest average household disposable income.[89]

Figure 14: Gross Value Added (GVA), 2012

Source: ONS Regional Economic Indicators, July 2014

This could partly be an artefact of the way in which Government office regions are defined: London is predominantly urban, whereas the other regions are a mix of city areas, towns and rural areas. However, even when London is compared against other cities, it still has the highest level of weekly earnings. It also has the highest rates of business creation and private sector employment.[90]

IS THE DISPARITY A PROBLEM?

Disparities in economic growth across regions can arise for a range of reasons. At a superficial level, one reason why London has grown faster is that it has a high concentration of fast-growing sectors such as finance, real estate and professional services, and a low concentration in slow-growing sectors such as manufacturing. The firms within these sectors are also more competitive than average.[91]

Growth is driven by a range of factors, including infrastructure, skills and the general business environment. But city growth cannot be reduced down to these component parts. In a sense, growth creates growth. Firms often benefit in productivity terms from locating close together, to take advantage of labour supply and knowledge spillovers. In turn, this creates incentives for workers to locate to these areas, and a wider labour pool encourages more firms to locate, and so on. This virtuous circle is referred to as an agglomeration effect. A small advantage in growth could therefore be magnified over time, as the growth area becomes even more competitive and even more attractive as a business location.

This means that it may be both undesirable and very difficult to attempt to “re-distribute” growth more evenly across the country. Undesirable because it would mean losing the benefits associated with agglomeration. Very difficult because it is hard for policy to try to work against these agglomeration benefits. Previous policies such as regional development agencies and the New Deal for Communities saw only limited success in redistributing growth.[92] Often, a risk is that regeneration in one area simply displaces economic activity in another.

For this reason, other policies may be more effective in ensuring that growth is shared across the population. For example, improving transport links can help those living in less prosperous areas to access jobs in growing ones. This can allow a greater proportion of the population to share in the proceeds of growth, even if such proceeds are generated in a narrow geographic area. Allowing growing areas to expand – by allowing more housing to be built in these areas – can play a similar role, by improving labour mobility from areas where growth is not as high.

But whilst it is likely to be very difficult for policy to redistribute growth across the country geographically, the structure of political decision-making itself may hold some areas back from fulfilling their full potential. The UK is relatively centralised in its political decision-making: under 30% of public spending is local, with the rest spent by central Government. Other countries have much higher levels of sub-central Government spending: in Canada, the proportion is just over 60%; in the United States, it is over 40%; in Germany, it is just under 40%.[93] It is unclear which way causality lies, but many other developed countries have also been able to sustain more successful and faster growing "second-tier" cities.[94]

Scotland, Northern Ireland and Wales have substantial devolved powers. However, the picture is different within England. At the moment, London has more autonomy than elsewhere in England. The Greater London Authority has responsibility for a number of areas, including transport and economic development. However, even London has relatively little fiscal autonomy compared to equivalents in other developed countries. Other local areas in England have even less.[95]

POTENTIAL ADVANTAGES FROM MORE DECENTRALISATION

This political structure may be problematic for two reasons. Firstly, local decision-makers may be able to better understand the needs and priorities for their local areas. And as one specific urban area becomes more dominant, there is a danger that more central Government policymaking focuses on the dominant area to the detriment of the rest. Over time, differences could therefore be exacerbated. Greater autonomy at the local level could increase growth in these other areas.[96]

Secondly, it may mean insufficient focus on economic growth by local government, even when it has the ability to make a difference in these areas. If voters hold central rather than local government accountable for growth, and local government shares little of the "upside" of economic growth in their areas, then there is likely to be less incentive for local governments to take measures to increase growth at the local level.

This means that in many cases, there is not enough openness to development that increases economic growth, including housing, infrastructure and commercial development. The political nature of local government can mean that such development is less likely to be approved due to the "insider-outsider" effect. "Insiders" – such as current residents – are likely to be more opposed to new development in their areas compared to those who might benefit, many of whom may live outside the local area. The current way in which decisions over planning and housing are made has led to a situation where building levels are around half what they need to be to cope with demand for housing – putting ever more pressure on housing costs.[97] In turn, this constrains growth by making it harder for families to move to areas where there are greater job opportunities, and making recruitment harder for businesses. Where local government is held more accountable for economic growth, it has a greater incentive to weigh up these economic growth benefits against the potential political costs.

AREAS OF CURRENT POLICY

The current government has – as part of its geographic rebalancing strategy – introduced a number of local growth initiatives, which to some extent address the issues set out above. These are summarised below.

Business Rates

From 2013 to 2020, local authorities are able to retain between a quarter and a half of revenues raised through business rates. This is designed to provide greater incentives for local authorities to promote business development in their local areas. DCLG expects that the policy would boost national income by an average of £1.4 billion a year, mainly through a reduction in planning restrictiveness leading to the development of more business premises and lower costs for business. In 2020, there will be a review of funding allocations.

Incentives to promote local growth could be increased by allowing local authorities to retain more of the tax collected; this could, however, risk widening disparities between areas. The 2020 cut off could also introduce some perverse incentives as local authorities will have fewer incentives to approve developments close to the cut-off date.[98]

City Deals

City Deals are risk-sharing agreements between government and particular cities, and provide cities with more autonomy in return for being held responsible for increasing economic growth. Areas of autonomy include powers over decision-making that affects local growth and the ability to decide how public money in their geographic area should be spent. Two waves of City Deals have now been completed, with 28 cities in total.[99]

LEPs

Initial developments

The current Government abolished Regional Development Agencies, and in their place set up Local Enterprise Partnerships (LEPs), which are partnerships between local authorities and businesses. Their purpose is to decide priorities for investment, roads, buildings and facilities in the local area. There are 39 LEPs, covering the whole of England. Following a competitive process, 11 LEPs have been awarded “enterprise zones”. These zones carry a number of incentives to attract businesses, including business rate discounts, simplified planning processes, government grants and tax reliefs.[100]

Initially, LEPs were to have no direct central funding for running costs. However, Government subsequently provided some limited financing, and also announced that a matched funding pot would be made available of up to £45 million in the period up to 2014-15. [101] There are also other funds that LEPs have been able to access to allow investment in their areas.

These include funding from the Regional Growth Fund, which LEPs were able to apply for in competition with other organisations; and the Growing Places Fund which was focused on infrastructure investment, and which allocated money to LEPs based on population and employed earnings.[102]

The Single Local Growth Fund

The Heseltine Review, published in 2012, argued that more funding devolution to LEPs was needed – beyond that outlined above.[103] The Review recommended that a single local growth fund should be created from budgets earmarked for specific areas. The purpose was to allow greater flexibility at the local level for budgets to be allocated in way that better meets the economic needs of specific areas.

Following the review, a Single Local Growth Fund will be available from 2015-16, with funding for skills, housing and transport. LEPs were asked to develop local strategic plans, to be used to negotiate "Growth Deals" and to allocate funding from the Single Local Growth Fund,[104] which LEPs can access after developing strategic economic plans for their areas. Allocations of much of the fund is determined through a competition, with LEPs with the best strategic plans likely to be awarded more funds.

Whilst a competitive process provides a mechanism to ensure that money flows to areas where it is likely to have the largest impact, it arguably still retains some of the disadvantages of centralisation. Since central Government administers the competition, national decision-makers will still continue to have a strong say in how money is spent, and in trading off the needs of different local areas.

Areas for improvement

In principle, local enterprise partnerships provide a mechanism for local businesses to feed in their priorities for their local area, potentially helping to increase local growth. However, there has been criticism on a number of fronts, including whether there is sufficient presence of smaller businesses on LEPs, whether they have sufficient powers to make changes and whether they are sufficiently accountable, with no clear mechanism for accountability.[105] Lord Adonis's Growth Review argued that LEPs required significant improvement, saying that in some cases they do not reflect the underlying geography of the local economy; and some need to do more to work with local authorities. The Review also argued that Government needed to be clearer on the core remit for LEPs, and that LEPs needed more certainty in funding.[106]

The latter highlights a fundamental tension: the extent to which the terms of decentralisation initiatives are dictated by central government. Having some central government involvement may help to reduce spending that results in mainly "displacement effects" and increase spending in areas that are likely to have a greater overall contribution to economic growth. But it also risks removing some of the benefits of decentralisation, such as the ability to leverage local knowledge to set priorities for spending that is most likely to increase growth in different areas.

