

Economic Survey of the United Kingdom, 2007

How has the UK benefited from globalisation?

What are the fiscal challenges?

What needs to be done to raise skill levels?

How can spending on schools be used more efficiently?

How can the functioning of the labour market be improved?

What can be done to boost productivity growth?

What can be done to maintain tax competitiveness without impacting revenues?

For further information

For further reading

Where to contact us?

Summary

The United Kingdom's welcoming approach to globalisation has contributed to a strong growth performance. GDP per capita is now the third highest in the G7, compared with the lowest 10 years earlier. GDP growth has been close to its trend rate of around 2¾ per cent for a number of years, suggesting that the amplitude of the economic cycle is smaller now than in previous decades. This strong performance is not only due to the willingness to embrace the opportunities offered by globalisation, but also to sound institutional arrangements for setting monetary and fiscal policy as well as a period of robust trading partner growth.

Despite offshoring, employment has grown steadily and unemployment is low. But the labour market position of many low-skilled workers needs to be further improved. The participation rate of some groups is low and others suffer from poor incentives to progress in work. To raise the adaptability of the workforce the government has invested in education. It is also spending more on fighting poverty and has been addressing weaknesses in the transport and health systems. The budget deficit remains large, and slower growth in government expenditure will be required over the coming years, as well as more effort to ensure good value for money in public spending. Against this background, further rewards from globalisation can be reaped by addressing the following challenges.

Improving prospects for the least skilled to benefit from globalisation

- Because the benefits of globalisation are potentially greater with a flexible labour force, primary and secondary schools need to make sure all young people acquire core skills before leaving full-time education.
- More needs to be done to improve education outcomes for young people from low socio-economic backgrounds. A faster transition to a more equitable

This Policy Brief presents the executive summary of the 2007 OECD Economic Survey of the United Kingdom. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, discussed this Assessment. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

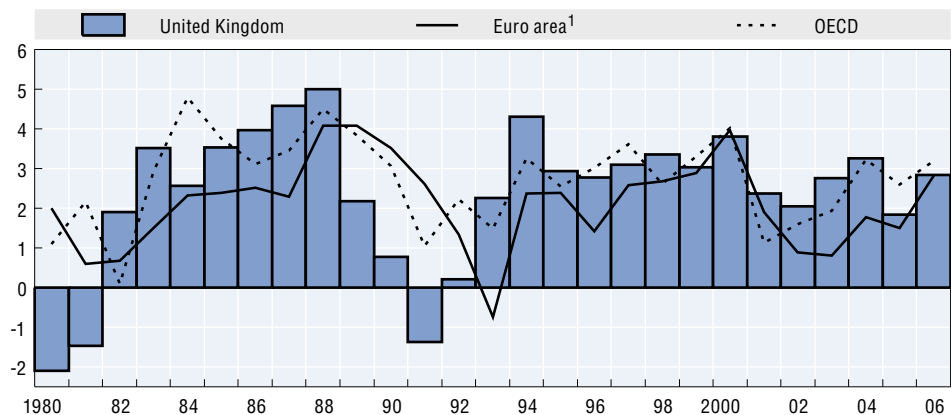
allocation of school funding would help and more should be done to encourage the best teachers to move to the most disadvantaged schools.

- Incentives to join the workforce and to progress in work should be improved for certain groups such as second-income earners, lone parents, and incapacity beneficiaries. This may require reducing marginal effective tax rates and providing greater access to child-care support. A slower rise in the minimum wage may also improve the employment prospects of the low-skilled.

Enhancing business conditions for productivity growth and job creation

- Planning regulations need to give more weight to economic considerations to promote firm entry and local plans should ensure that more land is freed up for development.
- Sufficient levels of investment in the transport infrastructure should be ensured, while the potential for more extensive road-pricing to reduce congestion should be explored.
- Tax competitiveness should be improved by continuing to broaden the corporate tax base while cutting the rate. The corporate tax system should be simplified and there may be room to shift taxation to less mobile sources. ■

Figure 1.
STRONG GDP GROWTH
Percentage change in real GDP



1. Break in series in 1991: western Germany up to then, total Germany thereafter.

Source: OECD (2007), OECD Economic Outlook: Statistics and Projections, No. 81 – online database.

