

improving competitiveness

The Smith Institute

The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

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improving competitiveness

2004

A series of three seminars held between
December 2003 and March 2004

Edited by Ben Shimshon

BAA 

British Gas 

 **EDS**


**THE SMITH
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December 2003 and March 2004

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Preface

Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank, which has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years, the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

The series of seminars which are transcribed in this monograph were held between December 2003 and March 2004. The initial idea for the series grew out of our earlier work with Dr Irwin Stelzer on productivity and competition policy. The structure of the series was informed by the issues that the Chancellor raised in his speech to the Social Market Foundation of February 2003, and by the challenge posed by Professor Michael Porter's DTI report *UK Competitiveness: Moving to the next stage* in which the authors called for a 'new conception of competitiveness'.

Over the course of the series we attempted to address questions such as how to develop competition further within the natural monopolies, and the problem of monopolies within the network industries; the future role and function of industry specific regulators, particularly in relation to balancing the manifold social and environmental impacts of the energy sector. The final seminar offered a wider view of Britain's competitiveness, focusing on Professor Porter's analysis of the underlying reasons for the persistence of the productivity gap with our main competitor countries. Each seminar saw these themes drawn out through presentations by, and discussions between, politicians, business people, commentators, academics and public servants from across the political spectrum.

Due to unforeseen circumstances, the 'first' seminar in fact took place after the 'second'. The seminars are reproduced here in the order that the series was originally intended to follow hence the stated dates of the seminars do not appear in chronological order. Inevitably, in transforming live events into print, some of the colour and texture of the original has been lost. We hope, however, that those who attended the seminars will recognize much of what is included, and that those who read it fresh will respond to the flow of good ideas which emerged during the series.

As always, we are very grateful to Dr Irwin Stelzer for his guidance, enthusiasm and expertise in bringing this series together and in chairing two of the events. The Smith Institute gratefully acknowledges the support of BAA, Centrica/British Gas and EDS towards this publication and the associated seminar series.

Seminar 1

Monopolies, competition and efficiency

A seminar held on Tuesday 20 January 2004

Monopolies, competition and efficiency

Welcome

Wilf Stevenson, Director, Smith Institute

Good morning, ladies and gentlemen, thank you very much for coming. Over the last three years we have been working with Irwin Stelzer, who has kept us in line with where the cutting edge of this debate is. We are very pleased to welcome him back, and he is going to chair this event for you. We have also been working with the DTI, Centrica, BAA and EDS, all of whom contributed, and we are also very grateful to them.

Introduction

Dr Irwin M Stelzer, Senior Fellow and Director of Economic Studies, the Hudson Institute

Many of you will recall that about a year ago the Chancellor gave a speech at the Social Market Foundation: this new series on competitiveness follows on from that speech. It has been a consistent theme of earlier Smith Institute seminars that many economists – myself included, I guess – often disagree with the government, with the ministers and bureaucrats who tend to see scope for subjecting an industry to their tender care. We have argued not only about how much market failure justifies the risk of government failure, but about questions of the effect of the continued and multiple adjustments to the regulatory regime on the ability of small businesses to survive – businesses, by the way, that need certainty in order to raise capital and do not have large human resources and regulatory staff to cope with the latest idea that comes out of the Treasury. We've also had discussions of the dangers of "regulatory creep", a disease that seems to afflict regulators whose self-image is proportionate to the size of their staff.

The good news is that these seminars are unique in that they actually result in things happening. I think it is fair to say that because of the earlier seminars we got a better, more vigorous competition policy. Today we are addressing the more important issues raised by the Chancellor in his SMF speech. In that talk, Gordon Brown said that when privatisation took place, there was often a failure to put in place the conditions for effective markets. Well, he would say that. Instead, utilities were privatised rather than liberalised, and the old monopolies returned, but this time in the private sector. Now, we are assuming that few argue that the level of consumer service has improved under

privatisation, but few too would argue with the Chancellor's statement that our clear and robust defence of markets must be combined with a clear and robust recognition of their limits. We would differ where those limits are, but certainly that is true.

Today, we are fortunate in that we do not have the dedicated ideologues on both sides of this argument; that is those on the right, who would prefer highly imperfect markets to any form of regulation, and those on the left who would prefer government control or government ownership to even well-functioning markets, because they do not like the distributional consequences. So, we are very fortunate in our speakers, and particularly fortunate, I think, that John Kay is here. I looked up his references to me in his book, and I was first delighted to see that he said that I am a man who occupies the role of ambassador to London for the American business model. I thought that is rather nice. Then I read that support for the American business model reflects self-regarding materialism, so I wasn't quite so happy.

Presentation

Professor John Kay, Economist and commentator

After 20 years of privatisation in the United Kingdom, it is time to look back on the history of the process. One of the peculiar things about privatisation is that reports of its success relate very largely to the fact that it happened, rather than to the consequences of it happening. It is now the time to study those consequences.

One point stands out immediately. Almost none of the privatised companies have performed well as independent, private sector companies. The companies that seemed in the early years after privatisation to be conspicuous successes of the process – companies like British Airways, British Steel, British Telecom and Cable & Wireless – did not prove so successful in the long-run, and the diversification record of privatised companies is so poor that it would be humorous were it not such a tragedy. The lesson is that if you are going to set up a new private sector company, a government agency is not a very good place to start.

Hybrid Activities: Privatisation without Government Disengagement

But I am going to focus on a different issue – public policy towards the industrial sectors and businesses that were privatised. Governments undertaking privatisation believed they were achieving disengagement. This has not been quite the reality. There is a part of the privatisation agenda that is today finished, and a part that is not. All of the companies I mentioned above, like British Airways, British Steel, British Telecom and Cable & Wireless, were privatised into what were or became competitive markets. Most companies in this category have already disappeared in the form in which they were initially structured, or ultimately will so disappear. They will be absorbed into other parts of a competitive private sector. These four examples, all recently struggling, will – we must hope – revitalise themselves. But the former public firms in these competitive markets pose few public policy issues today.

Public policy issues remain topical for businesses which are still not, and will not be, part of ordinary competitive markets. Either because they involve natural monopolies, or because, like rail (which is also in large part a natural monopoly), they perform activities which either could not be, or are not desired to be, undertaken by competitive commercial companies.

The serious agenda today, at the beginning of the 21st century, is how to deal with hybrid

activities: those which are neither appropriate nor possible for competitive private markets, but are not well conducted by government agencies with a political chief executive. What needs to be considered – and this ought to have been the agenda a much longer time ago – is how to learn lessons from the private sector about the control and management of these kinds of enterprises.

This is not an agenda of mimicking corporate organisation: it is depressing when public sector reform consists of reproducing formal structures, the job titles and strategic plans, of private sector businesses, or worse, replicate the visions and slogans which are characteristic of the private sector at its most superficial. This is also a very different agenda from that which divides the world into private and public sector activities, and calls for detailed definition of the boundary between the two, either by contract or by regulation. What should be focused on now are customer corporations, also called public interest companies: hybrid entities that have a wide range of complex public obligations, even though they are engaged in the delivery of goods and services in much the same way as ordinary private sector businesses.

To clarify the notion of hybrids and their activities, the following is a non-exhaustive list of the activities which have that character: railways, airports, universities, London underground, BNFL, hospitals, electricity and gas transmission systems, the BBC, commercial waste disposal, the Royal Mail, schools, air traffic controls, museums and galleries, water supply, Channel Four.

It is a long list, and one that encompasses a wide variety of organisations, and a wide variety of organisational structures. Indeed, in the water industry alone, there are today three different models for these companies. This is not a bad thing from the viewpoint of pluralism and experiment: there are potential rewards in conducting a variety of different experiments. But what is strikingly missing at the moment is the capacity to read across from one sector to another. Policy is derived for each of these areas in separate boxes, as if none of these other boxes exist. We hear sustained criticism of the rail model, although the truth is that the rail model is not very different from the airport model. Most people seem to think that the airport model works rather well. Is the difference the industry, the detail of the model, or the people? Who is asking that question?

The issues that need to be tackled in structuring hybrid institutions are of two closely related kinds. First, they are concerned with the governance structure: who makes operational decisions about prices and investment, who hires and fires the management,

and to whom is management accountable. Next, the capital structure must be defined. In any activity that delivers goods and services for which cost, quality and demand is unpredictable, there are risks and uncertainties. The question of capital structure is not just a narrow question of the kind with which investment banks engage. It is a broader question of how the consequences of inescapable uncertainties are shared between the customers of the service, the people who are supplying capital, and the tax-payers who ultimately underwrite the provision of public services.

The bizarre thing about the hybrids is that despite, in some cases, the enormously detailed contractualisation or regulation which exists in relation to these activities, and despite the millions that have been spent on legal and other advisors, the answers to these questions are rarely clear. If there is a formal allocation of risk sharing, it is likely to be overridden in the event of major – or commonly quite minor – deviations from expectations. And who really does hold ultimate management responsibility? If one raises a question of that kind in Britain, the answer one tends to get is: "Well, this demand for clarity is very unpragmatic and very un-British, it will all be all right on the night". But it is not all right on the night, or not often. There are major problems today in railways, in universities, in air traffic control, in BNFL, and in Royal Mail. All of these problems are to some degree associated with failures of definition in governance structure and capital structure.

These questions have to be answered. In large part, the crisis in these areas is the product of vagueness itself. That vagueness is the result of a very British way of dealing with these problems, in which government departments, in particular the Treasury, will neither give up control of activities, nor take responsibility for the consequences of their intervention.

This was also the fundamental reason why nationalisation worked so badly in the UK. In Britain's nationalised industries, the government would neither take responsibility for these activities, nor effectively delegate that responsibility to other people. That is what created the abrasive relationships between people who were operational managers and the people who were politically accountable. Today, that is just as true in the areas which are the potential subject of public service reform as it was true of the nationalised industries before privatisation.

We need to face up to these problems and deal with them, and do so by finding correct structures for hybrid institutions rather than believing it is possible to escape the necessity of hybrid institutions with sufficiently detailed rules and sufficiently elaborated contracts. That is a real shift in position from where Britain has been over the last 20 years.

But it is a necessary shift in the discussion if we are both to deal with the unfinished agenda of the privatisation process, and take the lessons of that, both positive and negative, forward in the reform of our public services more generally.

Presentation

Ian Hargreaves, Group Director of Corporate and Public Affairs, BAA

Can I just say at the beginning that although these days I am closely associated with two organisations – one a regulator, Ofcom, the other a heavily regulated hybrid organisation, BAA – I am not speaking for either of these organisations in this discussion this morning. I got up on Saturday morning and picked up my *Financial Times* and read an excellent magazine article by John Kay about obliquity. Its theme was that it is often better to go by an indirect route than the direct route. I thought that provided an interesting, contrasting thought to what John said to us this morning, namely, that we need greater clarity. As I set off, having read my copy of the FT, to an unfamiliar destination in the central Cotswolds, I became increasingly convinced of the virtue not only of direct routes versus indirect routes, but also of having real-time information about the latest speed camera formats on that route. It reminded me, as I shall argue is the case with regulation, that what we have today is a growth in the number of variables, and therefore the complexity with which regulation is trying to deal.

I believe we have come an unfathomable distance from the point when Stephen Littlechild said in 1983, in a report to the DTI, that "regulation exists only to hold the fort until competition arrives". In practice, regulation has turned out to be less like the Alamo and more like the 30-Years War. Or, to use a less violent figure of speech, regulation is more gardening than civil engineering; it involves occasional re-landscaping, constant vigilance, an unavoidable amount of tinkering, but a gardener also knows when to leave well alone. I agree with John that we do need much greater clarity about the goals and range of regulation, but not because regulation is in crisis. I do not think there is any evidence of that, and if it were the case that the subjects of regulation were in the crisis that John summarises, then it would not be possible to claim even moderate success for the process of regulation itself.

The reason that we need to think more deeply about regulation is precisely because it has been relatively successful in Britain, and because it is undoubtedly becoming more pervasive in, I think John correctly describes, a hybrid world, where we are seeking values that we associate with the market on the one hand, but also the values we associate with democratic politics on the other.

Regulation

There are three main reasons, I think, why it is fundamentally improbable that we will

get less regulation. First, because we haven't reached the limits of privatisation and the extension of the role of, markets, in health, in universities, in pensions. Secondly, we have not reached the limits of what consumers and citizens expect from markets. The demands of the citizen or consumer will continue to get higher in terms not only of economic performance, but in terms of the management of risk, public expectation about corporate responsibility in business, the sustainability agenda, and in terms of transparency. All these areas which involve debate and negotiation between competing interests, and which are the natural domain of politics, are now deemed too complex for direct government intervention. If government can trust an unelected committee to set interest rates, it is difficult to imagine an area of life that government would, in principle, not think some kind of agency arrangement made sense. The key, of course, is well-designed and skilful regulation. As a trade union voice said at a previous seminar, to have the kind of referee who knows how to play the advantage rule in football.