What policymakers need to address

- There is a **deep structural divide between London and the rest of the country**; this can only partly be explained by the fact that London is an urban area.
- **Attempting to rebalance geographically is difficult and may, in some cases, be undesirable.**
- **Improving transport links, and reforming the planning system to allow prosperous areas** to expand can help to ensure growth is shared across the population.
- The UK is **currently among the most centralised developed countries,** reducing incentives for local government to take measures that increase local growth.
- **LEPs** have given local businesses a voice, but **accountability and impact** remain two key concerns.

PROCUREMENT

PROCUREMENT, PUBLIC SPENDING AND THE BUSINESS ENVIRONMENT

Public procurement – government and other public bodies purchasing goods and services – accounts for a large proportion of the UK's GDP.[107] The OECD estimates that, in 2008, general government procurement accounted for just under 15% of GDP. Since 2008 the procurement spend has remained high, with £230 billion spent in 2012-13 across the whole of the public sector, representing 34% of total public sector expenditure.[108]

Effective public procurement is extremely important for a number of reasons. Efficient and well-targeted procurement provides value for money for the government, and ultimately the taxpayer. Encouraging competition – particularly amongst innovative firms including SMEs – in bidding for contracts is one way of driving better value for money. Access to public procurement tenders can also be highly beneficial for businesses since the scale of public spending on procurement is very large. At the same time, however, it is necessary to have procedures in place to ensure the procurement process is fair and transparent, and contracts go to the right firms that can deliver the best value for money. More generally, effective procurement can drive market competition.

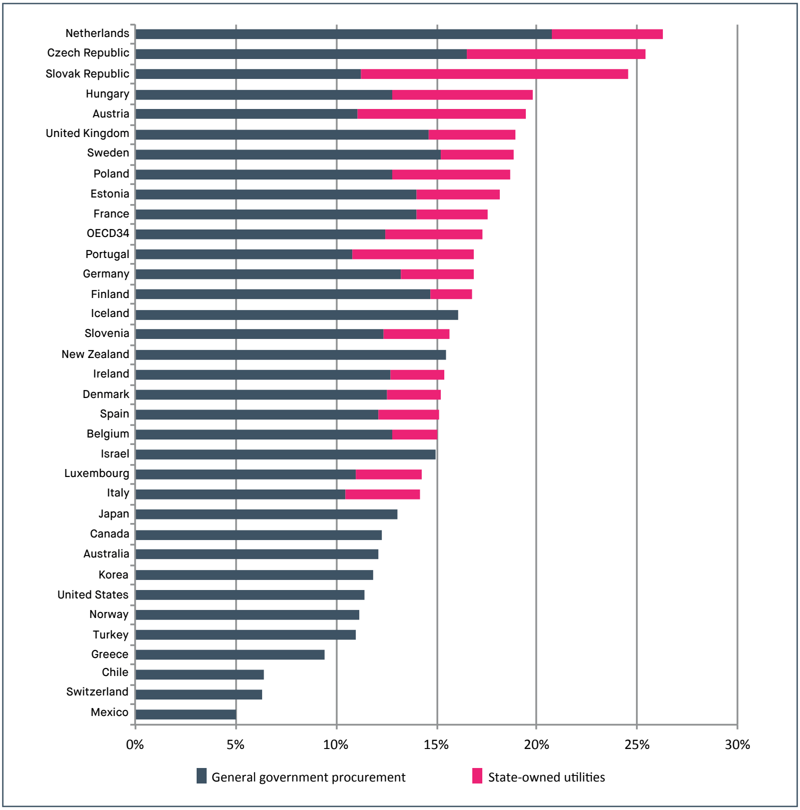
UK procurement is governed by several key bodies and pieces of legislation. Two EU Directives set out the regulations for different sectors: the Public Sector Directive provides regulation for most sectors; whilst the Utilities Directive coordinates procurement procedures more specifically in water, energy, transport and postal service sectors – although it has more limited application in the UK since many of the UK's utility organisations belong to the private sector.[109]

Some recent modifications to the Directives were made in 2014 in order to update the rules following political, social and economic developments and increased pressures from budgetary constraints. These new modifications in particular focused on simplifying procurement procedures, increasing small and medium enterprise (SME) participation, fighting corruption, and new emphasis on integrating procurement objectives with environmental objectives and social integration.[110] These rules apply to tenders over a certain value, with smaller tenders allowed to be governed by national law. More generally, within these Directives there is scope for national governments to choose paths of procurement regulation deemed most appropriate for that country, but nevertheless constitute a framework for coordination of procurement across the EU.

HOW THE UK COMPARES INTERNATIONALLY

In terms of the size of public procurement the UK spends more than the rich country average. Figure 15 below shows that, in 2008, only five OECD countries spent more on procurement as a proportion of GDP, if one includes procurement of state-owned utilities; and even without utilities, the UK is one of the highest OECD spenders.

Figure 15: General government and state-owned utilities procurement as percentage of GDP (2008) [111]

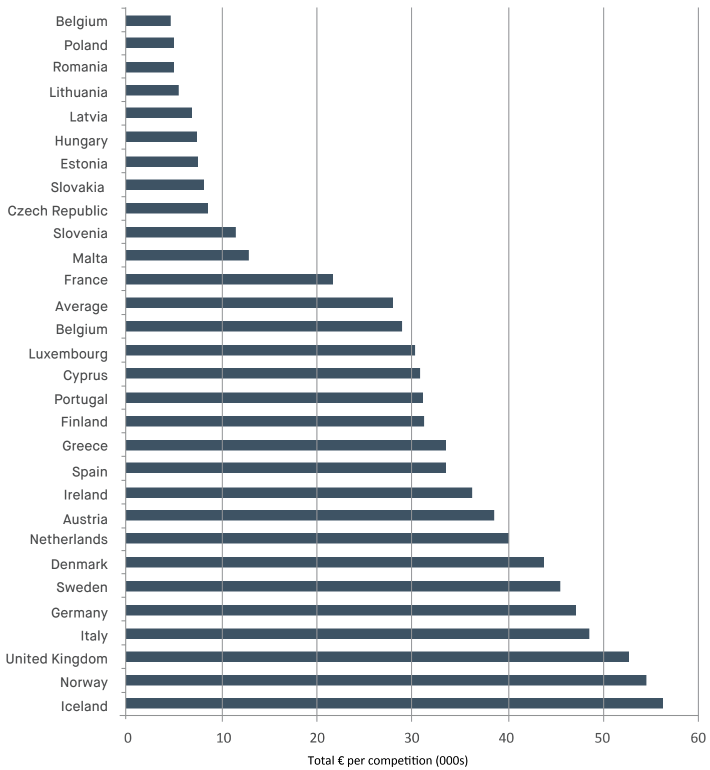


Source: OECD National Accounts statistics and Eurostat

Despite the fact that the UK spends a large proportion of its GDP on procurement, the UK has more costly procurement processes than the EU average. Figure 16 below shows analysis for the European Commission on the overall costs of the procurement process to businesses and the purchasing authority. The figures shown are in thousands of euros.

Unsurprisingly the richer countries tend to have more expensive procurement processes, partly reflecting the higher cost of labour; the newer EU countries are, therefore, to be found towards the top of the chart. Yet even within those richer countries the UK still has one of the most expensive procurement processes in the EU, with only Norway and Iceland being more expensive. When one keeps in mind the fact that average labour costs are relatively competitive in the UK compared to other rich countries then procurement costs are clearly expensive compared to our competitors.

Figure 16: Average total cost to authorities and firms of a procurement competition [112]



Source: European Commission

INCREASING ACCESS FOR SMES

SMEs are under-represented in public procurement. Motivations for increasing SME participation include increasing competition for government contracts, thereby promoting value for money, and to maximise jobs and growth. Not only are SMEs extremely important in terms of the number of people employed in the UK, but employment growth has also been higher amongst SMEs than for all firms on average. Increasing the value of public procurement contracts going to SMEs should therefore boost employment and growth.

