

Economic Survey of the United Kingdom, 2004

Summary

The performance of the UK economy has been impressive in recent years, underpinned by wide-ranging structural reforms and sound macroeconomic policy frameworks. The OECD projects growth above potential in 2004 and 2005, with unemployment remaining low, but instability stemming from the housing market is a risk. Monetary policy should continue to tighten to reduce future inflationary pressures and the risk of a further sharp rise in house prices from becoming a potential source of fragility. At the same time, the current rigidity of house supply should be eased by reforming land planning, while a reform of the regressive council tax could help to reduce the risk of housing market instability. Over the projection period, government spending will continue to rise as a share of GDP, reflecting the government's ambitious targets in priority areas. Slowing spending growth may be warranted on efficiency grounds: bottlenecks have become apparent, while time is needed to pilot new innovative approaches. More generally, getting incentives right is essential to meet the ambitious service targets. Slowing spending growth would also benefit the public finances. An income-contingent contribution scheme for university graduates is an equitable way forward; other forms of user charges not compromising equity concerns could improve efficiency. Both are preferable to raising taxes. Trend growth has already been boosted by the sharp decline in structural unemployment, but measures are still needed to reduce the number of inactive, especially those on incapacity benefit. While educational performance of students has risen, policy needs to further address the lack of vocational skills as one element in a strategy to reduce the productivity gap with the best performers elsewhere. In this respect, competition is also important. The government has strengthened the competition framework and active enforcement along with the market studies of the Office of Fair

What are the main challenges for the United Kingdom economy?

What is the risk of instability from the housing market?

Will be the fiscal rules be met?

Should public spending be slowed or revenues be raised?

How can long-term growth be raised?

What is the scope for improving competition?

How could sustainable growth be achieved more efficiently?

For further information

For further reading

This Policy Brief presents the assessment and recommendations of the 2004 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, reviewed this Survey. 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.

Trading and the Competition Commission's market investigations should help to ensure that markets become more competitive. However, planning restrictions and market power are a problem in the retail sector and industry regulators will need to remain vigilant in the electricity, gas and telecom sectors. Ensuring macroeconomic stability, while addressing the remaining weaknesses through further structural reforms offers the prospect of continuing strong economic performance. ■

What are the main challenges for the United Kingdom economy?

The UK economy has proved remarkably resilient during the recent downswing with output falling only a little below potential. At the same time, inflation has remained close to the target and the unemployment rate is among the lowest in the OECD. More recently the economy has been gaining considerable momentum, well ahead of the euro area. This strong performance is underpinned by wide-ranging structural reforms and sound macroeconomic policy frameworks. A pro-active monetary policy successfully stabilised activity and inflation, helped by a strong transmission channel operating through the housing market. The government budget balance was in substantial surplus at the peak of the cycle and this has enabled fiscal policy to be strongly supportive of growth during the downswing, although the government deficit has now become sizeable. In the context of this impressive macroeconomic performance the decision that was taken in June 2003 to wait further before holding a referendum on entry into the European monetary union is perhaps unsurprising. All in all, the United Kingdom seems well placed to take advantage of the global recovery and move towards a more broadly based growth that relies less on consumption and housing wealth.

Looking ahead, three major policy challenges arise:

- In the short term, it will be important to gradually withdraw the policy stimulus to avoid running into supply constraints at a premature stage of the ongoing upswing. Early monetary tightening will also contribute to reducing the risk of macroeconomic instability that may emerge from the housing market, but there is also an issue as to what other policy measures might contribute to this.
- In the medium term, improving the quality of public services in a cost effective way in such priority areas

as health and education will be a major challenge. This may be helped by slowing down the ongoing build-up in public expenditure. A smooth phasing in of new spending could also ease the difficult trade-off between raising taxes or departing from the government's "golden rule" and Code for Fiscal Stability.

- In the long term, the challenge is to raise growth performance further, by reducing the still sizeable "productivity gap" with the best performing OECD countries, while inactivity of some groups is still of concern. ■

What is the risk of instability from the housing market?