The third reason I think that regulation is not going to recede is that in accepting cases of conspicuous and exceptional policy failure – the UK rail industry may be an example of this – governments really show very little appetite for re-appropriating regulatory power. Rather, the trend is towards more independence for regulators, who are themselves increasingly attracted to ideas around co-regulation and the regulation of self-regulation. One possible consequence of this greater distance between the state and the regulator is that the courts will come to play an increasingly important role. The emergent role of the Competition Appeals Tribunal is an important case in point, and one which, in my view, entails some dangers in moving Britain towards a litigious model in regulation which is suitable for a country with a weak central state, like the USA, and not suitable for a country like Britain, which has got a relatively strong central state. So, when the Chancellor asked in his *Social Market Foundation* speech, which Irwin referred to, how the public interest should be defined and promoted through the interplay between markets and the state, he was indeed asking the right question. One can see that regulation is increasingly a component of what is involved in supporting and defining the public interest. As my colleague from Demos, Paul Skidmore, recognised in a recent pamphlet on regulation, regulation has become much more than a technical practice; it is a mode of governance, and it is interesting that John used the word "governance" on a number of occasions.

How does this square with the widespread demand for lighter-touch regulation? It is not necessarily incompatible in areas of life where the evidence shows that unregulated markets, or markets subject only to the most straightforward forms of competition-based regulation, will deliver the greatest range of benefits. In those circumstances, regulators

should certainly stand back and let competition policy deal with the abuse of market power. The idea that regulation is only about this is simply naïve. Regulation of monopolies and the corporate abuse of market power is a basic necessity, but it sits today along so many other types of business regulation – of environmental and health standards, of the way that firms treat their employees, the extent to which their behaviour meets legitimate public expectations in terms of honesty and plain dealing.

To take just one example – the creation of a university access regulator. To the economic purist, this is a horror show because it confuses economic and social regulation and purpose. But I am not sure that these distinctions can be made in such a hard and fast manner. Just as we should expect a body like the Food Standards Agency to have close regard to the economic implications of its activities, so we already expect some regulators, whose fundamental purpose is economic, to have regard, for example, to environmental issues – the water regulator being a case in point. What this underlines is that John's plea for a more systematic and less pragmatic approach to regulation is a very ambitious proposal indeed. Regulation has grown up to suit the political circumstances of the time, and the statutory basis for different regulators differs hugely. In aviation, for example, the four objectives of the Civil Aviation Authority are:

- to further the reasonable interests of users of airports;
- to promote efficient, economic and profitable operation of such airports;
- to encourage investment in new facilities in a timely way; and,
- to keep restrictions to a minimum.

No mention of the environment there, and no clear requirement either to give priority to the interests of consumers, unless we take the word "users" to mean "consumers" – it could mean airlines, or it could mean travellers. The point matters when it comes to determining who should pay for facilities to expand an airport. In the case of Ofcom, the Communications Act deliberately, and after heavy debate in parliament, sets the interests of citizens-consumers in tension with each other. Ofcom has said that its job is to safeguard and promote the interests of these citizens-consumers (note the hyphen) encouraging competition where appropriate.

It is difficult to make the case for a one-size-fits-all approach to regulation because as markets move into spaces that are increasingly politically sensitive, like health, the issues that are of concern, the components of what we would take to be the public interest, are simply more complicated than that. What I think we can do is talk about – and this I think is where I would say the debate needs to go – are the underlying values and commonalities

that do exist between different goals of regulation, and different sets of regulatory purpose. I think we need that kind of generalised debate, and I think that we need to think back – a final thought – to the populist politics of this.

Those of us who remember quasi-autonomous national government organisations will recall how possible it is for a move away from direct, Whitehall control of certain areas of economic activity and public life to be easily discredited and undermined by either poor performance of quangos or the operation of successful political rhetoric. That this has not happened to regulators does, I think, suggest relative success. But if we are going to make regulation a success in the future in a more demanding environment we are going to have to deal with the politics around that, and regulators are going to have to be successful political animals as well as successful economic animals. Thank you.

Discussion

Dr Irwin M Stelzer

John, I wanted to ask you, isn't the failure of the privatised companies attributed to the success of privatisation? These were terribly inefficient, overmanned, overinvested operations. The fact that, through exposure to market forces and exposure to privatisation, they failed or they are failing tells us that privatisation is really a success, doesn't it?

Response: Professor John Kay

Yes, I think in that sense privatisation of these activities was a success, and the withdrawal of the British government from areas like running airlines, making steel and running telephones in Hong Kong, all activities at which it was extremely bad, is a very good thing.

Dr Irwin M Stelzer

Ian, give me three examples of things you would not do as a regulator. I can tell what the limits are from the vantage point of an economist; I can tell what I would not do. When you say that regulators have to be more political animals and consider the social consequences, tell me three things you are planning not to do because they are things regulators shouldn't do.

Response: Ian Hargreaves

There are plenty of things regulators should not do. All regulators are obliged not to do a great deal because their powers are set out in statute. The task of defining the power is not a task for the regulator, and if the power is not conferred by the democratic process then regulators should not go there. If we are going to understand how we are going to manage politically and economically the relationship between the market and the state, we are going to have to face up to the fact that this is a very jagged border indeed. We are going to have to try to understand this, not constantly oversimplify it and pretend that something is happening which is not happening. I think that what I described is closer to the reality of what is happening – you may not like it – than the way you would describe it.

Dr Irwin M Stelzer

Yes, I would describe what is happening almost the same way you did. Whether I like it or not is irrelevant to this discussion – I do not like it. So, you do not feel that regulators have an open ticket – bound by the legislation of course, although this is subject to rather broad interpretations – and you are comfortable with that because you have to move

between politics, economics and social policy?

Response: Ian Hargreaves

Yes, because the regulator's interpretation of the statute is going to be tested within the micro-politics of the industry, through the courts, if it comes to that; through process of appeal, if it comes to that. There are plenty of checks and balances in this system. But one of the great difficulties with regulation is that it can become so algebraically complex, because it is complex in many respects that the public cannot be expected to follow it, and that is an issue.

Roger Lyons, General Secretary, AMICUS – MSF Section.

You said, Irwin, that it is good that we do not have the old ideological splits, yet I think that some of the discussion comes back to the fact that there are ideological splits, that some people – in fact the majority of the people in this country – would like the railways renationalised. Whether they are right or wrong, that is seen as an ideological issue. At the other extreme there are people that say, if only the market could take over and decide these things it would be much easier. I did play a role as the price regulator for the BAA, from my time on the Competition Commission when we had to decide what the role of Heathrow, Gatwick and Stansted was. Now, this mixes up politics, economics, public policy, everything under the sun, and it was not clear-cut, but we were controlled by the statute, as Ian says. We did have a much bigger role to play than perhaps a free-enterprise market solution may dictate. Finally, the divisions that exist in this country between supporters of public ownership or nationalisation, and free enterprise and public enterprise, are far sharper, as it was mentioned before, than in many other European countries. The fact that the lighting in this room is supplied by Electricity de France should not cause anyone any problem, but if it were to be supplied by "Electricity of the British State", it would cause an ideological heart attack among a number of people present.

Response: Professor John Kay

We are making a public-private distinction which is not actually important or central. I think the railways have been renationalised, although we could probably argue about that. What I think we ought to be arguing about substantively is the question of whether we have a control and management system for Network Rail that works effectively, because what people really want from the railways is not whether they are publicly or privately owned – they want them to come on time and provide reliable services, and that is the primary objective. Therefore, I want to shift the agenda away from this sterile

discussion of public versus private. The point I want to make is that we cannot in the areas I am talking about simply consider the public/private distinction to be the main issue. One could structure a way of running universities that would say we have profit-making universities controlled by Off-university. I think, actually, that would be a terrible way of running universities. I think a rather good way of running universities would be to have the autonomous, private institutions – not profit-making institutions – that we used to have in the UK. So, we need to stop having this argument about the boundaries between private and public sector, understand that we have a lot of institutions that have a hybrid character, and think about how to run them best. The BAA, the body for which Ian works, is actually quite a good example of a complex hybrid that is a curious mixture of regulatory functions, while yet being a quoted company with a stock exchange quotation. If we understand that it exemplifies the hybrid institution we can start thinking about these issues in the right kind of way.

Professor Mike Scott, Principal, North East Wales Institute

We are quite a small university institution in Wrexham. However, it is one of the most efficiently run institutions in the UK. We brought in a 6% surplus – we are not allowed to say profit – on revenue last year, and that is almost unheard of. How do we do that? We concentrate on a particular market; we do not diversify into other areas. One of the big problems of the HE sector now is that each institution is being asked to do everything and it is not being allowed to operate as a private organisation. Let me just give a suggestion. At the moment we are talking about this *Higher Education Bill*, which is actually a hybrid. It is doing exactly what you are talking about: it is messing up ideology and the pragmatics of running an institution. If we said – and dare we say it – that Oxford and Cambridge should not even be looking at undergraduate education, that if they want to compete in the international market they should be looking at research and postgraduate education, leaving other types of institutions to do the undergraduate work. What the government is doing – and I am a great supporter of this government – is mixing up agendas as far as the public sector is concerned, and in doing that we are going to have the mess in higher education down the line that you referred to with the railways.

John Pickering, Labour Finance Ministry Group

I speak as a manager first, engineer second, and very much as an economist third. I would like to bring this discussion right down to the ground floor, and practical street level, and take up from where John Kay was. I joined a small team in BT in 1982 to discuss this question of natural monopoly and what do we do with it. Exactly as John said, we needed to decide how to manage this natural monopoly, and one or two of us came from the

outside to have a go at this. In fact, the government of the day decided that the free market economists will decide what to do, and they would expose it to whatever market forces they could dream up. So, the message was "liberalisation and be damned", rather than "management and think".

My view is that the difficulty with all companies – and I do not make the distinction between mixed, private and public or whatever – is to manage these companies. If it is a management problem, let us apply management solutions. Do not let us apply fancy economic modelling solutions, which probably do not bring the skills you require. I rather like George Soros, who said: "Markets are amoral, they do not deliver on the national interest." The only difficulty is that Stephen Littlechild, in his analysis 20 years ago, said all regulators get captured, and I believe that is the problem we have to try and work out. I think it is possible to avoid regulators being captured, but you have got to have a different sort of regulator, and you have got to have very, very strong teeth.

John Gossage, Policy unit, Age Concern England

One of the concerns that we are having about regulation and competition is the degree to which regulation and competition policy can actually hold the state accountable. One area that we are looking at is a very badly performing market in the social care market. It is complex but one element in the problem is the monopoly power of local authorities. There is a super-complaint been made to the OFT, and it remains to be seen whether the OFT will find it within their competence to address that issue.

Lord Brooke

I am in the House of Lords but I speak principally as a non-executive director of that hybrid, National Air Traffic Services, a PPP. First of all, I would like to ask John why he thinks it has been a disaster. After all, the management is better than it has been for many, many years and we have turned the corner. That is not to say we have not learned lessons and gone through a difficult period. The major issue that remains for me as a non-executive director there is the nature of the relationship we have with the banks and the extent to which there is competition within the banking area. Secondly, the major beneficiaries from most privatisations have been the legal industry, who have literally made billions and billions out of the whole business, and that is an area worth looking at.

Response: Professor John Kay

I think NATS is a very good example, and it is representative of quite a lot of PPPs, of where the issue of what is the capital structure of this entity has simply been fudged from the

beginning. The initial story was that the equity would be provided by a group of airlines. It is clear that the group of airlines neither had the financial capacity nor the willingness to provide that equity. This is actually characteristic of almost every PPP that has been put forward. There is, as it were, a theoretical capital structure put in place which does not relate to the actual reality, and it is not clear what the reality is until things go wrong. If one believed what is described is happening in PPPs one would believe that billions, if not tens of billions, of government and taxpayer risk have been transferred to some balance sheet somewhere in the private sector.

Well, where are these balance sheets from the private sector that are taking these risks, and where, as it were, has that risk gone? What we have done in all of these cases, and NATS is an illustration of it, is say we will deal with this risk allocation and the management consequences of that later, when something actually goes wrong in the structure. The interesting thing about NATS, and the reason I describe that as a crisis, is that the crisis actually emerged within such a short period of the structure being put in place. These are the issues which I am saying we need to talk about in relation to the whole set of entities which I am describing, and come up with some systematic and coherent set of answers. That is, for me, the agenda, and it is one we are failing to address properly at the moment.

Response: Ian Hargreaves

I want to say something about BAA, which Roger Lyons and John Kay both spoke about as exemplifying the way something works. It is worth reflecting on what has happened across the aviation sector as a whole in the 20 years of privatisation because, although John listed British Airways as failed privatisation, I am not sure by what measure. If you are comparing it with the global airline industry, I do not think British Airways has been a failure. If you look at the whole structure of airlines, airports, air traffic control, while what you say specifically about the immediate, early course of the capital structure of NATS is true, what you would see broadly is that the UK has got the most competitive aviation industry in Europe. It has been the home for the most entrepreneurially driven, consumer-responsive new airlines in Europe. All of the aviation structure that has been built by BAA has been paid for by the people who fly on aeroplanes. None of it has been paid for by the state. Why is it that in France, in Germany and in the Netherlands they are still trying to find the right way to pursue the course that we have followed?