A recent report by BIS and Aston Business School found that, between 1998 and 2010, increases in employment were driven by smaller firms, with firms employing 50 or fewer people particularly likely to expand their employment over this period. Moreover, on average, small firms and start-ups created two thirds of all new jobs each year over this period.[113] Data from the ONS Annual Business Survey show that, per £100 of turnover, large businesses create an average of £26 value added to the UK economy, whilst SMEs create an average of £33.[114]

Yet procurement processes often favour larger firms and incumbents, with frequent complaints including a lack of transparency in the awarding of contracts, and difficulty in accessing information on contracts to bid for. Other key problems for SMEs include the time required to complete pre-qualification questionnaires (PQQs), the lack of availability of legal teams to complete complicated applications in-house, and a lack of standardisation of application processes.

Government has responded to some of these concerns by getting rid of PQQs for tenders under £100,000. Whilst a welcome development for SMEs, this PQQ reform only currently applies to central government procurement, which accounts for only around 20% of public sector business for small firms. However, plans are in place to reform public sector procurement further in late 2014 and 2015. Two particularly important plans are to incorporate all procurement – and not just central government spend – into a new Contracts Finder, and to standardise PQQs across the public sector.[115]

If successfully implemented, the new Contacts Finder could be extremely beneficial for SMEs; it will, for instance, include NHS and local authority procurement, organisations that 70% of small businesses doing business with the public sector deal with. Standardised PQQs have the potential to reduce business costs of bidding for contracts – an important reform given the fact that complaints about the complexity and stringent requirements of PPQs are frequently made by businesses to the government.[116]

Recent improvements that have already been implemented include the government's CloudStore – an online catalogue of more than 1,000 suppliers offering a wide range of services to the public sector. Public sector bodies can buy services through its online marketplace.[117] This service avoids lengthy contract procedures and is designed to make procurement easier for SMEs. Government departments have quoted savings of between 30 and 90% obtaining cloud-based ICT services through this catalogue, as compared to offers from incumbents and large organisations.[118] Further improvements that would be beneficial to SMEs include creating a full 'single market' in procurement, whereby all PQQ rules, payment terms, and accountability are standardised to reduce the complexity and associated additional compliance costs.[119]

Central government procurement to SMEs increased from 6.5% in 2009-10 to 10.5% in 2012-13, and Government has been working towards a target of awarding 25% of public procurement by market value to SMEs by 2015.[120] Slow progress with procurement reform means that this target is unlikely to be met; in order to fulfil this goal central government would need to more than double its spend with SMEs.[121] Both recent improvements such as CloudStore, and the new proposed reforms to the Contracts Finder and PQQs, however, are steps in the right direction and, if implemented fully, may help progress towards meeting the 25% target eventually.

RECENT TRENDS: HARMONISING PROCUREMENT WITH SOCIAL AND ENVIRONMENTAL OBJECTIVES

A recent focus of public procurement reform is the harmonisation of procurement with social and environmental objectives. This has occurred at both the EU and national level: some of the recent 2014 EU Procurement

Directive reforms, for instance, are explicitly designed to help public purchasers work towards environmental goals by including environmental compliance within the procurement process;[122] and also to allow public purchasers to award a contract on the basis of social criteria, such as employing a large number of disadvantaged or long-term unemployed people.[123] At the national level, the Public Services (Social Value) Act 2012 makes it a duty of public bodies in England and Wales to consider wider social impacts when procuring contracts.

Examples of procurement contracts incorporating social or environmental goals include housing improvement contracts by Glasgow Housing Association, in which apprentices and trainees were targeted for employment, with nearly half coming from the most deprived areas of Glasgow. In addition, a construction contract for Birmingham library targeted local employees, with over half coming from Birmingham Council's 'priority' areas.[124] The emergence of explicit social and environmental targets could provide opportunities for local businesses employing local trainees and apprentices to gain access to valuable procurement contracts. Current best practice in social and environmental procurement currently comes from the devolved provisions in Scotland and Wales, however, with provisions in England being less developed.[125]

What policymakers need to address

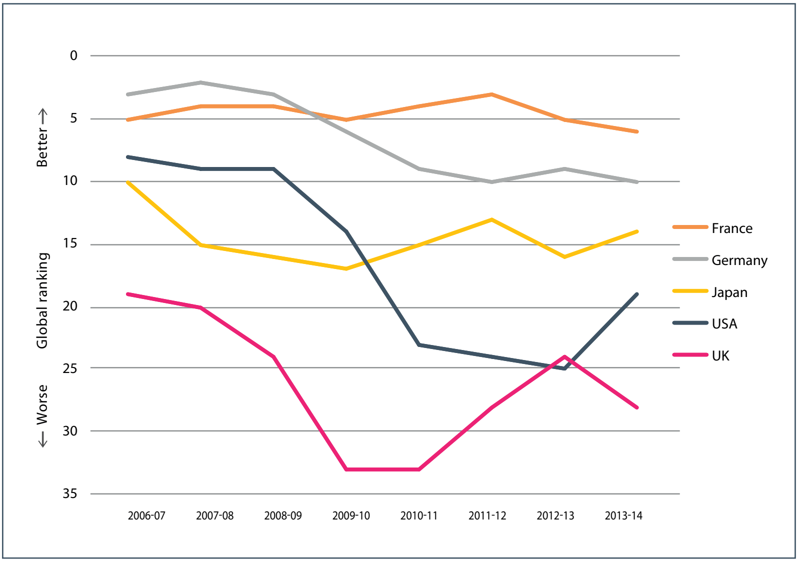
- Procurement processes in the UK are among the **most expensive** in the EU.
- **Opening up competition for contracts to more SMEs** could create greater competition for tenders, better value for money for the taxpayer, and drive employment and growth.
- The UK **lags behind many other rich countries** in providing an **effective 'single market'** in public procurement that would reduce business costs of bidding, be more friendly to SMEs, and promote competition.
- **New proposals for further reform** - particularly to the Contracts Finder and PQQs - are promising, but need to be implemented fully and as quickly as possible in order to improve access for SMEs.

INFRASTRUCTURE

The UK compares poorly with other developed countries in terms of the overall quality of its infrastructure. The Global Competitiveness Index ranks the UK at 28th out of the 148 countries surveyed, behind many of its major competitors, with Germany, France and Japan all well ahead of the UK (see Figure 17). Despite some areas of relative strength, such as its status as a global aviation hub, the UK lags well behind other developed countries in other areas, such as road infrastructure. The UK has experienced substantial underinvestment in infrastructure for a number of years. Public investment is well below the OECD average, and private investment has been hampered by regulatory problems and an absence of long-term strategy.

High quality and affordable infrastructure is essential for business, economic growth, productivity and global competitiveness. This section discusses the problems created by considerable underinvestment in the UK's infrastructure, and shows areas of comparative strength and weakness by comparing the UK to its competitors internationally. Since the Confederation of British Industry (CBI) Infrastructure Survey shows that UK businesses attach most importance to the quality and reliability of transport and digital networks, and to the affordability of energy,[126] this section focuses in particular on three key infrastructure sectors: transport, energy and telecommunications.

Figure 17: Global Competitiveness Index - quality of overall UK infrastructure, global ranking [127]



Source: World Economic Forum, Global Competitiveness Index

TRANSPORT

The UK compares poorly with other rich countries in terms of its transport infrastructure, and in some areas has deteriorated over recent years. The quality of roads is particularly poor by international standards. Increasing the quality of transport networks is crucial for the UK's productivity and competitiveness: the 2006 Eddington Transport Study suggested that reducing business travel time by 5% on roads alone could save around £2.5 billion a year.[128] Total road congestion costs the economy around £7-8 billion each year,[129] and the UK's railways suffer from a poor reliability record and crowding at peak times.[130]

The UK is a global hub for aviation, and – despite the UK's poor overall record for infrastructure – aviation is in some respects a competitive strength, with the World Economic Forum putting the UK in the top three countries worldwide in terms of the availability of airline seats.[131] However, airport capacity is becoming a serious problem, particularly in London and the South East, and is contributing to some of the worst delays in Europe.[132]

There are possible responses to these problems on both the demand and supply sides. Demand-side responses include measures targeted at reducing road congestion, such as traffic-flow management, which potentially could return £5 for each £1 invested.[133] Rail pricing structures discourage consumers from using peak-time trains unnecessarily, decreasing peak-time congestion.