How has the UK benefited from globalisation?

Living up to the challenges posed by globalisation is the over-arching theme of this *Economic Survey*. Compared with its large European neighbours, the United Kingdom has been more proactive in adapting to international economic forces. This is reflected in support for free trade, openness to foreign direct investment, a willingness to open its labour markets to the citizens from the new EU member countries that joined in May 2004, the adoption of regulatory policies that promote efficiency and a macroeconomic policy framework that has enhanced economic resilience. This willingness to embrace the opportunities offered by globalisation is generally backed by widespread support among key groups, including politicians, trade union leaders and employers. This has been rewarded with a stronger economic performance. The level of gross domestic product (GDP) per capita is now the third highest in the G7 (after the United States and Canada). Ten years earlier it was the lowest in this group. The United Kingdom's GDP per capita ranking among all OECD countries has also improved. GDP growth has been close to its trend rate of around 2¾ per cent for a number of years, suggesting that the amplitude of the economic cycle is smaller now than in previous decades.

Despite buoyant activity in recent years, strong inward migration has contributed to an easing in labour market tightness. Although the unemployment rate has crept up over the past two years, particularly among young unskilled school-leavers, it is still relatively low at around 5½ per cent. Consumer price inflation temporarily spiked to just above 3% earlier this year, partly because of unusually large increases in electricity and gas prices, but has since dropped back to just under 2%. Looking ahead, the interest rate increases over the last year, together with recent financial market volatility, are expected to slow the housing market. Prior to the recent financial market turmoil the OECD projected growth of 2¾ per cent this year and 2½ per cent next year, with inflation remaining close to the 2% target. However, although indicators of economic activity have been robust in 2007 to date, there is now a risk that growth will be weaker going forward, which could imply a need for interest rate reductions. A slowing in growth, together with reduced profitability in the City, could also reduce tax revenues and imply a rise in the budget deficit, which is still relatively high by international comparison.

Earnings growth has remained moderate, despite significant concerns earlier this year that the spike in inflation might push up wage inflation. Strong inward migration helped in this regard by filling skill shortages and preventing labour market bottlenecks. Wage bargainers typically use as their inflation benchmark the retail price index. However, neither this index nor the consumer price index (CPI) are ideally suited for this purpose. An improved index would be based on the CPI but include a better measure of housing costs. The UK authorities should continue to support the development of the CPI index to include housing. ■

What are the fiscal challenges?

Government revenues and outlays – but particularly the latter – have trended upwards over the past few years as a share of GDP, albeit from relatively low levels by UK historical standards. Increased spending was a deliberate policy choice, motivated by the desire to improve certain government services, notably health and education. This contrasts with a general tendency towards spending restraint in most other OECD economies. The government deficit has fallen from 3.4% of GDP in 2003 to 2.7% in the year to March 2007, but the cyclically-adjusted budget shortfall is still substantial and significantly larger than in most other OECD countries. There is a need to further reduce the government deficit, which will require much slower growth in government expenditure – as the 2007 Comprehensive Spending Review promises to deliver – and more effort devoted to ensuring that publicly-funded services provide good value for money.

In 2005 the government renegotiated the policy that would have raised the normal public sector pension age from 60 to 65 for existing workers from 2013 in return for a commitment from unions that they would agree other reforms in the pension schemes to recover equivalent costs to those that would be lost by retaining the existing pension age for existing workers. Some of the subsequent negotiations have yet to be finalised and the final savings are not yet known, but the government is optimistic that the measures should deliver significant cost reductions.