John Napier, Chairman, Kelda Group

If you look at the success and failure of privatisations you have got to look at them in

terms of international competitive factors in sectors like airlines, and you cannot necessarily define them as failures in the simplistic sense of the word.

Why has water privatisation been a success? There has been a massive transfer of investment onto bond markets and massive improvements in productivity. If you like, they got ten boards of directors, ten sets of managers, dealing with a national problem. If you look at British Rail, it was doomed to fail because British Rail, since the time it went into state ownership, was never operated as a single company. It was a whole series of regional companies. When the government puts it back together again I think it will probably have the good sense to link assets and operations by region with a strategic overlap to get better co-ordination, and perhaps take the cost of the taxpayers back by actually floating those separate regions off again. Then you'll have seven or eight management groups to deal with, and that gives a regulator a comparator basis to work with.

Dr Irwin M Stelzer

Before you sit down, Ian raised the question of regulators handling non-economic, environmental, social issues, and I am assuming in the water industry there are a few of those?

John Napier

We have several regulators. We have an economic regulator, we have a drinking water inspectorate and we have an environment agency, so we have a battery of regulators.

Dr Irwin M Stelzer

And how does that work?

John Napier

That works relatively well. The social utility of water is so high, and the economics of providing it on a regional monopoly basis are so good, that monopolies are not necessarily bad things, gentlemen.

Dr Irwin M Stelzer

Not with the right kind of scale.

John Napier

And, properly regulated. The average household spends the equivalent of, shall we say, two

pints of beer a week to provide water and sewage services to a high standard. That is good value.

Dr Irwin M Stelzer

What is the constraint on, let's say, the environmental regulator on imposing costs that have to be recovered by the economic regulator?

John Napier

The government puts him in a ring, so the economic and the environmental have to be traded off against price increases. At the end of the day all risk is carried by the final client. The failure of that regulation, if there is any in the water industry, is there is no one who picks up the responsibility for industry strategy, it is not the regulator's thing. In theory, it is a department's responsibility, but civil servants are not, by definition, very good at long term industrial strategy; they avoid it like the plague. Just on a matter of information, I believe that the air traffic control in the US is government-owned, isn't it?

Dr Irwin M Stelzer

Operated, yes.

Response: Professor John Kay

Could we just notice one thing that was said there, which is that customers provide the equity in the water industry in the UK. That is not the way it is perceived.

John Napier

The equity is not necessarily held by customers in our own back yard, we are regional companies, don't forget. They are held by institutions, so only indirectly are they shareholders.

Response: Professor John Kay

Sorry, the misunderstanding there is so fascinating that we need to explore it. You said quite explicitly that the risk associated with a bond finance structure, which is the modern water industry, meant that the risks and the costs associated with the activities which you were describing fell on customers. The equity base of the water service businesses themselves, as you know, is now relatively small, and is widely held by institutions, but it is not the real equity of these companies.

Baroness Blackstone

My question is really to John, but Ian might want to come in on it too. I thought, John, you produced a really fascinating analysis of the post-privatisation dilemmas for regulation, but apart from asking for clarity and read across? It was, perhaps, a bit short on solutions. I wonder if you could say a bit more about what some of your solutions to the problems you have identified are, but taking into account Ian's point about the social and political dimension, because I do not think you can leave this out.

Perhaps I could just pick up the point made by the principal at Wrexham, where I am afraid I really profoundly disagree with him. It is not true that universities cannot develop their own niche activities; he has done it successfully himself. If the universities of Oxford and Cambridge wish to go entirely postgraduate, there is nothing the government can do to prevent them. What prevents them are huge vested interests; they cannot abandon science teaching just like that because there are too many people committed to retaining science teaching, and that would be true of many other universities, even if it were the case that they might be better off doing that. The decision-making structures are not good enough in institutions of this sort, the vested interests are too great, and what I would want to argue is that autonomy does not necessarily lead to effective change in those sorts of organisations. Moreover, market failure cannot simply be allowed to ride, and no government could get away with it because the pressures on them would be far too great to rescue an institution that has primarily been in the public sector for a long time – that is what the electorate would expect, and that is certainly what the consumers of those institutions would require.

Response: Professor John Kay

Let me take the bits of that question together. You were absolutely right in your observations about Oxford and Cambridge in the sense that their problems and failures are a result of an inability to conceive their own strategy, rather than restrictions being imposed on them in the implementation of that strategy. They might well come across these problems the second time around, but they have not got to the first base in terms of that. That raises issues as to what kind of institutions we are looking for. I think we are looking for more autonomy, and we have a very clear model that works in terms of the best institutions in the United States, which have autonomy but have accountability to what are essentially local boards and trustees that exist for institutions like Harvard and Stanford.

What I would want to put together across the set of areas we are talking about are institutions that are much more autonomous from political control than we have at the moment; which internalise a lot of the activities of regulation so the multiple objectives which the public has for all the kind of bodies we are talking about are largely taken on board by the people who manage these institutions themselves, rather than being imposed on them by some external regulator; and, which gives these bodies enough power to raise funds and raise capital on their own account to give them that real management autonomy and accountability. That is the kind of broad structure we should look at.

We have had the usual discussion of railways, where people say the real problem is the separation of infrastructure and operations. Actually, I do not think it is. That is precisely what exists in airports and everyone thinks that works fine. The reason it works fine in airports is because the airline industry is growing so fast and there is a flood of money coming in. There is not in railways, and you can solve most problems if there is enough money around. In railways, because there is not enough money around, what you have is layers of partial responsibility for the system. So, you have the process we've been having for last five years, in which as everything goes wrong, everyone tries to pass the parcel of responsibility for what has gone on to somebody else. That, to my mind, is the central problem we have in the rail industry, and that is why we need to have thought through the nature of these kind of hybrid institutions.

Dr Irwin M Stelzer

John, there was one question lurking in that comment. This is the problem that came up with foundation hospitals – of moral hazard. You were saying that no one was going to tolerate a failure of these institutions if they are mismanaged, because the public pressure would be to bail them out somehow. When an economist looks at your nuclear industry, it is a very simple matter, close it down, let it go bankrupt. But it managed, politically, to get out of that. But, what do you do with the Treasury argument that you cannot let a hospital go bankrupt? How do you handle the moral hazard question within the framework that you are suggesting?

Response: Professor John Kay

Nobody wants a system where you have "hospital closed" signs hanging on the front door of the hospital. What you need to have is the mechanism that ensures that when the hospital fails – either on financial grounds, or by reference to failure in terms of it is non-financial objectives – there is a functioning process of intervention which leads to a

change in the management. Actually, we have had that in relation to quite a number of these privatised monopoly activities, in terms of the various kind of special administration procedures that are put in place. We learned in the Railtrack case that it does not actually work terribly well, but what we need to do is learn from that lesson and put in place a structure that will operate well in that particular case. What did not work about it was the administrators put in place who (a) were accountants, and (b) had too wide a range of responsibilities.

Matthew Trimming, Head of Government Affairs, EDS

We are one of the supporters of this series, and we are delighted to be so. One quick comment and then one very quick question. The first comment is, John, to your point about where does all this financial risk transfer to when things are privatised. Or in the business that we are in, outsourcing, you were wondering where that goes and whether it is just a chimera or real. The difference between an outsource situation and a fully privatised situation is that the business risk, obviously, remains with the department, so the child support reforms are still not as successful as they could be and should be, and will be. To your direct point about where does financial risk go, it definitely does go somewhere, it does go to the private sector and it does worry our Wall Street financiers no little bit. A quick question: listening to all the conversation this morning, I end up slightly wary about a solution to market failure that highlights a uncharted, unknown, sort of third-way approach, or what you describe as hybrid organisations. Surely, after 20 years of experience, are not these three good themes – capital, governance and management structure – to look at when you privatise things, rather than thinking there is some kind of helpful third way that is still totally uncharted and untested.

Response: Ian Hargreaves

I do not think that we need to set up a commission to change the total map of regulation and the capital structure of all the companies privatised since 1983 – I think that would be not a useful exercise. One of the first things that the Blair government did when it came in, among the welter of taskforce exercises that it set in train, was something called the Better Regulation Taskforce. Now, I am not an expert in that, I did not follow its work closely, and Chris Haskins is not here today to talk about it, but it would be a very valuable exercise to try to distil out, in the way that John is trying to do, a set of questions and tests which ought to be being applied when the occasion for addressing an area of regulated business arises. Just to take a small example from the aviation industry, when we, the airports, come up for five-yearly price reviews we have two regulators. We have the Civil Aviation Authority and then the Competition Commission. The reason for that is

historical. The Civil Aviation Authority was not regarded as a reliable economic regulator back in the early 1980s. I have looked into how you might change it, because most people involved in the discussion would think it would be the right thing to do to change it. It turns out that to change it is legislatively very complicated and rather difficult to get done. I think that if you could get to where John wants us to get to you would then encounter very significant difficulties. It may be that the system is too immutable to change in response to rational analysis.

Gerry Smith, Computer Sciences Corporation

I previously worked for Royal Mail for 23 years. I agree with John about the comments about the need to define "hybrid", and my point really is about where hybrid kicks in. I think it is different for different industries. In Royal Mail's case – and this is essentially where the social element comes in – it is the network delivery of postmen that is actually crucial. You could happily introduce competition into sorting and collection in one company – Royal Mail, in that case. It would not necessarily destroy the market, and would not ruin the social element of the delivery, but I do think that it varies from industry to industry. You cannot let the health service go bust, as was being described, and that is where the social element kicks in.

Response: Professor John Kay

Let us be clear about this: you can let an individual hospital go bankrupt, what you cannot do is shut the hospital down and turf the patients out in the street, and that is a very important distinction.

Gerry Smith

Bust in the sense of closing it down, or an airport, you cannot do that. Or the railways, for that matter, as they've gone bust at least once recently.

Dr Irwin M Stelzer

If you cannot let the railroads go bust, is it not the case that that risk should be on the national balance sheet?

Gerry Smith

I think in the context of regulation you will inevitably find that the government is effectively obliged to stand behind.

Dr Irwin M Stelzer

Well, then, should it not be on the government balance sheet?

Gerry Smith

I don't think it is necessarily the case that government has to own. I think the government has to be prepared to regulate those sort of industries where you cannot let the thing go bust in the wider sense of the word.

Dr Herman Hauser, Amadeus Capital partnership

I have been a serial entrepreneur most of my life, and recently have become a venture capitalist, and I want to make a comment on the hybrids that John talked about with respect to the Russell group of universities. Since the subject of our meeting here is improving competitiveness, I think people finally realise that competitiveness is closely related to the ability of a nation to turn innovation into successful products and services in a timely manner, and this does include our universities. I think the government rightly has introduced a third stream and a third mission to our universities, in addition to teaching and research, and that is knowledge transfer. In order to be competitive in reducing the period that it takes from an innovation appearing in a university to a product appearing in the marketplace, you have got to streamline each of the phases of that development, and that, I think, is where the problem lies.

Our universities at the moment are ill-equipped to do this knowledge transfer because it is something that is really quite alien to them. What needs to be done to have an effective knowledge transfer out of our universities. First of all, you have to tell the people in the university to look out for innovations that could be exploited, either through licences or through start-ups. The second is, if the decision is that you have to support spin-out then you have got to connect these people with the venture capitalists or the big companies that can take advantage of it. I have a prejudice – I think it ought to be done through a subsidiary of the university in a commercial way, and therefore free that particular part of the university structure from the university rules. It ought to still be 100% owned by the university so all the benefits go back to it, but it allows a hire-and-fire culture, and a board that actually has the responsibility of doing it. I'd be interested to hear from people what they think.

Sir Alan Thomas, Chairman, Three Valleys Water

The agenda is very ambitious, ranging as it does so widely over so many diverse sectors. It is kind of tough, I think, to find a read across in such diverse industries. My own

experience is that to really make out in these sectors you have to understand each one pretty well because the capital structures are very different. For what it is worth, and keeping it short, I think the reason why the customer is indeed bearing the risk is that equity is being driven out of many of these sectors by what is broadly called regulatory uncertainty, but also such things as the Railtrack experience, and indeed, the windfall tax before that. So I think in formulating public policy, these lessons are the very important ones, rather than perhaps exploring more the metaphysical areas that we have been touching on this morning; really practical issues about what shareholders are prepared to do and what the rules are when they invest.

