



Supporting UK growth while balancing the budget

Final

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Contents

Executive summary.....	1
I. Introduction	7
II. UK economy: 2010 and beyond – the challenges	10
III. Role of the London economy in the UK economy	16
IV. A policy framework for sustainable growth	26
V. Tax policy.....	44
VI. Infrastructure.....	65
Appendix	87
Glossary	91
References	92

Executive summary

Introduction

The UK has experienced a severe economic contraction as a result of the global credit crisis and recession. Public finances have deteriorated substantially as tax receipts have fallen and demands on Government spending increased. The Government now faces major challenges to design and implement the policies that will enable a return to fiscal stability and sustained growth. It must make tough choices about reprioritising spending and enhancing tax revenues. However, we believe there are opportunities, in responding to the crisis, to position the UK for sustainable growth over the medium term. A well-designed policy programme could remove impediments to growth and enhance the competitiveness of the UK.

This report sets out proposals to address the fiscal crisis while at the same positioning the UK for medium-term growth. It examines the role that London can play in the UK's economic recovery, how Government policy can enhance London's contribution, and the potential risks around ill-conceived policies which could undermine growth in London and the UK. It provides recommendations for a new policy framework and processes that can give better outcomes in terms of prioritisation of spending, efficient investment decisions, and taxation that creates fewer distortions without sacrificing fairness.

Role of London in the UK economy

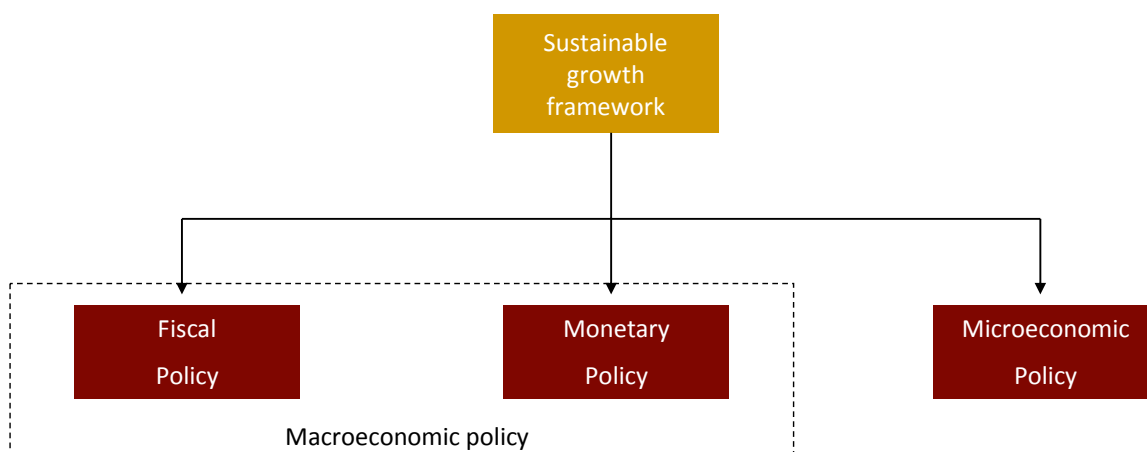
London plays a central role in the UK economy and will be critical to the UK recovery. Globalisation and the increasing importance of high value services in the UK economy place London at the heart of the UK's future prosperity. It provides the rest of the UK with broad economic benefits and opportunities, both as a centre of financial and human capital and through trade between London and the rest of the UK. London's productivity advantage is also instrumental in attracting new business and services to the UK and providing new opportunities to the rest of the country.

Given the source of its economic strengths, London is highly sensitive to certain aspects of Government policy, such as corporate taxation and investment in key infrastructure, notably public transport. Undermining London's competitiveness through ill-designed policies in these or other areas would jeopardise the UK economy and hamper the country's long-term growth.

Sustainable growth framework

Our sustainable growth framework addresses the three main areas for Government intervention: fiscal, monetary and microeconomic policy. A coherent and credible macroeconomic policy will require both sound monetary and fiscal policy. The importance of monetary policy in terms of achieving price and financial stability is well-established and mainly devolved to the Bank of England. Some of our recommendations address monetary policy issues (primarily in relation to the link between monetary policy and financial regulation), but our main focus is on fiscal policy, where the Government's influence is greater, and the policy issues and risks more immediate. In addition, we discuss microeconomic reforms to complement macroeconomic policy in order to boost productivity and promote economic growth.

Figure 1: Sustainable growth framework



Source: LECG

Fiscal Policy

Our recommendations for fiscal policy include:

- **A new fiscal framework:** the Government should adopt new overarching fiscal rules, with clear quantitative objectives such as targets for medium-term Government spending as a percentage of GDP, that better anchor Government decision-making on fiscal policy.
- **Redesigned budget process and institutions:** the budget process needs to be redesigned to provide transparency and encourage efficient and effective expenditure reduction. The Government should assess the value of spending in a comprehensive manner, following the processes set out in the HM Treasury's Green Book. We believe that such a discipline would facilitate a return to growth

and best serve the UK's interests. It could be enhanced by strengthening the role of independent fiscal analysis in terms of both economic forecasting and advice on the value for money of new spending proposals. International experience shows the importance of political leadership at the highest levels throughout the budget process.

- **A comprehensive medium-term fiscal consolidation plan:** a credible plan, with an appropriate timetable, should be laid out to bring government finances into compliance with the new fiscal framework. The plan will necessarily focus on expenditure reduction as part of a credible macroeconomic policy, and should involve a comprehensive review of departmental budgets. Departments should be given multi year budgets with improved accountability and autonomy and provided with incentives to make savings
- **Active management of the Government balance sheet:** the Government's portfolio of assets should be reviewed to identify possible improvements in the utilisation of assets, and evaluate the scope for divestiture.

Focus on tax policy

Addressing the fiscal crisis is likely to require increases in tax revenue as well as reductions in expenditure. Nonetheless, reductions in expenditure should be the central element of the fiscal stabilisation programme, as increasing marginal tax rates are likely to damage the strength and speed of the economic recovery and may undermine long-term competitiveness. Recent changes have already affected the UK's position in terms of tax competitiveness: the country is now at the top end of the range of income taxes compared to other major economies, and the competitiveness of the corporate tax rate has declined in recent years as other countries have reduced rates.

We have identified tax reforms that can increase revenue while minimising adverse effects on both efficiency and equity. A pro-growth tax reform package would ensure that tax reforms are consistent with base-broadening principles. For example, removing some VAT exemptions while providing specific measures to protect low income households may be preferable to increasing income tax rates. Alternatively, VAT rates could be increased. Reducing tax allowances, or replacing them with a tax rebate regime, could produce more revenue from high income taxpayers without raising marginal tax rates.¹

¹ Ian Crawford, Michael Keen, Stephen Smith, "Value-Added Tax and Excises", Mirrlees Review, Institute of Fiscal Studies, 2008.

Monetary policy after the credit crisis

Whilst the primary focus of this paper is on fiscal policy, the evolution of monetary policy in the aftermath of the financial crisis will be an essential part of a successful framework for growth. A key issue to be addressed following the crisis is the link between macroeconomic policy and the prudential regulation of financial institutions. Many analysts have identified the lack of a macro perspective as a key failing in financial regulation.² In the future, macro-prudential data – analysis of credit supply, liquidity and asset prices – should also inform financial regulation.

To establish the link between regulation of financial institutions and macroeconomic factors, a macro-prudential body – at the UK national level, a Financial Stability Committee or a Financial Policy Committee – should set parameters for the prudential supervision of financial institutions. These parameters could include a target range for capital and liquidity requirements, on the basis of data covering credit supply from the regulated and unregulated sectors, leverage, liquidity, asset prices and other criteria. Through such a mechanism, the Committee would modify capital and liquidity requirements to lean against the economic cycle.

Microeconomic policy

Microeconomic policy should be targeted at regulatory reform to remove impediments to enhancing productivity. Efforts have been made in recent years to improve the quality of regulation, through the work of the Better Regulation Executive (BRE) and through the use of Regulatory Impact Assessments (RIA) to assess new regulations. These efforts could be strengthened further through stronger scrutiny of new regulation, for example by giving the National Audit Office (“NAO”) a role in reviewing RIAs. The Government should also review existing regulations that unnecessarily restrict long-term growth. A particular focus should be on whether the goals of regulation could be achieved in a more efficient, less distorting manner.

Focus on infrastructure

Infrastructure plays a vital role in enabling economic and social activity. It is particularly important in enabling London to take advantage of so-called “agglomeration economies” (i.e. the extra value that is created by bringing together a portfolio of distinct talent pools, assets, entrepreneurs and investors) and maintaining its competitiveness as a global centre. Past experience shows there is a real risk that short-term considerations will lead

² See for example FSA, “The Turner Review - A Regulatory Response to the Global Banking Crisis”, March 2009.

to inefficient cuts in expenditure on infrastructure. As noted by the OECD in its recent economic survey of the UK in regard to investment programmes, “... *these are typically the first victim of fiscal consolidation efforts while other less productive but politically sensitive programmes survive*”³.

It is therefore crucial for the Government to prioritise its spending on the basis of a careful assessment of costs and benefits. In making that assessment it must take account of the significant long-term economic value of investments, including specific investment programmes in infrastructure where cost-benefit analysis shows large positive returns.

While London is well endowed in terms of some infrastructure (e.g. telecommunications), some other forms of infrastructure, notably the London Underground (“the Tube”), have suffered from decades of underinvestment. A major programme of modernisation of the London Underground, along with the Crossrail project, are designed to address the overcrowding and reliability issues and provide capacity to meet growth in demand for London rail over the next two decades. The combined net benefit of the London Underground modernisation and Crossrail is estimated to be in excess of £50bn.

Another key infrastructure issue is the provision of additional airport capacity. Heathrow is operating at capacity, while Gatwick and other airports only have limited available capacity. Overall demand is expected to grow well beyond available capacity once the recession ends and further capacity is required. Whilst there are genuine environmental issues around aviation, limiting airport capacity is a crude tool. Concerns around the contribution of aviation to global climate are best addressed through the sector’s integration into the EU ETS.

Conclusion

The global crisis has had a severe effect on the UK economy, and the Government faces difficult choices in addressing the fiscal consequences of the recession. London’s ability to attract international investment and talent are important to the UK’s economic prospects. However, this attractiveness relies in part on “the London brand”, based on attributes such as the efficient regulatory and tax environment and supportive infrastructure. A well-designed response to crisis, based on the policy framework outlined in this report, will both enhance the UK’s medium-term growth and maintain London’s position as a world city and a key contributor to the UK economy. In that sense, the crisis provides an opportunity to

³ OECD, “Economic Survey of the United Kingdom”, June 2009.

position the UK to overcome current challenges and return to a path of sustainable growth.

I. Introduction

I.1 Background

- 1.1 The UK has recently experienced its largest economic contraction in 50 years as a result of the global credit crisis and global recession. Public finances have deteriorated substantially as tax receipts have fallen and demands on Government spending increased. The country now faces major challenges to design policies that will enable a return to both fiscal balance and sustained levels of growth.
- 1.2 Recent economic policy has been dominated by the need to stabilise the international banking system as well as loosening monetary and fiscal policy in order to address the immediate impact of the crisis. This has involved a three-track approach of monetary, fiscal and state ownership interventions, with new instruments and procedures being adopted. Measures taken include swift intervention in money and capital markets, substantial state takeovers in the banking sector, state aid for other industries and unprecedented levels of public borrowing to fill a rapidly widening gap between public spending and receipts. These short-term measures have succeeded in limiting the impact of the crisis, and the debate has now moved on to address the fiscal imbalance and the need to return to sustainable growth.

I.2 Terms of reference

- 1.3 LECG has been commissioned by London First to develop an evidence-based approach to prioritising tax and spending measures which will best support and enhance London's contribution to the sustainable growth of the UK. This report was commissioned, overseen and funded by a steering group of London First members. It reviews London's multifaceted relationship with other regions in the UK economy and the contribution this makes to UK economic activity. It assesses London's future role in the recovery process and how this can best support the long-term sustainable growth of the UK.
- 1.4 The study assembles the evidence and assesses the role of the government's tax and spending regime with a focus on its impact on London, in order to:
- explain the relationship between London's role in the UK economy and its role as the UK's global city;
 - make the case for prioritisation of public spending which will enable and support economic growth, and thus long-term social cohesion;

- make the case for a tax policy both in terms of level and mix which will support London's growth, and
- assess the UK-wide case for investing in productive and sustainable infrastructure in London.

1.5 A number of important policies that are beyond the scope of the present report, such as monetary policy, will also have a far-reaching impact on the medium and long-term competitiveness of the UK. While we do not cover in detail policies outside our terms of reference, where relevant, we provide broad views on policies that would be consistent with our recommendations.

I.3 Approach of study

1.6 We propose an economic framework aimed at restoring public finances while also maximising London's and the UK's long-term competitiveness. Our approach focuses on sustainable growth and highlights the key trade-offs that policy makers will have to address over the next few years.

1.7 Much of this report addresses issues important both to the UK and London's economic recovery. It is not part of our mandate to engage in special pleading on behalf of London. However we believe there is strong evidence that London plays a crucial role in the UK economy, and that elements of future policy, including ongoing support for key infrastructure investments, will provide significant net benefits both for London and for the UK as a whole. In essence, we believe that sound policies provide an appropriate framework for sustainable growth in both London and the UK.

1.8 The work programme to deliver this report has involved an in-depth review of existing studies, assembling and assessing the evidence which relates to London's and the UK's fiscal and economic situation and testing our analysis in interviews with key experts and stakeholders.

1.9 In particular we have reviewed a number of key reports, research papers and policy documents including:

- the Chancellor's High Level Group initiated studies on the global competitiveness of professional and financial services and the competitive position of financial services (the Snyder, Bischoff and Wigley reports);
- Institute of Fiscal Studies (IFS) papers on fiscal policy and Mirrlees review of taxation;

- Her Majesty's Treasury's (Treasury) 2009 Budget and 2007 Pre-Budget Report and Comprehensive Spending Review (CSR); and
- OECD Economic Survey for United Kingdom 2009.
- the Mayor's Transport Plan, Transport for London (TfL) Business Plan and Transport 2025;
- City of London commissioned research papers on London's place in the UK economy, tax policy, financial regulation, demand for aviation services and information and communication technology (ICT) infrastructure requirements;

1.10 A full list of documents reviewed, the people we interviewed as well as the information on the members of our project team and expert panel are set out in the Appendix.

I.4 Structure of report



1.11 The rest of our report is set out to address our terms of reference, as follows:

- Section II summarises the current economic climate, the government's fiscal state, and the challenges to keeping UK and London competitive;
- Section III sets out London's contribution to the UK economy and its role in the recovery;
- Section IV sets out a policy framework for sustainable growth through fiscal policy;
- Section V investigates the current UK tax regime, its impact upon the London economy, and how it relates to a suitable policy framework; and
- Section VI explains the role of infrastructure in the London economy, and assesses the need for capital investment in various aspects of the transport system.

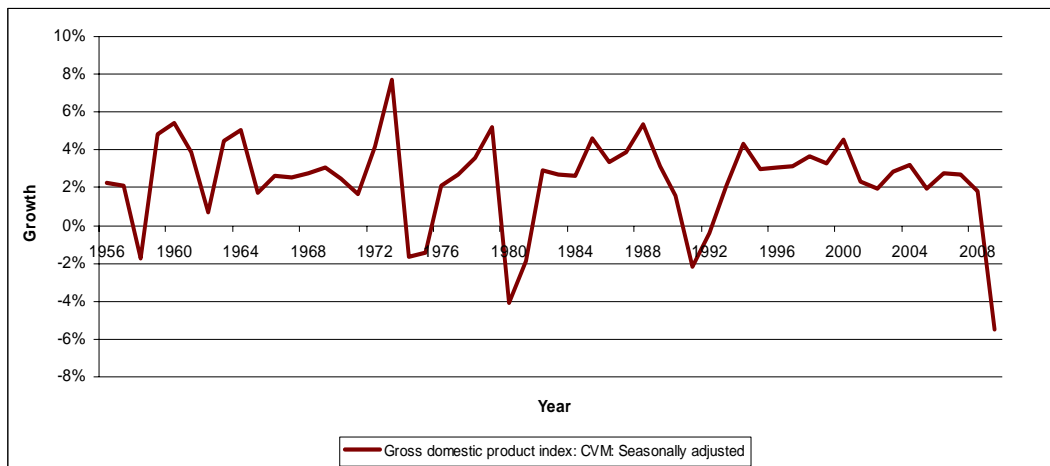
II. UK economy: 2010 and beyond – the challenges

2.1 In this Section, we discuss the impact of the global crisis on UK economic growth and we assess the implications for the Government's finances.

II.1 The recession

2.2 The UK economy has been in recession since the third quarter of 2008 and is currently experiencing its steepest decline in Gross Domestic Product (GDP) for the last 50 years.⁴ The figure below shows that between the late 1950s and the current recession, the UK's GDP annual growth rate was between -4% and 8%, with an average growth rate of 2.5% across the period.

Figure 2: Historic UK GDP Growth



Source: Office of National Statistics (ONS), Reference – ABMI. 2009

2.3 While most forecasts predict a relatively swift return to growth by 2010, the speed of return to the trend growth rate of 2.5% is more uncertain.⁵ However, the expectations of a rapid return to growth are, in part, due to the consistently high levels of Government spending in the UK. These levels of government spending are in turn putting significant pressure on the Government's finances.

⁴ ONS data set, updated May 2009. Reference – ABMI.

⁵ Treasury, Forecasts for the UK economy – a comparison of independent forecasts, August 2009. <http://www.hm-treasury.gov.uk/d/200908forcomp.pdf>

2.4 The Treasury believes that the long-term productive potential of the UK economy has contracted by 5%.⁶ A loss of productive potential or long-term output of the economy arises because, although the economy is forecast to return to growth, some of the lost output is never compensated for by faster growth in the future.⁷ This long-term loss of GDP has profound implications for the state of the Government's finances.

Impact on London

2.5 The impact of the downturn has also been experienced in London. As data on regional economic developments lags national data, there is less evidence about the extent of the impact of the credit crisis on the London economy than on the UK as a whole.⁸ Early research finds that London has come through the downturn in better shape than expected and doing no more than to follow the national trend in terms of job losses. However, the timing of the impacts are unclear, with greater earlier impact of the downturn in regions with high levels of manufacturing due to destocking and potentially a delayed effect in the services sector. If this were to be the case, then London may experience more severe impact later in the recession than other regions.

2.6 Forecasting the impact of the crisis on future growth is difficult. It is possible that the effect on financial services has been masked to some extent by Government intervention to stabilise the financial sector. The sector could suffer further consequences as these interventions are unwound and new financial regulation is introduced. In any case, the outlook for financial services is likely to be for slower growth than experienced prior to the crisis. Future employment growth is projected to be driven primarily from the business services sector⁹. Long-term growth forecasts project employment to grow from 4.7m in 2007 to 5.5m in 2031.¹⁰

II.2 Government revenue and expenditure forecasts

2.7 The consequence of this long-term contraction in UK GDP is lower Government receipts throughout the entire length of the Treasury's forecast period. However, recent Treasury forecasts indicate that Government expenditure is still expected to grow for the next few

⁶ Treasury, "Financial Statement and Budget Report 2009", Table B2, page 197.

⁷ The long-term loss of output will be influenced by whether or not there is faster growth following the recession (ie catch up growth) and whether or not there is an impact on the long term rate of growth. For an introductory discussion, see The Economist, "The Long Climb", 3 October 2009.

⁸ LSE, "London's Place in the UK Economy, 2009-10", City of London, October 2009.

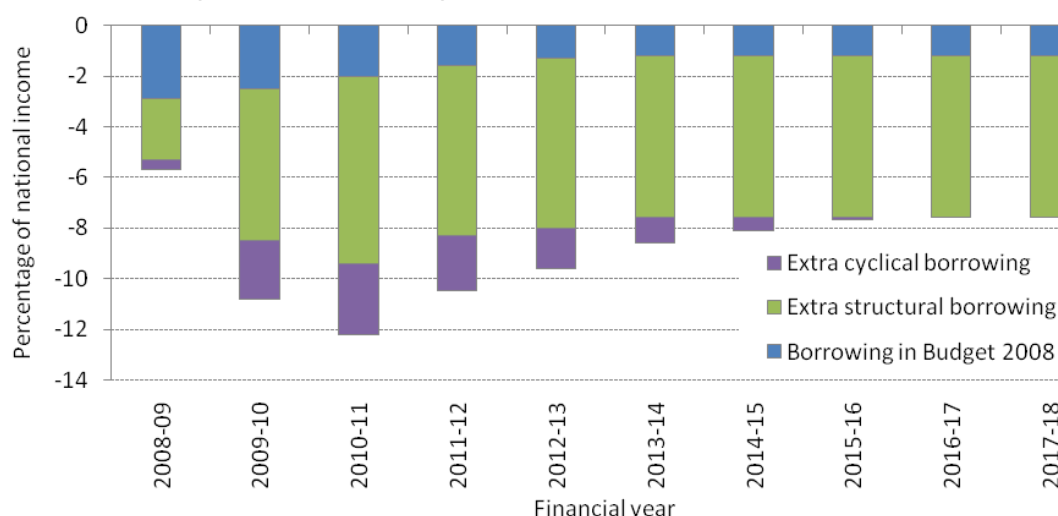
⁹ GLA Economics, Economic Evidence Base, October 2009.

¹⁰ GLA Economics, Economic Evidence Base, October 2009.

years.¹¹ Unless action is taken, this will result in a large increase in the structural deficit in the medium term.

2.8 This growing gap between government receipts and expenditures creates a growing fiscal deficit, which must be financed by Government borrowing. The Treasury’s forecast of increasing Public Sector Net Borrowing in the short term, followed by an eventual decline, is shown in the figure below.

Figure 3: Deterioration in Treasury borrowing forecasts between Budget 2008 and Budget 2009, excluding impact of new policy measures



Source: Robert Chote *et al.*, “Britain’s Fiscal Squeeze: the Choices Ahead”, Institute of Fiscal Studies Briefing Note BN87, September 2009.

2.9 The result of continuing high levels of Government borrowing is a growing public debt. If the imbalance in public finances is not addressed, public debt will escalate and will be driven onto an unsustainable trajectory. Credit rating agencies have stated that the UK will need to severely adjust its fiscal policy, in order to maintain its credit rating.