There is, however, a limit to how much can be achieved by managing demand without also addressing the supply-side problems in the UK's transport system, at least if one is concerned about productivity and growth. Indeed, one of the OECD's main recommendations to improve the UK's growth and productivity prospects is to improve public infrastructure, especially for transport.[134]

Many of the UK's railways are predicted to reach capacity within the next decade, although new rail infrastructure - such as the new High Speed Rail link - should help increase capacity. There is, in addition, substantial variation in speed between different rail services, with average speeds between cities in Northern England and London nearly twice as fast as between different Northern cities; improvements in rail network quality could, therefore, be made on some lines.

Investment in the supply of road networks has seen particularly large reductions in recent decades, and there is evidence to suggest that investment in road networks might provide the best value in terms of reductions in congestion and gains to productivity and growth. In contrast to the plans for rail expansion there is, however, no correspondingly large-scale plan for road infrastructure. Indeed, road construction has fallen to less than half the level seen in the 1980s and 1990s.[135]

ENERGY

Stable, secure and affordable energy infrastructure is also essential for business, growth and productivity. The UK compares reasonably well with other developed countries in terms of its energy infrastructure, with the Global Competitiveness Index giving the UK a ranking of 9th for the quality of its electricity supply.[136] However major issues exist, particularly with regard to replacing ageing infrastructure, and with meeting legally binding commitments to reduce carbon emissions. Furthermore, both of these objectives need to be balanced with the ongoing requirement to ensure energy is affordable, especially in the context of the sharp rises in wholesale prices seen over the last decade.

The UK has an urgent need to replace a considerable amount of ageing energy infrastructure. Ofgem estimates that, by 2015-16, spare capacity will be only 4%, and that only relatively small reductions in margins could result in serious risks to supply, including the possibility of customer disconnections.[137] More than 20% of the UK's electricity generating infrastructure will have gone out of commission over the next ten years,[138] contributing to the £110 billion of capital investment that is needed to build new energy infrastructure by 2020.[139] Some progress has, however, been made already, with the government committed to ensuring the Hinkley Point nuclear project goes ahead without delay.[140]

The UK also faces a big challenge in meeting its legally binding obligations to cutting carbon emissions and moving towards a much greater use of renewable energy sources. It has done well in meeting its short-term carbon targets: the 2008-12 Kyoto target has been comfortably met, and the UK has outperformed many other OECD countries in terms of the pace of emissions reduction since the 1990s.[141] However, extremely ambitious further targets remain, including a 50% carbon emissions cut - from 1990 levels - by 2023-27, and a target of producing 15% of energy from renewable sources by 2020.

This latter target will be a big challenge. Only 7% of the UK's energy was produced from renewable sources in 2010 – a level that is lower than the OECD average, in contrast to the UK's strong performance on carbon emissions. Furthermore, there is evidence to suggest that the recent progress with reducing carbon emissions may be driven by one-off factors that cannot be relied on for future progress. Much of this reduction can be attributed to a combination of the privatisation of the electricity industry, subsequent moves away from usage of oil or coal and towards gas, reductions in gas prices, and substantial improvements in electricity generation technology, all taking place in the 1990s.[142] In addition, the economic downturn reduced energy demand, bringing the UK further towards its carbon targets than anticipated. The historically specific nature of these factors implies that meeting future targets cannot be taken for granted. Nevertheless, there are some indications that steps towards meeting future ambitious targets are being made. Investment in the energy sector is at high levels compared to recent decades, and investment in renewable sources accounted for 31% of the total in 2012.[143]

Both environmental commitments and replacing ageing infrastructure create an additional cost burden, and this comes at a time when energy prices have already been through substantial increases: for instance, wholesale gas prices in the UK increased more than fivefold between May 2007 and May 2013.[144] Affordability is extremely important for businesses: according to the CBI Infrastructure Survey, 95% of UK companies were concerned with the costs of energy in 2013.[145] The challenge for policy on energy infrastructure, therefore, is to balance the long-term stability and security of the UK's energy supply with tough environmental targets and affordability concerns from both consumers and businesses.

TELECOMMUNICATIONS

Investment in telecoms infrastructure is important for economic growth.[146] Establishing the appropriate level of investment in a specific area of telecommunications, however, is complicated. For instance, the OECD demonstrates that there is a strong correlation between broadband subscriptions and GDP per capita,[147] but the relationship between GDP and internet usage is complex. More affluent consumers may be more likely to buy broadband subscriptions, but more effective communication and access to information also has the potential to drive growth.

The UK has only a moderate level of telecommunications infrastructure by international standards. Ofcom estimates that more than 99% of UK premises have outdoor mobile 3G coverage, and over 99.9% of homes were connected to a broadband-enabled exchange. Super-fast broadband coverage is also being improved, with coverage up 8% between 2012 and 2013.[148] However, fibre broadband subscriptions are very low compared to leading rich countries – in June 2013 only 7% of broadband subscribers had a fibre connection, compared to 35% in Sweden, and 68% in Japan.[149] Very recent improvements in fibre coverage have been accompanied by strong demand, with BT reporting higher profits driven by its fibre services,[150] and only Mexico and Luxembourg experiencing higher annual growth in subscriptions within the group of OECD countries.[151]

However, more can be done to improve access to fibre broadband, with evidence that some small business premises do not have access to the same quality of internet provision enjoyed by domestic premises, particularly with regard to fibre connections.[152] The opportunities for growth by further improving telecommunications infrastructure in the UK are very great. Indeed, the LSE Growth Commission argues that "compared with other advanced economies, we tend to spend more time online, buy more online and the value added generated by internet-related activities represents a larger share of GDP than in almost any other country",[153] yet the UK's telecommunications infrastructure is only moderately competitive compared to other rich countries. Targeted investment in telecommunications infrastructure most likely to achieve growth could improve productivity and be beneficial for businesses.

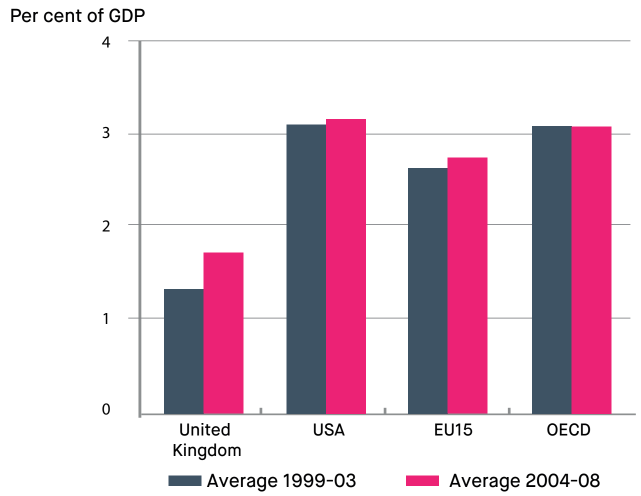
WHY HAS THE LEVEL OF INVESTMENT IN INFRASTRUCTURE BEEN SO LOW?

There is room for improvement with regard to the UK's infrastructure to catch up with, or exceed, the standards set by its major competitors. Although there are some areas of strength, well-targeted investments in certain sectors, particularly in roads, some types of telecommunications, and in balancing the multiple challenges presented by the energy sector, could bring considerable benefits in terms of growth and productivity. Indeed, one estimate, by the Civil Engineering Contractors Association (Ceca), suggests that the cost to the UK of having weaker infrastructure than the typical developed country was £78 billion each year between 2000 and 2010 – GDP could have been an average of 5% a year higher over this period if infrastructure had matched that of other leading countries.[154]

The UK's poor performance on the overall standard of its infrastructure has been accompanied by a relatively low level of investment compared to its major competitors. Public infrastructure investment as a proportion of GDP has fallen markedly since the 1970s, from over 5% in 1975 to less than 2% in 2013-14.[155] Compared to other OECD countries this level of investment is well below average (see Figure 18).