The golden rule explicitly permits the government to borrow to pay for capital investment while the sustainable investment rule puts a limit on the extent of borrowing – by limiting public sector net debt to 40% of GDP. The golden rule only requires that the current budget is in surplus or balance over the cycle, and so does not require the accumulation of surpluses. Thus, it does not by itself explicitly address the perceived need to go further in preparing the public finances for the long-term challenges due to the ageing of the population. However, the government publishes annually the Long-Term Public Finance Report, which provides a comprehensive assessment of long-term fiscal sustainability, including the impact of ageing. Moreover, by separating current and capital spending, the fiscal rules have helped to tackle the United Kingdom's historical bias against capital spending and low investment in public infrastructure. The rules have also put the public finances on a more sound and sustainable footing than in previous economic cycles and have played an important role in anchoring expectations and improving the transparency of fiscal policy. But some refinements to the rules could be considered. In particular, the golden rule relies on the notion of a clearly defined economic cycle, which has become harder to identify given that the economy has remained close to full capacity for a prolonged period of time. In addition, revisions to the cycle dates have occurred, which may have undermined the credibility of the golden rule. The golden rule could be made less reliant on cycle dating and output gap estimates, possibly by replacing it with a positive target level for the current budget balance over the medium-term, together

with a comprehensive independent auditing of revenue projections. This could be accompanied by mechanisms that put a tighter constraint on overall spending and prevent the spending of revenue windfalls. The fiscal framework should also be transparent about fiscal drag, either through indexing tax brackets to wage growth or through efficiency enhancing tax reform. In addition, greater account should be taken of the large off-balance-sheet liabilities, which are not currently monitored under either rule. This could be done by publishing estimates of other public sector liabilities on a regular basis alongside those of public sector net debt and by setting a ceiling on a broader measure of public sector liabilities.

There are a number of channels through which globalisation has spurred productivity. Openness to trade has promoted competition and encouraged economic resources to shift towards those sectors in which the United Kingdom has a comparative advantage. As a result, the manufacturing sector has shrunk as a proportion of total output, while knowledge-intensive and other business services have grown. This means that the United Kingdom is little affected by head-to-head competition from the emerging markets. Offshoring has facilitated productivity growth by allowing UK firms to re-locate lower-value-added production and service functions (such as information technology) to lower-cost locations, while increasingly specialising in areas of comparative advantage. There is evidence that foreign direct investment and multinational enterprises – particularly those from the United States – have also contributed to productivity growth, by facilitating the transfer of new technologies. Somewhat fortuitously, living standards have also been boosted by terms-of-trade gains, because the United Kingdom has tended to import those goods which have experienced the largest price falls, while being a leading services exporter, where prices are rising. In addition, the United Kingdom is nearly self sufficient in oil and the terms of trade have therefore not been much affected by higher world oil prices. There are some uncertainties regarding the extent to which these positive benefits can be relied on in the future. Compared with many other OECD countries, the labour share of income has been relatively stable over the past decade, rather than declining. This may be a positive reflection of policies that encourage labour to move to where it is most productive and policies that have ensured a relatively low rate of structural unemployment. ■

What needs to be done to raise skill levels?

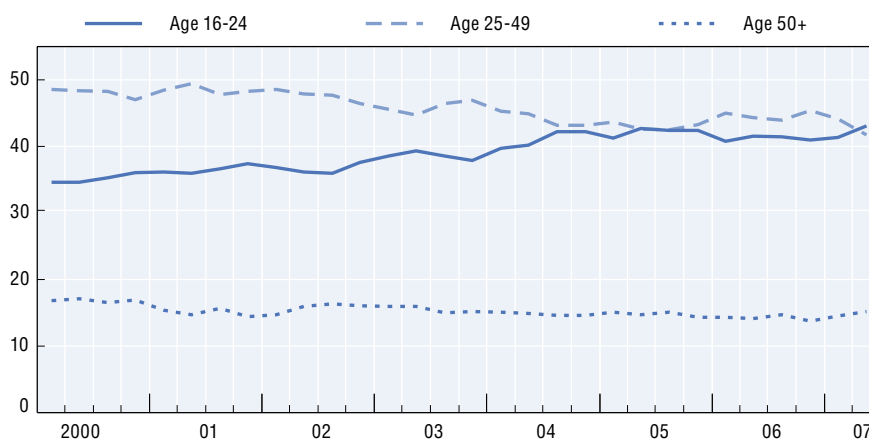
Technological change over the past two decades has significantly raised the level of cognitive skills required for many jobs, including many that were considered relatively low-skilled in the past. Moreover, the strongest employment growth and the largest wage increases have been in professions that require cognitive skills involving good judgement and complex communication. Recognition of these facts by both the public and policymakers explains why there is now much greater pressure on the education system to equip more pupils with better skills. However, the educational performance of the UK population is below the standard