Matthew Trimming

Firstly, I agree with Herman. That is exactly what we are doing as far as technology transfer is concerned. I disagree with Tessa because it is a fundamental issue – it is to do with university charters and the inability of universities to be able to change their management, and the fact is that we do not allow them to go bankrupt. The only one we got close to was Cardiff, but we bail them out before they go bankrupt and in doing that we allow the charter to remain and we allow the traditional management structures, which are anachronistic, to continue. That is the problem.

Response: Professor John Kay

I particularly value these last two contributions because they are spelling out what I want people take away from this seminar. People have said that I am trying, as it were, to invent new kinds of hybrid institutions: I am not. We have got these hybrid institutions, whether we are talking about universities, or whether we are talking about the way the water businesses have reconstructed themselves, or whether we are talking about schools, hospital, railways. I do not think we should have a single, universal, one-size-fits-all model for them, but there is a set of questions we need to ask about each of them. One is, who is bearing the risks involved in these activities, because that is what the real capital structure is, and the answers to that are complex and not at all obvious in most of those cases. The second question we need to ask about all of them are what are the lines of accountability: who is responsible for what and to whom? The third issue, which is common to all of them is, once we have recognised that they have this fundamental character of hybrid institutions, how much of what we would otherwise do through regulation can we internalise in these bodies themselves? In other words, we have these hybrid bodies, we have a common set of questions we need to ask about them, and we need to recognise that they are not simply anomalies in a world that is basically polarised between public and private bodies which are completely different in character. That is not

the nature of the mixed economy we have, it is really different from that, and what we need to do is face up to that and, I hope, analyse the issues which arise from it in the ways I've described.

Response: Ian Hargreaves

I will only add to that, because I agree with what John has just summarised entirely, and I would only add that a further question is to understand the relationship between non-economic and economic regulatory processes in the industry concerned. The description of it that was given about the water industry I think provided a good and clear example of the point.

Seminar 2

Social obligations, economic regulation and competition

A seminar held on Wednesday 3 December 2003

Social Obligations, Economic Regulation and Competition

Welcome

Wilf Stevenson, Director, Smith Institute

Good morning, ladies and gentlemen, thank you very much for coming. This is the second seminar in our series on improving competitiveness and today we would like to look at the question of natural monopolies. We have chosen to focus on the energy industry to try and see how economic regulation and social obligations, in relation to the industry as a whole, fitted with our considerations about natural monopolies.

Introduction

Dr Irwin Stelzer, Senior Fellow and Director of Economic Studies,
Hudson Institute

It is really good to be here because this has been an effective programme of work for the Smith Institute over the years. It is satisfying not only because of its effectiveness, but because it is the first series I have seen which integrates micro-economic and macro-economic policy. This is, I think, Gordon Brown's great contribution to the debate. Forget whether he gets it right all the time; that is another matter. The fact is that he has pointed out that a competitive, open society contributes to macro-economic growth, and we therefore need competition policy and sensible regulatory policy.

Today, we are going to consider whether or not regulation can, or indeed should, be used to achieve social objectives. As politicians find that their ability to raise taxes diminishes, they have to find a way to get their increasing number of social objectives paid for. A handy way to do that is to impose obligations on regulated companies and then let them pass on the costs as a hidden tax in the water, electric or gas bill. That way, the politicians get the credit for the innovative social program and the utility gets the blame for the cost of it. This is the division of labour that politicians generally prefer. It is their equivalent of a free lunch.

Presentation

Colin Robinson, Emeritus Professor, Department of Economics,
Surrey University

Good morning ladies and gentlemen. I am going to spend a few minutes talking about regulation in general, and what you can and cannot expect it to accomplish, and then move on to energy regulation in particular, because we have evolved a particular approach to regulation in energy markets, and more generally in the utilities.

Regulation

First of all, regulation in general. The main intellectual backing for the argument that government should regulate is that markets fail. The market failure argument is an interesting one, since failure means not actually living up to a particular market form, perfect competition, which can never be achieved. This means that markets always fail, and therefore it provides an excuse for government intervention everywhere. There is also an inconsistency in the market failure argument, in that it treats people differently depending upon whether they are in the private sector or in government. In the private sector they are supposed to be self-interested; in the government sector they are pursuing the so-called public interest. This is a very difficult distinction to maintain.

The problem is, once you bring in the government, you bring in an organisation which bears very few of the costs of the actions it takes. Most studies, particularly in the US, have shown that budgetary costs of regulation are really very small indeed, and that the principal costs of regulation fall upon the people who are regulated and, eventually of course, on consumers. The situation in which those taking actions do not bear most of the costs of what they do is classically a recipe for an excessive expansion of the activity concerned, so one might be worried that government regulation has an inherent tendency to over-expand because the costs fall upon the people who are regulated rather than those who are taking the actions. These are controversial issues, but I think that one should at least accept the general presumption that you cannot assume that regulation is going to make matters better. It can very well make matters worse and might reduce welfare compared with what you would have had if you had just left matters to markets.

Energy market regulation

If you look at energy regulation we have developed a particular type of regulation of energy markets in this country. I think the form of regulation that has evolved in the energy market since the first utility privatisation 19 years ago really is a very long way

from traditional regulation, and it does provide quite good incentives for utility regulators to keep regulation within reasonable bounds. Until recently, people used to think that utilities like gas and electricity were so-called natural monopolies in their entirety, but we have evolved a utility regulation regime which I think has four pillars. The first is independent regulatory offices. Second, a separation of so-called natural monopoly networks from the rest of the industries. Third, a price cap form of price control. Fifth, and finally, the promotion of competition. Together, these pillars have produced something very different from traditional regulation, which concentrates on static objectives such as price and profit control. It has substituted for those objectives the vigorous promotion of competition. Energy regulators have an incentive to promote competition because that is one of the ways in which their success is judged.

I am not a fan of the privatisation schemes in energy – I think they are actually very badly conceived – but the regulators and the competition commission have saved us from the worst effects of the privatisation schemes. For instance, they have removed potentially competitive areas like meter reading and gas storage, and outside those natural monopoly areas, they have tried to start competitive processes. They have not tried to guess at what the outcomes of those processes might be, and that approach circumvents one of the great problems of regulation, which is that it minimises information requirements. The regulator does not have to guess what the outcome of a competitive market would be. Instead he or she attempts to start a competitive process which achieves a competitive market outcome.

Though that is the form of regulation we have evolved in energy markets, which I think is superior to traditional forms of regulation, is it going to persist? Over the last couple of years, I have detected a threat to independent energy regulation and the promotion of competition. The *PIU Energy Review* was much too interventionist in tone, and although the Energy White Paper drew back from some of the more extreme ideas in the review, I do think there are some problems in the approach the government is now taking. We may be at the beginning of a return to the bad old days of a politicised energy market. The first problem, I think, with the new policy is it revives energy targetting and support programmes. Combined heat and power (CHP), and energy efficiency schemes are favoured, and the degree of support is really quite considerable. The renewables obligation, for instance, together with the exemption from the climate change levy, is going to benefit the renewables industry by about £1 billion a year in 2010, so the government says. There is an effort to push what is described as good-quality CHP, and this energy efficiency commitment for households may be extended. People with long

memories are going to recall previous attempts by governments to "pick winners", and I think we may be getting back to that kind of thing, where the government is trying to, first of all, fix energy demand by the energy efficiency route, and also to fix the shares of different fuels. Once you have fixed the shares of renewables, there is no reason why you should not fix the share of nuclear, and that is certainly going to be an issue in the near future. I would like to sweep away these kinds of schemes and rely much more on general economic instruments. A carbon trading scheme, for instance, or even a carbon tax would be superior to all these attempts to pick winners.

So, in conclusion, a threefold message. First of all, government regulation is something that should be minimised and only applied in circumstances where there is nothing else you can do. Second, there is a danger now that the renewed government intervention, as outlined in the white paper, is going to undermine the competitive forces which we have in the market, leading to rather costly ways of trying to achieve environmental targets and reducing the security of energy supply. Finally, I would like to get rid of the return to targeting and rely on general economic instruments.

Dr Irwin M Stelzer

Colin has just demonstrated his personal antipathy to regulation, but I am sure that the regulated person who is about to speak next will be more amenable to it.

Presentation

Mark Clare, Deputy Chief Executive, Centrica, and
Managing Director, British Gas

Good morning, ladies and gentlemen. In the UK we have the most competitive energy market in the world. We have some of the toughest environmental targets to achieve and we have some of the world's best and fittest energy companies, so I think we must start by being very proud of what has been achieved. That is down to the politicians, the regulators, and of course the energy companies themselves. That said, I believe today's discussion is very timely. We need to answer the question of how we can continue to deliver ever-tougher targets at least cost, and without damaging that which has already been achieved. What I would like to do is to add to Colin's comments by offering a practical perspective.

Let me start with the competitive energy market in the UK. There is no doubt that we are streets ahead of other countries and other UK service sectors, especially telecoms. It has taken over 10 years to get the policy framework right. It has involved massive investment in new systems and radical corporate restructuring across the companies involved. As a result, prices are lower, and service levels to customers have improved. But we must not make the mistake of assuming competition means continuously falling prices. UK supply in both electricity and gas have tightened, and prices are moving up. Of course, if we want new investment, that has got to be the right signal. Switching rates remain high, but somewhat lower than they were. However, the power of competition has not diminished. Our figures show that this year over five million customers will switch their gas or electricity supply.

I also think that a slightly different market is emerging, one that emphasises service as an absolute priority over price. We are currently investing around £400 million into improving our services, and are doing so because we want to improve the whole customer experience, because that will deliver the loyalty we are looking for from our customers. But clearly, the times are changing; the Energy White Paper does place more emphasis on environmental issues as a driver of energy policy. Yet the government, commendably, maintains a commitment to competition. The white paper says that liberalised and competitive markets will be the cornerstone of energy policy. It also says that we believe that independent economic regulation delivers very significant benefits and goes on to say that changing this would politicise the regulatory process so as to cause unacceptable levels of uncertainty in the market.

Social and environmental regulation

To date, most of the social and environmental intervention has been through the energy efficiency commitment, or EEC, as we call it, and renewable obligations. Let me start with EEC. This is an obligation placed on energy companies to work with their customers to save energy. It will cost around £3.60 per customer per fuel to discharge. There are two objectives; emissions reductions and alleviating fuel poverty. So, roughly 60% of the expenditure goes to the disadvantaged customers, with the rest subsidising energy efficiency measures to the non-disadvantaged customers. On fuel poverty, our approach has been to try and turn an obligation into an opportunity. We have brought on board seven leading charities to provide additional services: debt services, security measures for the elderly, support for those with disabilities, and most importantly, benefits health checks. Results so far suggest that the impact of benefits health checks may be as great on household disposable income as the energy efficiency measures themselves. That will be a great result.

The environmentally focused aspect of EEC is different. Here we have to subsidise energy efficient appliances, like light bulbs and insulation. The focus is to overcome consumer apathy to energy saving. This is very much an obligation, it is not a market mechanism. What we do under the scheme is largely defined by the rules which are by no means perfect. The scale is immense – we are currently spending around £65 million of our customers' money on implementation. We will be distributing three million light bulbs and installing 180,000 insulation measures this year.

The renewables obligation requires electricity suppliers to grow their purchases of renewable electricity, until it reaches 10% of supplies by 2010. There are a couple of interesting design features. First, customers are given some protection by a buy-out price that limits the cost to around two times the current price of other electricity. Second, the type of renewables is not specified, so the government is not trying to pick winners from within the renewable sectors. Thirdly, and most importantly, the economics are working. We believe that we can construct offshore and onshore wind generation at an acceptable commercial rate of return and are looking to spend up to £500 million on this over the next five years. There are, I would argue, benefits of these obligations in terms of social and environmental effects, and given the current level of obligations, perhaps we should not worry too much about the cost, but the obligations are set to grow substantially.

So, we do need to weigh the benefits against the costs, and I do have some concerns. My first concern is that the obligations do take up scarce resources. Capital is rationed and

resources invested in one cannot, clearly, be invested in another. Some of my best managers are implementing social and environmental schemes. We have engineers diverted from activities and products that customers are prepared to pay for to installing measures that they are not. Good news for the schemes, of course, but less good news for wealth creation. My next concern is that, as environmental abatement grows, prices will rise and we will end up chasing our tail on fuel poverty and the social agenda. This is the fourth richest nation in the world, so we can hardly be proud of the extent of fuel poverty in this country. I am also going to need some convincing that companies' roles can be expanded much beyond that which already exists, yet the intent seems to be to double the EEC obligation in 2005. As a private company, we just do not know who qualifies for this fuel poverty work. The gateway is the benefits system, but we, quite rightly, do not have access to the benefits databases.