Expenditure

2.10 In 2009, Government operating expenditure is expected to be £672bn.¹² Approximately 60% of this amount of operating spending is spent on social protection and education.¹³ The Government will also undertake significant investment spending. In 2009, Public Sector Net Investment is expected to rise to £44bn, or 3.1% of GDP, which will be the

¹¹ Treasury, “Financial Statement and Budget Report 2009”, Table C4, page 226.

¹² Treasury, 2009 Budget Report, page 12.

¹³ Social protection includes the following categories of services and transfer payments: adoption, childcare, disability, elderly care, healthcare, housing, pensions & survivors, social security, social services and unemployment.

highest level for 30 years.¹⁴ The key areas for investment are local authorities (37%), transport (23%) and housing (19%).

- 2.11 Although the Government plans to raise current expenditure to £701.7bn in 2010/11, the background of increased social security costs (£6.2bn) and national debt interest (£15.7bn) means that very little will go towards improved service provision. In the 2009 Budget, the Government proposed to increase operating expenditure by 0.7% per annum. However, the expected increase in social security costs and debt servicing, means that other expenditure will need to be cut by 1.7% per annum over the next three years to this target for operating expenditure as a whole. Allowing for the Treasury forecast growth in local authority spending and public sector pensions of 3.1% per annum means that real cuts to remaining expenditure of 2.9% per annum are required over this period. This amounts to a cumulative reduction of 8.6% or £32.9bn per annum by 2013/14.¹⁵
- 2.12 The Government is proposing to halve the level of net investment from £44bn in 2009/10 to £22bn in 2013/14. This equates to an annual reduction of 15.9% per annum over that period. Public sector investment is forecast to fall from 2.6% of GDP in 2008/09 to 1.3% in 2013/14.¹⁶ The Government brought forward £3bn of investment from 2010/11 to 2008/09 and 2009/10 as part of the fiscal stimulus. However, much of the rest of the change relates to a reduction in the level of planned investment spending over that period.¹⁷
- 2.13 While the economic returns from some types of investments may take some time to materialise, such investments may be necessary to deliver economic growth in the medium and long term. For example, a lack of investment in some public services and infrastructure, such as transport, may hinder economic growth and hence the economic recovery upon which increased receipts are predicated. Not making such high-return and pro-growth investments therefore risks disadvantaging future generations. We discuss the role of infrastructure investment further in Section VI with particular reference to London.

¹⁴ To maintain consistency and comparability, we use the same terminology as used by Treasury in the Budget ie operating spending and investment. The distinction between capital and operating spending is somewhat artificial and dependent on accounting convention. From a broader perspective, at least some of operating spending represents investment in human capital.

¹⁵ Robert Chote *et al.*, "Britain's Fiscal Squeeze: the Choices Ahead", Institute of Fiscal Studies Briefing Note BN87, September 2009.

¹⁶ Treasury, 2009 Budget Report, Table 1.1, p.4.

¹⁷ Treasury, 2009 Budget Report, page 121.

Revenue

- 2.14 The recession has had a significant negative impact on Government tax receipts. Forecasts show that current receipts are expected to drop significantly in 2009/10, before recovering by 2011/12. This table below shows the actual and forecast impact of the recession on the Government's revenues.

Table 1: Actual & forecast current receipts

Year	2007	2008	2009	2010	2011	2012	2013
Current receipts, £bn	548	531	496	528	577	620	662
As a % of GDP	38.6%	36.9%	35.1%	36.2%	37.2%	37.7%	37.9%

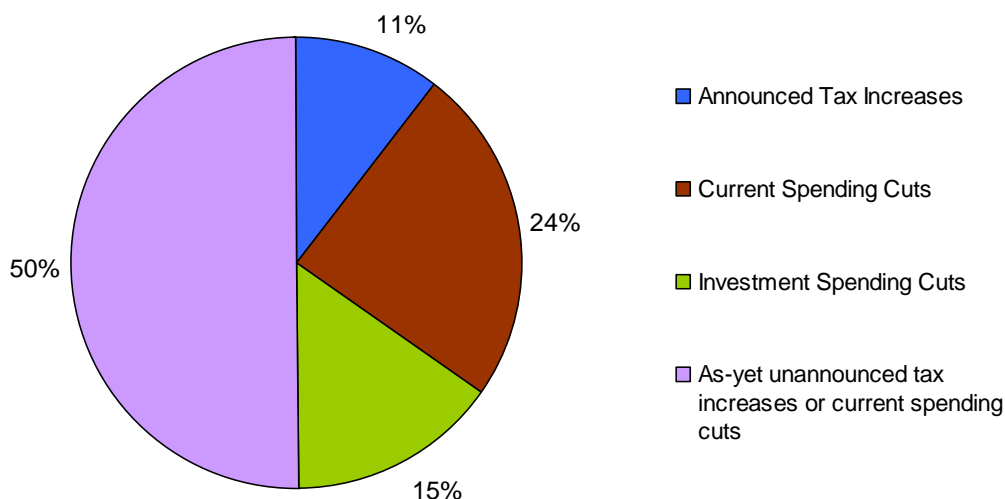
Source: Treasury, 2009 Budget Report, page 226.

II.3 Composition of fiscal tightening

- 2.15 The figure below illustrates the key components of the Government's proposed fiscal tightening. The Government is proposing to reduce the deficit by around £90bn, or 6.4% of GDP, by 2017/18.¹⁸ The shape of the first set of measures has been announced: 24% will come from spending cuts; 15% will come from cuts in investment while tax increases, such as the increase in national insurance and the top rate of income tax, account for 11% of the total. The way in which the remaining 50% of the Government's proposed deficit reduction will be implemented has yet to be announced.

¹⁸ Robert Chote *et al.*, "Britain's Fiscal Squeeze: the Choices Ahead", IFS Briefing Note BN87, September 2009.

Figure 4: Composition of the proposed deficit reduction plan (Total £90bn per annum by 2017/18)



Source: Adapted from IFS Robert Chote *et al.*, "Britain's Fiscal Squeeze: the Choices Ahead", IFS Briefing Note BN87, September 2009.

2.17 Several commentators have suggested that the fiscal consolidation policies announced to date by the government are insufficient and further measures in addition to the unannounced tax increases/spending cuts are needed to cut expenditure and boost revenue.¹⁹

II.4 Summary

2.18 The economic slowdown is having a severe effect on public finances. Government borrowings, and consequently total debt, have reached levels not seen for over half a century. This will need to be addressed and any policy measures designed to return the UK back to growth must be constructed in the context of this deteriorating fiscal situation.

2.19 The Government has announced a range of expenditure and tax measures to reduce the structural deficit. These measures will result in severe reductions in investment and spending and an increase in taxation. However, around half of the Government's proposed fiscal tightening measures are yet to be announced. It is also possible that further measures will be required to reduce the deficit, particularly if the economic recovery is weaker than the Treasury's current forecast.

¹⁹ See for example. Robert Chote *et al.*, "Britain's Fiscal Squeeze: the Choices Ahead", Institute of Fiscal Studies Briefing Note BN87, September 2009.

III. Role of the London economy in the UK economy

III.1 Introduction

- 3.1 In this section, we discuss the role of London in the UK economy. First, we provide an overview of the economics of cities and explain how globalisation influences the development of cities in the UK. We then discuss the role of London in light of these findings and discuss its contribution to the UK, not only in fiscal terms but also as a global centre for professional services, as a gateway of foreign investment and as a human capital centre.

III.2 Economics of cities

- 3.2 The importance of cities in the development of modern economies has been increasingly highlighted by a number of economists and this has given rise to a new branch of academic research sometimes referred to as economic geography or agglomeration economies. The economic literature explains that, despite declining transport and communication costs, the economic importance of cities grows over time. Globalization and new technologies attract people to big cities, by increasing the returns to urban proximity.²⁰
- 3.3 Economic geography theory implies that instead of spreading out evenly around the world, production will tend to concentrate in a few countries, regions or cities, which will become densely populated and act as engines for growth. London's global ranking as a city of choice for knowledge-based businesses is an illustration of this economic model.²¹
- 3.4 Agglomeration economies refer to the benefits arising from concentrating economic output and housing in particular areas. These benefits manifest themselves in a number of ways including:²²
- labour market pooling, which draws both human capital and firms demanding labour;

²⁰ Edward Glaeser, "Why Has Globalization Led to Bigger Cities?", New York Times, 19 May 2009.

²¹ In the Global Financial Centres Index, London ranks 1st in "Human Capital" category, out of the countries considered. In the Mastercard Worldwide Centres of Commerce Index, of the 75 cities measured, London ranks 1st in the "Knowledge creation and information flow" category.

²² Edward Glaeser and Joshua Gottlieb, "The Wealth of Cities: Agglomeration Economies and Spatial Equilibrium in the United States", NBER Working Paper No. 14806, March 2009.

- increased communication flows, creating better coordination of economic activities and creating conditions that are conducive to knowledge based economic activities as well as innovation; and
 - reduced cost of transportation.
- 3.5 There are also environmental benefits and, in particular, the low carbon per capita carbon emissions of people living cities, which are of increasing importance. One study found that carbon emissions per capita in London were about half of the UK average.²³
- 3.6 As competition has intensified, the economy in many parts of the world has shifted so that specialised expertise, intellectual property and other intangible assets are more important to economic success than physical resources and labour costs. This shift is often referred to as the “knowledge economy” and has made location yet more important to the sort of business activity in which the UK needs to maintain its competitiveness to ensure rising standards of living.²⁴

III.3 London’s scale and contribution to the UK economy

- 3.7 The development of cities is now widely seen by economists as a cornerstone of long-term sustainable growth. In the UK, London is by far the largest city and is continuing to expand.²⁵ As the Government’s report on the state of English cities notes:

“London is unique among English cities. Its scale and reach is so large that in recent years it has been a crucial component of national economic performance. London’s economy illustrates dynamic adaptation, particularly over the last decade or so. Its competitive success is primarily based on a range of specialist knowledge-intensive labour functions, whether offered by innovative service or manufacturing institutions.”²⁶

- 3.8 London’s total gross value added (GVA) in 2008 was £215bn, around 20% of UK GVA and 30% above the UK average on a per capita basis.²⁷ London accounts for 12.4% of the UK population, yet was responsible for approximately 20% of GDP growth in the period from 1994 to 2004.²⁸

²³ International Institute for the Environment and Development, “Cities produce surprisingly low carbon emissions per capita”, Media release, March 2009.

²⁴ Hannah Brown, “UK Cities in the Global Economy”, Centre for Cities, September 2008.

²⁵ GLA Economics, Economic Evidence Base, October 2009, Appendix 1.4.

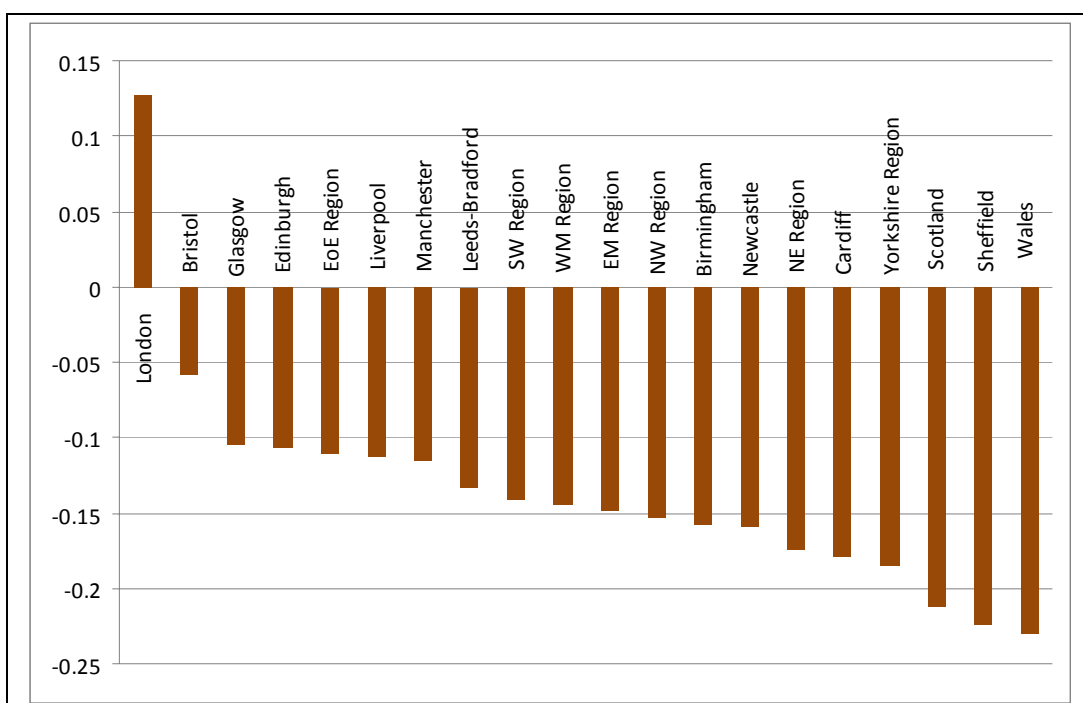
²⁶ Department of Deputy Prime Minister, “State of the English Cities: A Research Study”, 2006.

²⁷ GLA Economics, London’s Economic Outlook, October 2009.

²⁸ London First submission to CSR 06/03/07.

3.9 London's economic scale provides it with a substantial productivity advantage. This higher economic productivity in London has been measured by economists and directly attributed to the benefits of agglomeration economies. The figure below shows London's productivity advantage relative to other UK regions and cities. The baseline of the study is productivity in the South-East of England, a positive value illustrates that productivity is higher than in the South-East and a negative value shows that productivity is lower than in the South-East. This study found that most of the difference between London and the South-East could be explained by agglomeration economics.

Figure 5: Productivity differences between London and the rest of the UK



Source: The case for agglomeration economics, Independent Manchester Economic Review. 2009. www.manchester-review.org.uk.

London's links to the rest of the UK

3.10 The UK benefits from the large volume of trade between London and the rest of the UK. For example, it is estimated that London purchases approximately £108bn in 2003 (£123bn in 2007) from, and sells £124bn in 2003 (£130bn in 2007) worth of goods and services to, the rest of the UK. All English regions enjoy benefits from trade with London, from 8% of regional sales in the North-East to 18% in the South-East²⁹.

²⁹ Paula Lucci and Patricia Seex, "London's links: who benefits from London's success?", Centre for Cities, November 2007.

- 3.11 Financial services provide another illustration of the interaction between London and the rest of the UK. Financial services are a key sector in the UK economy, responsible for approximately 8% of GDP³⁰. It also provides capital to firms throughout the country and offers a sophisticated platform for financial management. The UK private equity industry has generated a positive net inflow of capital in the UK; 67% of the total capital invested over the past six year has been committed to UK companies.³¹ Small and medium-sized enterprises (SMEs) benefit from London's venture capital and private equity financing.³²
- 3.12 London is well known as an international financial services centre; but the major role of financial services in the rest of the UK is less well-known. London's success as an international financial centre has generated employment and expertise in the regions, including processing centres, customer support functions and legal and consultancy services. Financial centres outside London have developed their own specialities, such as Edinburgh with its expertise in asset management and Leeds and York with their expanding business services market.³³ This mix between London and the regions is reflected in the employment split for financial services in the UK: around 300,000 in London and around 700,000 in the rest of the UK.³⁴
- 3.13 London has a concentration of highly skilled workers that creates an unparalleled environment in which to learn. Its position as a centre of excellence for training benefits the UK in a number of ways, including attracting a large amount of skilled international human capital. London is a centre for education and research: University College London and Imperial College are ranked fourth and fifth best universities in the world respectively.³⁵
- 3.14 The rest of the UK also benefits from London's access to international talents, as there is substantial migration from London to other regions within the UK. On average, there was a

³⁰ The Bischoff report.

³¹ The British Private Equity and Venture Capital Association (BCVA), "Private equity's impact as a financial service", February 2007.

³² Michael Parkinson *et al.*, "State of the English Cities: Volume 1", Office of the Deputy Prime Minister, March 2006.

³³ The Bischoff report.

³⁴ The Bischoff report.

³⁵ Times Higher Education-QS World University Rankings 2009.

<http://www.timeshighereducation.co.uk/Rankings2009-Top200.html>

net transfer of around 60,000 people a year from London to the rest of the UK between 1995 and 2003.³⁶

- 3.15 London is also the UK's principal international tourist centre. This industry brought in over £10bn in overnight visitor spending in 2008, with 80% coming from overseas. This represented half of all spending in the UK by overseas visitors, many of whom then go on to visit other parts of the UK³⁷.

London's net fiscal contribution to the UK - "tax export"

- 3.16 London makes a net fiscal contribution to the Government - London's tax contribution is larger than the amount of public spending it receives. This difference is estimated to lie between £8bn and £19bn, depending on the method of calculation.³⁸
- 3.17 Although Government expenditure per capita is greater in London than across the rest of the UK (public spending per person for London is £9,005 versus £7,675 for UK),³⁹ it represents only 28% of London's GVA per capita compared with the UK average figure of 36%. This difference is accentuated by the fact that some public expenditure in the London area benefits the UK as a whole, for example parliamentary costs.

III.4 London is a major gateway for foreign investment

- 3.18 London attracts a large amount of Foreign Direct Investment (FDI) to the UK and currently holds a stock of £38bn, which is the same as New York.⁴⁰ The Mastercard Worldwide Centres of Commerce Index evaluates 75 cities across a range of criteria such as ease of doing business, financial flows and liveability (the criteria are discussed in III.10 below).⁴¹ Each of these dimensions captures a number of quantitative indicators, which are weighted to calculate an overall result. This study ranks London first, as set out in the figure below. London ranks highly as a centre of knowledge creation, as a business centre and for financial flows; and relatively less well on liveability and economic stability.

³⁶ Paula Lucci and Patricia Seex, "London's links: who benefits from London's success?", Centre for Cities, November 2007.

³⁷ LSE, London's Place in the UK Economy, 2009-10

³⁸ GLA Economics, "Filling the coffers: London's tax export", November 2008.

³⁹ Public Expenditure Statistical Analyses (PESA) 2008, Table 9.11; "London's Role in the UK Economy 2008-09", Table 7.2.

⁴⁰ CEBR, "Keeping the UK competitive", London First, 2007.

⁴¹ Mastercard, "Mastercard Worldwide Centres of Commerce Index", 2008.

Figure 6: Mastercard Worldwide Centres of Commerce Index



Source: Mastercard Worldwide Centres of Commerce Index, 2008

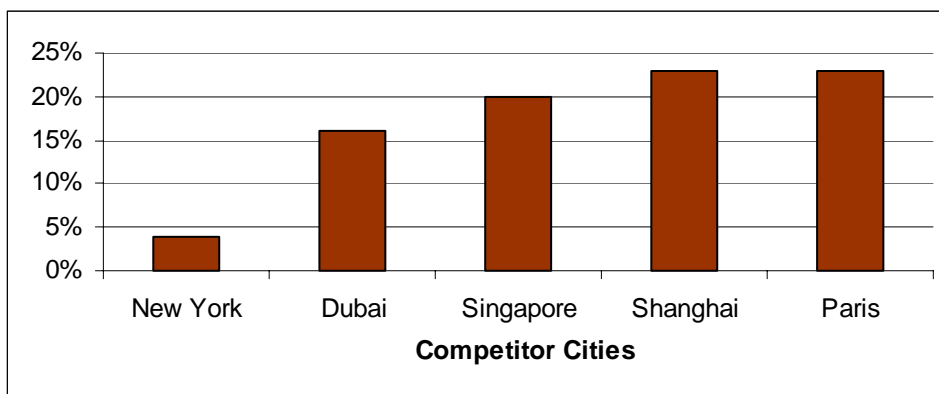
- 3.19 A regular survey of leading executives in the financial services industry has consistently placed London as the premier city in which to conduct business. The Global Financial Centres Index ranks cities across the globe by distinct practice areas and by five quality categories. London ranks first across four of the quality categories and second in the category for regulation.⁴² As an illustration, in the last three years, 14 of the top 20 Initial Public Offerings (IPOs) in London were from foreign-owned firms while in New York the figure was only four.
- 3.20 A recent study commissioned by Think London analysed the key factors behind the competitiveness of London from the perspective of firms which do not currently invest in London but are considering where to invest in the future. It provided key insights into the attractiveness of London as a business centre and international platform.⁴³ The study surveyed perceptions in developed countries (US, Europe) as well as major emerging economies such as Brazil, Russia, India, and China (BRIC). This study found that London and New York are perceived as the most competitive global cities. London is perceived as an attractive place to locate for BRIC investors seeking to access markets in mature economies.

⁴² City of London, The Global Financial Centres Index, May 2009.

⁴³ Think London, "The World Via London: Where will your company be in 2012?", November 2008.

3.21 The Think London study estimated the brand premium of London over a number of other cities. This is based on a survey of executives' preferences for business centres and indicates the amount that they would be willing to pay to locate in London over the other centres.

Figure 7: London's brand premium over key competitor cities



Source: Think London, "The World Via London: Where will your company be in 2012?", November 2008.

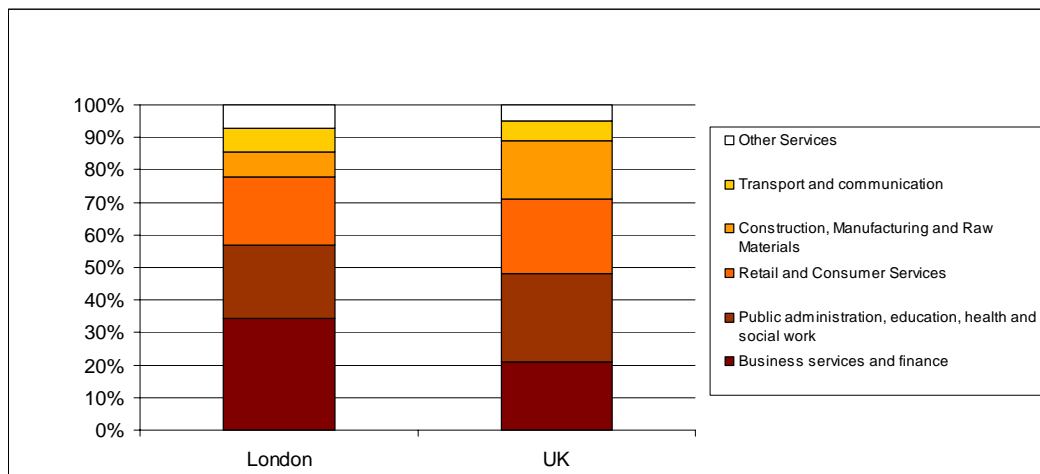
3.22 The high brand equity of London is a key asset that needs to be actively managed and protected. Some policies and measures could undermine London's brand and hamper long-term economic growth.