of the best performing OECD countries. The government has responded by spending more on education and by expanding capacity in key areas such as pre-primary and upper secondary education. Some measures of performance, such as secondary school completion rates, have been improving although they have further to go. However, it is difficult to evaluate the extent of improvements in cognitive skills as the lags between spending and outcomes are long and some domestic measures of education performance may have been biased by target-driven output measures. To permit more comprehensive evaluation of progress, the government should ensure continued participation in international tests of cognitive ability, such as the Programme for International Student Assessment (PISA) and the Programme for International Assessment of Adult Competences (PIAAC).

How can the cycle of perpetuating inequality be broken?

As globalisation raises the return to higher education, the impact of education policy on the labour market outcomes of those from disadvantaged backgrounds is increasingly important, particularly in the United Kingdom, where occupational and education mobility is lower than in many other OECD countries. The government has addressed this with a broad range of policies, including funding formulas that aim to direct additional resources to areas with a higher proportion of pupils from deprived backgrounds. Performance in the most disadvantaged schools has improved, but overall the socio-economic gaps remain large. One explanation may be that local authorities and schools are not distributing funds as intended by the central government, resulting in inequitable outcomes. To correct this imbalance the government should promote the transition to a more efficient and equitable allocation of funds by reviewing the funding allocation procedures. More research should be done into determining how resource mixes within schools can help to narrow

Figure 2.
UNEMPLOYMENT IS HIGHER ESPECIALLY AMONG THE YOUNG
Per cent of total unemployed



Source: National Statistics website, www.statistics.gov.uk – Labour Force Survey, Historical Quarterly Supplement.

the socio-economic gaps and the pros and cons should be evaluated of introducing a differentiated voucher system of funding, where pupils from poorer families receive vouchers that are valued more highly than those for the general population. Also, given the importance of teacher quality, more should be done to encourage the best teachers to move to the most disadvantaged schools. ■

How can spending on schools be used more efficiently?

There is no strong empirical link between aggregate education spending and pupil achievement so that additional resources do not automatically translate into better results. Given the need for tight expenditure control, this suggests that the focus in education spending should shift to improving the efficiency of existing spending. The key priority should be to continue to promote a focus on the acquisition of core literacy and numeracy skills for pupils at all age levels. The government is considering raising the number of years of compulsory education or training but care should be taken to ensure that greater quantity of education is not sought at the expense of quality. One way the United Kingdom has tried to ensure spending efficiency is through the use of sophisticated school benchmarking together with the setting of targets. While the benchmarking exercise has provided a lot of information, the focus on targets may have made progress more difficult to evaluate, by inducing “gaming” of the targets. All targets should be designed in a way that limits the potential for gaming, by ensuring an interactive performance management system that captures the complexity of the education process. To improve evaluation, it should be ensured that performance measures are not the same as the targeted outputs, unless other mechanisms are in place to guard against gaming. ■

How can the functioning of the labour market be improved?

Compared with most other OECD countries, the United Kingdom has relatively few distorting labour market regulations. As a result, job-to-job mobility between similar industries is relatively high, suggesting that resources shift quite smoothly. The labour market is also better at getting the unemployed back into work than labour markets in the country's large European neighbours, although some Scandinavian economies have much higher unemployment outflow rates.

Strong economic growth over the past decade helped to reduce the unemployment rate from around 8% in 1996 to a low of around 4½ per cent in 2004. Since this was the same year that the United Kingdom opened its labour markets to workers from the new EU member countries, an influx of migrants helped to fill skill vacancies and cool inflationary pressures in the labour market. Since then the unemployment rate has crept up to around 5½ per cent, but it is unclear whether increased immigration is partly responsible. Relatively little is known about migration flows and the characteristics of the migrants. Statistical monitoring of the stock of migrant labour should be improved.