The complexity of this work is enormous – the British Gas "here to help" programme could involve 500 contracts with individual local authorities. On the environmental side we seem to be involving a patchwork of measures – renewable obligations, energy efficiency commitments and the Climate Change Levy. As each individual aspect of the patchwork is expanded, we risk consumer legitimacy. On the electricity side, the domestic customer could be paying £50 more per annum on their bill by 2008. Sooner rather than later we should ask is this the least cost way of saving carbon, and sooner rather than later, customers will question what is being done in their name. As Colin mentioned, emissions trading does look like the most market-based mechanism, but it is not the silver bullet, there are very significant design failures. In particular, the free allocation of allowances to polluters could have a major distortionary effect on the electricity market. It is likely to redistribute income from consumers to generators, all in the name of green policy.

Finally, I want to make a slightly old-fashioned point. Yes, companies and regulators should play their part, but the government, through a complex web of mechanism and obligations, is perhaps downplaying its own role. So, in the area of fuel poverty, the simple answer is that more resources have to be found and targeted better to improve the housing stock. The central thrust should be government funding, not trying to manipulate fuel prices or debt policy, or imposing increasingly difficult obligations to execute. The government also has to better focus those resources it currently has. Are winter fuel payments really the best way of targeting help? Similarly, on household energy efficiency, the government should will the means as well as the ends and provide compelling incentives to consumers. It could be done through stamp duty rebates or council tax reductions to energy efficient homes.

So, let me try and sum up very quickly. Like Colin, I fully support the efforts that have been taken to make the energy market more competitive. As the level of intervention increases, it will become more important that we find mechanisms that are fully compatible with the market. We should certainly not always assume that the answers lie in adjusting market rules. On occasions we just have to accept that government may need to play a larger role in meeting their objectives. Finally, I would like to leave you with a context for all of this: there is no doubt that this is an area of increasing complexity, but as an energy supplier, it is not the issue that gives me the most sleepless nights. The prize for that goes to the ever-sharper question of how we are going to make progress in the European market, which remains effectively closed. I am not making a plea for national champions, however we must recognise that the energy market in Europe is consolidating very fast and we are firmly a part of it. While progress is being made to open those markets and to establish some form of independent regulation, I firmly believe that it will take many years to realise our ambition of operating at scale in continental Europe, as Europeans can operate in Great Britain. The danger, if these time scales are extended, is that the uniqueness of our position that I referred to at the start will fade. That would be a real shame for consumers, Centrica's shareholders, and the country. Thank you.

Discussion

Dr Irwin M Stelzer

We have a statement by Colin that government regulation has a tendency to over-expand. I wonder, Derek, if you can tell us how you have managed to avoid that tendency, because I think you have, yet I agree with Colin that regulators tend to expand, partly because legislators impose more burdens on them. Is there any way to resist this tendency?

Sir Derek Morris, Chair, Competition Commission

On the specific point, the Competition Commission has the undoubted advantage that although it operates under, I think, 15 different acts – a lot of them, of course, being the regulatory privatisation acts – under none of them do we ever get to choose our own cases. So we can only deal with what comes to us, and I think one of the advantages of this system is that we are rarely called upon to intervene. When we do have a case, it involves looking, typically, at a whole set of principles underlying the regulatory regime, and they can then work as a sort of template for future cases. Obviously, we do not take any credit, it is just the way it has been set up. On another point, my impression is – though this is grossly simplistic – that what essentially has happened is that through a series of privatisation acts, a series of economic regulators were set up as independent regulators, essentially dealing with the economic issues of monopoly and the huge need to improve efficiency when they were privatised. That, as the speakers have said, has all worked extremely well. Increasingly, government now sees, or is brought to see, all sorts of other objectives – environmental, social, fuel poverty, security of supply etc. It looks as if the way in which government has responded to this is to add another set of obligations, non-economic obligations, to the independent regulators. My concern is that one then sees the inevitable trade-offs between costs and environmental issues, costs and social policy and so on, being left to “unaccountable” regulators. I do agree with Colin that typically, market mechanisms – emissions trading, carbon tax and so on – are preferable, but I would have thought there is an important need for the government to take responsibility for those objectives, rather than, as I see it, a tendency to leave that to independent regulators to, in effect, become policy makers.

Dr Irwin M Stelzer

A way to force politicians to take responsibility for the cost of their policies is something for which people have been hunting for a long, long time. But it is true that the regulators are finding themselves increasingly burdened with non-economic issues, essentially political and social issues. If you are regulating the water supply, and new and higher

standards of purity get imposed while the minister is saying "you've got to keep the bills down", it is very hard to do.

Dan Corry, Executive Director, NLGN

You can go two ways: either we are unhappy that the regulators are somehow making social and environmental policy, and government is not taking responsibility and making those decisions, or the alternative is that government does set the policy and then asks the regulator to actually administer it. The latter is not a problem, I don't think. I think the government is doing what the government should do. The Energy White Paper finally had the government coming off the fence and saying what it wanted, and requiring the regulator to help carry out government policy. One of the things that we tried to do was to bring in guidance for regulators, and that was partly because even though we wanted regulators to do economic regulation, every decision they make will have impacts upon the environment and on social issues, and at the very least, you wanted regulators to somehow take into account what they were doing and give them some sort of guidance. So, I would be interested to hear whether people think the guidance approach worked at all.

Response: Colin Robinson

Yes, a lot of interesting points. I am concerned principally by what Dan said. Obviously, regulators have got to work within the context of a policy set by government, but the present policy is a reversion to the policies of the past, though with different fuels being favoured. We used to favour coal, we used to favour nuclear and look where that got us. We politicised the energy market and produced pressure groups in favour of subsidies, and I think that it is a dangerous road on which to embark, particularly given the scale of subsidy for renewables which there is at the moment. That is why I think we would be far better off employing general economic instruments. I am not sure that carbon trading or a carbon tax is the best policy, not least because I am doubtful about the environmental threat, particularly this draconian suggestion from the Royal Commission on Environmental Pollution that we need to reduce carbon emissions by 60% by 2050. I'm just not sure that it is something we need to do at the present time.

Dr Irwin M Stelzer

When economists know what the right thing to do is, but politicians will not do it, the question is, what do you do as a second-best alternative when you cannot get the politicians to face up to economic rationality?

Response: Colin Robinson

That was the context in which I spoke. If you insist that you must take fairly drastic action to protect from an environmental threat which may or may not be there, the best way to do it is by some general instrument, not by this programme of subsidies and support which produces a politicised energy market – that is the essence of my argument.

Dr Irwin M Stelzer

The second question is, how do you put rational bounds around the directions in which they want to nudge the markets? I come from a country which just tried to pass an energy bill that was a \$35 billion monstrosity, so we are in no position to criticise. It seems to me that there are social costs associated with the use of carbon-based fuels that are not reflected in the price of the fuels. That is, the consumer who burns gasoline, fuel oil or natural gas is not paying the full social cost that he is imposing on society. Economists would say that it is a simple matter: you just impose a tax to get the price up to include the social cost. Well, politicians will not impose a tax, so then the question for policy makers is not to sit around saying, well, I wish they would impose a tax. The question is: these are the cards we have been dealt, what do we do?

Response: Colin Robinson

I have heard so many people say that you have to bend to what politicians are willing to do. The danger of that attitude for economists is you never do anything, you simply bend to what is politically acceptable – a very, very dangerous attitude. Secondly, on the tax, maybe they will never impose a tax, but we do have a carbon trading scheme, why don't we stick with it? Why do we need all these additional things which are going to produce this kind of politicised market and undermine independent regulation?

Response: Mark Clare

In terms of the way the market is structured, I think the way Dan's described it is probably what is happening at the moment. Government is setting policy, things like EEC, renewables and the Energy White Paper takes that a lot further and the regulator is there to implement that effectively. Of course, in the end, the responsibility for delivering all this, as we have already said, really rests with the energy supplier and then the customer, of course, pays. My big challenge is, is this the least cost way of doing it? Well, the answer has got to be no, and I suspect that a direct tax is a much, much more effective way of dealing with a lot of these things.

If we take something like fuel poverty, for example, the only thing that we can really do under the current structure is to ensure that the housing stock is reasonably insulated. That is all energy companies can do. It is impossible for energy companies to take on any real form of responsibility for solving fuel poverty – that is more about disposable income, about the interaction of the various government departments that define social benefits. Of course, the challenge the government has is, how does it get all these things done without raising more tax? What they have done is put out this patchwork of different policies, each one of which is trying to tackle one particular part, but we are going to get to the point where the interaction between all of these means the whole process will just grind to a halt. At some stage, government is going to have to come back and say "this is a responsibility that we take, and we are going to have to deliver against this".

Dr Irwin M Stelzer

Mark, you said that we are in an era in which prices will start going up. We had that wonderful post-privatisation era in which the fat was sweated out of the system and prices could keep coming down. I think you also said that we now rate service as a priority over price. That is what the airlines, mostly the bankrupt ones, used to say, and it is what former regulated companies tend to say when prices start going up. I wonder if you are haunted at all by the airline model, in which everybody said no-one will fly on these low-cost airlines because the service is terrible, or are you quite content that you have a different situation?

Response: Mark Clare

I think you have to take the lessons from the airline model, which is always look at your business structure to make sure that you are running at the lowest possible cost. I think what energy companies have done is to fundamentally reduce their cost base. Once you have got through that and reduced prices you have to ask what is going to give you a competitive advantage over other companies. The focus we should have is on customer value: how do we deliver more value for our shareholders from delivering more value to our customer? That is about delivering better service, and better service could be better customer service, but it also could be about a wider range of services and products that you can deliver to those customers. I think that is where the relationship starts to deepen. If you look at retailers, who have been through this process, they are now looking at how to cement and deepen their relationships with customers. Companies like Tesco's have moved themselves towards a company that really does command respect from all its consumers – it is a real trusted brand. That is where energy companies should be going.

John Earls, Head of Research, UNIFI

I'm wondering if there is another model, whereby there is a stated government policy objective, but it is not explicitly handed to the regulator. I am thinking perhaps in the context of financial services, where the government has a stated objective to increase access to financial services. While the Financial Services Authority has some stated objectives, such as preventing financial crime and promoting financial understanding, extending access to financial services, as I understand it, is not explicitly one of them.

Dr Irwin M Stelzer

I talked to the financial services regulators about this, and consumer ignorance is an enormous problem. You say to an ordinary person "the discounted present value of this instrument is higher than the discounted present value of that instrument, unless of course I've got the discount rate wrong", and you realise that this is a tough product to sell. This may be an insoluble problem – there are insoluble problems and this may be one of them. I don't know how you extend the range of financial services, especially in British society, which is very risk-averse, compared to American society.

Response: Colin Robinson

I don't think there is a solution, but I think there is a danger in financial services regulation of regulating so much that you remove all incentive for consumers to find out about financial products. I think that is one of the most serious dangers. People assume that a regulator is protecting them, and if things don't work out with their investments they claim they have been mis-sold. This is an example of the way in which regulation often grows too big. In an attempt to protect people you end up in a situation where people lose all incentive to get information about products.

Sir Derek Morris

It is only 18 years, I think, since British Telecom was privatised as a monopoly. The notion of competition in utilities was way off anyone's radar except for a few mad economists, and see where we have got to now? If you look at emissions trading, 20 years ago this was just esoteric mathematics in the academic journals. We all had great fun with it but no one thought seriously it would ever happen, and of course now it is happening around the world and in the UK. Taxes to deal with environmental issues are now a very understood feature. If you look at what's happened in competition policy it is very much the government setting the framework and then pulling out and letting independent regulators apply it. So, in all these sorts of ways, it seems to me the thrust of what Colin wants could be expected to occur. It may take 10 or 15 years more, but I don't think we

should be too pessimistic that governments, where I think the responsibility must lie, will always go for a "picking winners" style of approach, as opposed to using market mechanisms.

Dr Irwin M Stelzer

I would like to thank you all for coming, and I believe we stand adjourned. Thank you very much.

Seminar 3

Developing a new conception of productivity

A seminar held on Tuesday 16 March 2004

Developing a new conception of productivity

Welcome

Wilf Stevenson, Director, Smith Institute

Thank you very much indeed for coming, and welcome to one and all. I have a lot of people to thank for this seminar series, because without these we would not have been able to run it. We owe a lot to Irwin Stelzer, who we have worked with throughout and who started us off on this track of thinking. We have also worked with BAA, Centrica and EDS, and all of them have supported different aspects of this programme. This is the third seminar in the series. In the first we looked at what constitutes a natural monopoly, and how we could learn more about how they operate. In the second seminar we discussed the lessons from privatisations within the UK, and to see why some have worked well, some perhaps not so well, and what lessons there are from that. Today we are going to look more generally at productivity, and to pick up the arguments made by Michael Porter and Christian Ketels, that future productivity gains in the UK are going to come from supply-side measures.

Introduction

Vicky Pryce, Chief Economist, DTI

Thank you Wilf. Just to remind you of what has happened. A year ago, we published the Michael Porter report, co-written by Christian entitled *UK Competitiveness: Moving to the Next Stage*. Hopefully you have all received copies. It followed a seminal talk by Michael Porter at the LSC in January 2003, which looked at how we should best approach the issue of competitiveness if we are to improve productivity.