III.5 London is a global professional service centre

3.23 The role of London in the global economy is illustrated by the development of professional services in London. The UK's professional services sector is a world leader in areas such as accountancy, law, architecture, project management, maritime services and management consulting. London also has a competitive advantage in many of the creative sectors from TV/radio and advertising to life sciences and medical research. It is also a centre for the life sciences and medical research.

3.24 Professional services make a significant contribution to the UK economy as a whole and are responsible for over one million jobs in London. The professional service sector also underpins the success of London as a financial centre. London accounted for one third of all UK exports of services in 2007. London's main exports are financial and business services, management consultancy, computer and information systems and transport.⁴⁴ The figure below illustrates the importance of business and financial services to both London and the UK.

Figure 8: UK and London: composition of GVA

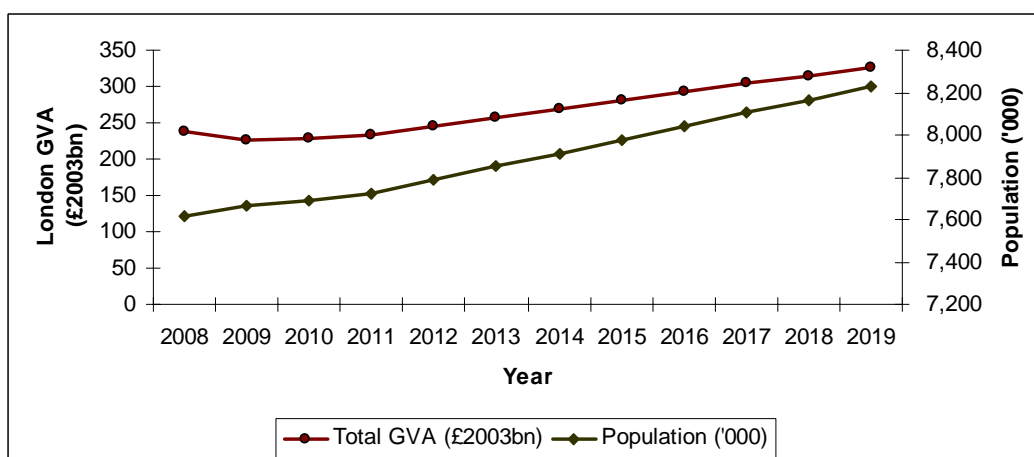


Source: GLA, "Economic Evidence Base" October 2009.

III.6 Future challenges

3.25 Prior to the global economic downturn, London was forecast to move from the sixth richest city in the world in 2005 to the fourth richest city in the world by 2020 (in GDP terms)⁴⁵. There has been no updated forecast but recent economic growth forecasts suggest that London will return to growth in 2010 and relatively strong growth will resume in the medium term. London's forecast economic growth (in terms Gross Value Added) and population growth to 2019 is set out below.

Figure 9: Forecast London Gross Value Added and Population Growth



Source: Oxford Economics forecasts for the City of London Corporation, August 2009.

⁴⁴ GLA Economics, Economic Evidence Base, October 2009.

⁴⁵ PricewaterhouseCoopers (PwC), "London to rise from sixth to fourth place in global city GDP rankings by 2020", Media release 7 March 2007.

3.26 However, it is still very early to evaluate the full impact of the global downturn on London's medium-term growth. London faces a number of future challenges to its position as a leading global city. Based on a recent study of London competitiveness, we focus on the following aspects: competitiveness in terms of attracting and retaining firms; attracting investment to London; and in attracting and retaining skilled labour.

3.27 There are a number of potential dimensions to London's international competitiveness. The Mastercard Worldwide Centre of Commerce Index measures the standing of global cities by the following criteria:

- legal and political framework: national institutional structure;
- economic stability: volatility of economic growth, inflation and exchange rates;
- ease of doing business: taxes and regulation such as ease of starting a new business, employing staff and enforcement of contracts;
- financial flows: connectedness in terms of financial flows such as volume of equity, bonds and derivative transactions, share of international banking, securities and insurance sectors;
- knowledge creation and information flows: innovation and creativity such as educational institutions, education of the population, number of researchers and scientific and technical articles;
- business centre: connectedness in terms of international sea and air traffic volumes; and
- liveability: quality of life and personal freedom.

3.28 Similar measures were used by a study for the London Chamber of Commerce on future challenges to London's competitiveness from several emerging cities⁴⁶.

3.29 The Greater London Authority (GLA) has identified a number of threats to London's attractiveness to business and people:

- tougher regulation of financial markets;
- reduced tax competitiveness due to changes in other countries and due to fiscal pressure as a result of the economic crisis;

⁴⁶ Europe Economics, "The Competitiveness of London – Future Challenges from Emerging Cities", April 2008.

- higher cost of doing business in London;
- reduction in international migration;
- transport infrastructure, crowding and congestion; and
- quality of life issues such as air quality, green spaces and crime.

3.30 There are a number of factors affecting London's competitiveness which are broadly outside the control of the UK central or local Government such as changes in patterns of world trade, economic development in other countries and policy settings in other countries. For example, the growing economic importance of China and India is likely to mean that major cities in or near these countries will grow in economic importance. Other factors, however, such as the quality of the transport infrastructure, tax policy and regulation are within the control of Government.

3.31 In the rest of this report, we consider how government policy can enhance and maintain London's competitiveness in the face of these challenges. First, we consider how the Government can respond to the fiscal implications of the crisis in terms of a framework for sustainable growth. We then discuss tax policy and the implications for London's competitiveness and the role of infrastructure in maintaining London's competitiveness.

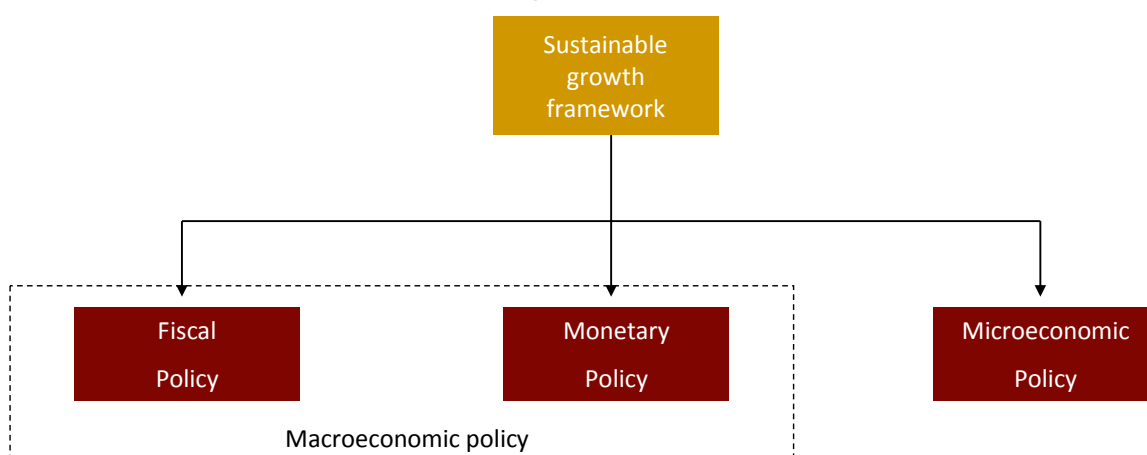
III.7 Conclusion

3.32 London's contribution to the UK economy, both as a driver of economic growth and as a gateway for foreign, human and financial capital is significant. London plays a unique part in the UK economy, and its relationship with the UK is mutually beneficial. London faces a number of challenges to maintaining its international attractiveness to businesses, capital and labour. The design of policies for the UK must therefore take particular account of their effects on the competitiveness of London.

IV. A policy framework for sustainable growth

- 4.1 Addressing the consequences of the crisis requires action by the Government in a range of areas, but it is vital to provide the conditions that are most likely to support economic growth. In this section, we outline a high level policy framework for sustainable growth. We provide an overview of the growth framework and briefly discuss its component parts: monetary, fiscal and microeconomic policy. We then discuss fiscal policy and in particular, budget processes and institutions which will enable rigorous fiscal reprioritisation. Finally, we discuss microeconomic policy such as regulatory reform which can promote medium-term growth.
- 4.2 Our recommendations here are focused on promoting the interests of the UK as a whole, through developing a framework which enables an effective response to the fiscal consequences of the recession and promotes medium-term economic growth. We believe, and our analysis confirms that, at a high level, the interests of the UK and the interests of London are coincident. The framework we propose is intended to secure the future competitiveness and prosperity of the UK as a whole.
- 4.3 The figure below provides an overview of our sustainable growth framework with three main policy roles for Government: fiscal, monetary and microeconomic policy.

Figure 10: Overview of sustainable growth framework



Source: LECC.

- 4.4 Public policy should have a strong and sustained medium-term orientation towards economic growth. Given the difficult economic and fiscal situation it is possible that quick fixes might be favoured, such as cuts in maintenance of public infrastructure. These may

deliver short-term fiscal gains but would also compromise long-term national output and the government balance sheet. The growth framework should be sustainable both in terms of its medium-term focus and in giving appropriate weight to broader social and environmental objectives.

IV.1 Establishing a credible medium-term macroeconomic policy

4.5 A coherent and credible macroeconomic policy will require sound monetary and fiscal policy. Whilst the primary focus of this report is on fiscal policy, the evolution of monetary policy in the aftermath of the financial crisis will be an essential part of creating a framework for growth. In light of the growth of credit prior to the crisis⁴⁷, there is a question as to whether long-term financial stability requires additional intervention to manage the supply of credit through the economic cycle by raising and lowering bank capital ratios.

4.6 A second issue exposed by the crisis was the lack of connection between macroeconomic analysis and the prudential supervision of individual institutions. The Turner Review noted:

“A common theme of this chapter is the vital importance of a system-wide macro-prudential perspective. The lack of such a perspective, and the failure to specify and to use macro-prudential levers to offset systemic risks, were far more important to the origins of the crisis than any specific failure in supervisory process relating to individual firms.”⁴⁸

4.7 One response to the financial crisis has been to raise capital requirements applying to banks and other financial institutions.⁴⁹ There is a clear trade-off here, as in the long term, excessive high capital requirements will tie up the funding needed for economic growth. To resolve this, a regulatory framework for growth will need to allow for lower as well as higher capital requirements, in order to make credit available when needed. To achieve this with confidence, the prudential supervision of individual institutions, and the setting of appropriate capital ratios to their mix of business, should be connected to authoritative macroeconomic analysis. Such a connection would fill the critical gap in the pre-crisis framework, because it would enable regulators to respond to indications of systemic stress, and thereby maintain the stability of the financial system. How this could be achieved is explored in Section IV.3 below.

⁴⁷ FSA, “The Turner Review - A Regulatory Response to the Global Banking Crisis”, March 2009, pages 13-20.

⁴⁸ FSA, “The Turner Review - A Regulatory Response to the Global Banking Crisis”, March 2009, page 83.

⁴⁹ FSA, “A regulatory response to the global banking crisis - Feedback on The Turner Review and DP09/2”, September 2009.

- 4.8 A further issue for macroeconomic policy is the balance between fiscal and monetary policy. The UK's current expansionary monetary policy stance, including quantitative easing will have to be unwound carefully while accommodating a significant tightening of fiscal policy. Fiscal policy is currently stimulating economic activity but the Government plans to withdraw the stimulus from 2010/11.

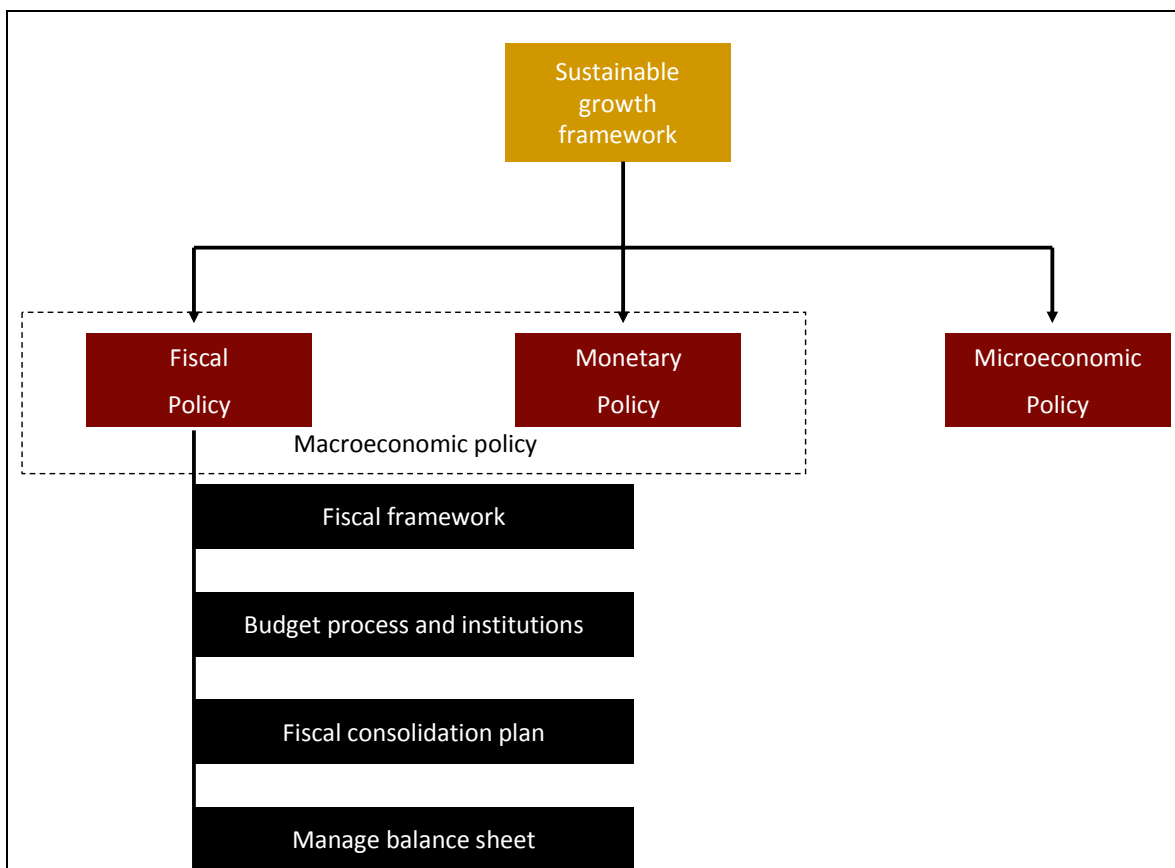
IV.2 Fiscal policy

- 4.9 Fiscal policy should aim to set a clear, credible consolidation plan and re-establish and extend appropriate fiscal rules for the long term. Compared to past crises, inflation is low as are interest rates including, critically, the cost of government borrowing. The risk premium attached to Sterling borrowing is modest.⁵⁰ However, there is a market expectation of fiscal consolidation and failure to deliver could result in debt markets rapidly reappraising the risk premium (with associated consequences for debt servicing costs) and/or the value of the Sterling.
- 4.10 The drastic short-term cuts in expenditure combined with major tax increases that are being implemented in a number of countries (such as Latvia and Iceland) are not required in the UK and would be likely to be counter-productive. However, the UK Government must adopt a credible plan with clear short, medium and long-term objectives. It can then undertake sensible early actions that demonstrate commitment to the longer-term goals.

⁵⁰

NIESR Economic Review, January 2009

Figure 11: Key elements of proposed fiscal policy framework



Source: LECG. Note: Fiscal policy involves both tax and expenditure reduction decisions. We discuss tax policy in the Section 5.

4.11 There are a number of elements that have an important part to play in fiscal policy.

- **New fiscal framework:** the Government should adopt new overarching fiscal rules with quantified economic objectives, to rehabilitate previous policies such as the “Golden Rule”;
- **Redesigned budget process and institutions:** the Government’s budget process needs to be redesigned to ensure effective sustained political leadership for the necessary fiscal consolidation, to provide transparency and encourage efficient and effective expenditure reduction;
- **Comprehensive medium-term fiscal consolidation plan:** a credible plan with a time-line to bring government finances into compliance with the new fiscal rules should be laid out; and

- **Managed balance sheet:** the Government balance sheet should be reviewed comprehensively to identify scope to improve utilisation of assets, identify and manage risks and contingencies and assess the scope for privatisation.

Fiscal framework

- 4.12 The Government's previous fiscal framework as established in the Code of Fiscal Stability has been overtaken by the credit crisis. It had in any case been subject to criticism as lacking objectivity and transparency, being backward-looking, open to manipulation, and potentially pro-cyclical.
- 4.13 The new fiscal framework needs to include formal anchors for the overall level of government expenditures and taxation. First, therefore, we recommend the adoption of forward-looking multi-year expenditure rules, stated (for example) in terms of Government spending as a proportion of GDP averaged over a multi-year period. Clear rules of this kind would make compliance more transparent, increase market confidence in the Government's fiscal management, and strengthen the Government's ability to maintain fiscal balance.
- 4.14 Such rules would also allow capital expenditure to be excluded, provided the amortisation and capital charge aspects of investment are properly reflected in accrual expenditure rules. As the OECD notes:
- "...capital expenditure can be quarantined from the expenditure rules as these are typically the first victim of fiscal consolidation efforts while other less productive but politically sensitive programmes survive."*⁵¹
- 4.15 In relation to the Government's balance sheet, the target should reflect government assets as well as debt, so a net debt/GDP or net worth/GDP target would provide a better measure.
- 4.16 We recommend that liabilities currently held off the balance sheet, such as Public Finance Initiatives (PFI) and pensions, should be incorporated into the balance sheet in line with best public sector accounting practice. The incorporation of off-balance sheet items would provide greater transparency and avoid any artificial incentives for the Government to adopt particular sources of finance simply to avoid missing its debt targets. The incorporation of assets would also provide greater visibility on the use of debt funding for capital expenditure. If the Government raises debt to invest in valuable infrastructure assets, then both the new asset and the additional debt will be reflected in the measure,

⁵¹ OECD, "Economic Survey of the United Kingdom", June 2009.

whereas if additional spending is for operating purposes then only the debt will appear and the overall measure will deteriorate.⁵²

Budget process and institutions

- 4.17 Arrangements at political and administrative levels must reflect the stark challenges the Government now faces. Addressing one of the largest fiscal deficits in UK history will require a radical rethink of institutional arrangements. We propose a number of budget process and institutional changes to promote sound long-term decision-making.

Senior leadership of budget process

- 4.18 We recommend a Cabinet Committee, chaired by the Prime Minister with the Chancellor and senior ministers as members, be given the remit to manage the Budget development policy, process and communications so that the economics, politics and implementation are fully integrated. This Cabinet Committee will be required until the new policy framework is in place and fully implemented (at least therefore until the delivery of the next Government's second Budget).

Independent office for fiscal analysis

- 4.19 We also recommend the creation of an office of independent fiscal analysis and forecasting capacity, along the lines of the Congressional Budget Office in the US, reporting directly to Parliament. The provision of an independent review of Government forecasts will provide assurance to financial markets that the Government's economic and financial projections are based on the best possible information and appropriately reflect current economic risks.

- 4.20 This office could be part of an expanded role for the NAO, which already plays a valuable role in reviewing Government spending and commenting on its value for money. Its autonomy could be enhanced to ensure that its reports reflect robust and impartial advice and assessment. The NAO role could be extended to advise Parliament on the proposals for new spending, in addition to its current ex-post review of Government programmes. This would provide independent and balanced advice on the value for money of spending proposals.

Stronger emphasis on rigorous application of cost-benefit analysis

- 4.21 Government already has a potentially effective framework for cost-benefit analysis (CBA) of expenditure, in the form of the Treasury's Green Book. The Green Book provides a

⁵²

Giles Wilkes, "A balancing act", CentreForum, 2009, p.46.

comprehensive framework for appraisal and evaluation of spending programmes and of capital investment. It provides guidance on the development of options, assessing benefits and costs (including non-market impacts), dealing with risk and uncertainty and distributional issues. However, the framework has little benefit unless it is rigorously applied across Government. One study has noted that, despite departmental commitments to the evaluation of policies there is little evidence of the assessment of the impacts of infrastructure projects on the economy once the projects are operational.⁵³

- 4.22 We therefore recommend that all departments should be obliged to undertake a CBA of their spending proposals. The CBA requirement should be tailored to the size of the spending programme, so that larger programmes receive more scrutiny than small programmes. While the many different areas of government have different types of benefit, it will be important that they are assessed by reference to a single common framework, as they are competing for the same scarce funds. Given the importance of economic growth, the CBA should be required to assess the expected impact of the spending programme on productivity, which is a key determinant of long run economic growth.

Enhancing departmental change management capacity

- 4.23 The scale of the fiscal reprioritisation required will create major challenges for the permanent secretaries and senior management teams of Government departments. There is an opportunity to learn from private sector experience along with relevant public sector lessons with effective change management and cost cutting.
- 4.24 Exercises of this sort in the private sector are typically conducted out of the line, by a separately recruited, specialised change team reporting to a senior executive (usually the CEO). They appraise the firm's culture, and they examine reporting lines, decision-making processes, spans of control, the fitness for purpose of management information, job specifications, accountabilities, risk appetite and management, as well as terms of reference and incentives. They use this information and insight to prepare a reorganisation plan which is then implemented under the direct oversight of the sponsoring executive. Cost savings vary, but it is not uncommon to realise savings of 15-30% of a company's operating costs⁵⁴.
- 4.25 We propose the following approach:

⁵³ Nick Bosanquet *et al.*, "Road to recovery", Reform, October 2009.

⁵⁴ Source for consulting, "Intelligent cost cutting", 2009.