As in many other OECD countries, the wages of those at the top of the earnings distribution have increased much faster than those of the rest of

the population. These top earners seem to be reaping the biggest gains from globalisation. Among the rest of the population, the earnings distribution has not changed much. In part this is because minimum wage increases and tax-benefit changes have cushioned low-income households. In addition, those with mid-level skills may be as affected by globalisation and skill-biased technical change as those with very low skill levels, since many medium-skill jobs are vulnerable to offshoring, while many low-skill service sector jobs must be done at home. However, at least so far, the real median wage has risen in line with productivity, in contrast with a number of other OECD countries.

The introduction of the minimum wage has mitigated the increase in wage inequality. To date, the minimum wage does not appear to have had a significant adverse effect on employment. However, there are some signs that this could be occurring in certain low-skilled industries. Consequently it may be prudent to increase the national adult minimum wage and the youth wage by less than median earnings in order to foster employment of the low-skilled.

What policies can better serve young and lower skilled workers?

It is widely agreed that the ideal way to improve income prospects for the low-skilled is to facilitate higher labour force participation and encourage up-skilling. With respect to participation, the UK record is mixed: on the one hand, the UK tax-benefit system has been successfully designed to minimise unemployment traps for most people. However, high child-care costs continue to create a high implicit tax rate on second-income earners returning to work, reducing labour force participation among this group. Incentives for low-skill second-income earners to participate in the labour market should be improved by providing greater access to child-care support. At the same time, there are concerns that the same “make work pay” policies may have left certain groups of low-skilled workers in “low-wage traps”, with reduced incentives to invest in further education and training. Improving these incentives is not easy, since reducing marginal effective tax rates in one place tends to push them up in others. Nevertheless, modifications to the tax-and-benefit system should be considered in order to reduce the marginal effective tax rate faced by lone parents and one-earner couples when extending their hours or when progressing in work. Extending the availability of child-care support could also enhance incentives for low-skilled parents to engage in further education. To do this, the child-care element of the Working Tax Credit should be extended to low-skilled parents undertaking approved courses of study. Work testing for lone parents should also be made more stringent, along the lines suggested in the government’s recent Green Paper. Currently the United Kingdom has one of the most lenient regulations in this respect in the OECD.

What reforms are required to get disadvantaged groups back to work?

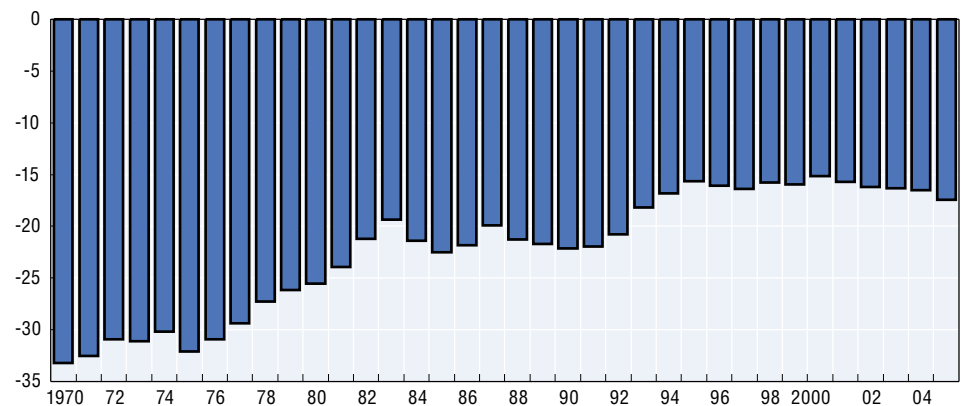
Significant efforts have been made to help those on sickness and disability benefits back to work. The Pathways to Work pilots have successfully used work-focused interviews, targeted support, and financial incentives to help people to better manage their health conditions and get back to work. New welfare legislation will further enhance the financial incentives for claimants to return to work while providing enhanced financial security for the most severely sick and disabled. This will take effect in late 2008. The Pathways to Work scheme should be extended on a mandatory basis to the full stock of claimants, if the pilots are successful and cost-efficient. More attention should be given to the health status of job-seekers on unemployment benefits, and those with jobs who are reaching the end of their entitlement to sickness pay and benefits, so as to identify the need for earlier support and minimise the number of transfers onto the incapacity benefit. A new active labour market initiative focused on those without work in the most disadvantaged areas was introduced in 2006, but no evaluations of its effectiveness are yet available. ■

What can be done to boost productivity growth?