Improving competitiveness

What the Porter report recognised is that the UK has been very successful in raising competitiveness through a deregulatory market approach. The microeconomic reforms that we have seen, particularly creating an independent Bank of England, have helped create a very stable environment for firms, and we have enjoyed substantial growth in the UK economy as a result. But, as the report notes, this improvement in growth has been achieved mainly by bringing lots of people into work by making access to work a lot easier. The result has been that productivity, by comparison with other countries, has tended not to rise as fast as we would have liked it to, even though we have done reasonably well against some of our competitors. The gap remains, and we will be hearing

about the fact that UK workers have less plant, less machinery, and fewer skills than their competitors. So, although we have done well in terms of economic growth, the issue of productivity has been one that has worried us for quite some time. As a result, we have taken some of the recommendations in the Porter report seriously across government, with the DTI and Treasury working very closely together.

First of all, the report recommended a sustained commitment to increase the rate and efficiency of public sector investment in areas such as education, transport, science and technology. Well, you cannot open a newspaper these days without reading issues to do with efficiency in the public sector, but also there has been a sustained commitment to increase investment spending and we will hear more about this tomorrow in the pre-budget report. So, we have taken those recommendations on board already. The report also stressed the need to create a policy context that raises the pressures and the incentives for investment in the private sector. The progress on microeconomic stability has been good news, but we have also seen the development of a number of proposals to ensure that we operate in a more competitive and transparent business environment.

As you know, the DTI, in particular, has been involved in a number of issues to do with corporate governance: we have the Higgs review on the role and effectiveness of non-executive directors, the Operation and Financial Review, and the Company Law Review which is concerned with ensuring that companies engage with a wider range of issues, such as relationships with employees. In this context, Denise Kingsmill's report on accounting for people has been very, very important in highlighting the importance of caring for workers as one of the major areas of encouraging productivity in companies. A lot of things have happened in the labour market front, such as more flexibility for workers, and again, we have taken measures to encourage firms to upskill their people. Regulation was another area mentioned in the report and we recognise that badly designed regulation imposes unnecessary costs. We are now committed to a process of regulatory reform through the government's regulatory reform action plan, which has been recently updated, and contains over 650 proposals for deregulation or simplification of existing regulation.

The report also encouraged the government to mount a sustained programme of cluster development and to further strengthen the regional dimension of economic policy. Well, we have taken that very seriously as well and a great deal of work has been done to assess the potential for policy in this area. In 2003 the Chancellor announced the *Devolved Decision Making Review*, whose terms of reference were how best to achieve

decentralised delivery and responsive local and regional services in a way consistent with efficiency and equity. We have done a big review of business support programmes to simplify and reduce them to just a few hard-hitting products for business, and the new regional business support product, which replaces the regional selective assistance, will now be delivered largely through the RDAs. In addition, the RDAs themselves are preparing cluster strategies as part of their regional economic strategies.

Finally, we have published the *DTI Innovation Report*, and the Treasury's independently run *Lambert Report*. The *Innovation Report* proposes the establishment of knowledge transfer networks – and, again, networks are something that Michael Porter has majored on. He has asked why it is that the UK has so many networks that do not actually work particularly efficiently. So the innovation report addresses that, and the Lambert review itself suggests how knowledge transfer could best be tackled. Porter has also talked about the importance of science, and you will be aware that a consultation document is going out today covering a 10-year strategy for science and innovation in the UK, so we are making a lot of progress in this area. Having done all that, are we, as a nation, able to take full advantage of these policy initiatives? I think a lot depends on businesses themselves, and we have stressed again and again that the demand side is very important. How do we engage businesses to ensure we have a proper public-private partnership in this, and do businesses have the skills to turn the inputs into proper outputs? Again, this is something the Porter report addressed, and we are now very actively involved in the Advanced Institute of Management, which we have funded to look at the issue of how we can enhance skills in the UK, particularly at the managerial level.

This is why today's seminar is very important for us. It would be very interesting to hear from Christian whether he thinks things have changed, and to see whether the issues that were raised in the report still need addressing. One small addition, and that is the focus that has taken place on public sector productivity over the last year or so. There is now a review being led by Tony Atkinson on behalf of the Office of National Statistics (ONS) using Treasury, ex-Treasury, ONS and Bank of England officials which is doing consultation work on productivity in the public sector. We are also looking at whether the measures that we use to be able to track our progress in meeting our productivity targets are the right ones, so if any of you have any thoughts on this please get back to us because only by having the right measures will we be able to have the right policies. Thank you very much.

Presentation

Christian Ketels, Co-author, *Competitiveness: moving to the next stage*, DTI and ESRC, and Principal Associate, Institute for Strategy and Competitiveness, Harvard Business School

Vicky, thank you very much, and Wilf, thank you very much for organising this event. It is a great pleasure to be back. What I want to focus on in my short remarks this morning is the issue of process. Understanding what needs to be done and what the priorities are to improve competitiveness is really only the first stage. What we have realised more and more is that moving from the macro, market opening agenda to the more microeconomic agenda not only requires new analysis, it also requires a new process of translating analysis into action. This means moving from a process that can be very much government-driven, where it is relatively easy to implement a decision once it is taken, to a process where the way and the means are almost the goal. In effect, you are never finished, you need to bring a lot of different people to the table – universities, companies, government and the different agencies within government.

The Report

Let me start by giving a brief overview of the main themes of our report. The title of our report was *UK Competitiveness: Moving to a New Stage*. The first thing that we wanted to point out, and as Vicky has said this morning, is that we felt that the country should be proud of the last decade or so. What has been achieved in terms of economic policy is that the country – which had been in slow but clear decline, that had lost position in terms of its European competitors and the United States and other countries – has managed to stop that decline and moved forward in terms of productivity, wages and prosperity. We should also not forget that even though the comparison to the US sometimes does not look as favourable, the US experience over the last few years is really very unique, and it is not fair to only compare the UK to the US. I think we really have to look at the experience of the other European countries as well. You might argue that that makes it a little too easy because they are doing so terribly, but we need to keep the whole group of peer countries and their experience in mind when looking at prosperity. A lot of work had been done already in the UK that we could build on, by the DTI and by Jonathan and his colleagues, on UK competitiveness.

Two Dimensions of Growth

We wanted to find out where we could make the biggest addition to this work. A lot of the existing work had tried to point out, in a type of growth accounting framework, where

the prosperity growth came from. If you want to split it up very easily, you can separate two different dimensions of economy-wide prosperity growth; either the people that you have employed in the labour force are becoming more productive, or you increase the level of employment, either by getting people to work longer or by getting more of them into the labour force. If you look at labour productivity, there are issues of capital intensity, there are issues of skills, and there are issues of what is often called total factor productivity, which is either new technology, or seeing how hard people try, which depends a lot on the incentives – what the literature has called 'X inefficiency'. If you look at the UK turnaround, in terms of competitiveness, it was focused mainly on two elements. The first addressed the broad issue of labour participation, getting down unemployment, getting more people in the labour force, and getting people to work longer. The second focused on getting more out of the people that were working, the X inefficiency dimension, so that people try harder to make use of their assets. It was the right approach because those were the areas where the UK had the main problems. So, I think the past approach was the right answer to the failings that the UK economy had at that point.

The problem with looking at labour participation and looking at efficiency, as I narrowly define that, is that those are inherently limited. There is only so much you can do to get people to work more. At some point it is naturally exhausted; people cannot work longer, they do not want to work longer, and it has a negative effect on productivity. The same is true with X inefficiency, you can just sweat your assets and sweat your people so much until you run into negative returns. That was what we really tried to point out – that past reforms were the right ones at the time, but they were reaching diminishing returns, so we needed to move to new priorities and find the new barriers and bottlenecks that were holding back the UK economy.

Capital stock

Let's just go through the three elements that we identified as the most important. First there is capital stock, and there has been a long discussion in the UK about the capital stock. Everybody acknowledges that the capital stock, both private capital and public capital, is essentially lower than in a lot of other countries, a fact that has often been linked to the structure of the UK capital market. We agreed that it's true that there is a lower capital stock in the UK economy, but our sense was that you cannot just say it is an issue of the capital market. It seemed to us that this was more systemic, because of the capital market, but also because of all the other microeconomic conditions that companies in this country were facing. I think it was interesting that a couple of recent

studies looking at the German and French situation found that those countries had extensively over-invested in the capital stock. They created a negative fallout through excessive capital-labour substitution, creating intense pressure on employment. I do not know if that is true, but I think what that signals is that the capital market story is really a very complicated one, and I am not 100% sure if we understand all the systemic linkages of what is going on. So, given a lot of the other advantages in the UK capital market, it would in our view be relatively dangerous to dramatically change the capital market situation in the UK.

Skills

The second issue is the topic of skills and training. Again, I think it is a topic that has long been recognised in the UK and there have been numerous research reports and policy initiatives. Essentially, policy is moving in the right direction. It has to be recognised though that skills are a long-term problem. In the UK it is essentially a stock problem, so even if you are pretty good in educating new people – and if you look at the science and engineering graduates, the UK does not look that bad compared with other countries – it takes many years for these new generations of students to feed through the system. There remain issues around companies' investments in training. But again we think that this is again at least partly a result of an environment that makes it less profitable for UK-based companies to make this investment in the labour force than for their peers abroad. We need to look at the business environment in more general terms to understand the root causes of this problem.

Innovation

The third element that is driving labour productivity is innovation. That is an area where the UK is facing a clear issue, and the Lambert review looked in detail at the relationship between companies and universities. I think it is interesting that the review finds that, yes, the universities can and need to do a lot more, but it is essentially a problem of demand. The companies do not really go out and seek to work with universities. So, what do you do about it? We need to understand the elements that are missing in order to make innovation more attractive. The first area we identified is the so-called factor input side, where the UK still lacks and needs to do more. Investing efficiently and building a stronger public asset base will in turn also help to change the logic for companies to think about what is profitable in terms of investing in private assets. It is important to point out that assets includes quite a lot of things – public infrastructure, public assets, private capital stock, investment in the skill force, and institutions. The second area we identified was that this country needs more of a discussion about what the UK, as a location for

business, will want to stand for in the future. I think that in the past there was an implicit consensus that "access to Europe" described what the UK was about. What does the UK want to stand for as a place for business in the future? We did not give an answer in our report: I do not think it is up to us to do that, but ideally you want to have a discussion between government and business that at least gives a direction, and also gives investors and business people a bit of a direction to understand where the country is going.

The two other issues we felt were really important are related to process. One, and I think probably the most important one, is the relationship between the private and the public sector. As you move the policy focus to the microeconomic business environment, what you immediately see is that government does not know and cannot know what – on a very detailed, cluster-specific level – the bottlenecks are that hold companies back from making that extra investment. You need to include private sector leaders in the process of identifying what are the priorities and where money should be spent. We felt that that process needs to change, which also means that the government really has to let go, and not feel responsible for everything – it just cannot handle that responsibility. There is no way that even the best government can know all these things and make the right choices. But this is not easy because it also requires the private sector to change its attitude. This is a big issue and it is a process that will take some time, but it is important to get it started.

The second element that we felt important is to think more about the regional institutional structure. With RDAs the UK has moved into a very interesting experiment, and it is too early to tell what the impact has been. In our experience it is important that you have regional leaders also in government that are perceived as having the credibility and the power to make real important decisions. It is very dangerous if you have a situation where the business leaders essentially feel that its better to go to London because that is where the decisions are ultimately made, rather than engaging with people in the regions. The RDAs are a good attempt to try to address this issue, but it will be critical to really give them the power to be perceived as the important people to talk to for the private sector.

Thanks very much, I'm looking forward to the discussion.

Response

Jonathan Haskel, Head of Economics Department, and Professor of Economics, Queen Mary & Westfield College

Thank you for inviting me, Wilf, and thanks everybody for coming. I will try to be brief. Let me start by saying that I think there are two neglected features of the Porter report which are worth discussing. The first neglected feature is that, although it is called the Porter report, it is a joint piece of work between Michael Porter and Christian and I suppose it is the fate of people writing with more senior authors that they get neglected. The second issue of the report is that it is radical in the sense that when you engage a professor at Harvard Business School you would expect they would be telling you that you have got to have more deregulation and more privatisation and more liberalisation and so forth – many people would have that caricature before reading the report. Actually, the report says exactly the opposite of that: namely that privatisation, deregulation, liberalisation, a lot of those aspects have been finished and the question is what is there that is left to do on the deregulation agenda.

Unpacking the productivity gap

Let me then talk a little bit about some of the issues Christian talked about. I am involved in the Advanced Institute of Management Research team and we have been trying to look a little bit closer at the US-UK productivity gap. One interesting thing you find is the following: if you look at the gap by industries it gives you a lot of extra information. We all know that there is a wide gap between the UK and the US overall, but you can work out the fraction of the overall gap accounted for by different industries. It turns out that wholesaling and retailing account for around 25% of the whole gap. So, just one industry accounts for really quite a big share of the whole gap. In fact, half of the whole gap is accounted for by three industries – wholesaling and retailing, financial intermediation, and the machine and equipment sector, where the US has got a very high productivity lead. So, I think it is worth concentrating a little bit on.