Low levels of public investment would not necessarily be problematic if private investment filled the shortfall and, indeed, government strategy has focused on increasing private investment to compensate. Although the government's model splits responsibility between the public and private sectors,[156] in practice private investment is of much greater importance. According to the National Infrastructure Plan (2014) only 19% of planned investment was purely publicly funded, with a further 17% a mix of public and private funds, but with 63% of planned investment between now and 2020 coming purely from private funding.[157] This differs markedly from the pattern seen in the 1970s and 1980s – in 1980 only 3.5% of infrastructure construction investment came from private sources.[158]

Figure 18: International comparisons of public investment



Source: OECD, Country notes: United Kingdom (2010)

However, the plan to allow the private sector the largest role in UK infrastructure investment has not led to a level of private investment that is sufficient to compensate for the lack of funding from public sources, at least if one wishes to attain internationally competitive levels of investment. Infrastructure-related construction output had been consistently above 0.8% of GDP from the late 1980s until 2002. Between 2003 and 2007, however, output fell to as low as 0.5% of GDP, reflecting an aggregate reduction in public and private investment. Infrastructure construction output between 1980 and 2002 had an average growth rate of 3.6%, but this fell to only 1.6% between 2003 and 2012. In fact, the UK had the lowest investment in infrastructure of all OECD states between 2000 and 2007.[159]

The weight given to either public or private investment varies by sector, with most road projects, local transport, and High Speed Rail being publicly funded, and most standard rail projects, and Transport for London, receiving a mix of public and private funds. The picture of overall infrastructure investment is complicated by the fact that the shift from public to private investment seen since the 1980s may not have been managed equally well in each infrastructure sector. Road building, for instance, has traditionally been – and is still – largely funded by public investment. Whilst rail construction – funded by a mix of public and private investment – increased, road construction decreased markedly. Yet in terms of its economic importance and the volume of passenger and freight travel, the road network remains more important than any other mode of transport.[160]

These differences in sources of funding between sectors depend, amongst other things, on whether a particular infrastructure project is able to generate a future revenue stream. The lack of private investment in road construction can mainly be attributed to a reliance on toll-free roads, which would not generate future revenue for investors, in contrast to the privatisation of the electricity industry in the 1990s, made possible by future charges that could be levied on electricity consumers.

In addition, there are two other key issues as to why private investment has not provided as much funding for infrastructure as was hoped. First, in some sectors the regulation and finance arrangements have not been good enough to allow for private investment. Second, there has been a lack of a long-term government strategy and credible cross-party commitment to certain policies, which has led to increased risks for private investors interested in long-term infrastructure investment.

WEAK FINANCE PROVISION AND POOR REGULATION AND GOVERNANCE

The Coalition government implemented a substantial reduction in public investment – of around £25 billion[161] – after taking power in 2010. However, the government did not anticipate that finance problems would be a substantial barrier to the private sector 'filling in' the gap that this reduction in public investment created. Bank lending to businesses has been considerably lower than before the financial crisis, as banks began to repair their already overstretched balance sheets, and new, more stringent, rules on capital reserves were introduced. Indeed, the Global Competitiveness Index survey of businesses operating in the UK suggests the most problematic factor cited for doing business was access to financing – this factor had a weighting of almost double any other problematic factor. [162]

As a result of this, the government has more recently recognised that "some commercially-viable projects might have stalled, or been cancelled, because they could not obtain the capital required to get construction underway".[163] The government has responded by launching several initiatives, including the new UK Guarantees Scheme, which makes available £40 billion of financial guarantees for certain infrastructure projects,[164] and a new Green Investment Bank with funds of £3.8 billion, designed to "mobilise investment in the UK's green economy".[165]

The problems the UK has experienced with infrastructure investment cannot, however, be explained purely in terms of a lack of finance caused by the financial crisis. As the previous section outlined, these problems have existed for some time – the UK had the lowest investment in infrastructure of any OECD state as early as 2000.[166] Large institutions – such as pension funds, sovereign wealth funds and insurance companies – that are interested in investing in long-term projects such as infrastructure, and that have had access to substantial funds, have failed to find a sufficient number of suitable infrastructure projects globally.[167] Demand for the type of long-term, stable and predictable investments infrastructure projects typically offer has not been matched by government supply of them; and the UK has been no exception. In short, the UK Government wants more investment in infrastructure, many large private institutions wish to invest more heavily in UK infrastructure, but the two are not coming together.

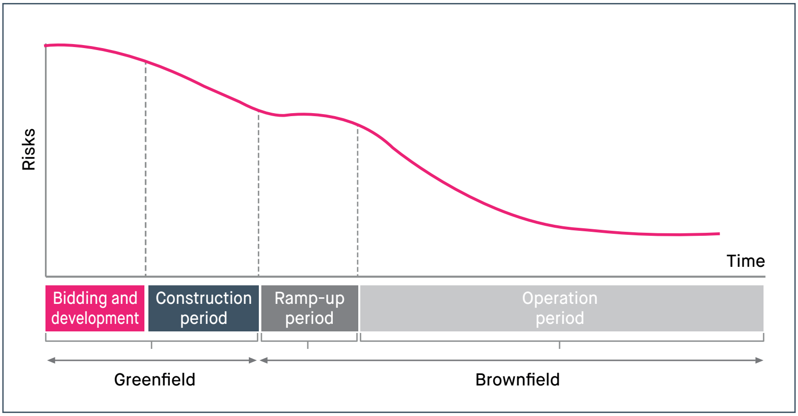
Infrastructure projects have characteristics that imply a greater level of government regulation or guidance than is typical of many other investments. They often require a very large amount of capital, and produce cash flows which are often partially determined by a government body. In addition, they often represent a monopoly.[168] The role of the UK Government in creating an environment that attracts investors in its infrastructure is therefore particularly crucial.

Given the very long-term nature of infrastructure investments, the role of a long-term strategic vision is very important; and policy and regulation should be stable over time.[169] Yet the UK has a track record of unstable infrastructure policies with frequent changes of direction, a tendency to make decisions for short-term political gain, and a lack of long-term planning and vision.[170] These traits detract from the UK's ability to obtain private investment in infrastructure.

Private investors are likely to find the purchase of infrastructure assets more appealing as time goes on due to their decreased risk as the project becomes operational, as demonstrated by the World Economic Forum in Figure 19 below. For infrastructure with a future revenue stream, a system whereby the infrastructure assets are publicly funded initially when risk and uncertainty are greatest (the 'greenfield' stage below), then assets are sold off later (during the 'brownfield' stage), could help manage public debt whilst also ensuring significant infrastructure development goes ahead.

The UK's ability to use public funds for infrastructure projects is, however, limited by its accounting methods. In particular, the current public debt measures and targets do not distinguish consistently between public debt accrued as a result of investment or the purchase of an asset, and public debt accrued as a result of consumption expenditure. This is despite the fact that investment that increases growth can boost future tax revenues. The current method of accounting for debt limits the public funds available for infrastructure investment since this spending will necessarily be curtailed by the debt target. This method of accounting, however, does not apply to all purchases: for instance the acquisition of substantial stakes in several banks following the financial crisis is accounted for in a way that is outside the debt target. Being more consistent with accounting methods between different types of investment or asset purchase could potentially free up public funds for infrastructure investment.

Figure 19: Risk profile development of an infrastructure asset



Source: World Economic Forum, Infrastructure Investment Policy Blueprint (2014).