- creating a separate unit within Government with an explicit mandate to achieve efficiency savings. The unit would have a life span limited to the accomplishment of its mandate and should be located within the Cabinet Office. The unit must be off-line, outside the spending departments to achieve a sufficient degree of unfettered, objective challenge;
- staffing the unit both with officials taken out of their departments and with key contract hires from the private sector to capitalise on experience of reorganisations outside Whitehall, and to enable skills transfer;
- empowering the unit to scrutinise mechanisms for the delivery of the public services in depth, inside departments and agencies; and
- setting an explicit target for delivering savings and providing for an independent audit of the savings achieved.

Special advisers

4.26 Cabinet (and some other senior) ministers have special advisers whose role is to support them as politicians, as a complement to their permanent departmental staff. We suggest that each Cabinet Minister should appoint an expert in value-for-money and efficiency issues to enable them to navigate the politics of the difficult decisions that the next administration will face. Their role will be to provide advice on maximising the value-for-money of Government expenditure, reducing any risk of departmental gaming (e.g. “Washington Monument” behaviour) and ensuring a strong focus on implementable efficiency gains. This would provide a different perspective to the permanent staff and help Ministers achieve fiscal consolidation despite institutional incentives and the pressures on departments to protect narrow sectoral interests.

Approval of budget submissions

4.27 Departmental budget submissions set out a department’s bid for funds and its proposed efficiency savings. These submissions should be approved by the departmental Chief Economist/Statistician and CFO as well as the Minister to encourage accountability, professionalism and a government-wide approach.

New funding

4.28 Government will always have new spending proposals and it is important for the fiscal planning process to provide for this demand for new funds. Fiscal planning should therefore establish a new fund to pay for new initiatives, funded by tighter limits on

departmental budgets. The terms of this new policy fund would set limits and prioritise funding for new spending.

4.29 The case study below illustrates how Canada tackled a fiscal crisis between 1994 and 2000.

Case Study: Addressing a fiscal crisis - Canada

The Canadian Government engaged in an extensive and highly successful set of reforms in expenditure management between 1994 and 2000, in an effort to rebalance their public finances. The fiscal position was consolidated by 5% of GDP between 1994/95 and 1997/98, including a reduction in expenditure of 3% of GDP. The two main focuses, expenditure review and autonomy and accountability, are relevant to the current debate in the UK.

An extensive expenditure review process:

The Minister of Finance announces a programme to review all Government spending. The review is based on deciding what is the appropriate role of Government and what package of programmes are affordable (1994).

The Government undertook a line-by-line comprehensive spending review of all departments. The programme, led by the Minister for the Public Service, required that all ministers reviewed all spending within each of their departments and portfolios. A Coordinating Group of Ministers and a Steering Committee of Deputy Ministers was also established to review departmental proposals (1995).

The Government established an Expenditure Management System to incorporate more rigorous expenditure restraint. Its role was to review programmes continually, set annual targets and consider new proposals within the context of a tight fiscal framework (1995).

The Expenditure Management System consisted of the following:

- improved expenditure planning by requiring the review and reallocation of expenditures within the Budget process;
- Treasury Board changes its role from “funder” to “banker” by reducing the size of its central operating reserves to focus on departmental investments to yield future year savings or avoid costs;
- central policy reserves were formally eliminated, with new any new initiatives to require greater scrutiny and to be funded through reallocations;

- departments were directed to focus on performance and programme results with increased public accountability;
- departmental business plans were established, focusing on strategic changes in departmental programmes and business to achieve budget targets;
- some increased administrative and budget flexibility was provided to departments to encourage more effective management and delivery of programmes within significantly reduced resources; and
- departmental Outlook documents were established, to assist the House of Commons Standing Committees in reviewing departmental expenditure planning by focusing on future expenditure trends and priorities;

The second phase of the programme review, with the focus less on targets and more on the implementation, increased user charges, cost recovery and contracting out. (1996)

The Treasury board was re-orientated towards results-based management and strengthening results-based accountability. (1997)

What other developed nations could learn from Canada’s response to their own fiscal crisis:⁵⁵

- fiscal targets must be clear, measurable and simple. Complex targets involving cyclical balancing will lose public understanding and therefore credibility;
- public support for balanced public finances is critical to gather support for the necessary measures. As a result, attention must be paid to the public dialogue;
- base fiscal planning on the understanding that there are often unforeseen circumstances and events. A prudent fiscal framework will maintain market credibility;
- avoid long-term projections where possible, as they are very sensitive to assumptions; and
- it is as difficult to manage a surplus as it is a deficit, as demand for funding is magnified.

Comprehensive medium-term fiscal consolidation plan

4.30 We recommend a comprehensive spending review to provide comparative analysis of the value of existing spending and investment.

4.31 Experience shows that a sound decision-making process for budgets needs to be used consistently and comprehensively, so that the best choices are made between

⁵⁵ “Commentary: Balanced Budget – A Canadian Fiscal View”.

expenditure reductions, tax increases and balance sheet improvement options. Decision-makers need the best available information presented in a timely and tractable form. This is needed as an input into each Budget and, given the time consuming nature of the analytical work required, we believe that the process should be initiated now.

- 4.32 We believe that there may be considerable scope for realising efficiency gains. The ONS estimated that public sector productivity declined by 3.4% between 1997 and 2007, while at the same time private sector productivity increased by 27.9%.⁵⁶ Improving productivity of the public sector enables the delivery of the same level of outputs at lower cost. However, we also believe that the required reduction in expenditure will require difficult decisions.
- 4.33 The review should examine the public spending line by line, in terms of value-for-money, with costings taking account of the deadweight costs of taxes, and a realistic cost-of-capital.⁵⁷ While we recognise the legitimacy of political decisions to safeguard the overall level of provision in certain areas, no department should be excluded from the need to identify efficiency gains, reduce costs and discontinue low priority or low value outputs.
- 4.34 When undertaking cost-benefit analysis, it will be important to carry out a strict prioritisation exercise based on net present values, taking account of a public discount rate that best reflects the fiscal constraint. Given the Government's funding constraints, we believe that the current discount rate of 3.5% should be revisited. The Government needs to reprioritise capital to its highest value uses. A higher discount rate would reflect the scarcity of Government capital,⁵⁸ and effectively lower the value placed on future benefits and costs. The alternative to a higher discount rate would be to ration capital by some other means. An increased discount rate would have the benefit of making the higher cost of capital explicit providing a common basis for assessing funding bids.
- 4.35 The expenditure review process should be designed to provide departments with incentives to work with the review to deliver the best results. We recommend:

⁵⁶ ONS Statistics, "Total Public Service Output and Productivity – Correction Notice", 14 August 2009.

⁵⁷ In economics, a deadweight loss is a loss of economic efficiency that occurs because the tax drives a wedge between the price consumer pay and the price received by producers. This wedge distorts the level of economic activity.

⁵⁸ In effect this can be viewed as adding to the social cost of capital a premium that reflects the shadow value of scarce government funds.

- **Multi year budgets:** giving the clearest possible long-term objectives and challenging multi-year budget limits;
- **Autonomy:** giving greater responsibility with commensurate accountability so that each authority can make the right decisions in respect of value-for-money and efficiency. This autonomy should include:
 - decisions on staff numbers and remuneration (including pensions); and
 - responsibility for the long-term maintenance of agency capacity at the level required by the Government; and
- **Incentives:** creating financial incentives to find efficiency gains by rewarding departments that can control spending; for example, allowing organisations to retain a modest share of efficiency gains.

Managing the public sector balance sheet

4.36 The Government should launch a comprehensive review of the public balance sheet to identify the scope for rationalisation, commercialisation and privatisation. Despite the UK's achievements in this area, there is still the potential for further advances. The Government possesses a considerable portfolio of assets that could be sold to reduce the national debt. While in one sense, this could be seen as simply shifting resources between assets and debt, there is opportunity for the private sector to increase value from the management of assets and hence benefit the wider economy. After three decades of experience in the UK and around the world with public sector divestment, there is strong evidence for this.⁵⁹

4.37 The Government should explore the opportunity for private ownership and funding of major infrastructure projects. A number of infrastructure elements are already in private ownership such as telecommunications, water⁶⁰, energy networks and airports. There is potential to extend this model to other areas of transport such as roads and rail.

4.38 Examples of potential state assets that may be divested include:

- **Royal Mail.** The Government has already explored options for the partial privatisation of Royal Mail. As well as realising funding to repay debt, the sale of Royal Mail offers the opportunity to bring international management expertise to the

⁵⁹ John Kay, "The Future of UK Utility Regulation", in *Regulation Utilities: a Time for Change*, Institute of Economic Affairs, 1996.

⁶⁰ Water infrastructure is only under private ownership in England and Wales.

operation of the business and the potential to improve the efficiency of the provision of mail services.

- **Road network.** The highway network has a total value of over £80bn.⁶¹ Part or all of the network could be sold on the basis of long-term funding contracts with the Department for Transport (DfT). New capacity could be funded on the basis of tolls such as with M6 toll road. This may help promote public acceptance of toll roads. In the longer term, there is potential to use road pricing to raise revenue and for demand management purposes. We note that the Government has announced plans to sell the Dartford Crossing, which already has a toll arrangement for funding.
- **Public sector property portfolio:** The total value of the central Government and its agencies' property portfolio has been estimated at around £130bn.⁶² While the Government needs some level of property holding, there is a question as to whether the current holding is maximising value and whether agencies holding the property have appropriate incentives to efficiently use property and dispose of unnecessary holdings. There have been a number of proposals from the private sector to help manage these assets more actively, helping the state to derive income or realise the capital value of these assets.⁶³

IV.3 Microeconomic policy: seek pro-growth initiatives

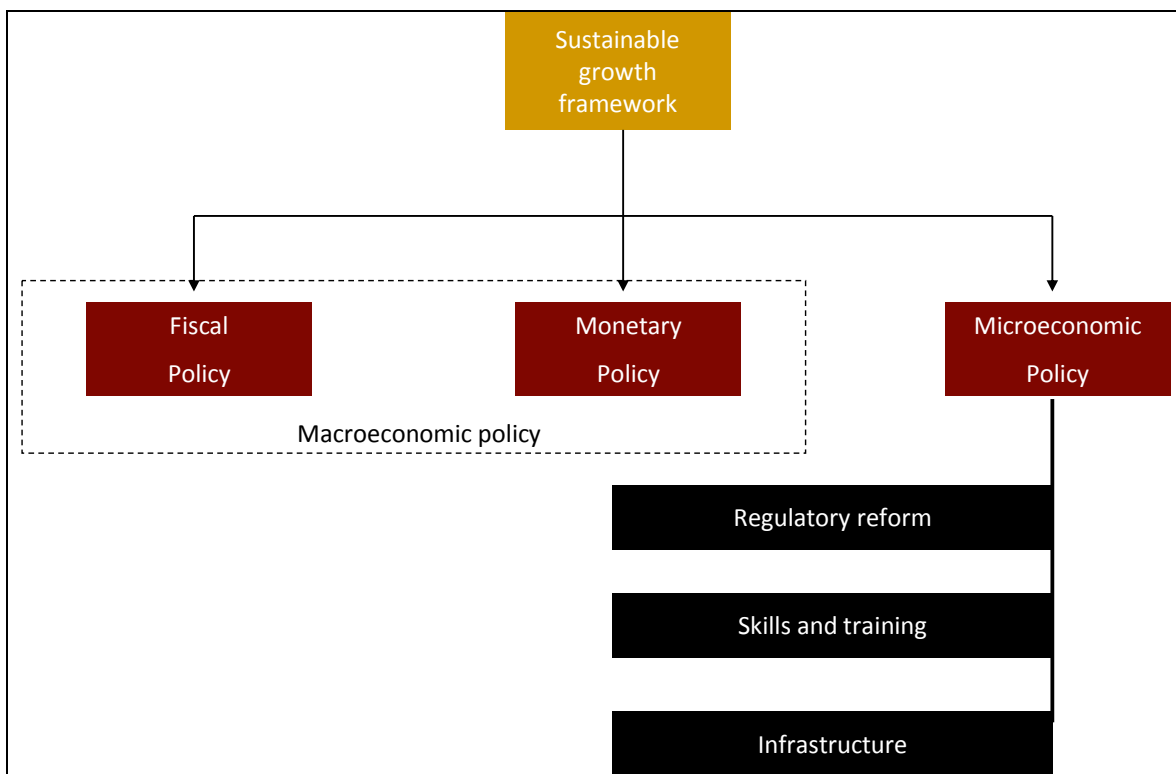
4.39 In this section we outline microeconomic (or structural) reforms to improve medium-term productivity and economic growth. It comprises three key elements: regulatory reform, skills and training and infrastructure. We discuss regulatory reform, employment and training in this Section, while Section VI is dedicated to infrastructure.

⁶¹ Highways Agency, Annual Report 2008/09. The £80bn asset value represents the strategic road network in the UK.

⁶² Vince Cable, "Tackling the fiscal crisis: A recovery plan for the UK", Reform, September 2009, page 54.

⁶³ Vince Cable, "Tackling the fiscal crisis: A recovery plan for the UK", Reform, September 2009, page 54.

Figure 12: Pro-growth microeconomic policies



Source: LECC.

Regulatory reform

4.40 We propose a programme with short and medium-term deliverables to enhance economic growth. These are “win-wins” for the Government – more economic output without increasing the pressure on Government finances. We conclude with some observations on financial regulation.

Process

4.41 The Government has implemented a range of measures to promote better regulation. This includes the establishment of the Better Regulation Executive (BRE) as part of the Department for Business, Innovation and Skills (BIS). The BRE aims to work with departments to improve the design of new regulations and to simplify and modernise existing regulations. However, there is concern that the cost of regulation is too high and that this cost is rising rather than falling over time. The British Chambers of Commerce have estimated that the total cost of regulation introduced since 1998 is £65bn.⁶⁴ It found that around two thirds of the additional cost originated from EC regulation. This limits the

⁶⁴ British Chambers of Commerce, “Burdens Barometer 2008”. Note: This assessment does not take account of the economic and social benefits of regulation.

opportunity to remove or reduce regulation, although we note that the Government usually has some degree of freedom as to how EC regulatory requirements are implemented in the UK.

4.42 The role of the NAO could be extended to the review of new regulation, consistent with its proposed role in reviewing new spending bids. This would help to ensure that RIAs were undertaken in a meaningful manner and improve the scrutiny and transparency of the process to adopt new regulation. In particular, work on the cost-benefit analysis that lies at the heart of the RIA should begin early in the policy development process. It should be an input into policy development, not an ex post justification, and it should be of a quality that would pass independent peer review.

4.43 Existing regulations should be subject to a comprehensive review. A Cabinet sub-Committee of Senior Ministers should be established to identify opportunities for the removal and reform of regulation to improve productivity and growth. The group should be supported by a working group of senior officials to identify proposals without adverse fiscal implications. These could include the removal of regulations that clearly constrain economic development. In many cases however there may be the potential to change regulations so as to achieve the same ends through more efficient, less distorting means. For example the following measures could be considered:

- **eliminate central Government imposed shop trading hour restrictions.**⁶⁵ One study has identified the benefit of complete de-regulation of Sunday trading restrictions to be £20.3bn (at 2006 prices and in present value terms).⁶⁶ The benefits are derived from the anticipated reduction in costs and prices, and the anticipated increase in customer convenience. The majority of the benefits come from reduced costs, but there are sizeable benefits attributable to co-ordination and the reduction of congestion;
- **measures to promote labour market flexibility.** Investigate and consider removing inappropriate barriers to the participation of young and less skilled

⁶⁵ The current restriction on Sunday trading limits stores over 280m² (3,000 sq ft) from trading for more than 6 hours within the time interval 10am-6pm on a normal Sunday, and from trading at all on Easter Sunday.

⁶⁶ Indepen, "The economic costs and benefits of easing Sunday shopping restrictions on large stores in England and Wales", May 2006.

workers, while identifying more efficient ways to safeguard required social protections;⁶⁷ and

- 4.44 A longer-term reform initiative with fiscal implications would be to give further responsibility to devolved administrations and local authorities, with clear legislated specification of objectives, functions and powers, including greater autonomy to the GLA and local boroughs with respect to their taxing and borrowing powers. Such a move would ensure greater congruence between the incidence of the benefits and costs of local public services. It would need to be accompanied by rules for strict information disclosure, transparency and public accountability to citizens.

Financial regulation

- 4.45 The credit crisis illustrates the importance of getting the regulatory framework right for the finance sector. Good regulation can enhance the competitiveness of the UK economy while poor regulation can have the opposite effect. While financial regulation is not explicitly contained in our terms of reference, we note that there is an active national and international debate on future structures and methodology, in which UK contributions, including the Turner Review, are playing an important part.⁶⁸
- 4.46 A key feature of the future regulatory framework should be its ability to align required capital ratios with the state of the economy, while taking account of systemic stresses and the business mix of different financial institutions. There is a risk that poor timing of increased capital requirements could reverse a fragile economic recovery by restricting the supply of credit at the very time the expansion of credit is required. As one example, we note that there are concerns about proposed changes in financial regulation affecting hedge funds. The Alternative Investment Fund Manager Directive will impose stricter capital requirements on investment firms. A recent study finds that these regulations would restrict access to capital and consequently result in increased finance costs.⁶⁹
- 4.47 To establish the link to macroeconomic and systemic factors, there should be a macro-prudential body (a “Financial Stability Committee” or “Financial Policy Committee”) which should set parameters for the prudential supervision of financial institutions, primarily in the form of a target range for capital and liquidity requirements, on the basis of data covering credit supply from the regulated and unregulated sectors, leverage, liquidity,

⁶⁷ OECD, “Economic Survey of the United Kingdom”, June 2009.

⁶⁸ FSA, “The Turner Review – a regulatory response to the global banking crisis”, March 2009.

⁶⁹ CRA, “Impact of the proposed AIFM Directive across Europe, October 2009

asset prices and other criteria. The Committee would be empowered to modify capital and liquidity requirements to lean against the economic cycle.

- 4.48 A national financial regulatory framework which effectively matches capital and liquidity requirements could give the UK and London a competitive edge, but the potential attraction of this is outweighed by the importance of ensuring that new regulatory frameworks and standards are adopted internationally to avoid arbitrage.. The UK and London would benefit from internationally consistent application of new rules. It is particularly important to the UK as a major export centre for finance that regulation does not raise national barriers to the UK banking sector through unilateral imposition, or gold-plating of new measures.

Employment and training

- 4.49 The London labour market is unusual in the UK context. It is characterised by the highest productivity of any region in the country, but at the same time suffers from high levels of unemployment and worklessness with costs to the taxpayer of supporting more than 600,000 workless people in London through the benefits system. London's labour market is very competitive, due partly to the large number of migrants attracted to London at all skills levels.⁷⁰ One of the reasons for worklessness is the lack of qualifications amongst some residents. London has over 3 low skilled residents for every low skilled job, compared to 2.3 in the rest of the UK.⁷¹ Furthermore, relative to other regions, London has fewer jobs in the average pay sectors, which means that it can be difficult to facilitate progression and provide opportunities in the labour market for those with low or mid level skills.⁷²

- 4.50 Most London businesses do not suffer from major skills gaps because of inward migration and commuting.⁷³ However, the low levels of employment have significant social implications and contribute to the polarised income distribution in London. The London Skills and Employment Board believes that the challenge is to equip local people to compete successfully for jobs and to encourage more employers to invest in their workforces.⁷⁴ Business employers are more concerned about the employability skills of

⁷⁰ GLA Economics, Economic Evidence Base, October 2009, page 102.

⁷¹ GLA Economics, Economic Evidence Base, October 2009, page 103.

⁷² GLA Economics, Economic Evidence Base, October 2009, page 103.

⁷³ Mayor of London, "London's Future: The Skills and Employment Strategy for London 2008-13", June 2008.

⁷⁴ Mayor of London, "London's Future: The Skills and Employment Strategy for London 2008-13", June 2008.

potential employees from schools, colleges and universities than their formal qualifications.⁷⁵

- 4.51 There is likely to be value in focusing on programmes to improve employability skills levels in London and improving outcomes from the education system. In a tight fiscal environment, it will be important to ensure that current labour market programmes are effective before committing any new spending. In particular, the London Skills and Employment Board has identified the importance of ensuring that the public provision of skills and employment services is better integrated and targeted to employer needs.⁷⁶

IV.4 Conclusion

- 4.52 The Government faces a difficult fiscal environment and uncertain economic outlook. The fiscal adjustment process is likely to be difficult and painful. However, there are opportunities to address the fiscal challenges in a robust and coherent fashion. Doing so along with a programme of microeconomic reform has the potential to improve the productivity of the economy and the fiscal situation.
- 4.53 It will be important for the Government to develop a medium-term programme with rigorous analysis of the benefits of expenditure to ensure that expenditure reductions are targeted at the right areas. It must avoid the temptation to cut or defer economically valuable investment that lacks popular or political support. The effects of such reductions may adversely impact long-term growth. This last point is of particular importance from a London perspective: as we discuss in Section VI, London has a number of major investment programmes that might be easy targets for expenditure reduction, but where cost-benefit analysis indicates that those cuts would not be in the national interest.

⁷⁵ Experian, "Voice of London Employers", July 2007.

⁷⁶ Mayor of London, "London's Future: The Skills and Employment Strategy for London 2008-13", June 2008

V. Tax policy

- 5.1 In light of the UK's fiscal position, it is likely that the necessary spending reductions will be accompanied by revenue enhancement measures in addition to those already announced. In this section, we briefly outline the tax increases proposed by the Government. We then consider the objectives and principles of tax policy, and analyse the various policy options for enhancing revenues. We argue that the severity of the current fiscal position provides an opportunity to implement tax reforms that reduce current distortions while increasing revenues. We discuss the advantages of implementing reforms as a package and set out proposals for a pro-growth tax reform programme.
- 5.2 As in the previous section, our recommendations here are designed to promote the interests of the UK as a whole. From the analysis we present below, it is clear that a tax policy that promotes the national interest is also a tax policy that promotes the continued competitiveness of London.