The strong overall performance has been driven by a buoyant services sector and domestic demand, while net exports and the manufacturing sector have been a drag on activity, reflecting both the sharp appreciation of the exchange rate between 1996 and 1998 and the weakening of activity in Continental Europe in recent years. In sharp contrast to the euro area, consumption, which has been boosted by terms of trade gains and more recently by wealth effects associated with sharply rising house prices, remained vigorous throughout. Indeed, private consumption has been the prime driver of growth. Yet, the propensity of house prices to surge in response to lower interest rates, which contributed to the resilience of the UK economy, may also become a source of fragility in the context of an inelastic housing supply and rapid build-up in household debt, increasing the risk of setbacks in the ongoing recovery. The OECD projects growth of 2¾ and 3 per cent in 2004 and 2005, respectively, underpinned by a recovery in foreign trade and the further rapid rise in public spending. Despite the assumption of a gradual decline in house price inflation, private consumption is likely to remain strong. Given the increased importance of mortgage equity withdrawal in driving consumption, a potential risk is that house prices surge ahead again in the short run instead of slowing down, but then fall abruptly which could trigger a sharp reduction in consumption growth. However, the situation is different from the late 1980s because of low household income gearing with high housing wealth in relation to income. In addition, there is now greater scope for monetary policy to react, particularly because inflation currently remains under control.

Despite this increasing risk to macroeconomic stability, but in line with the current consensus among central

banks, the Monetary Policy Committee of the Bank of England has repeatedly rejected the idea that monetary policy should explicitly respond to changes in asset prices, *except* insofar as they affect future inflationary pressures. Nevertheless, they raised the repo rate for the first time in nearly four years in November 2003 on the grounds that inflation is likely to pick up in the context of a vigorous recovery. The labour market is already tight with the unemployment rate near its structural rate and the wage share at a high level which in the past has signalled a pick-up in inflation. Gradually raising interest rates further would reduce the risk of a larger and more abrupt tightening later on, and hence reduce the risk of triggering instability in the housing market and the wider economy.

Beyond an early tightening of monetary policy, policy measures should focus on the supply side of the housing market. Reforms of the planning system which improve the supply of housing would be welcome, not only because a more elastic supply would tend to moderate swings in house prices, but also because increased housing supply and associated lower prices would be highly desirable from a wider economic and social perspective. The planning issue has implications for the efficiency of the housing and retail sectors and a variety of services sectors as well as capital accumulation, which in international comparison suffers from a low rate of investment in structures. The government is doing more, including through new legislation, to ensure that local authorities meet objectives for house building. However, given the inevitable lags before there is an appreciable effect of such policies on the housing stock, other measures acting on the demand side should also be considered, not least because reducing swings in house prices could itself be an important factor in encouraging housing supply. On the fiscal side the most promising option is to reform the “council tax” to relate it more closely to current valuations of property. The government is due to revalue properties for the purposes of the council tax by 2007, but revaluations should then be updated more regularly. At the same time it should be made less regressive. More regular updating would also imply that rising real house prices would generate higher taxes and so tend to automatically damp the stimulus to consumption and reduce the risk of macroeconomic instability. The advent of statutory regulation of mortgage markets by the Financial Services Authority in 2004 is also to be welcomed. There is a need, in particular, to ensure that prudent lending requirements are not relaxed during a boom in house prices. ■

Will be the fiscal rules be met?