Wholesaling/retailing.

One thing you observe in the wholesaling/retailing sector, and the Bank of England have done some very interesting work on this, is productivity growth in US wholesaling/retailing has been absolutely astonishing. Indeed, McKinsey claimed that almost all US productivity growth is driven by that one sector, and almost all of it is driven by Wal-Mart. I think that is a slight exaggeration, but if you look at the numbers, a very large fraction of this US productivity growth miracle comes in wholesaling/retailing. So, one question

then is, where does that growth come from? What is the mechanism behind that growth? One of the things we have looked at in manufacturing is the mechanism of entering and exit of new firms versus the growth of existing firms. Productivity, of course, can grow in two ways; existing firms can get better, or new firms can come in and displace bad firms who are going out. We have looked at that, so what is going on in retailing? Well, if you look at retailing, you find something very interesting. In the US, 100% – according to the best calculations – of the productivity growth in US retailing has come from the entry and exit of new stores, the closing down of inefficient stores and the entry of efficient stores. There are all sorts of quality issues – that is, whether you prefer to shop in Wal-Mart etc – but an enormous fraction is caused by that.

Barriers to UK Growth: Planning Restrictions

What is the comparable figure in the UK? About 7%, which is accounted for by the opening and closing of new stores. So, one immediately starts to wonder whether there is something which is inhibiting the opening and closing of new stores, and therefore might be inhibiting part of productivity growth in this terribly important sector between the two different countries. I have to say that research has not nailed this issue down yet. One would have to look at the different amounts of opening and closing in different regions, where regions have different institutions and so forth, but this at least suggests to me that there might be something in the argument that planning restrictions are a big issue, because a lot of what you hear from retailers when they complain about planning is precisely that – “we would love to open a big new store and get economies of scale and all of that, but because of these rules and regulations we just can't”.

Barriers to UK Growth: Investment in skills

Can I say one more thing about skills? What is the right public investment in skills? There seem, to me, to be two separate questions there. The first question is, what level of skills do we want to aim for as an economy? In general, do we want to upskill people, and that seems to me to be unarguable, although there are these very difficult stock problems, as Christian alluded to. The second, possibly slightly neglected question is, what is the gradient of public expenditure on skills? By which I mean should we be spending more as a society subsidising primary education, or subsidising secondary education, or tertiary education, or whatever? Of course, economists think about that in terms of the social returns, so what does that mean in non-economist speak?

In the argument about university tuition fees, people say, “these university students go to fine universities and earn lots of extra money, and therefore they should pay for it”.

The counter-argument to that is there are social returns when students go to university and they add to the community. Therefore, if there are social returns, the government should subsidise that kind of activity. So, one way of reformulating the question is to ask, are there more social returns to having lots of university students, or are there more social returns to having lots of well-educated primary school kids, or secondary school kids? In other words, what is the gradient, if you see what I mean, of the social returns and where should we concentrate our money? That turns out to be a really hard research issue, and unfortunately there are not many studies which look at that. Recently, there have been a couple of studies which essentially suggest that the gradient of funding that we currently have is completely wrong.

The gradient of funding that we have currently got is the following: public funding per primary child or student is about £3,200, whereas public funding per university student is about £5,300. In other words, there is a lot more funding for tertiary students than there is for primary students. But, the social returns, it turns out, seem to be the other way around. Namely, firms get a lot more of a productivity kick in terms of these social returns if there are more well-educated secondary students around. Most of the returns to university students accrue just to those university students rather than firms in general. So, I think we should think, in the skills agenda, not only about what the level of expenditure is, but whether we have got the gradient of spending right or not. Thank you very much.

Response

Sheelagh Whittaker, Company Director

Thank you, and good morning. I am going to talk a little on ICT, productivity, and quality of life. We all know that over the past decade ICT investment has contributed significantly to labour productivity growth in the UK across a range of sectors. We also know, however, that the UK still trails its competitor nations in traditional measures of productivity like GDP per worker, GDP per hour worked, and we know that some people feel that the digital revolution has not yet delivered the dramatic growth in productivity that they were expecting. Mind you, if people were expecting something that was self-evidently unlikely to occur and are now disappointed, I cannot help but feel that that may be their problem.

What about the measurement tool itself? When we apply traditional measures of productivity, we are using a 19th-century concept to describe a 21st-century reality. GDP per worker and per hour were measures that matched nicely with the industrial revolution. Productivity growth at the mechanised mills in Lancashire and elsewhere was spectacular, but eventually markets became glutted, mills were closing for lengthy periods of time, and many of those who had left farms and crowded into towns ended up leaving the country altogether for places like Canada and Australia. High productivity, for quite a while, yes, but sustainable growth and a happy, fulfilled population? I am not so sure. What I do know is that the industrial revolution and its aftermath ended up driving my grandparents out of this country, and now it is the digital revolution that has brought me back.

What are we measuring?

Of course, we do need measures, whether it is in school league tables or earnings per share, or even nation's economic performance, but they do need to be relevant to current realities. We all know that there are myriad influences on productivity, including education, labour skills, innovation, and government involvement in the economy, whether through provision of social benefits or through regulation. At its core though, traditional productivity measurement is designed just to tell us how narrowly successful we are in using people as commodities, and that is not the way that most of our society looks at, or wants to look at, things anymore. These days, as the Californians might say, we are into something else, doing our own thing like 'personal fulfilment'. A lot of ITC investment is used to create new services that contribute to quality of life in ways that traditional productivity measures just do not pick up. Yet organisations, whether in the public or private sector, that offer choice and satisfaction will still tend to do very well,

as more and more of them are realising.

In recent surveys, most CEOs and CIOs consistently ranked customer service and quality above cost reduction as primary motivators for investing in ITC. Now in the UK we have many claims online, an electronic small claims court, which is amazingly quick and convenient. Now there is a digitised help system for pension recipients in Canada, and where once nobody could get through by telephone, now every caller is answered within three rings. We have the Oyster card, which may well encourage more people onto public transport because of its greater convenience and speed. In every case though, the primary aim is customer satisfaction, making our lives better. Maybe we should be less worried about productivity in its traditional dark, 'Satanic' sense. Most of our traditional production has already shifted away to emerging economies anyway. I think about my grandparents in their early 20s in that Lancashire mill town in the 1900s, their own parents had left a tiring but varied life as small farmers, with a bit of weaving and a bit of stonemasonry on the side, and gone to work in a dreadfully noisy mill and live in a bleak, crowded town. For a while, the money had been a compensation, but then as markets stopped growing incomes fell sharply away, and so my grandparents married and headed off to a remote and beautiful part of British Columbia where they tried, with some success, to build a new version of the lives they'd been living before the machines so rudely interrupted them. Maybe this country is going to lose all of its manufacturing industry. Maybe it is destined to become a giant theme park for tourism based on history, literature and natural beauty, and a lovely, clean and sufficiently prosperous place in which to live. In effect, we are talking about a country where customers are satisfied, communications are friendly and efficient, citizens feel fulfilled by what they do, and traditional, industrial measures of productivity are largely irrelevant, and as someone who has lived elsewhere for much of my life, I must say that this is not really an unreachable or even so distant a goal.

Fresh terminology

Perhaps though, what we need first is fresh terminology. Emotional intelligence has already emerged as the new, rather subjective means of describing a form of intelligence which extends to recognising and adjusting for one's effect on others. Perhaps we should start trying, even in our approach to performance statistics, to see people as human beings with a whole complex of wishes, needs and responsibilities, and not just faceless commodities in the traditional economic construct. Perhaps instead of always looking backwards to measure our progress, we should be paying more attention to the emotional productivity which flows constantly from digital transformation, and is probably far more relevant to our lives and our whole society, going forward. Thank you.

Discussion

Sandy Walkington, Director of Public Affairs, BT

First of all, can I welcome what Sheelagh said which I thought was very, very sound. On the points made by Jonathan, if the gap between the UK and the US is based on the fact that we do not all shop in Wal-Mart, then I am afraid I am very happy that we do not all shop in Wal-Mart. I just would like to ask Sheelagh about her point that it did not matter too much that one could not measure exactly what the contribution of ICT was to productivity. I must say, we are finding this a tremendous challenge, because when it comes to Treasury coming up with money to fund, for example, getting broadband out into rural areas, they consistently say that they see no evidence that these technologies and these new forms of connectivity are actually adding to productivity and economic growth. We are really struggling to find exemplars and examples of how one can demonstrate that there is real benefit. I just wondered if any of the panel had thoughts on that and examples that we could use.

John M Hayes, Member, Smith Institute

I can quote an example; myself. I used to be very suspicious of new technology, but two years ago I took the plunge. In the first year the profits of my company fell by 30% because of the investment I was making. Then there was a dramatic change. In the second year we had 100% increase in profits, and that is continuing this year. I am just a small business, but through the introduction of technology there has been a dramatic impact.

Jonathan Charkham, Director, Mizuho

One of the things that has been of concern to me in the work I have been doing on governance over the last few years is the behavioural aspects touched on by Sheelagh. What we are talking about in the end is the result of a series of decisions which are made in individual companies by individual people up and down the country, and one of the questions in my mind is the behavioural patterns in boardrooms. What is it that we ask of the people in boardrooms which bear on all the things we are concerned with here, like innovation and so forth? I have a slight feeling that we have erred very much in the direction of constraint, accountability and restrictions and making it much more difficult for the people sitting around the board table to concentrate on ways in which they can carry the business forward. I do not know how we reverse this engine. It is not a bad thing that we get better governance, but I think it is a very bad thing if this is at the price of reducing the kind of time and effort people put into innovation. I entirely agree with

Sheelagh that what we are facing is a whole series of behavioural problems, not particularly economic or legal ones.

Wilf Stevenson

Vicky, we did a series last year on how you might rethink policy if you made it a desirable aim of government that it should be trying to increase happiness. Would that be a better way of driving productivity?

Response: Vicky Pryce

We are all for happiness, there is no doubt about that. Happiness of course extends to the way in which people work. Thinking about companies, having a happy workforce makes a big difference, and we have found strong evidence showing that high-performing companies tend to be the ones that have the happier workers.

Response: Christian Ketels

I have a lot of sympathy for broadening our concept of how we measure productivity, and I completely agree that I think we often use concepts that have been introduced decades and decades ago. One of the things that we try to point out in the report is that productivity is not really about output per input, it is really about value created, if you will, per effort. Then we get to the issue of how do you measure value, and that is much harder than measuring how many cars you have produced. We took the easy, economist way out and said it is basically the way that the market evaluates the products and services that you generate. Our overall guiding principle, and I think it is still very relevant, is that economic policy tries to provide the foundation for higher prosperity and productivity is the key driver of achieving that. I am a little bit concerned that we miss that discussion if we go too long in the other direction and say productivity is really an outdated concept and in the new economy this really does not matter. I think we need to update our concept of what productivity is, but we still need to have a very clear sense of how critical it is to really enable people to make those choices to make them more happy.

I also wanted to comment a little bit on this behavioural issue, which I think is central. If you talk about microeconomics, the key factors that determine the productivity of companies are the decisions that are being taken in those companies, so we clearly need to understand what is going on. I'm also concerned about the governance issues. There is this odd situation that on the one hand we make the chief executive the favourite villain of the economy. On the other hand, there is also this corporate saviour idea which says that we just need to hire a new guy or woman and they will fix it. What is interesting

though, and this is a phenomenon that is true in the UK, the US, and some of the continental European companies, is that the average tenure of a CEO has become shorter and shorter. So there is an issue about what a highly efficient company needs in terms of a governance structure.

Wilf Stevenson

What about the point Sandy raised on deciding between investing in broadband and investing in a mile of motorway?

Response: Christian Ketels

It is extremely hard to measure. I think we need a process where business and government work together on this. We need to make the business sector co-responsible in that decision, because ultimately the pot of money is limited. It introduces different ways of measuring things, but that is what we need to do. It reminds me a little bit about our work on clusters, because quite often people say, "show me the data to show that cluster-based policies actually have created higher returns". I'm happy to report that we are making progress on that, but it's very hard to measure.

Response: Jonathan Haskel

Just a couple of comments. These measurement difficulties are very hard, and I do agree with the speaker who said that if the British gap is explained by the fact that we don't shop at Wal-Mart and other people do, then we might be happy to keep our gap.

Can I just say a word on this vexed question of ITC? This is a very difficult issue because if you look at the data, the US invested huge amounts in ITC in the early 1990s, and their productivity took off massively in the later 1990s. So what is happening in the UK, you might ask? Why aren't we getting the benefits? The gentleman in the front row pointed to a view that the Bank of England are taking, which is that in the first year you invest in ITC it is very expensive but eventually the benefits come through. The Bank of England's most recent examination of this suggests about a five-year time lag and some of their research staff take the view that maybe those ITC benefits are around the corner because we have had a lot of ITC investment in the last half of the 1990s and maybe they might flow through.