What policymakers need to address

- The UK needs to address **serious capacity issues with its railways and airports.** The new HS2 rail link should help, but will take many years to complete; whilst concrete plans for expanded airport capacity in the South East have still not been decided upon. The **UK's roads are suffering from decades of underinvestment.**
- **Energy infrastructure is ageing** and needs to be replaced, and there are concerns about long-term energy security and the fulfilment of carbon targets.
- **Greater internet access** for smaller business premises and faster rollout of fibre would be advantageous.
- **Public investment in infrastructure is very low** by rich-country standards, and suffers from an inconsistent accounting procedure that restricts public investment.
- Private investment – the main focus of government investment strategy – suffers from **poor access to finance, poor governance and lack of long-term planning.**

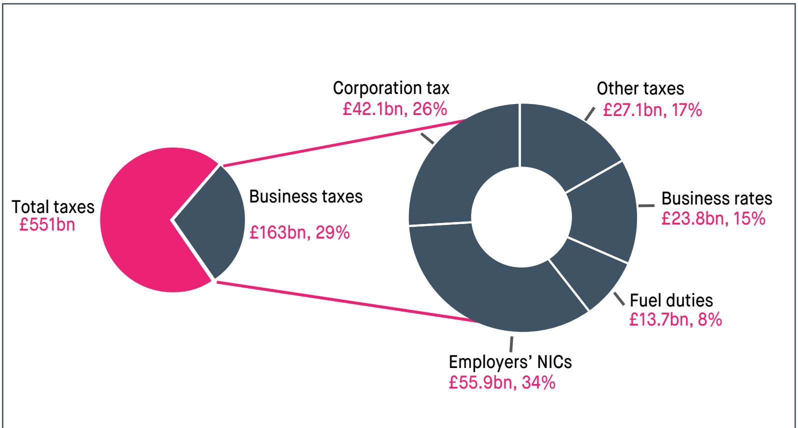
TAX AND REGULATION

It is informative to place the UK's overall business costs in context. KPMG's 2014 Competitive Alternatives survey of international business location costs places the UK in a favourable position compared to other mature economies: overall costs are 5.4% lower than in the US, and the UK ranks third of the mature countries surveyed, behind only Canada and (very marginally) the Netherlands for the overall cost of doing business.[171] Competitiveness, however, varies, with businesses in different sectors having different experiences of the business environment. We focus here on the tax system and regulation.

THE UK TAX SYSTEM

Business taxes generate around 30% of overall tax revenues (see chart below). Of the different business taxes, employers' national insurance contributions form the largest share, followed by corporation tax, 'other' taxes, business rates, and fuel duties.

Figure 20: Business' share of total taxes



Source: CBI, Tax and British Business, Making the Case (2012)

The UK generally compares favourably to other countries with regard to its overall system of taxation. Particularly since the headline rate of corporation tax has decreased in recent years – it will fall to 20% in 2015, well below the EU, OECD and global averages[172] – the UK has been seen as having a competitive tax system by international standards, at least as rated by executives in large firms. In the 2013 KPMG Annual Survey of Tax Competitiveness, the UK was seen as one of the most competitive countries from 2012 onwards, along with Ireland, the Netherlands, Switzerland and Luxembourg.[173] According to KPMG's Competitive Alternatives report, the UK comes second – after only Canada – out of the nine rich countries surveyed on its Total Tax Index, with total tax costs in the UK being 34% lower than in the US. If one breaks these results down by sector, the UK ranks first for corporate services, second for digital services and R&D, and third for manufacturing.[174]

However, some aspects of the tax system can have different effects depending on sector and type of business, potentially leading to perverse incentives, inefficiencies, and perceptions of unfair treatment if certain businesses are seen as having a greater tax burden than others. Examples include environmental tax exemptions or reliefs for particularly energy intensive businesses, and the way in which business rates can disproportionately affect sectors depending heavily on the use of property. Other concerns focus on the way in which different tax policy objectives can allow different tax mechanisms to contradict each other and, in addition, there has been some focus on the importance of future tax stability for business planning.

Responsibility for tax competitiveness and simplicity currently rests with the Office of Tax Simplification, whose aims include improving the comprehensibility and transparency of the tax system, in order to reduce compliance costs.[175] In international comparisons of the time taken to comply with tax obligations, the UK is reasonably competitive, according to the World Bank, although a number of its key competitors – including Luxembourg, Ireland, Switzerland and Australia – achieve better scores.[176] However, there remain some areas of the tax system that are complex and administratively costly, such as the separation between income tax and national insurance contributions.[177] There is, therefore, likely to be further scope to simplify the tax system, particularly for small businesses that may be most affected, which in turn could help increase competition, create jobs and drive growth.[178]

Beyond this, we focus in the following sections specifically on two areas of taxation that have, for reasons such as those set out above, created issues for some businesses. The discussion first turns to business rates, and second to Air Passenger Duty (APD).

BUSINESS RATES

As can be seen from Figure 20, business rates – or non-domestic property taxes (NDPTs) – make up 15% of overall tax revenues from businesses. Business rates are levied on occupiers of non-domestic property and are calculated based on the rental value of the property. In England there are almost 1.8 million such properties eligible for the tax. Exemptions or reliefs are given to some would-be ratepayers, such as small businesses or users of agricultural land.[179]

From 1990 the 'general rate' – a tax on both domestic and non-domestic property – was split into two different taxes: council tax (or its predecessors) was levied on domestic properties; and business rates on non-domestic property. Currently, the two taxes are regulated based on different rules. The main component of council tax has been frozen in recent years, but business rates are uprated based on the Retail Prices Index (RPI). A firm's business rates are determined partly by the rental value of the property it inhabits, but average rates rise each year in line with the RPI, although in 2014-15 the rise has been capped at 2%.[180]

Overall, business rates have risen faster than Council Taxes in recent years, in particular driven by a rate of RPI which, on several occasions, rose above 5%. In addition, it is not entirely clear why RPI – a measure of prices faced by consumers – should be used to uprate a tax for businesses that may have different experiences of inflation. Alternative measures of inflation – such as the GDP deflator, a measure of inflation across the whole economy – may be more appropriate to businesses.

Furthermore, the way in which business rates are uprated has resulted in revenues from them rising at a time when other taxes, such as corporation tax, provided decreased revenues to the government because of the economic downturn. This means that, despite more difficult economic conditions during the crisis, the business rate burden on companies rose, in contrast to the burdens of some other taxes. Indeed the effect of RPI linking combined with the economic downturn led to rates providing 3.9% of government revenue in 2007-8, but a much higher level of 4.6% of revenue in 2009-10.[181] Nevertheless, the proportion of revenue from business rates is currently lower than it was at the start of the 1990s.

There are substantial variations in the level of business rate bills both regionally and by business sector. The most recent valuation by the Valuation Office Agency is based on property values set in 2008 – at a time when non-domestic rents were relatively high – and revealed large differences between rents in different parts of the country. These differences in rents translate to large differences in business rate bills; indeed the KMPG Competitive Alternatives survey demonstrated that the increased tax burden in London as compared to Manchester was a key factor in Manchester being the most competitive of any rich-country city surveyed for the cost of doing business, with overall costs 10% lower than London.[182] Important differences by sector also exist, with firms heavily dependent on high-value property to conduct their business facing disproportionately high bills compared to similar businesses with less intensive property use. The Government recently provided rate relief for the retail sector, partly on the grounds that retailers' dependence on property – and the business rate costs this implies – put them at a competitive disadvantage as compared with online retailers.[183]

Recent debates on the reform of business rates have focused on the way in which properties are valued, including whether valuations should happen more regularly to reflect changes in the rental value of properties. The impact of revaluations, however, is currently limited by the rule that ensures that, even if property rental values have increased, average business rates bills are increased only in line with RPI.

Other issues are whether an upfront tax – one that must be paid regardless of whether a business has made a profit – is an appropriate way to tax businesses, and whether it discourages the formation of new businesses. Related to this are debates on the rules for exemptions and reliefs.

An important distinction can be made between property taxes and land taxes. Loosely, land taxes refer to taxes on the value of land itself and are unaffected by the use made of the land at a given time, whilst property taxes are affected by what has been built on the land. Whilst land taxes incentivise owners to exploit the land fully, property taxes can have potentially distortionary effects – for instance a tax relief on the owners of business property left empty can incentivise non-usage of otherwise useful premises and, in extreme circumstances, can incentivise the destruction of useable business property to avoid paying the tax.[184] They also create disincentives for making improvements to business premises, since taxes will be higher. Land taxes do not suffer from these same distortionary effects – a tax on the value of the land itself will remain the same regardless of the investment the owner puts into what is built upon it.