The government conducts fiscal policy to meet both its “golden rule”, that over the course of the cycle it should not borrow to finance current expenditure, and its “sustainable investment rule”, that public sector net debt remains below 40 per cent of GDP. The 2003 Pre-Budget Report projects a significantly weaker current balance from now on compared to the 2003 Budget projections, while the deficit could breach the Maastricht Treaty’s deficit limit in 2003. On the one hand, the golden rule is expected to be met over this cycle, projected to end in 2005-06, with the current balance returning to surplus at the start of the next cycle. On the other hand, the more pessimistic OECD projections suggest that, although the golden rule would just be met in the current cycle, a sizeable structural deficit would persist. In this case, meeting the fiscal rules in the future would imply revenue or spending adjustments. It would be advisable to start implementing these changes during the current upswing rather than postpone measures and thereby risk reinforcing the downswing of the next cycle. At the same time firm cost control is also advisable. Ensuring a safe margin against the risk of a persistent structural budget deficit may reduce the need for future increases in interest rates. ■

Should public spending be slowed or revenues be raised?

For many years outlays in health and education were low in international comparison, and raising spending was required to achieve ambitious outcome targets. Real expenditure on health is currently planned to rise at an annual rate of 7¼ per cent until 2007 and on education by 5¾ per cent until 2005. Although there are signs of better service outcomes and improved quality of services, some of these represent a continuation of earlier trends that were visible before the substantial recent spending increases were initiated, and the speed with which the spending increase is taking place is generating cost pressures within the public sector. A more gradual increase in health and education spending could therefore improve the chance of locking in improved performance rather than higher costs. This would also enable the government to carefully pilot and implement various promising innovations – such as Foundation Hospitals, which give hospitals more operational flexibility, activity-based funding mechanisms and Fast Track Surgeries. As an additional benefit, extending the period over which the increase takes place would yield savings

to public finances in the short term. All in all, assessing the effectiveness of such a large build-up in public health and education spending will always be fraught with difficulties. The current signs of overheating and overstretching may be more benign than they look. But the “option value” of waiting to ensure best value for money also seems high.

The deteriorating fiscal position also highlights a basic strategic choice in improving health care to a level common in most of continental Europe as well as further raising standards in education: either to accept the corresponding level of taxes and mandatory contributions that are typical in continental Europe, or to expand private funding in ways that do not compromise equity concerns. To avoid large tax rises, users could contribute part of the funding of improving health care and education. An obvious case for this is in higher education, because universities are publicly funded and the private returns are probably the highest in the OECD due to a wide earnings differential between persons with and without university education. Letting graduates pay a larger share of the study costs would be both fair and economically efficient, and the government’s plan to introduce a graduate contribution scheme is both innovative and welcome. It resolves the credit constraints facing students from poor backgrounds by giving a loan to fund increased tuition fees which will have to be repaid after graduation unless the person’s income falls below a minimum threshold. Expanding higher education based on income-contingent graduate contributions, while maintaining the large publicly funded improvements made in early childhood and compulsory education, is the most direct way to achieve equity in access to higher education and education outcomes more generally. In health care, private funding on a large scale is excluded by the government’s principle that access to health care should not depend on ability to pay. However, within this framework there is scope for extending cost-sharing. For example, additional user charges to cover the extra cost of non-generic drugs or charging for missed appointments, can improve incentives, while raising some revenue. Getting incentives right and finding the appropriate level of spending is all the more important in the United Kingdom because the most powerful fiscal pressures as a result of population ageing over coming decades will come from health care rather than pensions.

To get maximum value for the extra spending on public services, continuous improvements in the performance management framework are necessary. The United Kingdom is at the forefront of applying quantitative