Government proposed tax increases

- 5.3 The Government has proposed the following tax increases to reduce the deficit.⁷⁷
- National Insurance Contributions (NICs) will rise by 0.5%, beginning April 2011. This is expected to raise £5bn in the first year;
 - the Income Tax personal allowance will be fully withdrawn from those earning over £100,000 from April 2010. This is expected to raise £1bn in the first year;
 - the introduction of a 50% top income tax bracket will apply to those earning over £150,000 from April 2010. We discuss the increase in the top tax rate further below;
 - from April 2011, tax relief on pension contributions will be restricted for those earning above £150,000, tapered down until it is 20%. This is expected to raise £3bn in 2012-13;
 - increases in alcohol and tobacco duties effective immediately post Pre Budget Report 2008, together raising around £1bn annually; and
 - increases in fuel duty, effective immediately post Budget 2009, are expected to raise £600m in 2009-10, rising to £1.7bn in 2011-12.

⁷⁷ OECD, "Economic Survey of the United Kingdom", June 2009.

V.1 The problem

5.4 As discussed, in Section III, the gap between Government expenditure and receipts is estimated to be in excess of 12% of GDP, or £175bn in 2009/10.⁷⁸ This gap will not be eliminated solely by a resumption of growth, and may not be eliminated entirely by reductions in expenditure. However, expenditure reductions should be a priority as simply raising tax rates, particularly income tax rates, may not be consistent with promoting economic growth and may not be effective in raising net revenue. The OECD states:

“Experience in other countries suggests that a focus on expenditure cuts, rather than revenue raising, is associated with more successful consolidations, particularly when coupled with explicit expenditure rules, as it is more likely to result in lower interest rate spreads and instil confidence by signalling a strong commitment by the Government to robust fiscal consolidation”⁷⁹

5.5 There is evidence in the economic literature that fiscal adjustments based on spending cuts with no tax increases are more likely to reduce deficits and debt than those based on tax increases⁸⁰.

5.6 The net revenue raised from tax rate increases is also affected by the increased disincentive to work. International evidence suggests that the distortionary cost of increased taxes, in terms of reduced Gross National Product (GNP), is estimated to be between 20p and 60p per pound raised depending on the tax base and rate used.⁸¹ Given the current level of income tax rates, the economic costs may be at the higher end of this range for increases in the top rate of income tax. As these costs are largely the product of avoidance activity, the resulting efficiency losses may be accompanied by little gain in terms of the equity of the tax system. It is therefore worth considering whether other reforms may yield better outcomes in terms of both equity and efficiency.

⁷⁸ Treasury, Budget Report 2009 Table 2.3, p.33.

⁷⁹ OECD, “Economic Survey of the United Kingdom”, June 2009.

⁸⁰ Alberto Alesina and Silvia Ardagna, “Large Changes in Fiscal Policy: Taxes versus Spending”, NBER Working Paper No. 15438, October 2009.

⁸¹ See the Joint Economic Committee, on “Economic Benefits of Personal Income Tax Reductions”, United States Congress, April 2001. This paper summarised a Congressional Budget Office literature review, Winston Bates, “How much government? : The effects of High Government Spending on Economic Performance”, Wellington: New Zealand Business Roundtable, 2001, p.viii; Martin Feldstein, “Rethinking Social Insurance”, American Economic Review, Vol.95: No.1, March 2005, p.9.

V.2 Impact on the London and UK economies

5.7 Taxes impose costs on the economy by distorting economic activity and creating administration and compliance costs for taxpayers. By definition, taxes reduce the taxpayer's net income. However, this is a transfer rather than a cost to society as a whole. Taxes distort economic activity by changing the prices and returns to consumers, investors and workers.⁸² For example, income taxes reduce the level of income earned by employees, which may affect their decision to work or to work additional hours. Consumption taxes raise the price of a product and may deter a consumer from purchasing it. The Corporation Tax rate may influence the location decision of a new office or factory for a firm.⁸³ Tax policy must therefore strike an appropriate balance between producing sufficient revenue for the Government and minimising the impact on the economy.

5.8 In principle, many of the same issues that apply to efficient taxation of the UK economy will apply to London. In 2006/07, London paid £30.1bn in tax, which represented 20% of National Tax Receipts.⁸⁴ From both a national and a London perspective, it is important that tax policy takes account of:

- the highly mobile nature of both labour and capital employed in London. This increases its sensitivity to changes in tax rates. If businesses and employees exit the UK in response to tax changes then this could reduce economic growth and tax revenues;
- the importance, in particular, of high value professional services, which are more likely to face high income tax rates. Almost 30% of the new higher income taxpayers are located in London.⁸⁵ Income tax is one of a basket of factors taken into account by businesses when deciding whether to locate or to remain located in the UK;

⁸² Jonathan Shaw, Joel Slemrod and John Whiting, "Administration and compliance", IFS paper for Mirrlees review, April 2008.

⁸³ HMRC, "National Statistics", 2009. http://www.hmrc.gov.uk/stats/income_distribution/3-11-table-jan09.pdf

⁸⁴ HMRC, "National Statistics", 2009. http://www.hmrc.gov.uk/stats/income_distribution/3-11-table-jan09.pdf

⁸⁵ Mayor of London, "London hit four times harder than the rest of the UK by Government's plan to tax high income earners", 27 April 2009.

- the role of London as an international finance centre and as a location for global and European head offices, and therefore the importance of international and investment taxation;
- the importance of holding companies and the incentives for them to remain located in the UK;
- the importance of international employees and therefore heightened sensitivity to treatment of non-domiciles; and
- stamp duty on shares and property disproportionately affect London as a centre for share trading and due to high property prices relative to the rest of the UK.

5.9 Prior to the recent tax changes, the overall view of the UK tax regime appeared to be reasonably positive. For example, the Snyder report noted that:⁸⁶

“the design of the overall tax system works well for professionals and creates a favourable business environment.”

5.10 This was not because the UK was seen as a low tax regime, but because it was thought to offer a reasonable balance of value for money and certainty of process. There is a risk that recent tax changes have worked to undermine this view, both in terms of the substance of tax policy and the process for making changes to it. As we discuss below, this arises from the combination of reductions in Corporation Tax rates in other jurisdictions, recent Income Tax rate increases in the UK and the process for introducing changes to the tax system.

5.11 In the medium term, an unfavourable tax environment could have a major impact on the competitiveness of the UK, adversely impacting economic growth, employment and tax revenues. Uncertainty regarding the principles that will drive future tax regimes also adversely impact economic decisions faced by both firms and individuals.

V.3 Principles of good tax policy

Objective

5.12 The general aim of tax policy should be to raise the amount of funds necessary to finance budgeted government expenditures at the least long-term cost to the economy, including administrative, compliance and deadweight costs. Our aim has been to identify changes to the tax regime which would have the greatest positive impact on sustainable growth for

⁸⁶

The Snyder Report, page 15.

London, while maintaining fairness or equity of the tax system⁸⁷. This involves assessing the benefits of tax changes in terms of reducing the economic costs of taxation.

Principles

5.13 We believe the following principles will promote an efficient and effective tax regime.

- **process:** The process, as well as the taxes themselves, is important to minimising the economic harm of the tax system. As tax rates and policy are important for personal, household and business decision-making, the tax system should be as stable as possible;
- **simplicity:** The tax system should be as simple as possible to minimise the compliance costs on taxpayers. In a complex world, it will often be necessary to design sophisticated and detailed tax rules. However, the tax system should not create unnecessary or undue complexity;
- **broad base:** To minimise the inevitable adverse effects on output, the tax base should be as broad as possible as this allows the lowest rates to be levied consistent with the medium-term Government funding requirement. Effective implementation through comprehensive withholding arrangements (or deduction at source) and appropriate enforcement is essential;
- **multiple tax instruments:** Although our policy framework objective recommends broad-based taxation rather than higher rates, the use of a range of tax bases is economically justified to avoid excessively high tax rates on any particular base;
- **minimise harm:** the choice of taxes, along with rates, should be those that have the least adverse effect on the suggested public policy objective, the highest possible long-term living standards whilst ensuring that the burden of taxes is shared equitably. This requires careful consideration of administration and compliance costs as well as of the deadweight costs. Taxes on less elastic or less mobile tax bases are likely to have lower cost. In that context, land taxes and VAT are preferable to taxes on income.⁸⁸ This would also imply that there should be lower tax rates on highly elastic tax bases, such as internationally mobile financial capital;

⁸⁷ Our focus is on efficiency, however, the distributional consequences of tax policy need to be taken into account when considering changes to tax policy. Fairness or equity inevitably involves an element of political judgement as to the appropriate distribution of income, however, robust analysis can ensure that these judgements are well founded.

- **tax “bads”:** taxes on adverse externalities, such as pollution, may be useful as they can, if well designed and implemented, ensure that individuals and firms face the full social costs of their activities resulting in a more efficient allocation of resources. While the revenue generated can be used to lower the most inefficient taxes, recent research suggests there is unlikely to be a “double dividend” of increased revenue and improved economic outcomes⁸⁸; and
- **user charges:** appropriate charging for Government services, where consistent with the overall objective and to achieve full cost recovery, should be considered. Efficient road pricing is a major issue here. Ideally, revenue raised from road pricing should be used to lower fuel duties.

Tax competitiveness

5.14 In general, we believe that the principles outlined above provide a sound basis for guiding tax policy. The UK is part of a global economy and outcomes from tax policy will be influenced by international developments such as tax policy in other jurisdictions. As companies become more mobile and operate on an increasingly global scale, countries increasingly compete to attract businesses to locate in their jurisdiction. It is important for the UK to work with tax authorities and monitor tax policy in other jurisdictions. Maintaining tax competitiveness may also require adjustment to policy in light of developments in other jurisdictions to prevent erosion to the tax base. For example, as we discuss below, corporate tax rates have been declining in other jurisdictions over the past 10 years. While the corporate tax rate is not the only factor in determining how much tax a firm will pay, it will nonetheless influence business location decisions.

5.15 Any loss of tax competitiveness will affect all of the UK, but its effects will be most visible most quickly in London. This is because much of the UK’s mobile labour and capital that is most sensitive to tax changes is located in and around London.

V.4 Process and compliance

5.16 To generate the best results, all tax policy measures should be supported by a sound tax policy development process, together with transparent and efficient administration of tax

⁸⁸ For example, as suggested by Giles Wilkes, at the Centre Forum

⁸⁹ Note that if the tax instrument is successful in reducing output, then tax revenue will also be reduced. Bovenberg, L and Goulder, L (2002) “Environmental taxation and regulation” in *Handbook of Public Economics*, Vol. 3, A. Auerbach and M. Feldstein, eds., Amsterdam: Elsevier Science BV.

law. There is some evidence that the UK tax regime compares reasonably well with other countries in terms of compliance costs.⁹⁰

- 5.17 A recent survey of the financial sector found evidence of growing corporate dissatisfaction with the UK tax regime.⁹¹ This study involved interviews with 36 financial services firms and found that around 80% believed that the quality of the UK tax regime was deteriorating. The most prevalent factors mentioned were not related to each other, but focused on the application of the tax regime. The recent lack of consultation and the increasing aggressiveness of HMRC were consistently highlighted as reasons for its diminished standing. This evidence highlights the importance of a sound system of procedure and compliance that is user-friendly. These current trends are becoming apparent not just to tax advisors but company executives as well. The report by Robert Wigley highlights the same issues, and concludes that poor recent consultation weakens public confidence in Government claims that no further tax increases are required to respond to this crisis. There is anecdotal evidence that concern over uncertainty of policy direction in areas such as controlled foreign company rules, is a critical issue.
- 5.18 It should be borne in mind that despite this evidence of some deterioration in perceptions of the tax policy process, the UK still compares reasonably well with many other jurisdictions. For example, the KPMG UK tax competitiveness survey found that the UK was ranked fourth in 2008 against a range of international jurisdictions. The survey respondents were 50 senior finance professionals from FTSE 250 companies and large foreign subsidiaries. The UK's fourth ranking was stable compared to the previous year, but its aggregate score had declined. The countries rated more attractive than the UK were Ireland, Netherlands and Luxembourg.⁹² The survey also found that the Varney Review of the links between the HMRC and large businesses had resulted in better consultation.
- 5.19 The tax policy process is important to businesses. For example, the Bischoff report noted that:⁹³

⁹⁰ For example, the PwC/World Bank, in "Paying Taxes 2008: The Global Picture", November 2007, assesses a mid-sized case study example company on its ease of paying taxes, and ranks the UK 12th out 175 countries. As cited by Jonathan Shaw, Joel Slemrod and John Whiting, in "Administration and Compliance Report for the Mirrlees Review", IFS, April 2008.

⁹¹ CRA, "The impact of Taxation on Financial Services Business location decisions", Feb 2008.

⁹² KPMG, "UK Tax Competitiveness Survey", October 2008.

⁹³ The Bischoff report, page 11.

“The Government and the industry recognise the importance of moving away from binary discussion on tax rates (lower at all costs) and support continued efforts by multinational companies to work with Government to achieve a transparent, predictable and modern UK system that also recognises the competitive challenge of the international tax environment.”

5.20 There are a number of criticisms of the management of proposed changes to the tax regime, that are considered poorly developed and rushed, such as the zero-rate Corporation Tax for small business and taxation regime for non-domiciles. Prior to the change to the non-domiciles’ regime, the OECD had observed that the taxation of non-domiciles enhanced the UK’s competitiveness.⁹⁴ However, both the process of introducing the changes and the outcomes may have damaged this position.

5.21 The Howe Report provides a wide ranging critique of the process and complexity of the UK system.⁹⁵ Key findings of the Howe Report are set out below:

Key Headlines of the Howe Report

- The UK tax system has become much too complex – adding compliance costs and uncertainty, and undermining public trust.
- Major tax changes should be proposed at least four months before the annual budget, at the Pre-Budget Report before the Finance Bill that includes them⁹⁶.
- This will avoid poorly thought-through proposals produced with little consultation being rushed through parliament with little scrutiny
- Office of Tax Simplification to examine existing tax code and make proposals for simplification to a new Joint Parliamentary Select Committee on Taxation (JPSCT).

5.22 The OECD suggests that tax compliance costs in the UK are broadly in line with the OECD median, but considerably higher than the US.⁹⁷

5.23 A further concern lies with the current approach to modelling the expected revenue changes. The UK has no mechanism for forecasting the behavioural or total revenue consequences of tax policy decisions. All tax changes are currently considered in isolation solely in terms of their effect on that particular tax. A dynamic tax model would allow the HRMC to forecast the total revenue changes from a particular tax policy decision. While there always will be an element of uncertainty in forecasting, a dynamic model would

⁹⁴ The Snyder report, page 8.

⁹⁵ Lord Howe *et al.*, “Making taxes simpler”, Conservative Party Tax Working Group, July 2008.

⁹⁶ Other commentators have suggested that technical tax changes should be separated from significant changes and dealt with in a less time constrained process.

⁹⁷ OECD, “Tax administration in OECD countries and selected non-OECD countries: Comparative information series”, 2007.

provide greater appreciation of the revenue consequences of proposed changes and therefore a valuable tool in improving outcomes.

V.5 Key sources of tax revenues

5.24 We now provide a brief overview of key sources of tax revenue and the scope for increasing their contribution to Government revenues. The table below summarises our assessment of the six key sources of tax revenue. We discuss each of the taxes in more detail further below.

Table 2: Potential Sources of Further Tax Revenue

Type	Potential for increased revenue
VAT	Some scope to raise additional revenue – particularly from compensated base broadening
Income tax and National Insurance	Little scope to raise rates without damaging competitiveness. Potential scope to broaden tax base
Corporation tax	Little scope to raise additional revenue without damaging competitiveness
User charges	In theory, potential scope but further work required to assess practicality and amount of revenue
Business rates	Scope for additional revenue is likely to be limited
Environmental tax	Scope for additional revenue likely to be limited, apart from possible VAT reforms on domestic fuel and power.

Source: LECG.

VAT

5.25 VAT provided £81bn revenue (around 15% of total tax receipts) in 2007/08 and is forecast to provide £64bn in 2009/10, due to the one-off VAT reduction and effect of the recession.⁹⁸ VAT is an attractive tool for fiscal consolidation with its potentially broad base and stable revenues. Although both VAT and income tax are, in part, effectively taxes on labour⁹⁹, VAT captures a broader range of tax payers. Therefore, an increase in VAT rather than Income Tax would adhere to our suggested principle of broadening the tax base.

⁹⁸ Treasury, “Financial Statement and Budget Report”, 2009.

⁹⁹ As income earners will pay Income Tax directly on income but will pay VAT on taxable purchases when income is spent.

- 5.26 There is considerable scope for increasing revenues from VAT by reducing or removing exemptions and concessional rates. The total estimated cost of VAT exemptions and zero and lower rated goods is estimated to be £45bn per annum – representing more than one third of potential VAT revenues.¹⁰⁰
- 5.27 There is no evidence to support the traditional rationale for concessional rates as an important instrument for protecting low income earners. Most of the benefit of such rates goes to middle and higher income households and other instruments – such as income support and tax credits – are far more efficient and effective in supporting low income households. We discuss below, an IFS proposal for the compensated elimination of zero and reduced VAT rates, which would address this weakness in the VAT tax base while ensuring that low income earners are at least as well off after the change as they were before it. Such reforms would have other benefits as well. There is a strong case for the compensated elimination of reduced VAT rates on domestic fuel and power as an important element of the strategy for achieving Government’s climate change objectives. As noted below, the reform could and should include a compensation package to ensure that poor and elderly households are not made worse off and would yet still yield substantial revenues in addition to its environmental benefits.
- 5.28 Particular properties of VAT also make it suitable, within our stated policy framework, for an increase in the standard rate. VAT is a tax on expenditure and applies to a broad base, indicating stable revenues. The need for a comprehensive fiscal consolidation package makes it possible to combine any rate increase with appropriate compensation for low earners, through income tax or benefit adjustments, to ensure that the net impact is not regressive.

Case Study: Compensated VAT reform

The Mirrlees review quantified the impact of eliminating the current zero/reduced VAT rates for all commodities except for housing and implementing a compensation package, which would compensate the bottom 30% of income earners. The compensation package includes a 15% increase in all income support, tax credits and associated benefits.

Zero rated items currently include food, books, magazines, water services and passenger transport, while reduced rate items include domestic fuel and power, contraceptives and residential renovations.

¹⁰⁰ Ian Crawford, Michael Keen, Stephen Smith, “Value-Added Tax and Excises”, Mirrlees Review, Institute of Fiscal Studies, 2008. page 24.

However, moving directly from zero rated to standard rated could be too immediate. Consideration could be given to the movement to the lower EU rate of 5%.

The Mirrlees review notes:

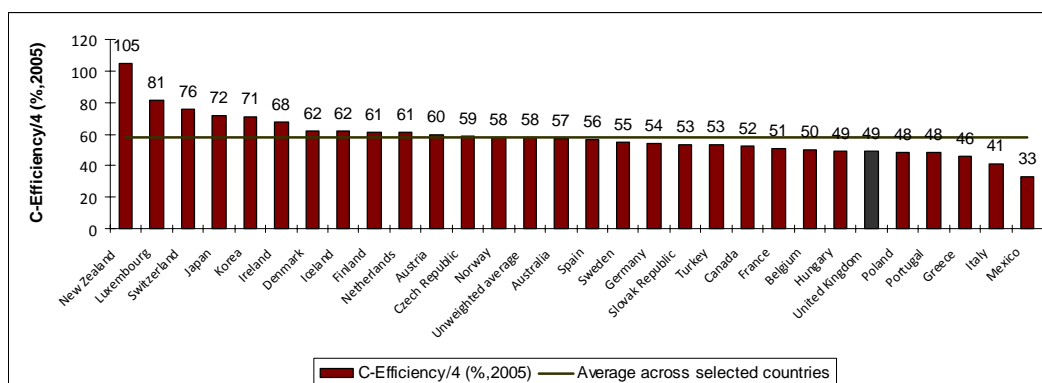
“It has been recognized for more than 20 years that the policy rationale for the zero-rating of food and children’s clothing is extremely weak. Theoretical and empirical developments over the last twenty years, as reviewed above, have only confirmed these doubts. Our own empirical results, discussed above, do not provide any suggestion that differentially low rates on these items—or indeed any others—is warranted, given the availability of fairly flexible earnings-related instruments...”

The impact of the compensation package is to result in increased incomes for people in the lowest three deciles of income.

This reform would produce additional revenues of £11bn per annum, after allowing for the compensation package.

5.29 The case for compensated VAT reform is underscored by the assessment in the Mirrlees Review of the relative efficiency of the UK VAT regime compared to other countries. The authors calculate the ratio of VAT revenues to the product of the standard rate and private consumption, hence VAT levied at a uniform rate on all consumption would have a 100% efficiency level. The UK efficiency level is 49%, reflecting the broad range of zero and concessional ratings; this is one of lowest ratings for the 30 countries in the study.

Figure 13: International comparison of efficiency of VAT regime



Source: The Mirrlees Review, Chapter 4: VAT and Excises, 2008.

Income tax

- 5.30 Income tax is forecast to generate £134bn¹⁰¹ in 2009/2010 of total expected Government receipts in 2009/10 of £496bn. Income tax rates are now relatively high and are applied to a narrow base with major exemptions.¹⁰² For example, the Government calculates that the pension contribution concession costs almost £30bn per annum while the personal allowance policy costs almost £50bn per annum.¹⁰³
- 5.31 Recent research by the IFS suggests that the proposed additional revenue from the increase in the top rate to 50% is highly uncertain and may be less than the Treasury is predicting or even negative. The key question is how responsive taxable income is to increases in top rates (the “elasticity of taxable income”). In response to an increase in the top marginal tax rate, the taxable income of high earners might decrease as a result of efforts to shift income into different forms (e.g. capital instead of labour income¹⁰⁴) or different periods (shifting between tax years) or to leave the UK. If the elasticity is sufficiently high, the revenue response to an increased top rate can even be negative (the Laffer curve effect). The IFS research suggests that this could be the case for the 50% rate, but the estimate of the elasticity is highly imprecise and the authors accept that the Treasury’s lower estimated elasticity is also within the plausible range.
- 5.32 Concerns about further increases in the top marginal tax rate suggested by the IFS findings are reinforced by an international comparison of top income tax rates, discussed below. Although, almost all the UK’s major competitors now have top rates of 40% or higher (once sub-national income taxes are taken into account), the 50% rate puts the UK at the top-end of the range with Japan.
- 5.33 Although there is no hard evidence that increasing the top tax rate to 50% on high income earners will result in significant migration, there is some anecdotal evidence from discussion with tax practitioners, as part of our study, that high earners are sensitive to their personal tax rates and to the tax paid by their businesses when they make location decisions. Where there are advantages for key decision makers and the firm as whole, there will be a greater incentive to relocate. This could lead to additional re-location of corporate activity outside the UK. Anecdotal evidence suggests that increasing individual tax rates may cause a tipping point on a basket of factors and lead to corporate

¹⁰¹ Income Tax net of Tax Credits, Treasury, Budget Report 2009, Table C6.