There are strong theoretical arguments against property taxes – a category in which business rates belong – and in favour of land taxes. Replacing business rates with a land tax would remove a distortion away from property-intensive production, and reduce discrimination between different businesses. According to the OECD, from an economic perspective a recurring land tax is the least harmful type of tax for economic growth. Similarly, the Mirrlees review argues that:

> “The business rate is not a good tax. It discriminates between different sorts of businesses … it is an important principle of the economics of taxation that an efficient tax system should not distort choices firms make about inputs into the production process”.[185]

Reforming – or even replacing – business rates, however, is a complicated business. They currently perform some of the function of funding for local authorities, and so reforms may face opposition if local authorities are perceived to lose out under any new system – particularly given the recent change allowing local authorities to retain between a quarter and a half of increases in rates due to new developments.[186] There may well be significant resistance from those doing well out of the current system – agricultural businesses, for instance, are currently exempt from rates – so a reformed system would have to be carefully designed to manage potential opposition to changes in existing reliefs and exemptions.[187] A consultation on business rates is currently underway, with a decision on reform due in 2017. Economically a land tax would be preferable, but a compromise between what is economically desirable and politically possible may be a more likely final outcome.

AIR PASSENGER DUTY

One of the more controversial duties levied in the UK is Air Passenger Duty (APD) – a charge on all passenger flights from UK airports. APD was first introduced in the UK in 1994, and initially had two tiers, with journeys within the European Economic Area (EEA) being charged a £5 levy, and journeys outside the EEA facing a £10 levy.[188] Charges increased over time, and in 2009 the structure of APD was changed to incorporate four tiers based on the distance of each flight, with long-haul flights facing substantially higher levies than shorter flights.[189] The increases in charges for the longest flights have been particularly sharp since APD was originally introduced.

APD has been the subject of criticism on several grounds, in particular focusing on the fact that it is easily the highest tax of its type in the rich world.[190] In the 2014-15 financial year, APD ranges between £13 and £97 for a standard class seat, depending on the distance of the flight;[191] the equivalent German air passenger duties range between €7.50 and €42.18.[192] In Belgium, Spain and the Netherlands, APD has been scrapped altogether.[193] The Republic of Ireland's Air Travel Tax – initially set at a rate much lower than the UK's APD, with a maximum levy of €10 – was scrapped in 2014.[194] The competitive advantage of Dublin over Belfast due to differential duties between the UK and Ireland led to the devolution of APD to Northern Ireland in 2011, sparked by a threat from Continental Airlines to discontinue its Belfast to New York service.[195] Since then devolved APD in Northern Ireland has been set at zero.

However, APD was brought in originally due to the perception that the aviation industry was under-taxed compared to other sectors. As Kenneth Clarke, then Chancellor of the Exchequer, observed in 1993, the aviation industry "benefits not only from a zero rate of VAT; in addition, the fuel used in international air travel, and nearly all domestic flights, is entirely free of tax".[196] APD was therefore intended to increase tax revenue from the aviation industry to bring it in line with other sectors.

It has also been justified, more recently, on environmental grounds stemming from the rapid growth in carbon emissions from aviation. Recent consultations on taxation of the aviation industry have discussed taxing fuel, both as a partial alternative to APD and on environmental grounds, but such a move would face significant obstacles since much aviation taxation is determined by the internationally agreed Chicago convention; taxing aviation fuel would, currently, be against EU law. If agreement was reached within the EU to impose an EU-wide fuel tax, the danger would exist of airlines flying into the EU with excess fuel in order to avoid refuelling inside the EU and incurring the tax.[197] The extra weight carried would clearly make global aviation emissions even greater; full international coordination would be needed to introduce such a tax, but progress so far has been very slow.

In addition to arguments that aviation fuel duties would be the best way to tackle the environmental problems of aviation, the fact that APD contrasts with VAT and fuel duty in other transport sectors – notably road travel – creates a potential distortion in the tax system. Discussions on reforming aviation taxes have included considering ending the zero-rating of VAT – bringing the UK in line with some other countries. As argued in the Mirrlees review, "continued zero-rating of domestic aviation for VAT looks very odd in the face of concerns about environmental impacts".[198] In the 2014 Budget, the government announced the scrapping of bands C and D of APD, with flights over 4000 miles now to be charged at the much lower band B rate from 2015.[199]

REGULATION AND THE UK'S LEGAL SYSTEM

A high quality legal system is fundamentally important to a country's performance on a variety of economic and social indicators. Well-functioning judiciaries are crucial for economic development, and can boost investment, competition, innovation and growth, such as by securing property rights and enforcing contracts.[200] The labour market can be substantially affected by a poor quality legal system, with factors such as biased courts and a lack of intellectual property protection decreasing employment levels.[201]

The UK's legal system is a source of competitive strength by comparison with other advanced economies. The World Economic Forum ranks the UK in the top 10 of all 148 countries surveyed for its property rights, intellectual property protection, judicial independence, and the efficiency of the legal framework in settling disputes and challenging regulations.[202]

With regard to market regulation, the UK also compares well with its competitors. Market regulation is important for many reasons – regulation could be intended to protect the environment, protect citizens' health, or to provide a safe and stable environment for investment. However, regulations can create compliance costs for businesses, and can discourage innovation and job creation; getting the balance right is crucially important.

OECD analysis places the UK second of all OECD countries – after the Netherlands – in terms of the effectiveness of its regulation of the overall economy.[203] In most areas, the OECD rates the UK as at or above the OECD average. However, businesses have voiced concern over the compliance costs and complexity of new regulations. These can be particularly problematic for small businesses, which have far fewer resources available to meet compliance costs – larger businesses may, for instance, be able to employ legal teams that could meet these compliance issues in-house. The British Chambers of Commerce found that 80% of small businesses it surveyed needed external assistance to help them comply with employment regulations.[204] In addition, the World Economic Forum found the second most common problem cited for doing business in the UK, of the businesses it surveyed, was inefficient government bureaucracy.[205]

The government has responded to these concerns by introducing policies designed to reduce the regulatory burden on businesses. The ‘one in, two out’ rule for business regulation is designed to ensure that, if policymakers wish to introduce a new regulation, they must first ensure they remove regulations with double the cost savings for businesses, compared to the cost burden of the regulation they plan to introduce. The Regulatory Policy Committee, set up in 2009, has been made fully independent and provides scrutiny of the Impact Assessments that accompany new regulatory proposals, in order to check the compliance costs businesses may face.

What policymakers need to address

- There is scope for **further simplification of the tax system** to reduce costs, increase transparency, boost competitiveness and avoid distortions.
- **Business rates have risen** substantially in recent years at a time when the economic climate has been difficult; and the way in which rates are levied **disadvantages some businesses more than others**, creating perverse incentives.
- **APD is the highest tax of its kind in the rich world.** It creates a competitive disadvantage for UK airlines and airports, but arguments in favour of scrapping it must be made in the context of other tax policies such as the zero-rating of aviation for VAT.

EUROPE

THE CONTEXT

Britain's future in Europe is looking more uncertain. The Conservative party has committed to a referendum on Britain's membership of the EU by the end of 2017, should it be in Government after the next election. In advance, it hopes to secure reforms that will improve the attractiveness of EU membership for Britain. David Cameron has set out priorities, which include: the EU giving up powers in some cases; improving the power of national parliaments to block EU legislation; reducing "red tape" and opening up trade with North America and Asia; limiting the availability of welfare for EU migrants; mechanisms to limit migration following future EU enlargement; and removing the concept of "ever closer union" between Britain and the EU.[206] Meanwhile, the Labour party has also said it would reform the EU should it be elected, but it would only hold a referendum on membership if there are proposals for more powers to be transferred away from national governments and to the EU. However, there are no current proposals for this to happen, so a referendum under a Labour government would be unlikely.[207] The Liberal Democrats are in a similar position, promising a referendum in the event of a treaty change, but emphasising the need for action on priorities in five areas: opening up online and services trade in the EU; pushing for the EU-USA trade agreement; reforming the EU budget; cutting costs related to the EU's parliament being hosted in both Brussels and Strasbourg; and reforming rules for small business.[208]

The Government is currently undertaking a review of the "balance of competences", looking at the balance of powers between Britain and the EU across different areas of policy and legislation, and the impact this has on Britain. This review is expected to finish by autumn 2014, and is likely to influence the types of reforms that the Government seeks to make.