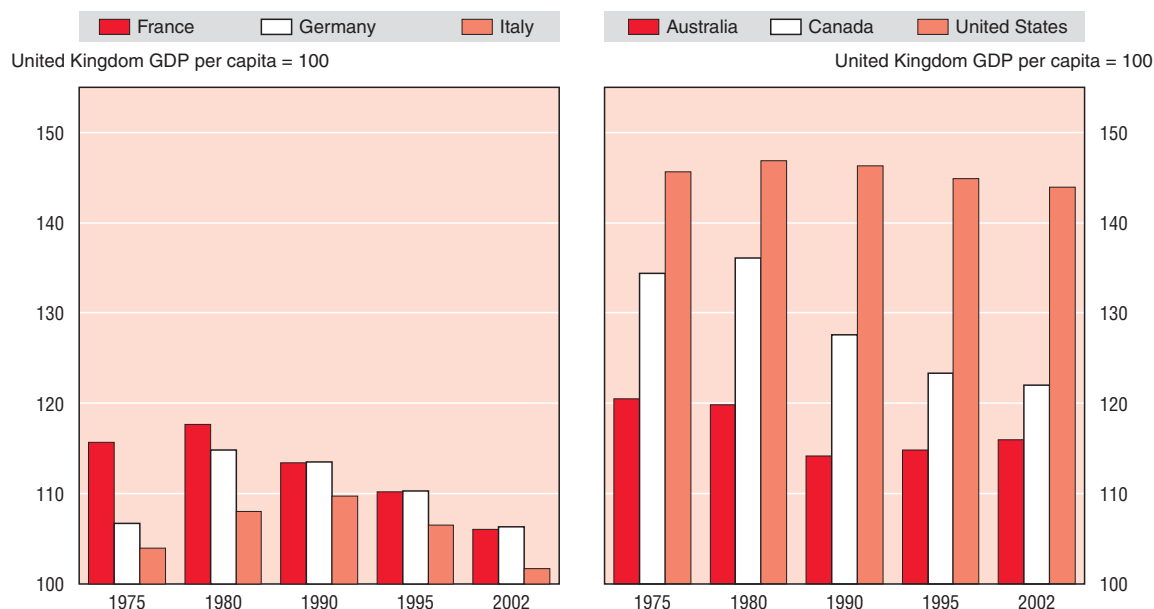
outcome focussed performance targets in the public sector. These targets have helped drive improvements in public services, created transparency and raised ambitions for service delivery. The framework now needs to evolve further – with fewer targets, which are limited to the main outcomes and key government priorities, with clearer focus on outcomes and with improved metrics. However, targets do not guarantee value for money; they only affect behaviour if service providers have an incentive and feel motivated to meet the targets. Activity-based funding for hospitals, for example, can help reduce waiting times and lengths of stay, but, within the framework of the recently agreed contract, incentive-pay for hospital doctors should be introduced faster and more broadly than currently planned. ■

How can long-term growth be raised?

The UK’s trend growth has been boosted over the last two decades by the substantial decrease in structural unemployment. However, there has been virtually no increase in the activity rate. Indeed, the male activity rate has shown a consistent downward trend and has been accompanied by a similar rise in men reporting long-term sickness or disability as the main reason for inactivity. There has also been a trebling of persons on invalidity benefit during the 1980s and the first half of the 1990s, and since 1995 the number claiming incapacity benefit has continued to rise, albeit at a slower rate, to a level which is now two-and-a-half times the unemployment claimant count. This may partly be because the rest of the income support system has been tightened so much that incapacity benefits have become a pressure valve. “New Deal” active labour market policies to deal with particular disadvantaged groups, notably lone parents, have been successful in raising their employment rates. The voluntary New Deal for Disabled People (NDDP) is the major employment programme available to all those claiming incapacity benefits. The new “Pathways to work” scheme offers improved financial incentives and support. Together these represent steps in the right direction, although an expansion in the scale of these programmes will probably be needed to make significant progress.

The United Kingdom has achieved a commendable rate of potential growth, which is above the European average. As a consequence, the GDP per capita gap with the major continental European countries has nearly closed. However, the gap with the best performing OECD countries – such as the United States, Canada,

Figure 1. **Real UK capita GDP compared to other major OECD countries**
In 1995 prices and 1995 PPPs



Source: OECD.

and Australia – has hardly diminished and stems mainly from weaker levels of productivity. Closing the “productivity gap” with major competitors has been an important theme motivating structural reforms and a multitude of policy initiatives address this weakness. The most important among these are: a “Skills Strategy” to raise skill levels throughout the workforce; increased government infrastructure investment; and a recent overhaul of competition policy.