¹⁰² See IFS Briefing Note BN84, 2009, p.4.

¹⁰³ Treasury, Budget Report 2009, Table A3.1.

¹⁰⁴ The UK capital gains tax rate is 18%.

migrations. There is also some evidence from our discussions with experts that firms and businesses are waiting to see whether there would be policy changes following the forthcoming election.

- 5.34 There is a risk that the perception of a more punitive attitude to high income earners will damage the London and UK brand as a good place to locate for high value knowledge intensive enterprises. This could have considerable long run costs for the economy and also tax revenue. We propose that the effect of the proposed tax increases be kept under review following implementation to identify their impact on economic activity and UK competitiveness.
- 5.35 A preferred alternative to further rate increases would be to remove the personal allowance, as has already been done for high income earners. As elsewhere in the tax system, this sort of base broadening yields increased revenues without the efficiency losses of a higher marginal tax rate. It seems particularly useful in the area of income tax in light of the above considerations suggesting that further increases in the top rate above 50% are undesirable. This conclusion gains some further support from recent research into salience and taxation, which suggests that changes in “headline” rates of tax are significantly more likely to have distortionary effects on behaviour than changes in the tax base.¹⁰⁵
- 5.36 The removal of personal tax allowances would need to be implemented in such a way as to avoid the spikes in marginal tax rates that resulted from the poorly designed removal of tax allowances for high income earners.
- 5.37 It is often assumed that increased tax rates on higher income earners will redistribute income from high to low income earners. However, the impact of the tax change will depend on the incidence of taxation. As discussed in the case study below, it may well be the employer who ultimately bears the tax increase. If so, the effect of the tax increase is to raise costs for businesses and to reduce their international competitiveness.

¹⁰⁵ Raj Chetty, “The simple economics of salience and taxation”, NBER Working Paper 15246, August 2009.

Tax incidence

The incidence of tax addresses the question of who ultimately pays a tax. Tax incidence is said to "fall" upon the group that, at the end of the day, bears the burden of the tax through either higher costs or lower incomes. The key concept is that the tax incidence or tax burden does not depend on where the revenue is collected, but on the elasticity of demand and supply.

This effect can be illustrated with the example of professional footballers. Top level professional footballers are a highly mobile human resource and are able to play in different leagues. An English club competing with a foreign club to sign a player may have to match the post-tax earning offered by the foreign club.

It follows that raising the top rate of Income Tax from 40% to 50% does not affect the net income of that footballer, and more generally, that the effect of the Income Tax increase will largely fall on premier league football clubs rather than on premier league professional footballers. This increased cost affects shareholders in the short run, and in the longer run could affect the competitive position of the English premier league, which is both culturally and economically significant (taxes paid by premierships clubs amounted to £860m in 2007/08).¹⁰⁶

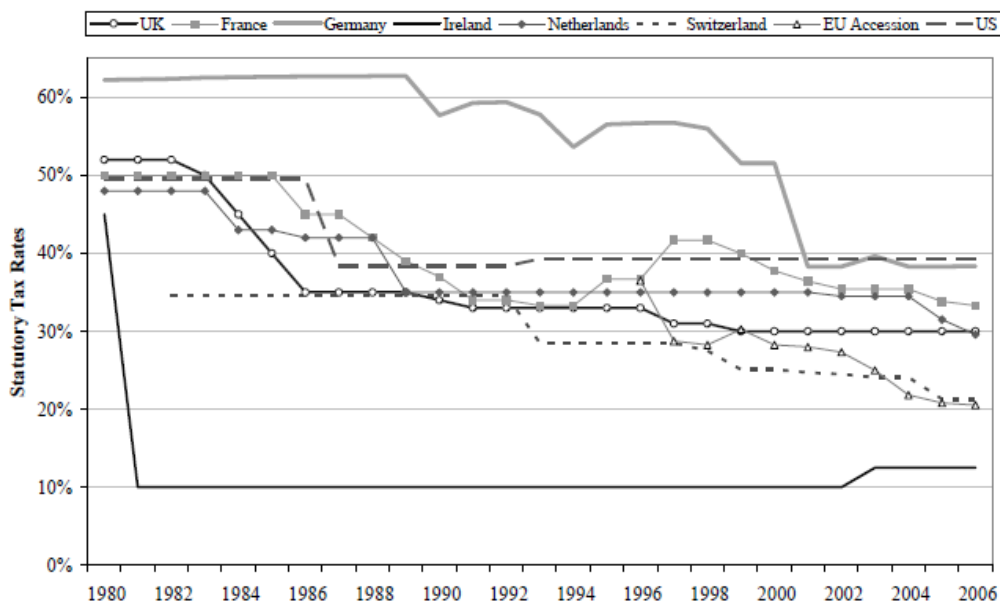
Corporation Tax

5.38 In 2007/08, Corporation Tax provided revenue of £47bn and in 2009/10, it is forecast to provide revenue of £35bn.¹⁰⁷ The trend in both the UK and internationally has been to reduce Corporation Tax rates reflecting the need to maintain international competitiveness so as to continue to attract international investment. The UK's Corporation Tax rate, for example, has moved from the fourth lowest rate to the 21st lowest rate in Europe between 2003 and 2007. The figure below maps the UK's relative historical Corporation Tax rate against a number of international competitors.

¹⁰⁶ Corporation Tax, Income Tax, NICs and VAT. See Deloitte, "Annual Review of Football Finance 2009", June 2009.

¹⁰⁷ Treasury, "Financial Statement and Budget Report", 2009.

Figure 14: Competitiveness of Corporation Tax rates (1980-2006)

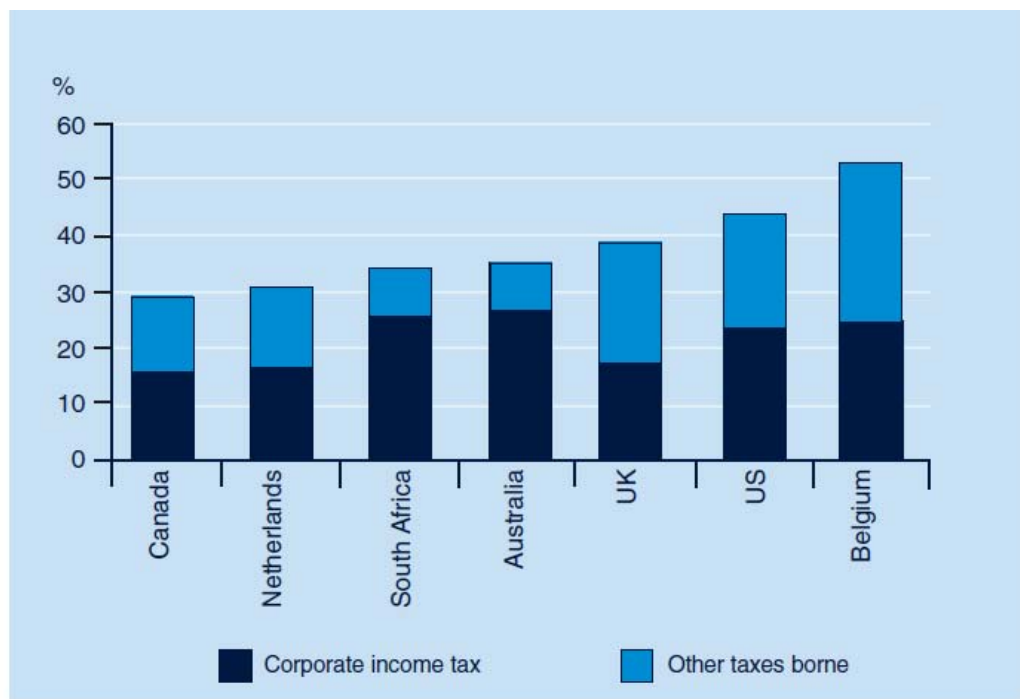


Source: IFS and KPMG 2006

5.39 Corporation Tax is only one of more than 20 taxes that affect businesses.¹⁰⁸ The figure below provides an international comparison of total tax contribution by businesses, disaggregated between corporate and other taxes. This suggests that prior to the yet to be implemented increases, the UK Corporation Tax regime compares reasonably well but that businesses face significant other taxes.

¹⁰⁸ Phillip Broadley and John Whiting, "Business taxes"; Dr Jonathan Leape *et al.*, "Fair Tax: towards a modern system", Smith Institute, 2008.

Figure 15: Total Tax Take Survey



Source: PwC Total Tax Contribution 2008 Survey.

- 5.40 The international tax regime is important to the UK economy. The Government has exempted dividends from foreign companies. This change has a positive impact on London and the UK's competitiveness. However new restrictions on the deductibility of interest, referred to as the "worldwide debt cap", which limits interest deductibility to actual consolidated debt of the group to third parties may raise some concerns.
- 5.41 Changes to the controlled foreign company (CFC) regime are being planned to take effect from 2012/13, although the precise detail is still to be determined. The Treasury is trying to prevent diversion of local profits to foreign companies but there is concern whether it will effectively become a tax on foreign dividends and so encourage companies to leave the UK altogether. This would affect London, as a location for international corporate headquarters. A sensible and certain CFC regime is essential to remaining an attractive location for these activities.
- 5.42 The Government is currently consulting on tax incentives for innovative activity such as royalties for intellectual property¹⁰⁹. Intellectual property, in various forms, plays a central role in the London economy and in future growth. It will be important for any change to consider the importance of intellectual property to future growth and its potential impact on

¹⁰⁹ Treasury, Budget Report 2009, PN01.

the location decisions of international firms. There is evidence that the UK is an unfavourable location for intellectual property activities. The KPMG Tax Competitiveness Survey found that the UK was rated as the least attractive location for intellectual property holding companies relative to other activities such as finance, head office and manufacturing.¹¹⁰

- 5.43 Corporation Tax rates affect investment and business location decisions.¹¹¹ It is therefore important that any further changes to the Corporation Tax system not only consider issues of revenue, but the broader economic consequences such as FDI.
- 5.44 Tax competition does not imply that the UK needs to have lower Corporation Tax rates than its neighbours,¹¹² but it does suggest there is little scope for raising additional revenue from Corporation Tax without damaging broader competitiveness.

User charges

- 5.45 Raising revenue from user charges may offer scope for improvements in both efficiency and fairness. This is because price signals about the cost of service may moderate users' demand for the service. Fairness can be improved for services where individuals capture most or all of the benefits and there is little social reason for subsidy. There are some areas of public service where the Government has determined in principle that user charges are inappropriate such as health care and compulsory education. There are other areas such as roads, where charging has in the past been practically difficult, but due to improvements in technology is now feasible. University tuition is another area where there is considerable private benefit to the user and partial charges have been introduced.
- 5.46 We consider that there is scope for greater cost recovery where there are well-identified beneficiaries of government services. This will lead to an improved fiscal position and economic efficiency. Many large companies indicated they would be willing to pay for services in exchange for control over quality. We discuss the potential role of road pricing in the Section VI.¹¹³

¹¹⁰ KPMG, "UK Tax Competitiveness Survey", October 2008.

¹¹¹ Michael P Devereaux, "The impact of taxation on the location of capital, firms and profit: a survey of empirical evidence", Oxford University Centre for Business Taxation, WP07/02, April 2006.

¹¹² For example, 12% Corporation Tax rate in Ireland.

¹¹³ Dr Jonathan Leape, "User charges – a reassessment", Chapter 7; Dr Jonathan Leape *et al.*, "Fair Tax: towards a modern system", Smith Institute, 2008.

Business rates

- 5.47 In 2007/08, business rates provided £22bn and in 2009/10 are forecast to provide £24bn of revenue. The UK is unusually centralised, with only 5% of tax revenue raised locally. This results from the decision to take business rates from local to central control as part of the poll tax reforms in 1990.¹¹⁴ There are broad but politically contentious suggestions for reform of Local Government financing including return of business rates to local control. Clearly, this would have to be part of a broader reform of Local Government and we do not consider such measures as a short-term possibility.

Environmental tax

- 5.48 There are a range of taxes that could be classified as environmental taxes, such as fuel duty, air passenger duty and landfill tax. Environmental taxes provided £34bn of revenue in 2007/08 and are projected to provide £36bn in 2009/10.¹¹⁵ A key potential environmental tax is the European Union Emission Trading Scheme (EU ETS) for carbon emission permits. Initially, ETS permits were given away to carbon emitters rather than auctioned. Nick Stern and Paul Johnson have estimated that an additional £6bn could be raised by auctioning 50% of ETS permits.¹¹⁶ The EC decision to auction all energy permits from 2013 will capture this revenue.¹¹⁷ There is still a question about carbon charges or taxes for non-energy sectors of the economy. A number of countries are discussing the introduction of carbon taxes. There would appear to be potential to extract both environmental and revenue benefits either from extension of the ETS to non-energy sectors and auctioning permits or adoption of a broad carbon tax.
- 5.49 In terms of other environmental taxes, Fullerton *et al.* note:

¹¹⁴ Stuart Adam, James Browne and Christopher Heady, "Taxation in the UK", IFS, page 29.

¹¹⁵ This is based on the sum of fuel duties, air passenger duty, landfill tax, climate change levy, aggregates duty and vehicle excise levy.

¹¹⁶ Paul Johnson and Nick Stern, "Commentary on Fullerton, Leicester, Smith, Environmental taxes", IFS, 2009.

¹¹⁷ http://ec.europa.eu/environment/climat/emission/auctioning_en.htm

“It is not obvious that environmental taxes have significant revenue-raising potential. Existing large-scale taxes such as excises on fuel are already near the upper limit of what can be justified by the environmental costs involved. Taxes on waste management represent an interesting case for reform but are unlikely to raise much additional revenue. Only perhaps in the case of a widely applied carbon or energy tax might we get large extra revenues. Even then, political pressures to exclude households or energy-intensive industry could limit the revenue potential.”¹¹⁸

5.50 As discussed above, the compensated elimination of the reduced VAT rate on domestic fuel and power has been advocated as a potentially important component in the strategy to reduce carbon emissions. The £3.5 bn that HM Treasury estimates suggest would be raised from such a reform would allow full compensation of poor and elderly households while still raising significant additional revenues – in addition to reducing carbon emissions by strengthening incentives for fuel efficiency.¹¹⁹

5.51 Aside from this change and potential extension of carbon charges or taxes, the scope for significant additional revenue appears to be limited.

V.6 Tax reform package

5.52 There is a case for tax reform to promote the productivity and competitiveness of the UK economy. We believe that the severity of the fiscal situation and the likely economic benefits of the reform offer the potential for “win-win” reform for the Government, which improves revenue but at little cost to efficiency, as the reforms will be designed to remove current distortions and inefficiencies. There is an advantage to addressing the reforms as a package to ensure the efficiency and distributional consequences of the reform are thought through and addressed.

5.53 The broad public recognition that some tax increases will be required in addressing the serious fiscal position provides an opportunity for a tax reform package that raises the necessary revenues while also improving the efficiency of the tax system in the long run. Even if a comprehensive tax reform is deemed to be too demanding of senior Ministers’ time - time that could be focused on expenditure reductions, deregulation and user charges – more modest measures should nevertheless be designed to maximise the long-run efficiency of the tax system.

¹¹⁸ Don Fullerton, Andrew Leicester and Stephen Smith, “Environmental Taxes”, IFS Report for the Mirrlees Commission, March 2008.

¹¹⁹ Revenue estimate from HM Treasury Budget Report 2009, Table A3.1.

5.54 On balance, we consider that in light of the fiscal constraints, a tax reform package that is efficient and revenue positive is both feasible and desirable. The main elements in a pro-growth fiscal consolidation package would be:

- seeking increased revenue from VAT through the compensated reduction or elimination of zero and concessional rates – with full, targeted compensation to ensure that low income earners and pensioners are not worse off – so as to bring the UK policy into line with best international practice;¹²⁰
- reducing or eliminating the major income tax allowances and deductions, such as personal tax allowances. For example, personal allowances for working age people could be replaced by targeted a tax rebate of £1,255;
- planning for justified taxes on adverse externalities (green taxes) along with any additional revenue from user-charges as part of this package; and

5.55 The forgoing is indicative of a pro-growth reform package but is not costed. The IFS¹²¹ along with many other groups¹²² have developed tax reform packages that contribute in differing ways to efficiency and fairness.

V.7 Conclusions

5.56 Addressing the fiscal crisis is likely to require tax as well as expenditure measures. However, in line with many other commentators, we believe that expenditure measures should bear the brunt of the fiscal contraction. Raising taxes risks damaging the strength and speed of the economic recovery and may undermine long term competitiveness. Our review has, however, identified tax reforms which can increase revenue and minimise the adverse effects on efficiency and equity.

5.57 The tax regime is a crucial element in the UK's (and London's) competitiveness. While the UK will never have a low tax regime, its attractiveness may have declined in recent years, due to increasing tax rates compared to major competitors and concerns about the process for introducing changes to the tax regime.

5.58 We believe that further increases in Income Tax rates or increases in the Corporation Tax rate are undesirable and unnecessary. The key elements in a pro-growth tax reform

¹²⁰ Ian Crawford, Michael Keen, Stephen Smith, "Value-Added Tax and Excises", Mirrlees Review, Institute of Fiscal Studies, 2008.

¹²¹ For example, the IFS Green Budget 2009, www.ifs.org.uk.

¹²² For example, the Tax Reform Commission, on "Tax Matters", 2006, and the on-going Mirrlees Review of UK tax policy, <http://www.ifs.org.uk/mirrleesReview>.

package would be to ensure that tax reforms are consistent with base broadening principles (for example removal of VAT exemptions or VAT rate increases would be preferable to increases in marginal tax rates on income). Measures such as the reduction of tax allowances (or their replacement with a tax rebate regime) would also enable a reduction in average rates.

VI. Infrastructure

- 6.1 In this section we consider the role of major infrastructure in supporting economic activity and contributing to the competitiveness of London and the UK. First we discuss the importance of infrastructure for productivity and economic growth and the need for a robust investment evaluation framework. We then outline the current state of London infrastructure and proposed improvements. We conclude by drawing together our findings and discussing the implications for London.
- 6.2 Infrastructure is important as a long run enabler of economic growth. The tight fiscal situation raises the potential for politically rather than economically motivated expenditure cuts. Infrastructure spending has a particularly long time horizon both in terms of the planning approval process, the construction or installation of new facilities or upgrades, and the future stream of benefits derived from the infrastructure over time. It is vulnerable to poorly designed reprioritisation decisions, which underlines the importance of ensuring that reprioritisation is based on thorough cost benefit analysis as discussed in Section IV.
- 6.3 We focus on physical infrastructure such as transport, energy and telecommunications. We recognise that social infrastructure such as education, health and housing are vitally important to the social and economic well-being of London and the UK. Our focus should not be interpreted as reflecting any view on the relative value of investments in physical or social infrastructure: any fiscal reprioritisation between those types of investment should be based on robust analysis following the approach outlined in Section IV, and we have not attempted to second-guess the outcome of such analysis. However, we note that physical infrastructure investments are particularly vulnerable to cutbacks as the political implications of cancelling new projects is often much less visible than reducing spending on existing programmes. Physical infrastructure has been identified as a problem in previous studies of London and the UK's competitiveness¹²³. In some areas, such as transport, London suffers from a legacy of decades of underinvestment.
- 6.4 It was outside the scope of this report to develop our own estimates of the costs and benefits of the various infrastructure projects that we consider. Instead, we sought to identify the extent to which various large scale projects are critical to economic growth based on available data and published cost benefit analyses.¹²⁴ For a limited number of

¹²³ For example, see the Bischoff and Wigley reports.

¹²⁴ Our findings therefore come with an obvious caveat: although we have applied critical judgment,

key new build projects we have also used these analyses to assess the likely costs of delay or cancellation.

6.5 Although the projects we discuss are mainly London-based, the criteria we recommend for analysing these and other infrastructure-based investments are based on the UK national interest, assessed by robust cost-benefit analysis. The evidence we describe below suggests that there are key infrastructure projects in London that should be supported on their objective economic merits, not because London requires any kind of special support.

VI.1 Economics of infrastructure

6.6 The economic literature on infrastructure and economic growth suggests that infrastructure can:¹²⁵

- reduce the cost of production, support agglomeration benefits and raise the productivity of labour by reducing workers' time in non-productive activities;
- enable benefits from network externalities¹²⁶ by connecting countries and regions;
- enhance competition by lowering transport and communication costs; and
- support the operation of the labour market by enabling workers to travel to work.

6.7 Infrastructure is a complement to other economic inputs. There is an optimal level of investment – too much investment will draw resources away from other uses to the point that growth is reduced, while too little investment will constrain the productivity of the economy.¹²⁷ An international review of a range of infrastructures in OECD countries found empirical evidence that investment in road and rail infrastructure in the UK has had a positive effect on economic growth.¹²⁸

6.8 Infrastructure is directly linked to the economic benefits of agglomeration. One study notes that infrastructure:

some of the studies we rely on may nonetheless contain errors or biases in their assessments.

¹²⁵ C. Kessides, "The contributions of infrastructure to economic development – a review of experience and policy implications", World Bank Discussion Paper No. 213, 1993.

¹²⁶ The effect an additional user to a network has on the value of a network such as an additional customer for a telephone network.

¹²⁷ David Canning and Peter Pedroni, "The effect of infrastructure on long run economic growth", November 2004.

¹²⁸ Balazs Egert, Tomas Kozluk and Douglas Sutherland, "Infrastructure and Economic Growth: Empirical Evidence", CESifo working paper No 2700, July 2009.