THE UPSIDES OF OUR CURRENT POSITION

There are strong advantages from an economic perspective to remaining in Europe. There are substantial benefits to being part of a single market with low barriers to trade and movement. Estimates of the path that UK GDP would have taken had it not been a member of the EU suggest that EU membership has added 24% onto UK GDP per capita.[209]

Trade

Being a member of the EU provides a wider market for our exports. Being part of the single market allows better access to the markets of other member states. There are no tariff barriers between member states. In addition, much EU regulation is focused on harmonising rules across countries so as to reduce regulatory barriers to trade between countries. The CER estimates that Britain's EU membership has boosted its trade in goods with other member states by 55%. [210]

In addition, the EU negotiates free trade agreements with other countries and trading blocs. The UK, could, of course, negotiate its own bilateral trade agreements with countries outside of the EU. However, the experience of Switzerland, which is outside the EU, of negotiating a bilateral trade agreement with China, suggests that the leverage that the EU – as a larger trading bloc – can exercise is much more significant than that which single countries can exercise on their own. [211] This means that outside of the EU, the UK would be likely to face substantially worse trading conditions with other non-EU countries.

Migration

Free movement of people between member states is a key tenet of EU membership. Migration allows businesses access to a greater pool of labour, helping to fill skills shortages more easily. The age profile of migrants means that they usually add to the size of the working-age population. One concern is that migration, at least in the short-term, could reduce the number of jobs available for the existing population. But there is, so far, little evidence of a "displacement effect" of EU migrants, suggesting – at least on average – little effect on employment outcomes of existing workers, although as we set out below any effects that do occur are likely to be felt most at the low skill end of the market.[212] Given political pressure on non-EEA migrants, migration from the EU could be an important way for businesses to fill skill gaps in the coming years. In addition, UK nationals also benefit from free movement across EU borders, with an estimated 1.8 million living elsewhere in the EU, mainly in Spain, Ireland, France and Germany. [213]

Migration also has a wider effect on the state of the public finances. Studies find that migration has a positive impact on the Government finances. In the case of migration from the EU, migrants from the accession countries that joined the EU in 2004 tended to work in lower wage occupations, but were more likely to be employed. They are less likely to receive state benefits and social housing than their UK counterparts, and so overall make a positive contribution to Government finances. [214]

PROBLEMS TO RESOLVE

On average, EU membership has increased our prosperity. But there are some downsides, related to areas where the EU has room to improve, short-term costs, the tension between national and EU level power and decision-making, and distributional consequences.

We are not yet getting the full benefit of a single market

As discussed in our earlier chapter on international trade, the UK has a strong advantage in services. But the potential of the EU single market to revolutionise trade in services has yet to be fulfilled. Services are largely still national markets, with 94% of services bought from home markets in EU-15 countries.[215] Whilst some services are necessarily location-based, others do not necessarily have to be: professional and financial services for example, can be traded across borders if there are few regulatory barriers. In fact, studies suggest that productivity growth has been higher in the US partly because it benefits from a more integrated services market that the EU.[216]

The EU has made progress here: the EU Services Directive is designed to make it easier for services to be traded across markets. However, there is more to be done to remove regulation imposed by individual member states that prevents and makes it harder for services firms to sell to different countries, and for the single market to achieve for services what it has done for goods.[217] A corollary of this, however, is likely to mean that more regulation will need to be agreed and set at the EU level so as to minimise differences across countries that make it hard for firms to trade across borders.

Apparent loss of sovereignty

A common complaint about the EU is the fact that much policy is made at EU, rather than national level with "rules made in Brussels". Only 19% of the UK public feel that their "voice counts in the EU".[218] Trust in the European Parliament and European Commission is especially low in the UK compared to other countries.[219] At the same time, recent polls and surveys have suggested that awareness of voters' representatives in the European Parliament – MEPs – is low. Given concerns about the impact of the EU on national sovereignty, this poses a political problem.

To some extent, EU membership is not, in fact, the root of the loss of national sovereignty. If the UK were to exit the EU, it most likely would still need to abide by regulations decided at the EU level in order to access the EU's markets, but with little influence on the regulations themselves. This is demonstrated by the experience of Norway.[220] In fact, this problem goes wider than EU membership. Globalisation effectively reduces sovereignty anyway: gaining access to other markets for trade means having to enter international agreements and negotiations.[221] This inevitably provides some constraint on what policies national Governments can pursue.

And the reality of EU membership is that it does still provide some flexibility to national Governments in how it implements legislation. This means that, for example, the UK has some of the lowest levels of employment regulation across developed countries.

There may well be some areas where the balance of powers between the EU and its Member States is not optimal. And, in the future, if Eurozone countries seek to integrate further, the UK will need to ensure that it is still able to shape decisions that affect the Single Market.[222] But overall, the perception of the problem that EU membership poses for national sovereignty may be greater than the reality.

Distributional consequences

Whilst the evidence suggests that migration is positive overall, there are likely to be some workers who do not benefit as much from EU migration. Evidence suggests that any “displacement” effect is likely to be strongest among the low-skilled group, and that this group may be more likely to see short-term effects on their wages and employment prospects. Usually, these displacement effects tend to dissipate over time,[223] as more jobs are created elsewhere in the economy.

However, the fact that this is mainly a short-term effect does not mean that it should not be of concern to policy-makers. There may a role to help those “displaced” get back into the labour market more quickly.

Public spending

Much concern over migration from the EU relates to the fact that influxes of new migrants may place pressure on public services, at least in the short-term. The data on the effect of migration on public services, such as health, education and social housing is sparse.[224] It is likely that migrants’ usage is different to that of the existing population due to their different age profile, and it is also likely that there will be short-term pressures on public services in some areas.

However, as set out above, it is also the case that migrants tend to be positive from a fiscal perspective. And they also fill jobs in public services, potentially making those public services cheaper to run, benefiting the existing population. Therefore, in the longer-term, migration may well be positive for the running and financing of public services. However, there may be shorter-term effects that need to be managed carefully, and from a political perspective, need to be seen to be managed carefully.

Opinions don't match the reality

Despite the fact that studies show that membership of the EU has been strongly beneficial for the UK, opinion surveys show that the public is not convinced. According to a 2011 Eurobarometer survey, 54% of UK respondents thought that the UK had not benefited from being part of the EU.[225] This creates a political barrier to continued membership of the EU.

Such views may be reinforced by the short-term costs of migration and public service usage, set out above, as well as concerns about national sovereignty. The distributional consequences may also mean that even if benefits outweigh the costs, short-term costs may be concentrated on specific groups. This may contribute to an apparent magnifying of the costs of EU membership. It also suggests that there is a significant lack of awareness about the corresponding overall benefits of the EU.

Uncertainty

Finally, there is also a cost to businesses in terms of uncertainty over the UK's place in the EU, and the consequences this could have for business investment and growth: polls find that the uncertainty caused by the potential of a referendum on membership is one of the top risks faced by businesses in the UK at the moment.[226] A change to membership could have significant ramifications for the tax, regulatory, trade and wider economic environment. This uncertainty is problematic because it may be delaying much needed investment in the UK economy.

What policymakers need to address

- There are strong benefits to being part of the EU, in boosting trade and growth, but **reforms are needed to exploit the full potential of the Single Market.**
- More progress is needed on **completing the Single Market, especially in services.**
- The EU should continue to push on **reducing barriers to global trade.**
- There are perception problems: public attitudes tend to reflect the potential costs of EU membership but not the benefits.
- Government may need to pay more attention to the **distributional consequences** of EU membership.
- **Uncertainty** in this area could have a **dampening effect on business investment and growth.**

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Growing Businesses
Britain's Productivity Challenge

The UK economy is finally recovering, with GDP surpassing its pre-crisis peak and unemployment gradually decreasing. But there is still a long way to go, and there are underlying problems that are unresolved. Productivity remains substantially below its pre-crisis level, the UK compares poorly with other developed countries in terms of its infrastructure, there are substantial skills gaps, and lending to businesses continues to fall.

Growing Businesses sets out the policy areas that are most important to address in order to fully exploit the potential of UK businesses. By providing an in-depth analysis of eight areas of public policy, along with detailed comparisons with our competitors internationally, it shows where the UK performs well and where there is room for improvement.

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