Productivity growth has remained strong in international comparison, but has slowed since the turn of the century. Investing in the human capital of the young is probably the most important lever to lift trend productivity growth, but there are also some other policy areas that can be improved:

- One priority should be to facilitate the entry of new businesses by reforming and simplifying planning regulations, especially in retail trade, as suggested by the Barker Review. Similarly, more land should be freed up for development by reconsidering the boundaries of the “green belts” in fast-growing areas. Ways to improve incentives for land development should also be considered.
- Good transport links are important for the efficient movement of goods and to support labour market efficiency and flexibility. After many years of under-

Figure 3.
CLOSING THE PRODUCTIVITY GAP WITH THE UNITED STATES HAS STALLED
 Percentage gap in GDP per hour worked¹



1. GDP in volume converted to US dollars using constant purchasing power parities.
 Source: OECD (2007), *Productivity database*, March, www.oecd.org/statistics/productivity.

investment in transport infrastructure, transport investment has picked up in recent years but still looks insufficient to meet the targets outlined in the government's Ten Year Plan for Transport. Looking ahead, ongoing investment will be required and more efforts should be made to ensure that infrastructure investment does not fall short of that envisaged in the Ten Year Plan.

Spending should be targeted on key strategic growth areas, as recommended by the Eddington Review, and the government should continue to examine options for addressing road congestion and environment impacts, including the introduction of a nationwide road congestion pricing system.

- A key policy to boost innovation performance has been the introduction of research and development tax credits, although it is uncertain whether these represent a cost-effective use of tax-payer funds.
- More broadly, innovation and productivity can be supported by raising the general skill level of the workforce. Workforce skill levels do not compare well with those of the best performing countries. The UK government has plans to address this including through publicly-funded adult training that focuses on the most disadvantaged groups, which currently receive little training. Greater private investment in training is needed as well, in order to raise skills at all levels. In terms of evaluating progress, the government should focus more on international measures of adult cognitive skills as well as on measuring the outcomes from domestic qualifications in terms of employment and pay progression. ■

What can be done to maintain tax competitiveness without impacting revenues?

Globalisation creates a tension between the need to spend on social safety nets and the need to maintain tax competitiveness, which may reduce revenues. This pressure has encouraged governments to make the corporate income tax system more efficient by cutting statutory corporate tax rates and broadening the base. As the two have offset each other, corporate tax revenue as a share of GDP has been maintained. The United Kingdom was ahead in the game of cutting rates, but has lost ground more recently. It will thus be important to continue with the strategy of broadening the tax base, while cutting the rate. However, there are likely to be limits as to how far this can go, because tax competition also plays out on the base. The United Kingdom's system of worldwide taxation creates incentives for headquarters to relocate offshore. Thus the government should consider the case for moving to a dividend exemption system of corporate income taxation, which exempts foreign source dividend income from domestic tax. The government has recently published a paper to consult on this issue. Moreover, the complexity of the tax system has increased, in part reflecting a need to respond to increasingly complex financial and commercial structures. However, there is room for simplification.

The degree to which globalisation might undermine the ability to tax corporate income remains uncertain. The location of production is determined by many factors, among which the corporate tax regime is not necessarily the most important. To the extent that globalisation

makes it harder to tax mobile factors of production, there may be room to shift taxation onto immobile ones. Property taxation is already high by international comparison, but there is room to raise value added tax (VAT) revenues. By European standards the standard VAT rate is relatively low and includes many exemptions. Thus, there is scope for broadening the base. More radical reform possibilities should also be considered, even though they all have advantages and drawbacks and few have been implemented in other countries. ■

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Economic Outlook No. 81, June 2007.

More information about this publication can be found on the OECD's website at www.oecd.org/eco/Economic_Outlook.

Economic Policy Reforms: Going for Growth, 2007 edition.

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