“Provides the means by which the close spatial proximity of economic activities can lead to increased productivity for all parties.”¹²⁹

- 6.9 This is because, without the provision of adequate infrastructure, the benefits of locating in close proximity to people and businesses will be offset by congestion and the inability to meet basic needs. The quality and reliability of infrastructure is particularly important. Poor quality or unreliable infrastructure may mean that firms are reluctant to invest in productive capital or have to spend more to compensate for the lack of infrastructure (e.g., backup generation to deal with power shortages).¹³⁰
- 6.10 Infrastructure investment is also closely linked to environmental outcomes. A key challenge for the UK is to move to a low carbon energy system in the next few decades. This will require major investment in energy generation and networks. Likewise, increasing use of passenger transport in preference to car journeys will require improved rail services. Road congestion increases emissions from motor vehicles.
- 6.11 Infrastructure is also central to the quality of life of users of the service. Overcrowding of public transport is unpleasant while delays and unreliability of services impact on passengers’ ability to plan journeys and wastes time. Likewise, road congestion increases journey time and reduces the quality of service.¹³¹

VI.2 Infrastructure and London

- 6.12 A number of reports have recently linked elements of London’s infrastructure to its economic growth. The Eddington Transport Study underlined transport’s role as a key enabler of productivity and competitiveness, and emphasised the need for the Government to prioritise investment in growing and congested urban areas, such as London, to avoid constraining the growth of the UK economy. The 2004 Barker Review of Housing Supply noted that transport had a significant role to play in building sustainable communities.
- 6.13 London’s population is increasing, largely due to the high rates of migration, and this growing population is putting strain on London’s transport infrastructure. Transport capacity is fully utilised and businesses now rate transport as the most important spending

¹²⁹ Randall Eberts. and Daniel McMillen, “Agglomeration economies and urban public infrastructure”, Handbook of Regional and Urban Economics, in: P. C. Cheshire & E. S. Mills (ed.), edition 1, volume 3, chapter 38, pages 1455-1495, 1999.

¹³⁰ Ritva Reinikka and Jakob Svensson, “How inadequate provision of public infrastructure and services affects private investment”, World Bank Working Paper 2262.

¹³¹ Sir Rod Eddington, “The Eddington Transport Study”, 2006

priority for the Government.¹³² This could get worse as forecast population expansion, estimated at 1.3 million new inhabitants in the next 20 years, would be hampered by a lack of new transport infrastructure.¹³³

VI.3 Assessment framework

- 6.14 The public provision of infrastructure is dependent on both available funds and the effective evaluation of new projects. There are many potential infrastructure projects that the Government could fund and there are many competing demands. As discussed in Section IV, the Treasury Green Book provides detailed guidance on how to undertake such an evaluation. The DfT has recently published guidance for evaluation in the transport sector, including the valuation of wider economic benefits such as agglomeration.¹³⁴ Clearly, evaluation will be most effective when based on common technical standards for measuring all costs and benefits, especially wider economic benefits. We recommend that the Government takes its spending and investment decisions based on comprehensive evaluation techniques. It is important to evaluate all the options and to assess the economic value of options not selected to ensure that there is a full understanding of the implications of decision not to invest as well as decisions to invest.

VI.4 Overview: key infrastructure issues for London

- 6.15 Significant investment is required, both to increase capacity in order to accommodate increased demand, and to maintain existing infrastructure in order to maintain efficiency. Within London, rail, underground and road infrastructure present the biggest risk, followed by airports. Other infrastructure, such as energy and telecommunications, are in a reasonable state. The table below summarises our assessment of the current state of infrastructure and key risks.

¹³² London First, "Keeping the UK competitive", 2007.

¹³³ GLA, "Economic Evidence Base", October 2009.

¹³⁴ DfT, "NATA Refresh Appraisal for a Sustainable Transport System", May 2009.

Table 3: London infrastructure

Infrastructure	Current state	Barriers to improvement
Telecommunications	High capacity but future investment required due to technological development	Some issues around planning approval for fibre access upgrades between adjacent local council areas
Energy	Sufficient, some concern about future security of supply	Uncertain policy framework for transition to low carbon economy may raise unnecessary uncertainty
Airports	Major capacity constraints. Reliability problems. Substantial upgrades required to meet demand	Planning approval for capacity expansion is difficult reflecting the difficult balance between environmental and economic development objectives
Tube/Crossrail	Major capacity constraints. Reliability problems. Substantial upgrades required to meet demand	Partly dependent on central Government funding
Rail	Capacity and quality of service issues. Some new investment required	Significant dependence on central Government funding
Roads	High levels of congestion. Significant improve in demand/network management required	Given limited investment, improved outcomes depend on better demand management. Maintenance dependent on Government funding

Source: LECC.

6.16 We now discuss the key elements of London’s infrastructure, considering their scale and capacity, and exploring some of the problems each network faces. Finally, we briefly outline important current developments and investment proposals.

VI.5 Telecommunications

6.17 London is well supplied with ICT infrastructure services. A recent study based on a survey of users concluded that London’s ICT infrastructure is “as good as anywhere in the world”.¹³⁵ Network connectivity is felt to be adequate for the next decade, even allowing for a doubling of demand every year.

6.18 A key telecommunications infrastructure development is the roll out of fibre next generation access (NGA) networks. NGA investment involves laying fibre-optic cable to the customer’s premises or some point between the exchange and the customer’s premises. The key benefit of NGA is that enables customers to receive broadband speeds of between 40 to 100Mbps. BT has announced plans to roll out NGA to 10 million

¹³⁵ Sami consulting, “An Assessment of the City’s ICT Infrastructure”, City of London Research, June 2009.

households by 2012.¹³⁶ The key potential constraints on infrastructure roll out are regulatory and planning approval processes. Regulatory issues around wholesale requirements mostly appear to have been addressed by Ofcom acknowledging the need to allow BT flexibility of wholesale pricing.

- 6.19 There is concern that the range of stakeholders in the planning process impedes the acquisition of consent for network roll out. This is particularly the case where infrastructure, such as local exchanges, cross borough boundaries. As a result, the planning process is perceived to complicate and delay the deployment of new infrastructure in London compared with other urban centres in Britain.

VI.6 Energy

- 6.20 Reliable energy supply is essential for a modern economy. The issue of power supply was discussed above as a potential concern by ICT users. The Sami consulting study for the City of London noted that the majority of ICT users were satisfied with the adequacy of current power supplies¹³⁷.
- 6.21 There is, however, general concern about the security of electricity supply in the UK over the next 10 years. The energy sector faces the challenge of moving to low carbon emissions. The Government's low carbon transition strategy proposes that by 2020 around 40% of UK's electricity will come from low carbon sources and by 2050 all electricity will come from renewables, nuclear or fossil fuels where emissions have been captured¹³⁸. This will require an unprecedented switch in sources of generation from fossil fuels to low carbon sources, in particular, renewables over the next 10 to 20 years. The Government is proposing a five-fold increase in renewable generation by 2020.
- 6.22 The Government has adopted a number of policy instruments to encourage the transition. These include participation in the EU ETS, which limits emissions for designated industries up to 2020, subsidies for renewable energy, and subsidies and regulation to promote energy efficiency. Some of these policies (in particular those relating to renewable energy) have been criticised for their high cost and lack of effectiveness.¹³⁹ While a carbon market can provide an efficient means of reducing carbon emissions across an economy, there is concern that the current arrangements suffer from volatile

¹³⁶ Nick Wood, "BT ramps up FTTP plan", Total Telecom, 9 October 2009.

¹³⁷ Sami consulting, "An Assessment of the City's ICT Infrastructure", City of London Research, June 2009.

¹³⁸ DECC, "The UK low carbon transition plan", July 2009.

¹³⁹ Ofgem, Reform of the Renewables' Obligation, January 2007.

prices and significant uncertainty about their long-term future. This is likely to raise uncertainty for long-term investments such as nuclear power or some types of renewable generation.

- 6.23 There are significant concerns about maintaining security of supply during this transition period. These are exacerbated as the North Sea oil and gas supply runs down, and a large part of existing generation capacity has to be retired, nuclear capacity because of age and coal-fired capacity because of environmental legislation relating to other pollution concerns (in particular the Large Combustion Plant Directive).¹⁴⁰
- 6.24 In general, we note that projections of future demand and supply of electricity are always likely to forecast a gap at some point in time – with rising demand and existing supply being retired. There is also no particular reason why a transition to low carbon energy supply needs to raise risks about security of supply. However, the lack of clarity about the future price of carbon and the range of Government interventions which are subject to frequent change may undermine certainty and delay the investment in new capacity. This will tend to push supply closer to demand and increase the risk of substantial power failure. While there is a low probability of such an outcome, the consequences could be significant for the perception of London's attractiveness as a global city.

VI.7 Airports

- 6.25 The main airports serving London are privately owned and are responsible for their own development. BAA's Heathrow, Gatwick and Stansted airports are subject to price control regulation. The Competition Commission has recently required BAA to divest Gatwick and Stansted airports to increase competition.
- 6.26 Heathrow is operating at 99% of capacity¹⁴¹; Gatwick is close to capacity. Stansted, Luton and London City have some capacity, but overall demand in the London market is expected to grow once the recession ends.¹⁴² Total annual passenger volumes in 2006 were 140m passengers, but that is expected to rise to 250m by 2026. Current airport capacity stands at 180m.¹⁴³
- 6.27 Scarce runway capacity is effectively regulated by slot mechanisms. Each airport, the air traffic controller, NATS, and airlines agree on slot capacity with the level currently set

¹⁴⁰ The Economist, "How long till the lights go out?", 6 August 2009.

¹⁴¹ BCC/Buchanan, "Economic impact of hub airports", July 2009.

¹⁴² York Aviation, "Aviation services and the city", July 2008.

¹⁴³ Mayor of London, "Mayor's Transport Strategy - Statement of Intent", May 2009, page 23.

allowing a ten minute delay in aircraft movements. Slot values at Heathrow are high as evidenced by recent purchases by Continental, £32m for a weekly landing and take-off slot pair, which translates into a £200 per passenger value.¹⁴⁴ Effectively, airlines rather than the airport (or NATS) benefit from the creation of extra slots even though the latter create them e.g. by building a new runway.

6.28 Price control helps to protect the consumers' interest in airports. However, they may also deter much needed investment if they are perceived to be too strict. At Heathrow, the price control has resulted in a large gap between slot values and the maximum charges the airport can levy. There is a large gap between the revealed incremental willingness-to-pay by customers for travel to and from Heathrow (i.e. the value) and the incremental cost of new capacity. Price-controlled firms generally can generally only expect to see a normal return on their investment and do not share in any social surplus (and risk). The weak incentives under price controls to develop valuable new capacity may be a contributing factor to the failure to develop new capacity at Heathrow. The Competition Commission has been critical of BAA's passive approach to developing and promoting proposals for new capacity.¹⁴⁵ However, Heathrow and Stansted now have plans for significant capacity expansion.

6.29 The Government supports extra capacity at Stansted.¹⁴⁶ In respect of Heathrow, the Government confirmed policy support for adding a third runway at Heathrow with additional passenger terminal facilities subject to an aggregate limit of 605,000 annual aircraft movements, subject to review in 2020.¹⁴⁷ This is in contrast to the current limit of 480,000 movements. The Government does not support the introduction of mixed mode on the existing runways as an interim measure before a third runway.¹⁴⁸ Mixed mode (operating Heathrow's two runways so that each runway allows both take-off and landing), would effectively boost capacity or increase resilience at a modest cost. The Eddington Transport Study estimates that mixed mode would generate £1.7bn of net benefits.¹⁴⁹

¹⁴⁴ <http://www.e-tid.com/News-Home/Continental-filing-reveals-Heathrow-slot-spend.aspx>.

¹⁴⁵ Competition Commission, "BAA Airports Market Investigation", Final Report, 19 March 2009.

¹⁴⁶ Mayor of London, "London Mayor's Transport Strategy – Statement of Intent", May 2009; The Govt has approved an expansion at Stansted Airport that will facilitate a growth from 25m to 35m passengers annually.

¹⁴⁷ DfT, Britain's Transport Infrastructure - Adding Capacity at Heathrow: Decisions Following Consultation, January 2009.

¹⁴⁸ DfT, Annual Report and Resource Accounts, 2008-09, page 94.

¹⁴⁹ Sir Rod Eddington, "The Eddington Transport Study", 2006, p.6.

6.30 The airport still has to seek planning approval for the proposed development and, if the development proceeds, the airport will only be able to make the capacity available to airlines if it complies with noise standards and air quality in the broader area. We note that while the Government has approved the construction of a third runway, the Conservative Party has stated that it is opposed to it. There is therefore considerable uncertainty as to the future development of the third runway.

6.31 The DfT impact assessment of the third runway identified the total benefits of the expansion as between £19.2bn to £20.2bn and the total costs as between £13.7bn to £14.1bn. The benefits were primarily derived from greater ability to travel, reduction in travel and increased movement of freight. The costs comprised of the construction costs (£7.8bn to £8.1bn) and monetarised environmental costs (£5.7bn - £5.9bn).¹⁵⁰

Issues

6.32 Several issues need to be considered. The lack of resilience and resulting low quality of customer service when problems arise are costly to customers and London. One obvious solution would be for the Government to allow mixed mode immediately provided that declared slot capacity does not increase. This could assist with resilience issues.

6.33 Price control inevitably weakens investment incentives. However, it is important for London to provide the best possible incentives for airports to propose new capacity.¹⁵¹ The competition benefits from the divestment of Stansted and Gatwick may be enhanced if the price control was removed and if new capacity were to become available at Heathrow. Competition law could be used constrain any damaging abuse of dominant positions. The gap between marginal benefits to customers and marginal costs would be reduced promoting much needed investment.

¹⁵⁰ DfT, "Adding capacity at Heathrow Airport – Impact Assessment", January 2009.

¹⁵¹ New capacity would actually only proceed if planning approval was given and environmental standards could be met.

Case Study: The loss of Heathrow as a hub to UK regional airports.

The limited capacity at Heathrow is evidenced by the shift away from serving regional UK airports. Heathrow now only serves six regional UK airports, down from 21 in 1995. In contrast, Amsterdam now serves 19 UK regional airports and Paris serves 14 UK regional airports. Regional connections from Heathrow to Durham-Teeside and Leeds-Bradford have both been lost in the past year. 69% of passengers who used to fly from Durham to Heathrow were connecting onto a long haul service.

The value of the North-East's connectivity with Heathrow has been estimated at £155m per annum¹⁵². Tees Valley has the second largest chemical/petrochemical complex in Europe, with major international companies such as SABIC, BASF, Petroplus, Huntsman, Terra Avecia, Johnson Mathey and world-class engineering and architectural design practices such as AMEX, Whessoe, Aker Kvaerner and Cleveland Bridge.

The link between Durham-Teeside and Heathrow has been identified as critical to economic development by the Tees Valley Joint Strategy Unit. While passengers are able to utilise Amsterdam to provide a link to long haul flights Amsterdam has fewer regular flights to key business destinations than Heathrow.

VI.8 London Underground

- 6.34 The Tube is key element of London transport infrastructure, carrying around 3.5 million passenger journeys a day.¹⁵³ In 2008/09, there were 1,089 million passenger journeys on the Tube, the highest in its 146 year history, with demand having grown by 10% over the last four years.¹⁵⁴ The Tube suffers from decades of underinvestment, overcrowding and unreliable services. As a result, passengers are often subjected to overcrowding, particularly at peak travel time. While some crowding at peak may be efficient, we believe that the high excess journey time per passenger (estimated at 7.46 minutes for 2008/09) almost certainly represents significant inefficiency.¹⁵⁵ Passenger usage of London Underground is expected to increase by 17% by 2017/18¹⁵⁶ and peak usage is expected to increase by 25% by 2026.¹⁵⁷

¹⁵² BCC/Buchanan, "Economic impact of hub airports", July 2009.

¹⁵³ We note the proposed upgrades to London Overground and other London rail infrastructure, but do not discuss further here.

¹⁵⁴ London Underground, "Performance Report to the Rail and Underground Panel", Period 31 March 2009 and Department for Transport, "Transport Statistics for Great Britain," 2008.

¹⁵⁵ TfL, "Business Plan 2009/10 to 2017-18", 2008, Appendix B

¹⁵⁶ TfL, "Business Plan 2009/10 to 2017-18", 2008.

Proposed upgrade

6.35 The modernisation of the London's Underground is one of Transport for London's six main Business Plan priorities.¹⁵⁸ TfL have committed to a nine year upgrade programme, from 2009 to 2018 that will cost £11.4bn in 2002 prices. This will be the biggest investment programme for 70 years. It includes line upgrades, new trains, and new signalling systems. The line upgrades will provide 25% more capacity by 2018 and 30% by 2022.¹⁵⁹

Benefits of Tube upgrade

6.36 One study of the proposed upgrade¹⁶⁰ estimates net present value of the direct benefits to users at £30.5bn and additional wider economic benefits to the UK at £23.5bn in 2002 prices, giving total economic benefits of £54bn compared to an estimated cost of £11.4bn.¹⁶¹

6.37 These wider benefits arise from:

- **a shift to more productive jobs** - as more people find high-value employment in one of the most productive regions in the country;
- **pure agglomeration effects** - an increase in the productivity of all central London jobs as a result of bringing talent, knowledge and expertise into close proximity;
- **increased labour force participation** - as new workers contribute to London's economy; and
- **imperfect competition** - the time savings that are not captured in the prices competing companies may charge for goods and services.

6.38 These benefits are quantified in the table below.

¹⁵⁷ Mayor of London, "London Mayor's Transport Strategy – Statement of Intent", May 2009.

¹⁵⁸ TfL, "Business Plan 2009/10 to 2017-18", 2008.

¹⁵⁹ TfL, "Business Plan 2009/10 to 2017-18", 2008.

¹⁶⁰ London First, "Holding the line: The economic benefits of modernising the Tube", October 2009.

¹⁶¹ All costs, revenues and benefits have been discounted to a common price base (2002), and are calculated over a 60 year project lifetime. Analysis is based on guidance set by the Department for Transport for calculating the wider economic impacts of transport projects.

Table 4: GDP growth arising from the wider economic benefits of Tube upgrade

Wider economic benefits	GDP (£bn)
Shift to more productive jobs	14.5
Pure agglomeration effects	5.9
Increased Labour Force participation	1.5
Imperfect competition	1.6
Total	23.5

Source: London First, Holding the line: The Economic Benefits of Modernising the Tube, 2009.

6.39 The study also found that the incremental revenues generated by the upgrade are greater than the incremental costs.¹⁶² The total cost of the Tube upgrade is £11.4bn, but this includes £5.9bn needed for maintenance, to prevent it from deteriorating further. The net present cost of modernisation, less the cost of routine maintenance, is £5.5bn. With forecast net present value of fare revenues of £8bn, the upgrade more than pays for itself.

Funding

6.40 The Tube upgrade is funded as part of the overall funding of the Tube. This is made up of passenger revenue (“Farebox”), TfL borrowing and use of reserves, and the DfT transport grant. Passenger revenues cover most but not all of total operating expenses, in 2008/09, Tube revenue was £1.9bn and operating expenses £2.4bn, (revenue is 78% of operating expenses). By 2017/18 Tube revenue will be £2.8bn, and operating expenses £3.0bn (revenue will be 93% of operating expenses). The remaining operating spending and capital expenditure are dependent on borrowing (or drawing down reserves) and the DfT grant. The DfT grant was £2.9bn in 2008/09 and rises to £3.8bn by 2017/18. While the DfT grant has been committed to TfL, the Tube upgrade is clearly dependent on maintenance of this commitment.

VI.9 Crossrail

6.41 Crossrail is the major new east-west railway which will connect the City, Canary Wharf, the West End and Heathrow Airport to commuter areas east and west of the capital, increasing London’s rail capacity by 10%. It is intended to provide additional capacity in response to projected population and economic growth and to ease overcrowding and congestion of existing transport services.¹⁶³

¹⁶² Note the financial benefits are not additional to the economic benefits, they are captured in the direct benefits to users.

¹⁶³ GLA Economics, “Proposal to levy a business rate supplement to finance the GLAs contribution to

Benefits

6.42 Crossrail's total economic benefits are estimated to be £36bn, comprising transport benefits and wider economic benefits¹⁶⁴. The wider economic benefits are estimated to be £15bn.¹⁶⁵ Transport benefits consist of:

- public transport journey time savings;
- reduction in crowding and improved journey ambience and quality;
- benefits to mobility impaired passengers;
- highway journey time savings through reduced traffic congestion; and
- highway vehicle operating cost savings and reduction in accidents.

6.43 The wider economic benefits consist of a move to more productive jobs, agglomeration benefits and increased labour force participation.¹⁶⁶

6.44 A study has estimated that each year of delay to Crossrail results in the loss of user benefits of £800m.¹⁶⁷

Funding

6.45 The total cost of Crossrail is £15.9bn. This will be jointly funded by a grant from the Department of Transport of £5.1bn,¹⁶⁸ fare revenue, and contributions from key beneficiaries, such as Canary Wharf (£150m) and BAA (£230m). London businesses will contribute through a variety of other mechanisms, including the Business Rate Supplement (BRS). The City of London Corporation has agreed to make a direct contribution of £200m and in addition it will seek contributions from businesses of £150m, and has guaranteed £50m of these contributions. The £15.9bn budget for the project is a fully inclusive cost, allowing for both contingency and expected inflation.¹⁶⁹ The central Government contribution to the total cost (the £5bn grant from the DfT) is relatively low and extremely modest in relation to the total benefits.

the Crossrail project – initial prospectus”, October 2009.

¹⁶⁴ Greater London Authority, “Crossrail Business Rates Supplement – Q&A”, 2009. <http://www.london.gov.uk/crossrail-brs/>

¹⁶⁵ Crossrail, “Distribution of Crossrail benefits”, 2009.

¹⁶⁶ Crossrail, “An Economic Appraisal of Crossrail: a summary”, 2005.

¹⁶⁷ Volterra, “Crossrail – Costs of Delay”, February 2007.

¹⁶⁸ Mayor of London, “Proposal to levy a business rate supplement to finance the Greater London Authority's contribution to the Crossrail project Initial prospectus”, Summer 2009.

¹⁶⁹ <http://www.crossrail.co.uk/the-railway/why-crossrail/funding-for-crossrail> viewed on 8 October 2009.