The recent OECD Growth Project highlighted the importance of human capital in explaining differences in growth performance among OECD countries. The United Kingdom compares poorly with its major competitors on both basic literacy and vocational skills, suggesting that this has been a major factor holding back productivity growth. It may explain why there has been no boost to multi-factor productivity growth recently, despite a substantial increase in ICT investment. The education system is now improving, but too many people still leave education early and relatively few get an apprenticeship, skilled craft or technician level qualification. Improving the educational opportunities of this group should remain a policy priority along with providing more resources to universities via the graduate contribution scheme. Training of persons with limited skills already in work is valuable from a personal

as well as productivity perspective, but only if improvements are sufficient to warrant the costs of tuition and the loss of production from being out of work. In this context, cost-sharing should be developed to ensure that relevant course content is chosen.

The government is committed to raising general government investment, which over decades has been sacrificed as a short-term palliative for achieving budget cuts, but which under the current fiscal rules should be insulated from such pressures. However, even plans to double the share of public net investment in GDP to just over 2 per cent will still leave government investment below the level in most other major OECD countries. Probably the area where insufficient infrastructure investment has most impinged on long-term growth prospects is transport. The government is committed to a substantial increase in investment in transport, especially on roads. However, this is unlikely to stem traffic congestion, which is already much worse and more costly to business than in most other countries. Following the early signs of success of the London congestion charge, the government should consider introducing road charging schemes on an experimental basis, with a view to deciding whether road use charges, which better reflect congestion costs, could complement and partially replace fuel taxes. ■

What is the scope for improving competition?

Competitive pressures appear to be relatively strong in the United Kingdom, with economic and administrative regulations inhibiting competition and barriers to trade amongst the lowest in the OECD. Nevertheless, there is scope for improvement and the recent overhaul of competition legislation should lead to progress in this regard. Active enforcement, together with market investigations which help to identify competition problems in markets that are not due to infringements of the competition law, will help to ensure that markets are competitive. But the government will need to continue to limit the use of “public interest” intervention and ensure the enforcement agencies’ independence. More emphasis should be placed on enforcement of horizontal price fixing and the Office of Fair Trading (OFT) has already started investigations. To underpin the credibility of the enforcement programme, the OFT should apply the stronger sanctions that are now available against horizontal price fixing. In the longer term, attention needs to be paid to potential overlap between the OFT and the Competition Commission (CC). As the OFT’s range and capacity expand the extent of the CC’s distinct contribution may need to be reconsidered.

In the *retail* sector, the recent Competition Commission enquiry concluded that in general the supermarket sector operates in a competitive environment and that price differentials with the European Union could mainly be explained by the strong exchange rate. However, market power, both buying and selling power on the part of large retailers, remains a problem. In particular, the enquiry found that retailers have used their market (buyer) power to the detriment of suppliers and competitors. In light of this, the OFT negotiated a code of practice to govern buyer-supplier relationships in this sector, although it is not clear that this will resolve the problems and the competition authorities will need to remain vigilant. As regards entry into the sector, the government’s recent approach to planning has made new large scale entry very difficult. Competition in the market is thus impeded both by inhibiting entry and by preventing firms from growing in size to achieve their full productivity potential. Over the 1990s, productivity growth of the UK’s retail sector has been particularly disappointing as compared to that of the United States. While the productivity gains arising from large scale entry are more difficult to realise in the United Kingdom due to land scarcity and overcrowding, the government is currently re-examining

the appropriateness of the current planning restrictions. They could be relaxed without compromising social objectives. These restrictions have been fairly successful in achieving social objectives such as preserving town centres but come at a cost in terms of competition in the sector, thereby harming consumer interests.

There have been many reforms in the *professional services* sector in recent years. An important step is that the regulations of self-regulatory bodies are no longer exempt from competition legislation and professional bodies have undertaken a number of actions towards removing or easing restrictions that the OFT identified as inhibiting competition. In its response to the findings of a recent OFT enquiry into pharmacies calling for open entry in the sector, the government, citing concerns over the current shortage of pharmacists, has left in place entry restrictions that inhibit the development of competition. However, the OFT report found that consumers are currently well served geographically and that, in general, there was no shortage of pharmacies. The government should reconsider the recommendations of the OFT and allow open entry into pharmacies, subject only to demonstrated professional qualifications. The Government will review this area in 2006.