Vicky Pryce

Some work that I have seen suggests that over the last 10 years half of the productivity increase in the UK has been accounted for by ITC, so we must not underestimate the importance of it.

Response: Sheelagh Whittaker

First of all, I would like to mention that I think if we are going to talk about productivity and ITC, that those of us in the business would say that the business transformation process is the real issue around realising the productivity benefits of ITC. It is not just applying a mechanised way of doing things, but it is rethinking the entire way you do things. I think separately, and I have felt this for a long time, that we are at one of those major discontinuities that can only be identified much later. I think strongly that we are in the digital economy, but we are in that lag recognition period where we think we are either industrial revolution or post-industrial revolution, but we have not come to grips with the fact that it is a different kind of economic construct, and that different kinds of economic construct require different ways of thinking. While it may make people uncomfortable, somebody, somewhere in our generation will be the revered economist who understood and identified what was happening and how it happened.

Denise Kingsmill, Author, Accounting For People report

I think one of the things we discovered when we were looking at the issue of governance was that there is a big gap in the way in which businesses manage people to enable them to be productive. There has been, for example, a very high investment in women's education over the last 30 years, yet women have not, on the whole, been given the opportunities to make a full contribution to economic growth and productivity, and I think that is down to the way in which the workforce is managed. When I talked to chief executives of many of the companies that I saw, they believed that their people were the main drivers of growth within their organisations. If you talk to someone like Niall Fitzgerald at Unilever or Sir John Rose at BAe, they would both argue that the way in which their people are managed is the most important thing, and yet it is not necessarily the thing which their investors rate as being the way in which they value their company. It is just not the sort of information which investors wish to hear about when they go and do their presentations to them. So, I think we have to have a very close look at the way in which people should be managed to increase their productivity.

One of our findings was that people were not being managed as assets at all, they were being managed as costs. They were not being managed in a way that enabled them to develop and grow and contribute to productivity, and this was illustrated by the fact that many of the companies we saw did not even know how many people they had actually had working for them. They knew just about how many people they might have on the payroll, but they certainly did not know what their dependency on contract workers, or agency workers, or anything else was. So, it does strike me that when we are talking about

the productivity gap, we need to look very closely at the way in which we manage our people assets.

John Pickering

As a Cranfield man to a Harvard man, I was slightly astonished to hear you say that everything matters. Certainly, we at Cranfield were taught to say that you have to pick up one or two things that really do matter, and focus on those. Personally, I do not think the productivity of retail is terribly important in this country, and I think international comparisons surely must depend on any given country having exactly the same range of services and exactly the same range of products, otherwise you are comparing apples and oranges. I would be very happy, actually, to see most work on productivity abandoned and concentrate on one or two things that I think do matter. It is still quite difficult in this country to bring an entrepreneur from outside and get him started, and create jobs and get him a passport.

Secondly, I think if we are going to measure performance, value-added is very important. If you look at Germany their output of high value-added products is very great.

Last thing, I would just like to agree with Jonathan Charkham. Virtue in the boardroom is only just coming about in this country. I can tell you that getting the right boss, getting the auditors to use their teeth, getting shareholders to be active is a marvellous watershed. Certainly, appointing the right boss, in my experience – and I have bought a few companies and sold a few companies – is one of the greatest dividends. Everything else flows, including ITC, if you do that. Thank you.

Carole Stone

I just want to go back to happiness, and remember what Professor Layard said, which was that one of the ways you can make people happy is if you give them a rise in their salary. But the extra happiness is less if the rise is also given to his or her colleague because we are all competitive. I was just wondering, do you think that if you encourage employers to give bonuses to people, who might then feel they have got one up on their workmates, it would be good for productivity, or would it be offset by the number of people that would be disappointed they didn't get a bonus?

Richard Brucciani OBE, Managing Director, Pal International

I run a small manufacturing exporting company, and I would like to just give you a few perspectives from the SME sector. I have to say that when Vicky Pryce started talking

I thought I was living in a parallel business universe. I am constantly told we are better than the Germans and the French. As a manufacturing company, I do not compete with the Germans and the French anymore, because I compete with Asian businesses, and no one seems to want to compare us with those. I am told that we have a caring environment for workers. Actually, I disagree with that, because I now have to treat my workers as legal entities, I cannot treat them as people anymore, because there are too many laws. We talk about regulatory reform from the DTI, and every government has deregulation, but it does not seem to get better. It is now 13 years since the one-stop-shop was invented. I think one of the things that is always missed is that if you want to influence SMEs you have to look at what SMEs are. They are owner-managed businesses, which have one person, at most two people, who run a business. If you want to influence that business, you do not want corporate programmes, you do not want initiatives that are supply-side driven. What you want is to get hold of that one person, and convince and motivate them to do something different, and the whole company will change. I do not see enough to do with actually motivating the owner/manager of a business.

In terms of competitiveness, I would like to have some guide about what people think is the best way that wealth should be created in this country, because I am very confused about this. I know we talk about full employment, but most employment growth is in the public sector. I know the public sector creates wealth – I am not entirely sure how, but it does, I am told – and it would be nice to understand where we want wealth to be created, because if we do that then we could go off and do it but, for me, motivating owner/managers will create more change than anything else.

Response: Vicky Pryce

I am not going to be an apologist for the things the DTI does, but I entirely accept that we have been trying to simplify things for some time, but it does take quite a lot of time to get out of various schemes, often because small firms actually quite like them so we have tried to change them in a way that has reflected wide consultation with firms. Your point about small firms is absolutely crucial, and I know we have done a lot of work in terms of the impact of entry and exit and giving encouragement to different areas. We do remain one of the cheapest countries to start a business in, and one of the countries where it is easiest and fastest, by any international comparison, to set up a business. The real problem, I think, is what happens then, and I think a number of your points are well made. How do you then encourage the one-man business, or microbusiness, to move from being small to something which is sustainable in the future with more employees, which is what we want. We certainly do not want you to treat employees as legal entities.

We want you, as Denise was saying, to care for them, and clearly we are looking at the entire set of policies to ensure that is the case. We have identified that there are problems in terms of encouraging firms to grow and there are gaps in terms of the availability of venture capital. As you know, we are working with the Treasury to ensure that there are products to plug that gap, and to ensure that companies remain in operation and grow. But, I take your points, and thank you for them.

Response: Christian Ketels

I think this is almost a symptom of what I tried to talk about when I talked about the process. I get the sense that the DTI is trying very hard to address these issues. At the same time, people in the business community feel like 'their' issues are not being addressed and, as you said, this process has been going on for years. It seems to be that what we are lacking is the institutions of process to get the two sides on the table, and not just in a kind of consultative process – where one side asks and you send in your opinion, and then a decision is made on the other side – but where it is a truly co-operative process in which business and the public sector work together to try to find out what needs to happen. There seems no clear reason why it should be in the government's interests to hinder small and medium-sized interests to grow more. It seems to me that this is the express goal of policy. So, how do we find the right process to make progress in that dimension? From the perspective of our work in other countries, you should not be too dispirited, because it is a problem that all countries struggle with. It is something that is very hard for DTI to know from the outset, so you need a new process together to cut through that complexity, and then find out, what are the four or five issues that we just need to drive forward because those are the most critical for productivity and prosperity growth.

Response: Jonathan Haskel

On this vexed issue about the role of the DTI, can I make two points? One is, on most of the indices of regulation and liberalisation, as documented in the Porter and Ketels report, Britain does fairly well. Constructing these indices is always a difficult issue, and it might be that a number of these indices just do not accord with what business people see. On the second issue about DTI schemes, I have always taken the view that in any ministry anywhere in the world which runs a portfolio of schemes there will be some good schemes and some bad schemes – that is just the nature of the beast. So, I would just turn that and say let us have more of the DTI where these things tend to work, and let us shift resources away from where things are not working quite so well.

John Napier, Chairman, Kelda Group

On the DTI, I think we have got to bear in mind that they have a range of services that have been developed through time. It is an organisation that is in transition, it perhaps needs to be, but I think the work that it is beginning to do, like looking at the science and innovation side, is critical for our long term success, so there is a lot of good work going on, but a lot more to be done. My hobbyhorse is that the government, like large US corporations in the 1950s, is using ITC to support unmanageable structures, and if they did not have ITC they could not perform in this way, and as soon as that is an enabler it is a very good message to any organisation that you have got it wrong.

Matthew Trimming, Head of Government Affairs, EDS

Sheelagh did give me a bonus so, in the short-term, I am very highly motivated! There is a theme that has not really been discussed, which was how you get a real, effective, genuine, empowered regional policy. How do you get regional policy in such a centralised country with such a centrist history? Partly, it may be to do with leadership and credibility. It may be to do with tax imbalance – everyone who has had the joy of council tax requests popping through their door in the last few days would have seen the imbalance between central funding and grant, and the ability to actually raise tax locally – so I think that may be something worthy of consideration.

On Jonathan's point about planning, this is another regional challenge because you could actually stop a lot of the sclerosis in the planning system by banning non-strategic things being allowed to be decided by the secretary of state.

David Pitt-Watson, Managing Director, Hermes UK Focus Fund

We have had a discussion about productivity and the way that that gets affected internally to the company, by its board, by its chief executive, particularly to its workforce. I was wondering, if there is any research about the structures and cultures that are likely to lead to greater productivity within those companies? The second question I had was about capital productivity rather than labour productivity. It would seem to me, as an observer, that we have numerous very successful companies in this country worth tens of billions of pounds. Yet they have spent hundreds of billions of pounds, often by the issue of shares, in creating themselves by acquisition. If that sort of activity is going on, if that is seen in the boardroom as being the way in which you expand your company and your success, how is that likely to affect your productivity, and again, is there any evidence on what it is that one might be able to do about that?

Response: Sheelagh Whittaker

I suppose that it comes full circle back to the governance issue that was raised earlier. I was thinking about governance and the many international scandals – fraud scandals, misrepresentations, mis-statements of oil reserves – which are motivated at the board-room level, in my opinion, by a desire to manufacture a kind of performance that's then adjudicated in the economic marketplace. The innovation is then focused not around improving your business, but around improving your finance, your balance sheets, your income statement, so it is a sort of misalignment of economic goals. I suppose that the issue is that if we create an environment where the yardstick is that kind of performance, we get the behaviour we deserve, and so it is a yardstick issue.

Response: Jonathan Haskel

David Pitt-Watson and others asked what we know about structures and cultures that raise productivity. I am not quite sure what we know about these sort of cultural things, but we do know something about effectiveness of years of education on productivity. I am very struck by this, because actually it is, rather small potatoes. If you look at the poorest five countries in the world and the richest five countries in the world, the gap in their education levels, as best one can measure it, is about eight years of education. If you then apply the standard returns to education types of calculations, you get a prediction that the richer countries, with eight more years' education, should be about one and a half times as productive. Actually, they are about 30 times as productive. So education does not actually appear to explain very much in terms of differences between countries: it is structures and cultures and all of the things that various, broader studies had pointed out. Whether we have pinned those numbers down exactly, I do not know.

Let me pick up a point that Christian raised, which is that one of the attractive features of decentralisation is it means if you decentralise powers and responsibilities then different regional authorities in different areas can do different things, we can get a bit of experimentation going, and then there is a bit of competition going between these different regions and different regional authorities to do the best thing. That may turn out to be a rather effective way of finding out what features actually work, given the uncertainties we have in a policy environment.

Response: Christian Ketels

I think there are a lot of issues that are related to productivity and company performance that are not related to location, and I think some of the issues that we talked about this morning, about bonuses and human resource management, are related to those. Those are

very important, but we have not focused on those in our report. I think what we try to focus on are the issues that are ultimately very strongly tied to a specific location and the unique conditions that you find in that location. The first point that I would want to re-emphasise is the one about process and for the DTI to learn and let go. This means thinking very hard about what are the decisions that we can live with if others are taking them. That is very hard for elected officials or the people that work for them, but I think it is necessary to get business leaders involved in this process.

Response: Vicky Pryce

Thank you very much for all that. In the interests of time I am not going to respond to each of those points, but just to emphasise that what we do is listen to what people tell us as well as commissioning quite a lot of studies. I should also stress that we only want to intervene if there is evidence of market failure and serious externalities. In many cases what we do is act as advisors, ensuring people understand what the issues are. I mentioned promoting innovation – we are not necessarily talking about having lots of schemes and spending a lot of money but actually facilitating the discussions and ensuring knowledge transfer, which we think is absolutely important for businesses. But, there are still gaps in evidence as to where indeed the market failures are, and where our policies might be most effective. The dimension of culture and people and so on is absolutely essential, and we can do a certain amount, but culture takes a long time to change.