VI.10 Rail

6.46 Rail is a key source of transport for commuters and travellers to and from London to other parts of the country and Europe. Over 70% of trips on the national rail network start or finish in London. Rail travel on London's commuter network accounts for around 40% of the total on the national network.¹⁷⁰ Rail travel in London and the south east has increased by 60% since 1994/95, while capacity has increased by only about 25%.¹⁷¹ TfL forecast 650,000 more rail trips per day into and around London by 2025.¹⁷²

6.47 The rail network has struggled to cope with the increasing demand. According to TfL:

*"London's railways are under great stress, with passenger satisfaction lower and crowding substantially worse than other UK regions."*¹⁷³

6.48 Transport for London's Transport 2025 strategy predicts an increase of 40 per cent in demand for rail services in London by 2025.

Proposal

6.49 Network Rail plans £8bn of investment into the UK's rail network by 2013/14, as part of a programme of total expenditure of £29bn.¹⁷⁴ This will provide improvements to capacity on each of London's main radial rail corridors, including the Thameslink programme, and 900 new carriages by 2014. This investment is estimated to have benefits of around £14bn, excluding wider economic benefits¹⁷⁵. There are also proposals to expand the UK high speed rail network to the north of England and Scotland. These proposals have the potential to provide significantly increased capacity and to reduce journey times.¹⁷⁶ They offer significant potential to better connect other parts of Britain with the highly productive London economy.

¹⁷⁰ London First submission to CSR 06/03/07.

¹⁷¹ London First submission to CSR 06/03/07.

¹⁷² London First submission to CSR 06/03/07.

¹⁷³ TfL, "A rail strategy for London's future: statement of case", 2007

¹⁷⁴ Network Rail, "Control Period 4 Delivery Plan", March 2009, pages 30-31 and Office of Rail Regulation, Periodic Review 2008: Determination of Network Rail's outputs and funding for 2009-2014, Oct 2008.,

¹⁷⁵ DfT, "Network Modelling Framework (NMF) and Appraisal for HLOS, The Evidence Pack", January 2008, page.24. This estimate is based on the benefit cost ratio of 1.71.

¹⁷⁶ Greengauge 21, "Fast Forward – a high speed rail strategy for London".

Funding

- 6.50 Network Rail is funded by a mixture of access charges and Government grant of around £3.5bn per annum.¹⁷⁷

VI.11 Roads

- 6.51 Sir Rod Eddington was commissioned by the Government to review transport policy and he reported in 2006. The Eddington Transport Study's core message is that the strategic economic priorities for long-term transport policy should be the growing and congested urban areas and their catchment areas, together with the key inter-urban corridors and the key international gateways that are showing signs of increasing congestion and unreliability. Government should focus on these areas because they are heavily used, of growing economic importance, and showing signs of congestion and unreliability – and these problems are set to get significantly worse.¹⁷⁸
- 6.52 The Eddington Transport Study's first headline recommendation was therefore that, to meet the changing needs of the UK economy, the key strategic economic challenge is to improve the performance of the existing network.
- 6.53 In spite of the dominance of rail and bus transport in and out of London and around inner London, roads are very important in all parts of London. Roads are a key source of transport in London as 60% of weekday journeys in London are made by road.¹⁷⁹ Roads are particularly important in outer London and the surrounding area where passenger transport is less available or effective.¹⁸⁰
- 6.54 The Eddington Transport Study shows that road congestion is disproportionately a London problem.¹⁸¹ Projections in his report show that, without effective national road pricing, congestion will grow substantially with London being the worst affected. TfL estimates the cost to London of congestion to be £2bn p.a., and this is forecast to rise by 32% by 2025.¹⁸² In a survey of leading business and Government executives by London First, the

¹⁷⁷ Network Rail, "CP4 Delivery Plan 2009."

¹⁷⁸ Sir Rod Eddington, "The Eddington Transport Study", 2006, p.1.

¹⁷⁹ London First. "Unblocking London"

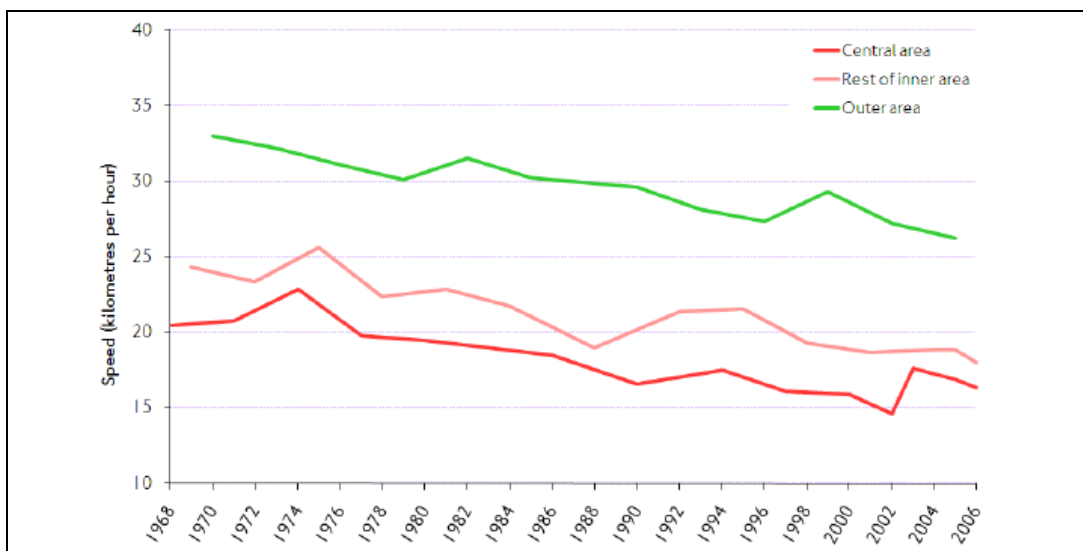
¹⁸⁰ TfL, Travel in London, Report No. 1, 2009.

¹⁸¹ Ibid page 28 Figure 6.

¹⁸² Mayor of London, Mayor's Transport Strategy, Draft, October 2009 and London Assembly Transport Committee. Driving Change – Exploring Solution to Traffic Congestion in London, Seminar Proceedings, March 2008.

removal of bottlenecks to improve traffic was prioritised by 79% of respondents, while 74% also prioritised the improvement of road-works to reduce congestion.

Figure 16: London traffic speeds in weekday morning peak



Source: TfL: Travel in London, Report No.1, 2009.

Improving network performance

6.55 The RAC Foundation Director recently commented that in the short term more can be done to enhance the performance of the road network such as providing motorists with reliable journey times. These include measures such as optimising traffic lights and bus routes and identifying 10 hot spots for improvement each year.¹⁸³

Road pricing

6.56 The London congestion charging scheme, while relatively crude and costly, has reduced congestion.¹⁸⁴ It can be improved by raising the tariff to lean against traffic growth leading to increased congestion. This could be assisted by complementary measures such as best practice traffic management, parking rules and taxes. However, the problems of congestion extend well outside the current area and the current model may not be well suited to addressing those problems over a wide area with varying usage patterns in a cost-effective way.

6.57 The Eddington Transport Study identified that the benefits of a national road pricing scheme are large – total benefits of around £28bn per annum by 2025.¹⁸⁵ These benefits

¹⁸³ London First, “Unblocking London”.

¹⁸⁴ Sir Rod Eddington, “The Eddington Transport Study”, 2006, Figure 3.7, pages 166 and 173.

¹⁸⁵ Sir Rod Eddington, “The Eddington Transport Study”, 2006, page 167.

are derived from a 50% reduction in congestion levels compared to forecast levels. The study does not separately identify the total benefits for London, but, it is clear that London would be a significant beneficiary.¹⁸⁶ By using pricing to manage road usage rather than queuing, better use is made of the road system. This would confer benefits on users in aggregate, and a reduced need to spend money on roads. In addition, better information would be generated on where road funds should be allocated while operating and environmental costs are reduced.

- 6.58 London and the UK would benefit from the introduction of a cost-effective area wide road pricing regime where charges varied by time and location to manage road usage to socially efficient levels. The net proceeds of the regime could be used to reduce crude usage charges such as fuel duties so that net revenue does not increase. It would be possible to contemplate extension of road pricing in the London area, in the absence of a national scheme. However, there are likely to be issues with administration and implementation of the scheme would benefit from a common nationwide standard.

VI.12 Alternatives to central government funding

- 6.59 In Section IV of this document, we discussed the fiscal problem facing the Government. Our discussion above illustrates the importance of proposed transport and other infrastructure investments. One question that may arise is whether there is scope to reduce the central Government contribution but continue the investment programme with greater contributions from other sources. We now consider potential alternative sources of funding for Tube and rail upgrades.

Farebox

- 6.60 Passenger fares could be increased to fund Tube and Crossrail upgrades. However, there is little realistic scope to fund major capital spending from increasing current revenues. For example, capital expenditure on the Tube in 2010/11 is £1.6bn while passenger revenue is £2.0bn, so fare revenues would need to increase by 80% to fund the investment on a “pay as you go” basis. Clearly, it would also make little sense to fund long lived investment from current cash flows. A more sensible proposition may be to raise debt and to repay the debt from increased passenger revenues. However, TfL borrowing levels are constrained by the delegated borrowing limits determined by central Government.

¹⁸⁶ Sir Rod Eddington, “The Eddington Transport Study”, 2006, Figures 3.3 and 3.4, pages 168-169.

6.61 London Tube fares are regarded as high in relation to other countries. However, there is still likely to be scope to raise further revenue from fare increases, as demand for Tube services is likely to be relatively inelastic. The Tube currently has a programme of small real increases in Tube fares.¹⁸⁷ This has scope to be increased, although this may have social consequences as the Tube is an important means of connection to employment opportunities and social facilities for low income earners. The most likely scope for raising revenue would be to withdraw free or concessionary passes, particularly those available for use in peak travel time.

Borrowing

6.62 The incremental cost of the proposed Tube upgrades could be met from the increased revenues from the upgrades. In theory, this could be financed by additional borrowing. There are two caveats.¹⁸⁸ The current level of revenue and spending from the modernisation will be reflected in the TfL business and so additional borrowing to fund the Tube upgrade may impact on spending elsewhere. Secondly, a major increase in borrowing capacity for TfL raises governance issues. The borrowing limits are in place to reflect the potential risk to central Government arising from TfL debt. Increasing the borrowing limits would need to be linked to a review of the governance structure of TfL to ensure the appropriate level of transparency and accountability.

Other sources

6.63 Other sources of potential funding could be used to raise additional revenue from London's Local Government or beneficiaries. The Crossrail funding arrangement already includes funding from beneficiaries and from a new precept by the GLA on property.¹⁸⁹ It does not seem obvious that substantial additional revenue could be raised from these sources.

Funding conclusion

6.64 There are potential alternative sources of funding to the Government contribution. Ultimately, these are likely to depend on increasing fares beyond current planned increases. There is scope for additional TfL borrowing, but this issue cannot be considered in isolation from governance arrangements.

¹⁸⁷ <http://news.bbc.co.uk/1/hi/england/london/7807056.stm>.

¹⁸⁸ Note this is an in-principle assessment, in practice; detailed analysis of the business plan would need to be undertaken before debt funding could be considered.

¹⁸⁹ GLA Economics, "Proposal to levy a business rate supplement to finance the GLAs contribution to the Crossrail project – initial prospectus", October 2009.

Problems with PFI

- 6.65 The Private Finance Initiative (PFI) has been a popular source of private funding for Government infrastructure - there have been over 900 PFI projects since 2000, with a total value of over £70bn.¹⁹⁰ However, there is concern that following the credit crisis, PFI finance may be more difficult to find. Two of the largest public sector infrastructure banks, Depfra and Dexia have largely withdrawn from the market. Other previous suppliers of finance such as monoline insurers have also exited the market.¹⁹¹ The Government has recognised the issue and has established the Treasury Infrastructure Financing Unit (TIFU) to fill the gap in the market. TIFU will lend to PFI projects that cannot raise sufficient debt finance on acceptable terms. It will lend alongside commercial lenders to provide the full amount of senior debt required by a project (if needed). The TIFU lending is intended to be a temporary intervention.¹⁹²
- 6.66 It is not clear to what extent the difficulty of funding PFIs is temporary and will be remedied when credit markets return to normal, but there are concerns that such funding may not recover completely.¹⁹³ If this is to be the case, then it will increase pressure on Government to find new sources of private funding or increase state funding. The latter would be challenging in a time of fiscal constraint.
- 6.67 One potential solution would be to extend the Regulatory Asset Base (RAB) model used for energy, water and rail networks to other infrastructure assets. The RAB is an amount which represents the past investments, including what investors paid when the assets were privatised plus the completed efficient capital expenditure since then adjusted for depreciation. Dieter Helm suggests that the concept could be more widely applied.¹⁹⁴ He argues that the RAB model enables low cost private (debt) financing of infrastructure, as risk has been transferred to customers (or to taxpayers in the cases of infrastructure that is subsidised by the Government). However, this solution seems to be of less value to financing the Tube as it is not finance that is the issue but acquiring the necessary revenue streams to repay debt. TfL could increase borrowing (if allowed) to fund the modernisation. The modernisation will remain dependent on DfT grants and therefore

¹⁹⁰ <http://www.partnershipsuk.org.uk/PUK-Projects-Database.aspx>.

¹⁹¹ Dieter Helm, James Wardlaw and Ben Caldecott, "Delivering a 21st Century Infrastructure for Britain", Policy Exchange, 2009.

¹⁹² http://www.hm-treasury.gov.uk/ppp_tifu_index.htm

¹⁹³ Dieter Helm, James Wardlaw and Ben Caldecott, "Delivering a 21st Century Infrastructure for Britain", Policy Exchange, 2009.

¹⁹⁴ Dieter Helm, James Wardlaw and Ben Caldecott, "Delivering a 21st Century Infrastructure for Britain", Policy Exchange, 2009.

alternative debt funding mechanisms do not appear to provide a real solution. Privatisation may have other attractive benefits in terms of bringing specialised managerial expertise, although at least some of these benefits should be captured by PFI arrangements.

VI.13 Implications and conclusions

- 6.68 The state of London's infrastructure is mixed and major investment is required to upgrade the Tube and rail to meet current and future demands. Major investments will also be required to expand airport capacity. Improvements in congestion require short-term action to optimise use of the network and longer-term action to extend road pricing.
- 6.69 Inadequate or poor quality infrastructure can impede economic growth. It is important that the fiscal and regulatory framework supports sound long-term decision making in respect of the future of London's infrastructure. This is particularly true in the current environment with pressure on the Government's finance and the need to promote sustainable growth in response to the credit crisis.
- 6.70 Given the crucial role of Government in funding rail and road infrastructure, it is vital that a comprehensive evaluation of benefits and costs are undertaken. Recent advances in evaluation methodology allow for quantification of a broader range of benefits and costs. These techniques should be employed to ensure that fiscal prioritisation is maximising economic benefits.
- 6.71 The table below summarises selected major infrastructure projects which are partly dependent on Government financing or regulatory approval.

Table 5: Major infrastructure projects

Project	Benefits	Costs	Timing
Tube modernisation	£54bn	£11.4bn ¹⁹⁵	2022.
Crossrail	£36bn	£15.9bn (£5.1bn by central Government grant and £10.8bn from other sources)	2017
Rail (national capacity improvements)	£14bn ¹⁹⁶	£8bn	2014
Heathrow third runway	£20bn	£8-14bn ¹⁹⁷ (funded by private sector)	2020
Total	£124bn	£43.3 - £49.3bn	

Source: London First, Holding the line: The Economic Benefits of Modernising the Tube, 2009. Mayor of London, "Proposal to levy a business rate supplement to finance the Greater London Authority's contribution to the Crossrail project Initial prospectus", Summer 2009., Network Rail, "Control Period 4 Delivery Plan", March 2009. DfT, "Network Modelling Framework (NMF) and Appraisal for HLOS, The Evidence Pack", January 2008, DfT, Britain's Transport Infrastructure - Adding Capacity at Heathrow: Decisions Following Consultation, January 2009.

6.72 The net benefits of Crossrail and the Tube upgrades collectively amount to over £60bn. Delays to these projects will lead to significant losses. As noted above, one study has suggested the loss of user benefits of delaying Crossrail could be £800m per annum.¹⁹⁸ Delays to the Tube upgrade are likely to be at least as significant and will be experienced sooner, as the benefits as the upgrades are completed. This suggests that the loss of benefits could amount to the order of £1.6bn per annum from 2017/18. The better management of congestion could avoid some of the economic cost associated with road congestion. Even, if we assume that road pricing is only successful in reducing 50% of the projected increase in congestion, this would amount to £200m per annum by 2025. A study of the expansion of Heathrow airport suggests that delayed investment in the third runway will result in lost productivity benefits of about £600m per annum and lost total benefits of £900m to £1.1bn per annum.¹⁹⁹

6.73 Clearly, there is significant uncertainty in estimating benefits of major infrastructure investment and adding these benefits together is fraught with risk. The relationships between the projects are not clear and the method of estimation varies. A crude addition

¹⁹⁵ Benefits and costs of tube modernisation in 2002 pounds.

¹⁹⁶ The benefit estimate for the national rail improvement does not include wider economic benefits.

¹⁹⁷ The higher cost estimate includes monetarised environmental costs.

¹⁹⁸ Volterra, "Crossrail – Costs of Delay", February 2007.

¹⁹⁹ BCC/Buchanan, "Economic impact of hub airports", July 2009.

of project benefits with an assumption of the potential for road pricing to yield £200m of benefits by 2017 would yield a benefit of £2.7bn.

- 6.74 In order to sense check these estimates, we have considered the magnitude of the benefits as compared to London GVA. Based on projected GVA by 2018, a 1% reduction in GVA (i.e. London's growth is 1% lower than forecast) would amount to an economic loss of £2.9bn per annum. In light of the economic evidence about the role of infrastructure in facilitating economic growth, this estimate is plausible; although we note that some of these economic losses will be experienced outside London.
- 6.75 These estimates should be considered as illustrative of the order of magnitude of the potential economic losses arising from the failure to invest in infrastructure. Government decisions to invest public funds in infrastructure projects should take account of the costs and the benefits of alternative spending options as well as alternative funding options. Nonetheless, as the OECD has observed, it will be important for the Government to take account of the long-term implications of its decision and not to cut investment in favour of less valuable but politically sensitive programmes.

Appendix

- 7.1 Our review of key documents and statistics was supplemented by targeted interviews with key stakeholders and regular reviews and presentations to the project's steering group made up of London First and City of London representatives.²⁰⁰

Interviews

- 7.2 We would like to thank the following interview participants who have contributed to our understanding on the issues.

Interviewees	Organisation	Area of Interest
Jeremy Fern/Joe Weiss	City of London	Transport and economics of cities
Thomas Hoehn/Yael Selfin	PwC	Economics of cities
John Preston/Neville Howlett	PwC	Taxation
John Tattersail	PwC	Financial regulation
Tim Hockey	London First	Transport
Charles Haswell	HSBC	Financial regulation
Gareth Powell, Shashi Verma and Tom Burton Page	Transport for London	Transport

Steering Group

- 7.3 We would also like to thank the Steering Group members listed below.

²⁰⁰ Stakeholders interviewed included representatives for Transport for London, City of London, as well as experts from PricewaterhouseCoopers.

Figure 17: Members of the Steering Group

Ian Powell	PwC (Co-Chair)
Andrew Ratcliffe	PwC
Stuart Fraser	City of London (Co-Chair)
Saxon Brettell	City of London
Chris Grigg	British Land
Adrian Penfold	British Land
Colin Matthews	BAA
Tom Kelly	BAA
Emma Gilthorpe	BAA
Duncan Ingram	BT
Stuart Popham	Clifford Chance
David Harkness	Clifford Chance
Peter Kenyon	Chelsea Football Club
Chris Alexander	Chelsea Football Club
Nick Ward	Clear Channel
Charles Haswell	HSBC
Antonio Simoes	HSBC
Roger Bright	Crown Estate
David Shaw	Crown Estate
Jonathan Moulds	Bank of America
Robert Everett	Bank of America
Fiona Church	Bank of America

Source: London First.

- 7.4 Finally, we would like to acknowledge the support and assistance from Steering Group liaison panel: John Dickie (London First), Saxon Brettell, (City of London) and Andrew Ratcliffe (PwC).

Authors

- 7.5 LECG's case team was led by Dr Boaz Moselle and managed by David Black, with support from Jack Wills and other economists.
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- Jack Wills is a research assistant at LECG. Jack graduated from Oxford University with a bachelor's degree in Philosophy, Politics and Economics, having specialised in Economics and is currently training for the Chartered Financial Analyst (CFA) qualification. Jack has worked in a number of practice areas including financial services, energy, carbon and climate change, and litigation consulting.

7.6 The work and analysis of LECG's case team was reviewed and discussed with an expert panel made up of LECG experts and academics including:

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7.7 Our approach has focused on the UK-wide case for investment in productive and sustainable infrastructure in London, and on the UK tax policy required to encourage sustainable long run economic growth. It has also required an assessment of the public spending priorities driving economic growth, and an exploration of options available to develop the role of private investment in the public domain, either directly or in the form of partnerships. By making trade-offs explicit, our framework provides a high level exploration of the required steps to return the UK to a healthy level of growth in the medium and long term.

Glossary

Term	Definition
BVCA	British Private Equity and Venture Capital Association
BRE	Better Regulation Executive
CBA	Cost Benefit Analysis
CFC	Controlled Foreign Company
CSR	Comprehensive Spending Review
DfT	The Department for Transport
EC	European Commission
ETS	Emissions Trading Scheme
FDI	Foreign Direct Investment
FSA	Financial Services Authority
GDP	Gross Domestic Product
GLA	Greater London Authority
GNP	Gross National Product
GVA	Gross Value Added
HMRC	Her Majesty's Revenue and Customs
HMT	Her Majesty's Treasury or Treasury
ICT	Information and Communication Technology
IFS	The Institute for Fiscal Studies
IPO	Initial Public Offering
IMF	International Monetary Fund
NAO	National Audit Office
NGA	Next Generation Access
NIC	National Insurance Contributions
OECD	Organisation of Economic Co-operation and Development
ONS	Office of National Statistics
PESA	Public Expenditure Statistical Analysis
PFI	Private Finance Initiative
PwC	PricewaterhouseCoopers
RIA	Regulatory Impact Assessments
SME	Small and medium sized enterprises
TfL	Transport for London
VAT	Value Added Tax

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