The opening up of the *electricity, gas and telecoms* sectors has led to increased productivity, but international comparisons suggest that there is still scope for prices to fall, particularly in telecoms. Reforms in electricity and gas have led to benefits for consumers where prices are generally below the EU average, but household electricity prices remain comparatively high. Prices for mobile and business telephone charges also remain comparatively high with business telephone charges amongst the highest in the European Union, probably due to market power on the part of the incumbent. In all of these cases there is a need for the relevant industry regulator to remain active to prevent abuses of dominant position and ensure consumers reap the full benefits from liberalisation.

Continuing problems in the *rail* sector need to be resolved. Recent actions, through tighter specification of outputs and guidance about planning and investment, show that the government is taking the lead in resolving some of these problems. The Strategic Rail Authority (SRA) is playing a stronger role in specifying franchises and a temporary role in assuring the operation of trains pending the award of competitive franchises. While these recent steps overcome the most serious weaknesses of the privatised rail system, prob-

lems regarding incentives and responsibilities remain to be resolved. In particular, there is still a need for an independent regulator, and the government should clearly define the lines of responsibility and reinforce and ensure the regulator's independence. The SRA should consider granting longer term franchises, as the current policy of short franchises with tightly specified performance criteria is unlikely to provide incentives for necessary long term investments. ■

How could sustainable growth be achieved more efficiently?

In the long run, there are also challenges to ensure that economic development is sustainable in both social and environmental terms. Unlike many other OECD countries, the United Kingdom's public pension system is financially sustainable, as the basic state pension will be uprated by prices not by earnings. Thus, the relative importance of the Basic State Pension will decline over time, partially offset by the contribution from the (earnings related) State Second Pension, which will increase over time. In addition, public provision is being increasingly targeted at poor pensioners. The authorities have set income adequacy on retirement as an important goal in recent reforms. These reforms should ensure that pensioners are guaranteed a basic income, if take up of the increasingly important means-tested benefit, the Pension Credit, is high. The Pension Credit rewards those with savings or income from employment within limits and from age 65, and in this respect is an improvement on the Minimum Income Guarantee. Nevertheless, the operation of the system will introduce disincentives for some individuals to save and work at the margin. The Government believes it is the responsibility of individuals to choose how and how much to save for retirement and whether or not to continue working

beyond the age of eligibility. In this light, if income adequacy on retirement remains a problem, the authorities may need to consider raising the level of the basic state pension, although such decisions would have to be made in the light of their effect on public finances. Proposed reforms to toughen the regulatory environment for occupational pensions and simplify the complex pension system are welcome. While further adjustments to the pension system may be necessary, it is important to establish stability in pension system rules and allow time for individuals to digest the implications of the latest wave of reforms.

Meeting the Kyoto Protocol related target should not present any major difficulties to the United Kingdom, given the wide range of measures included in the climate change strategy. However, the efficiency of the policy package could be improved by ensuring that marginal abatement costs are as uniform as possible across the different policies and measures. Participation in the EU's emission trading scheme offers an opportunity to reformulate the strategy towards this end. While the proposed EU scheme could usefully build on the strengths of the UK's already existing emission trading scheme, the UK's participation in the EU's emission trading scheme would help to create more targeted abatement incentives, in particular in the emission-intensive power generation sector. ■

For further information

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For further reading

- **Online Version:** The Policy Brief is available at www.oecd.org/eco/Country_Survey/UnitedKingdom with some additional key charts and an excerpt from the Survey about graduate contributions for higher education.
- **OECD Economic Surveys:** *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at www.oecd.org/bookshop.



- **Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco.
- **Economic Outlook No. 74**, December 2003. More information about this publication can be found on the

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